



MONETARY POLICY REPORT

December
2020



CENTRAL BANK OF PARAGUAY

Federación Rusa y Augusto Roa Bastos

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Asunción - Paraguay

Executive Summary

World growth

Annual change, percent

	September 2020		December 2020		
	2020	2021	2019	2020	2021
World	-3.9	5.2	2.8	-3.8	5.2
United States	-4.0	3.7	2.2	-3.5	3.9
Eurozone	-8.0	5.4	1.3	-7.4	4.6
China	2.1	8.0	6.1	2.0	8.2
Brazil	-5.3	3.5	1.4	-4.7	3.5
Argentina	-11.5	4.7	-2.1	-11.5	4.5
Trading partners	-7.1	4.4	0.5	-6.9	3.8
Mercosur partners	-8.3	4.2	-0.3	-8.0	4.0

Source: Bloomberg

The global economic growth prospects have improved slightly as compared to those given in the previous Monetary Policy Report, boosted by the continual recovery of the short-term economic indicators and the optimism generated by the start of the application of vaccines against COVID-19. However, record high levels of contagion continue to be observed in various countries, which has led to the implementation of new containment measures and the consequent slight deceleration of the services sector. In addition, new fiscal and monetary stimulus packages have been announced in the main economies that are going through the new waves of contagion. On the other hand, the greater dynamism of activity at the global level has been reflected in increases of the international quotes for the principal commodities.

In the United States, Gross Domestic Product (GDP) registered an annualized variation of 33.1% in the third quarter of 2020, reversing the result observed in the previous quarter (-31.4%). In the fourth quarter of 2020, the most recent data shows that the manufacturing PMI (Purchasing Managers' Index) remained in the expansion zone, reaching 57.5 in November. Thus, the growth prospects for 2020 have been revised upwards as compared to the previous Report, going from -4.0% to -3.5%, while the prospects for 2021 point to a growth rate of 3.9%. Regarding prices, a deceleration has been observed so far in the fourth quarter, standing at 1.2% y-o-y in November. In this context, the Federal Reserve (Fed) maintained the range of reference rates at 0.0% - 0.25% and announced that it will continue with its unconventional assets purchase programs.

In the Eurozone, the annual GDP variation for the third quarter of 2020 was -4.3%, exhibiting a better performance than that registered in the previous quarter (-14.7%). As regards the fourth quarter of 2020, the manufacturing PMI remained in the expansion zone, reaching a level of 53.8 in September. This has allowed for an upward adjustment of growth prospects for 2020, despite the second waves of coronavirus contagion and the applied restrictions, going

* The Spanish version prevails.

Gross Domestic Product by sectors

Annual change, percent

	2020	2021(f)	2021(i)
Primary Sector	7.1	-3.5	-0.4
Agriculture	9.0	-6.0	-0.5
Livestock	5.0	5.0	0.1
Forestry, fishery and mining	-4.6	0.0	0.0
Secondary Sector	0.4	5.2	1.7
Manufacturing	-1.5	6.0	1.1
Construction	9.8	5.0	0.3
Electricity & water	-2.5	3.5	0.2
Tertiary Sector	-3.5	5.0	2.4
Public Administration	4.6	3.8	0.4
Trade	-6.8	9.5	0.9
Other Services	-4.8	3.7	1.1
Taxes	-3.0	4.3	0.3
GDP at market prices	-1.0	4.0	4.0
GDP w/o agriculture and binationals	-1.8	5.1	

Source: Central Bank of Paraguay

(f): Forecast.

(i): Incidence.

from -8.0% (in the previous Report) to -7.4%. In contrast, a growth rate of 4.6% annually is foreseen for 2021. Regarding prices, the inflation rate in November stood at -0.3% y-o-y, remaining at the same level since the end of the third quarter of 2020 (0.3%). In this context, the European Central Bank (ECB) has maintained the interest rates applicable to refinancing operations, the marginal lending facility, and the deposit facility during the fourth quarter of the year, and has increased the assets purchase program to ensure liquidity, given the resurgence of coronavirus contagion.

In China, the data for the third quarter of 2020 showed an expansion of 4.9% of GDP in interannual terms, surpassing the 3.2% rate observed in the previous quarter. In addition, the indicators for the fourth quarter of 2020 showed that the manufacturing sector remained in the expansion zone, closing November with a PMI of 52.1. Notwithstanding, the growth forecasts for 2020 were revised slightly downwards, going from 2.1% (in the September Report) to 2.0% annually. For 2021, the growth aspects stood at 8.2%.

In Brazil, the quarterly GDP registered an interannual variation of -3.9% in the third quarter of the year, a lower fall than the growth rate of -10.9% observed in the previous quarter. On the other hand, the available indicators in the fourth quarter of 2020 showed a 2.6% contraction of economic activity in October, while the manufacturing PMI showed a significant dynamism, standing at 64 in November. Concerning the growth projection for the Brazilian economy, this has been revised upwards for 2020 compared to the preceding Report, going from -5.3% to -4.7%, while a growth rate of 3.5% was projected for 2021. As for prices, inflation increased in comparison with the previous quarter (3.1% in September), standing at 4.3% y-o-y in November. In this context, the Central Bank of Brazil's Monetary Policy Committee (Copom) maintained the SELIC rate at 2.0% annually in the fourth quarter, to continue to support economic recovery.

In Argentina, the GDP for the third quarter of 2020 registered an interannual fall of 10.2%, a smaller reduction than the one registered in the previous quarter (-19%). The most recent economic activity data revealed a contraction of 7.4% y-o-y in October, with negative performances mainly in transport, communications, hotels, and restaurants, while the only activity that reported a positive incidence has been

Economic growth and current account

Annual change, percent

	2019	2020	2021
GDP	-0.4	-1.0	4.0
Domestic demand	0.2	-4.4	5.0
Gross capital formation	-6.7	-7.5	6.2
Gross fixed capital formation (GFKF)	-6.1	4.1	6.9
Total consumption	2.2	-3.5	4.7
Private consumption	1.8	-5.1	5.0
Public consumption	4.7	4.8	3.5
Exports of goods and services	-3.4	-4.4	10.4
Imports of goods and services	-2.0	-14.4	14.9
Current account (% of GDP)	-0.6	2.3	1.1
GFKF (% of nominal GDP)	18.7	20.4	20.9

Source: Central Bank of Paraguay

that of financial intermediation. In October, the industrial output showed a reduction of 2.9%. As regards prices, a greater moderation of inflation has been observed (standing at 35.8% y-o-y in November), although it remains high. The Central Bank of the Republic of Argentina (BCRA) temporarily reduced the lower limit of the LELIQ rate to 36% annually in October, but then increased it again to 38% in November. On the other hand, the measures implemented by the government that restrict the use of foreign currencies remain in effect. In this context, the economic growth prospects for 2020 remain at -11.5%, while the prospects for 2021 stood at 4.5%.

At the domestic level, economic activity and demand showed a better performance in the third quarter of 2020, consistent with the greater flexibilization of the social contention measures and the reopening of more economic sectors that had previously been restricted. In the period from July to September, GDP again registered a contraction (-1.2% y-o-y), although this was much lower than the contraction observed in the second quarter (-6.4% y-o-y). This improvement was explained by the rebound of the secondary sector, boosted by the expansion of construction and the lower drop in manufacturing. The tertiary sector continued to show a retraction, although to a lesser extent than the figure for the second quarter. The primary sector experienced a slower dynamism as compared to what was verified in the first semester. On the expenditures side, investment has grown at a significant rate, while private consumption decelerated its pace of interannual contraction. Finally, the lower fall of exports and the weakness of imports allowed for a relevant positive incidence of net foreign demand. According to the short-term indicators, economic activity will continue to show a slight decrease in the fourth quarter of the year in interannual terms.

In the context of economic recovery, total inflation and the underlying measures have continued to show an upward trend, even though they are still at low levels, as compared to the medium-term target. This acceleration has been explained by the increases registered in the prices of food items, certain health care goods and services, and cement, while the interannual fall of the prices of fuels has continued to have a negative incidence on total, underlying, and core inflation. The average total interannual inflation for

Inflation projection

Annual change, percent

	2019	2020(f)	2021(f)	2022(f)
Average CPI inflation (*)	2.4	2.0	3.8	
December CPI inflation (**)	2.8	2.1	3.9	
CPI inflation in around two years (***)				4.0
Average underlying CPI inflation(*)	2.3	2.0	3.8	
December underlying CPI (**)	2.8	2.0	3.9	
Underlying CPI inflation in around 2 years (***)				4.0

(f) Forecast

(*) Corresponds to the average of the fourth quarter.

(**) Corresponds the inflation on the end of the period.

(***) Corresponds to the projected inflation for the fourth quarter of 2022.

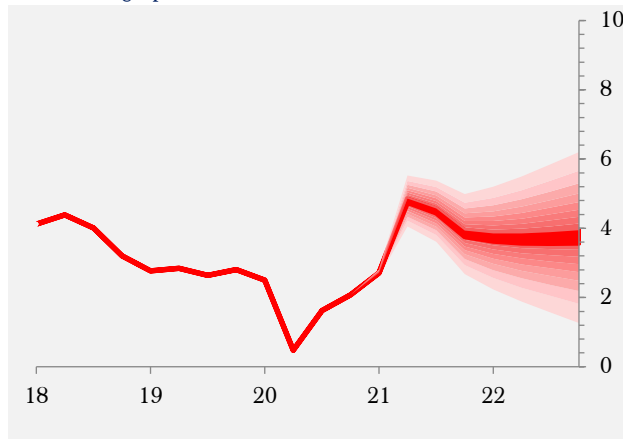
October and November stood at 1.9%, above the rate of 1.4% observed in the third quarter of 2020. Likewise, underlying inflation (which excludes fruit and vegetables) and underlying X1 inflation (which, in addition to fruit and vegetables, excludes tariffed services and fuels) averaged interannual rates of 2.0% and 3.2%, respectively, above the rates registered in the previous quarter (1.5% and 2.6%). Core inflation, in the same period, averaged a rate of 1.8% y-o-y, above the rate recorded in the previous quarter (1.6%).

The Monetary Policy Committee (CPM), at its meetings held in the fourth quarter of 2020, decided to maintain the monetary policy rate at 0.75% annually. The Committee deemed it appropriate to continue with the highly expansive stance of its monetary policy, with the prime objective of assuring the convergence of inflation to the target over the relevant projection horizon, as well as to continue to provide stimulus to economic recovery. At its meetings, the CPM pointed out that, in the international context, the economic outlook has improved as compared to previous months, given the favorable progress made in the development of vaccines against the coronavirus (COVID-19). However, it also emphasized the risks associated with the second waves of contagion, especially in Europe, which have led to new restrictions of economic activity. As regards the local economy, the Committee highlighted that the activity and demand indicators have shown better results in the last months, following the record lows observed in April. Furthermore, the Committee mentioned that, in accordance with the most likely scenario for the macroeconomic variables, the forecast models did not foresee any short-term inflationary pressures.

In the baseline scenario, the estimate of GDP annual growth for 2020 has been revised upwards, going from -1.5% to -1.0%, explained by a greater expansion of the construction sector, while a lesser contraction of both manufacturing activity and the electrical power & water subsector is foreseen. In the tertiary sector, the fall has remained similar to the figure reported previously. As regards the primary sector, while the expansion rate remains positive, it is noted in this report that growth has moderated. For 2021, the projection stands at 4.0%, sustained mainly by the recovery of the services sector. This is based, to a certain extent, on the assumption that the favorable advances made in the implementation of vaccinations will also benefit Paraguay during the course of

CPI inflation forecast

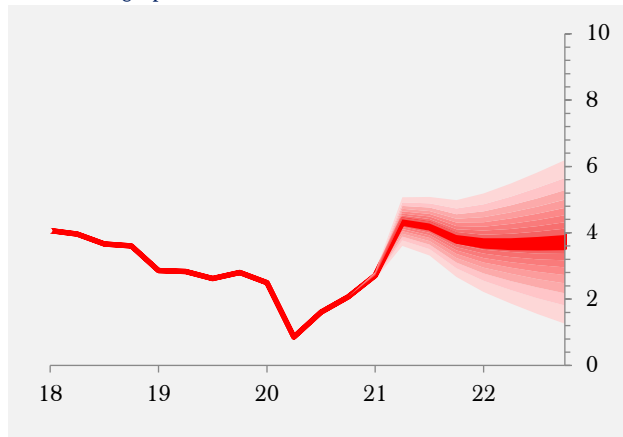
Annual change, percent



Source: Central Bank of Paraguay.

Underlying CPI inflation forecast

Annual change, percent



Source: Central Bank of Paraguay.

the coming year, which might boost the demand for certain services that have been strongly affected by the pandemic in 2020. Along the same lines, it is expected that the recovery of the regional economies, together with immunizations of the population against COVID-19, would have a positive influence on cross-border trade. In the secondary sector, it is assumed that there will be a greater expansion, which would be explained by the performances of the three sub-sectors (manufacturing, construction, and electrical power & water). For the primary sector, the estimates point towards a drop, due to lower agricultural production, while the livestock sector will continue its upward trajectory. It is important to remember that although agricultural production in 2021 will be lower than the record high registered in 2020, the international prices of the commodities exported by Paraguay have increased significantly, especially the prices of soybeans. On the side of expenditures, growth will be explained by the rebound of private consumption and investment, while public sector consumption will continue to increase, albeit at a slower pace. Net external demand, on the other hand, will have a negative incidence due to the greater increase of imports as compared to exports.

As regards prices, inflation in the last quarter of the year stood above the expected level, a context in which the baseline scenario forecasts have been revised upwards. Thus, total inflation is projected to close the year at around 2.1% and underlying inflation at 2.0%, higher rates than the ones reported in the September Report. For 2021, the projection for both total and underlying inflation is 3.9%. The expected rebound of inflation is consistent with the recovery of economic activity, which will be reflected in an output gap that will gradually close, as well as some monetary conditions that will remain lax during next year. In addition, the improvement of the international prices of export commodities, might bear influence, in some measure, on the economic development, as well as on the dynamics of prices of some foods. Taking into account the most likely assumptions about the future behavior of the internal and external macroeconomic variables, inflation is expected to settle at low levels until the first quarter of 2021, standing at around 4.0% from the third quarter of 2021 until the monetary policy horizon, in this case, the fourth quarter of 2022.

As regards the risks scenario, at the international level, given the deepening of the second waves of COVID-19 contagion in Europe, the measures for the restriction of social activities and the circulation of people have been reinforced, thereby causing less mobility of the population. Furthermore, there has been news recently about a new strain of coronavirus in the United Kingdom. Likewise, in the United States and Canada there has been a significant increase in the cases of contagion, reaching record peaks. In Latin America, the epidemiological situation has continued to deteriorate, although relative improvements have been observed in certain countries. Thus, a prolongation of the sanitary crisis constitutes a downward risk for the economic prospects in various regions. However, the favorable news regarding the efficacy of certain vaccines, verified in clinical trials, is highlighted. The use of some of these vaccines has been approved, and the application of such vaccines has started in various countries. This constitutes a positive bias for economic growth in 2021. Notwithstanding, the logistic challenges for the production of vaccines on a global scale and its timely distribution to all the world regions must be resolved. As regards determined risks of a political nature, in the United States the confirmation of the composition of membership in Congress is still pending. Meanwhile, a new stimulus package has recently been agreed upon and it is expected that it will soon be confirmed by the Executive branch of the government. The implementation of additional measures has not been discarded, and these could contribute to the improvement of both the outlook for this economy, as well as the optimism of investors. In Europe, the risk of a Brexit without an agreement has dissipated, given the recent negotiations between the United Kingdom and the European Union, which constitutes an upward bias for both economies.

As regards international prices, the recovery of the prices of the main commodities continued in the last quarter. The greater dynamism of activity worldwide has led to projections that energy prices for 2021 would be higher, on the average, than those observed this year. Furthermore, in order to mitigate the effects of the second waves of contagion of COVID-19 on the prices of petroleum, the OPEP has announced that it will limit or delay the increases in petroleum production in 2021. However, a prolongation of the restrictions on mobility imposed in Europe and the extension of these measures to other regions would again

assert downward pressures on the international quotes of crude oil. As regards the main agricultural commodities, better average prices are also foreseen for 2021. For soybeans, in particular, prices are estimated to be even higher than those of previous years, in light of the high demand of China and lower production expected in several of the main producer countries. However, a resurgence of the new strain of coronavirus at a global level, and especially in the Chinese economy, might change these prospects.

As regards the financial markets, the decrease of global uncertainty has continued following the results of the elections in the United States and the optimistic announcements of certain vaccines against COVID-19. This has favored a greater dynamism of the stock markets and a lower perception of risk in emerging markets. However, the dynamism of stock markets in the United Kingdom has retracted after the announcement of the new strain of coronavirus in the country. If the efficacy of the vaccines against the new strain is confirmed, the financial conditions in the United Kingdom would normalize, whereas, in the opposite case, prospects at the international level might be jeopardized. On the other hand, it is expected that the central banks of both advanced economies and emerging ones will maintain an accommodative monetary policy stance, as well as continue with their assets purchase programs during the coming year, thereby contributing to favor financial conditions.

In the region, a high level of coronavirus contagion persists, although a decrease of infection peaks has been observed in some countries. The short-term economic activity indicators have continued to show year-on-year improvements as compared to the record lows registered in April. While the growth prospects for the region point towards an expansion in 2021, an effective distribution of vaccines in the first months of the year could result in an upward slant for such prospects. Otherwise, a prolongation of the pandemic and logistical difficulties for obtaining vaccines constitute a downward risk. In Argentina, a lower fiscal deficit is foreseen for next year, given the withdrawal of transfers related to the pandemic, reforms associated with the pensions plan, and the implementation of a new tax on large fortunes. In Brazil, the growth prospects have again improved for this year and the next one. Notwithstanding, uncertainty about the fiscal outlook continues to represent



an element that could negatively influence the prospects for expansion and the value of the Brazilian currency.

At the domestic level, the two risk factors pointed out in the previous report have evolved in an opposite manner in the last few months. On the one hand, the pace of COVID-19 contagion has accelerated since the beginning of November, putting pressure on the health care system to the limits of its capacity. Given this situation, the authorities have again established certain contention measures, even though they are not as strict as those implemented at the beginning of the pandemic. In this sense, the sanitary situation will continue to represent a downward risk for economic activity until the population acquires immunization through some type of vaccination. On the other hand, the weather has had a favorable behavior in the last few weeks and the current prospects are encouraging. In this scenario, agricultural production, especially the 2020/2021 soybean harvest, is expected to yield favorable results. Although it is forecast that the soybean crop will not reach the record high levels of the previous harvest, the improvement of climatic conditions will contribute to a much lower rate of retraction than would have been the case in a situation of significant water stress. Likewise, the rainfall registered in recent months is expected to prove beneficial for livestock production, the generation of electricity, and the fluvial transport of cargo.