



MONETARY POLICY REPORT

March
2021



CENTRAL BANK OF PARAGUAY

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Asunción - Paraguay

Executive Summary*

World growth

Annual change, percent

	December 2020		March 2021		
	2020	2021	2020	2021	2022
World	-3.8	5.2	-3.5	5.6	4.1
United States	-3.5	3.9	-3.5	5.7	4.0
Eurozone	-7.4	4.6	-6.6	4.2	4.2
China	2.0	8.2	2.3	8.5	5.5
Brazil	-4.7	3.5	-4.1	3.5	2.4
Argentina	-11.5	4.5	-9.9	6.0	2.5
Trading partners	-6.9	3.8	-6.0	5.0	3.0
Mercosur partners	-8.0	4.0	-6.9	4.8	2.5

Source: Bloomberg

The growth prospects for the global economy have been revised upwards as compared to those reported in the previous Monetary Policy Report (IPoM), boosted by the progress of vaccination campaigns, the moderation of COVID-19 contagion in various countries, and the continual support of governments through monetary and fiscal stimulus measures. However, such advances are uneven, and, in some countries, there is a slow pace in immunization processes, together with the deterioration of the epidemiological situation. Given this scenario, some governments have once again begun to adopt containment measures, although with fewer restrictions of mobility and economic activities. In the manufacturing sector, the short-term indicators exhibit a favorable pace of expansion, however, at the margin, a divergence between the advanced economies and emerging ones has been noted, as the former showed an acceleration while the latter recorded a deceleration. The boost of both economic activity and demand continues to be reflected in the higher prices of commodities. This, in turn, has generated greater global inflationary pressures.

In the United States, the short-term indicators and growth prospects have evolved favorably in 2021. In the first quarter of 2021, the most recent data of the PMI (Purchasing Managers' Index) show that the sector significantly accelerated its expansion pace, reaching 64.7 in March. Thus, the growth prospects for 2021 have been revised upwards as compared to the previous IPoM report, going from 3.9% to 5.7%. Regarding prices, a significant increase has been observed in the first quarter, with inflation standing at 2.6% y-o-y in March. 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 measures.

In the Eurozone, a recovery of the economy in 2021 is foreseen, although the forecast was revised downward as compared to the previous report. In the first quarter of 2021, the manufacturing indicator (PMI) recorded a notable

* The Spanish version prevails.

Gross Domestic Product by sectors

Annual change, percent

	2020	2021(f)	2021(i)
Primary Sector	7.1	-2.0	-0.2
Agriculture	9.1	-5.0	-0.4
Livestock	4.7	8.5	0.2
Forestry, fishery and mining	-4.3	0.0	0.0
Secondary Sector	1.7	5.1	1.7
Manufacturing	-0.5	5.9	1.1
Construction	12.6	5.5	0.4
Electricity & water	-1.8	2.5	0.2
Tertiary Sector	-3.3	3.7	1.8
Public Administration	5.2	1.5	0.1
Trade	-7.8	8.0	0.8
Other Services	-4.4	3.0	0.8
Taxes	-3.9	3.8	0.3
GDP at market prices	-0.6	3.5	3.5
GDP w/o agriculture and binationals	-1.4	4.5	

Source: Central Bank of Paraguay

(f): Forecast.

(i): Incidence.

increase in its expansion pace, reaching a level of 62.5 in March. Notwithstanding, a recovery of the GDP growth rate, estimated to reach 4.2% annually, is expected for 2021, below the rate reported in the previous report (4.6%). Regarding prices, the inflation rate stood at 1.3% y-o-y in March, accelerating with respect to the levels reported in the fourth quarter of 2020. 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 first quarter of the year and has announced that the asset purchase program will continue.

In China, following the deceleration in the growth rate in 2020, an important GDP expansion is foreseen for 2021. The data for the fourth quarter of 2020 showed a GDP expansion of 6.5% in inter-annual terms, consolidating a 2.3% annual growth rate for the year 2020. The indicators for the first quarter of 2021 showed that the manufacturing sector remained in the expansion zone, closing March with a PMI of 51.9. Thus, the growth forecasts for 2021 were revised slightly upwards, going from 8.2% (in the December 2020 IPoM) to 8.5% annually.

In Brazil, growth prospects have remained stable, while the significant rebound of inflation has motivated an upward adjustment of the monetary policy rate. In 2021, according to the most recent data, the short-term economic activity indicator expanded by 1.0% in February. The manufacturing PMI remained in the expansion zone, although showing less dynamism, standing at 52.8 in March. Concerning growth projections for the Brazilian economy, they remain at 3.5% in 2021, the same rate as reported in the December IPoM. As for prices, inflation increased as compared to the previous quarter (4.5% in December), standing at 6.1% y-o-y in March. In this context, the Central Bank of Brazil's Monetary Policy Committee (Copom) increased the SELIC rate to 2.75% annually, in the first quarter of 2021, starting the process of partial normalization of its monetary policy.

In Argentina, growth prospects have improved in recent months, while at the same time inflation has accelerated. The most recent economic activity data showed a contraction of 2.6% y-o-y in February. In March, the industrial production indicator exhibited an increase of 1.6% y-o-y. In this context, the economic growth prospects for

Economic growth and current account

Annual change, percent

	2020	2021
GDP	-0.6	3.5
Domestic demand	-2.7	3.7
Gross capital formation	-4.5	5.9
Gross fixed capital formation (GFKF)	6.3	6.6
Total consumption	-2.2	3.1
Private consumption	-3.5	3.4
Public consumption	5.2	1.5
Exports of goods and services	-10.2	9.8
Imports of goods and services	-17.0	11.3
Current account (% of GDP)	2.2%	3.0%
GFKF (% of nominal GDP)	20.1	20.6

Source: Central Bank of Paraguay

2021 improved, going from 4.5% to 6.0%. As regards prices, a new acceleration of inflation has been observed, reaching a rate of 42.6% y-o-y in March. The Central Bank of the Republic of Argentina (BCRA) has reduced the lower limit of the LELIQ rate to 38% annually since November 2020.

Domestic Situation and Monetary Policy

The economic recovery that began in the third quarter of 2020 consolidated towards the end of the year, consistent with the phased withdrawal of the mobility restriction measures regarding mobilization of the population, the reopening of economic sectors, the adaptation of businesses to the new ways of work, the improvement of the labor market, and the support provided by the countercyclical policies. In the fourth quarter, the GDP registered a growth rate of 1.0% y-o-y, explained by the favorable performance of construction, manufacturing, and to a lesser extent, livestock. On the expenditure side, the components with the greatest incidence were net exports, gross fixed capital formation, and public consumption. With these results, the GDP contracted -0.6% in 2020. Along with the more favorable economic activity data, employment has also been recovering since the second semester of 2020. In the second quarter of 2020, employment decreased by 157,418 positions, while in the last quarter of 2020 the drop in employment stood at 12,721.

In 2021, economic activity maintained a moderate dynamism amid a worsening of the sanitary emergency. The Monthly Indicator of Economic Activity of Paraguay (IMAEP) registered an important contraction in January, mainly due to the results observed in services, manufacturing, and the generation of electric power. Notwithstanding, this indicator reverted its behavior in February. In the first two months of the year, the average monthly variation of the IMAEP (seasonally adjusted) was 0.6%. In inter-annual terms, the median variation of the indicator was -3.1%, explained in part by the high base of comparison (pre-pandemic). For the first time since the start of the pandemic, the Consumer Confidence Index surpassed the neutral mark in February 2021. However, given the worsening of the sanitary crisis in Paraguay and its repercussions in other spheres (both social and political), the index moderated again in March.

Inflation projection

Annual change, percent

	2019	2020(f)	2021(f)	2022(f)
Average CPI inflation (*)	2.0	3.8	3.9	
December CPI inflation (**)	2.2	3.8	4.0	
CPI inflation in around two years (***)				4.0
Average underlying CPI inflation(*)	2.0	3.8	3.9	
December underlying CPI (**)	2.2	3.8	4.0	
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.

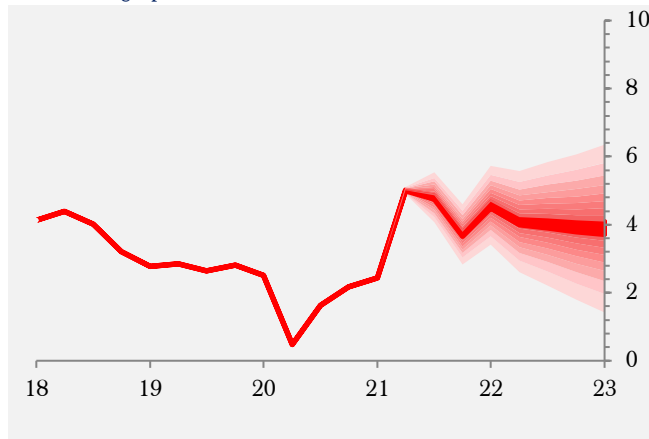
(***) Corresponds to the projected inflation for the first quarter of 2023.

Total inflation and some of the inflation trend measures increased in the first quarter of 2021, although they remained in the lower range of the target. In this period, the inter-annual variation of the Consumer Price Index averaged 2.5%, above the rate of 2% observed in the fourth quarter of 2020. This rebound was explained largely by the greater increase in the prices of food items and fuels derived from petroleum, in line with the recovery of commodity prices at the international level. However, inflation remained low, especially due to the deceleration in the variation of the prices of services, and to a lesser extent, to the strengthening of local currency which affected the prices of imported items, particularly durable goods (Table I). Underlying inflation (which excludes fruit and vegetables), underlying X1 inflation (which, in addition to fruit and vegetables, excludes tariffed services and fuels), and core inflation averaged rates of 2.3%, 3.3%, and 1.9%, respectively, in the first quarter, while in the previous period the rates had been 2.0%, 3.3%, and 1.8%, respectively.

The Monetary Policy Committee (CPM) maintained the reference monetary policy rate at 0.75% annually during the first quarter. The Committee highlighted that at the international level the economic prospects had improved, consistent with the favorable evolution of the short-term indicators, the deceleration in the pace of Covid contagion, and the progress in the vaccination process in various countries. In this context, the stock markets showed positive dynamics, while the yields of debt instruments increased as of the beginning of February. Regarding the countries of the region, the recovery that had been observed was interrupted at the beginning of the year by the imposition of new measures for the restriction of mobility in order to contain the second wave of contagion. As for the local economy, the CPM pointed out that the economic activity moderated in January 2021. Nevertheless, the Committee highlighted the encouraging prospects for the agricultural sector and for Paraguay's trade partners, which could bear a positive incidence on economic performance in the following months. However, the upsurge of the sanitary emergency represented an important risk factor. In relation to prices, there was a rebound in the food inflation, coinciding with the increase of international commodity prices. Notwithstanding, the lower inflation of services, in accordance with the fragile performance of the tertiary sector, continued to contain domestic inflation. Finally, the

CPI inflation forecast

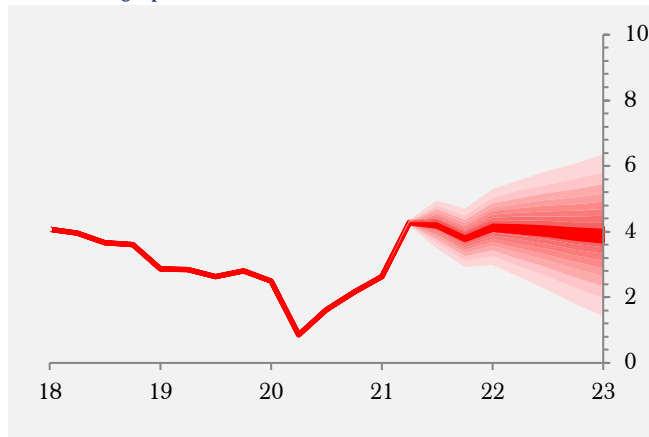
Annual change, percent



Source: Central Bank of Paraguay.

Underlying CPI inflation forecast

Annual change, percent



Source: Central Bank of Paraguay.

Committee members indicated that they will continue to carefully evaluate the new developments in the local and international scenarios in view of an eventual initiation of the process of normalization of its monetary policy.

Baseline Scenario Projections

The growth forecast for 2021 has decreased, going from 4% to 3.5%, affected mainly by the worsening of the sanitary crisis and the slower progress in the immunization of the population than had been foreseen in the previous report. The significant increase in the number of cases of COVID-19 contagion and the scant progress in the vaccination process have intensified uncertainties about the future dynamism of the economy, especially for the services sector. Notwithstanding, the positive prospects for the agribusiness sector (especially livestock production and the high international prices of soybeans), the favorable external outlook, the validity of expansive measures, and the adaptation of businesses to new work models will exert a positive incidence on economic performance. On the supply side, the revision of the growth projection was especially due to the contraction of services, from 5% to 3.7%, due to changes in general government –consistent with the fiscal convergence plan, trade, and other services (hotels & restaurants, services provided to households, and business services). In the secondary sector, the projection was slightly reduced from 5.2% to 5.1%, for a downward correction regarding electricity and water, although this was partially offset by an improvement of the projections related to the construction sub-sector. As regards the primary sector, a variation of -2.0% is anticipated (-3.5% in the previous IPoM report) due to expectations of a lower fall for agriculture and a greater expansion of livestock. On the expenditure side, a lower growth rate for consumption (private and public) and for investment is foreseen. Although an expansion continues to be expected, the rates of variation for exports and imports have been adjusted downwards as compared to the December 2020 IPoM.

The projections of inflation were slightly reduced from 3.9% to 3.8%, in line with the lower dynamism expected for economic activity. Inflation in the first quarter of 2021, while higher than in the previous period, stands below the projection published in the previous IPoM. In addition, the worsening of the sanitary crisis brought about a downward

revision of the expected trajectory of economic activity, which has resulted in an output gap that would be wider than assumed in the previous report. Finally, the assumptions about the exchange rate levels have moderated, considering their recent evolution and the favorable prospects in terms of export revenues. Taking into account the most likely assumptions about the future behavior of the internal and external macroeconomic variables, inflation would rebound in the second quarter, largely explained by the low comparison base, and would later converge towards 4% starting in the last quarter of 2021. It is expected that inflation would remain at that level over the relevant horizon of monetary policy.

Risk Scenarios

At the international level, a greater growth is expected for the world economy in 2021 and 2022. However, the uncertainty about the economic prospects persists, given that these depend crucially on the contention of the sanitary crisis. While important advances in the immunization processes of the population have been observed, the emergence of new variants of coronavirus (SARS-CoV2) that reduce the efficacy of vaccines and delays in inoculation due to doubts about adverse reactions are factors that could prolong the pandemic and consequently, negatively influence the pace of recovery of the global economy. On the other hand, an acceleration in the production and distribution of vaccines could motivate an upward correction of the current growth forecasts.

A longer duration of the health crisis could further reduce the fiscal space of countries for the implementation of countercyclical models that would contribute towards the mitigation of the adverse economic effects of the crisis. For emerging countries and developing ones, that encounter more limitations in terms of providing economic policy responses, this situation represents a greater downside risk in growth prospects. This is the case of some countries in the region in which the fiscal situation has deteriorated and there is a scenario of greater inflationary pressures, therefore limiting their capacity to maintain expansive monetary policies for a longer period of time.

The international prices of food and energy commodities have increased in recent months, generating pressures on

domestic prices in countries around the world. In the case of petroleum, its price has oscillated depending on the evolution of the pandemic and the imposition of measures to restrict circulation. In this sense, if the processes of immunization advances at a quicker pace than anticipated and the restrictions on circulation become more flexible, the international quotations of crude oil could increase more than expected. Furthermore, the rise of food prices at the international level has also been exerting pressures on domestic prices. A more rapid recovery of the global economy could keep food and petroleum prices at a high level. In addition, such factors as disruptions of the logistics for the transport of these commodities could provoke greater price increases. In the case of Paraguay, as it is a country that exports raw materials, the high prices of commodities could contribute to the moderation of pressures on the local currency, thereby buffering the pass-through effect on domestic prices (Box 1).

As regards the financial markets, the world's leading central banks have followed an unusually accommodative monetary policy stance. In particular, the United States' Federal Reserve (Fed) has announced that it may maintain this lax stance for a long period, even if inflation were to surpass the 2% target. However, an increase in Treasury bond yields has been observed recently, which is associated with improved prospects of economic recovery, and consequently of greater inflationary expectations. In this regard, the risk stems from the perception by economic agents of an adjustment in interest rates of the central banks, especially the Fed, ahead of the foreseen date. For emerging and developing countries, such a scenario would imply greater financing costs, capital outflows, and pressures on their currencies.

In the region, the monetary authorities of Brazil deemed it necessary to initiate the process of the gradual withdrawal of monetary stimuli earlier than had been announced in August 2020, due to the sustained increase of inflation in recent months. Furthermore, Brazilian fiscal accounts have limited space, with significant levels of debt. In Argentina, while there have been advances in the restructuring of its debt, the fiscal situation continues to be complex, and inflation has also rebounded recently. Given there is less space for the implementation of countercyclical policies, an upsurge of the sanitary crisis could worsen the prospects for both of these countries. This in turn might affect the



perception of risk in the region, which would encourage capital outflows and the depreciation of regional currencies.

At the domestic level, the risk deriving from the COVID-19 pandemic has intensified in recent months. The pace of contagion has increased significantly, leading to an overflow of the health care system. Given this situation, the sanitary authorities have temporarily reinstated restrictive measures on circulation and activities that involve social contact. Notwithstanding, given that the number of contagion cases and of hospitalized persons continue to remain at high levels, new measures of confinement in the upcoming months have not been discarded, although, if implemented, these measures would be in effect for short periods. In this sense, the worsening of the health crisis and the slow pace of the vaccination process are risks for a downturn in demand, economic activity, and inflation, especially in the services sector. As detailed in Box I, total inflation has remained at low levels, contained especially by the deceleration of the pace of price increases for services.

On the other hand, the weather has been favorable, even better than expected at the beginning of the soybean harvest season, and soy prices have rebound sharply in the last few months. While the volume of the soybean production is expected to yield less than the previous year's harvest, the contraction will be less pronounced than would have been the case if more adverse weather conditions had prevailed during the sowing period. In addition, the rebound of soybean prices contributes to the improvement of the terms of trade. To the extent that the favorable result of the agricultural sector permeates to other linked sectors and boosts internal demand (consumption and investment), the negative effects of the sanitary crisis on aggregate economic activity could be mitigated in the upcoming months. Even so, in this scenario recovery will continue to be unequal, considering that the services sector still be limited by the pandemic. Therefore, the great challenge that must be faced in a decisive manner, in the short-term, to secure the economic prospects of the various sectors is related to the acceleration of the speed of the immunization of the population.