



MONETARY POLICY REPORT

June
2021



CENTRAL BANK OF PARAGUAY

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Asunción - Paraguay

Executive Summary*

World growth

Annual change, percent

	March 2021		June 2021		
	2020	2021	2020	2021	2022
World	-3.5	5.6	-3.3	6.0	4.5
United States	-3.5	5.7	-3.5	6.6	4.1
Eurozone	-6.6	4.2	-6.5	4.5	4.3
China	2.3	8.5	2.3	8.5	5.6
Brazil	-4.1	3.5	-4.1	5.1	2.2
Argentina	-9.9	6.0	-9.9	6.0	2.5
Trading partners	-6.0	5.0	-6.0	5.7	2.9
Mercosur partners	-6.9	4.8	-6.9	5.6	2.4

Source: Bloomberg

International and Regional Economy

The growth prospects of the global economy have been revised upwards as compared to those given in the previous Monetary Policy Report (IPoM), boosted by the recovery of demand, given less restrictions to mobility and the progress of vaccination campaigns. Developments in the international scenario during the second quarter of 2021 provided clearer signs of recovery in economic activity and growing demand, particularly in advanced economies, where important progress in vaccination of the population was observed. Notwithstanding, the reduction of COVID-19 contagion has been affected recently by a new variant that has caused a rebound in various countries, and which implies a risk for growth prospects. At the moment, the greater dynamism of demand and a limited output capacity continue to be reflected in commodities prices that remain high. This, in turn, has generated global inflationary pressures, although it is expected that these will be transitory.

In the United States, the economic prospects have been adjusted upwards, while inflation has remained high. In the first quarter of 2021, quarterly GDP registered a growth rate of 0.4% y-o-y. In the second quarter, the most recent PMI data (Purchasing Managers' Index) shows that the sector decelerated the expansion pace that had been observed previously, registering a figure of 60.6 in June. Growth prospects for 2021 have been revised upwards, going from 5.7% to 6.6%. Regarding prices, the inflation rate has continued to increase, standing at 5.4% y-o-y in June. 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 the non-conventional assets purchase measures.

In the Eurozone, greater recovery of the economy in 2021 is foreseen, as compared to the previous report. In the first quarter of 2021, an inter-annual variation of GDP of -1.3% was recorded, which is an improvement as compared to the

* The Spanish version prevails.

Gross Domestic Product by sectors

Annual change, percent

	2020	2021(f)	2021(i)
Primary Sector	7.1	-2.5	-0.3
Agriculture	9.1	-7.0	-0.6
Livestock	4.7	12.0	0.3
Forestry, fishery and mining	-4.3	5.5	0.0
Secondary Sector	1.7	6.6	2.2
Manufacturing	-0.5	8.5	1.6
Construction	12.6	14.0	1.0
Electricity & water	-1.8	-6.0	-0.4
Tertiary Sector	-3.3	4.8	2.3
Public Administration	5.2	-2.7	-0.3
Trade	-7.8	9.5	0.9
Other Services	-4.4	5.7	1.6
Taxes	-3.9	4.4	0.3
GDP at market prices	-0.6	4.5	4.5
GDP w/o agriculture and binationals	-1.4	6.6	

Source: Central Bank of Paraguay

(f): Forecast.

(i): Incidence.

rate registered in the previous quarter. The most recent data of the manufacturing indicator (PMI) show record expansion figures, reaching a level of 63.4 in June. Thus, a recovery of the GDP growth rate, estimated to reach 4.5% annually, is expected for 2021, above the rate reported in the previous report (4.2%). Regarding prices, the inflation rate in June stood at 1.9% y-o-y, exhibiting higher rates as compared to those reported in the first quarter of 2021. In this context, the European Central Bank (ECB) maintained the interest rates applicable to refinancing operations, the marginal lending facility, and the deposit facility during the second quarter of the year, and announced that the assets purchase program will continue.

In China, a record growth rate was observed in the first quarter of 2021, although this is explained partly by an important base effect. The data for the first quarter of 2021 showed a GDP expansion of 18.3% in inter-annual terms, consistent with low comparison levels in the previous year, as well as the greater dynamism of demand. The indicators for the second quarter of 2021 showed that the manufacturing sector remained in the expansion zone, closing June with a PMI of 50.9. Thus, the growth forecasts for 2021 remained at 8.5% annually.

In Brazil, the growth prospects improved, and the process of the normalization of the monetary policy has continued. In the first quarter of 2021, GDP registered an increase of 1% y-o-y, while favorable results of the short-term economic activity were observed in the second quarter (reaching an expansion of 14.2% y-o-y in May). This reflected, in part, a lower comparison base. The manufacturing PMI remained in the expansion zone, showing greater dynamism in June, to stand at 56.4. Concerning the growth projection for the Brazilian economy in 2021, there has been an important upward revision as compared to the March IPoM, going from 3.5% to 5.1% annually. As for prices, inflation continued to increase in the second quarter, reaching a level of 8.4% y-o-y in June. In this context, the Central Bank of Brazil's Monetary Policy Committee (Copom) increased the SELIC rate to 4.25% annually in the second quarter, continuing with the process of the normalization of its monetary policy.

In Argentina, the growth prospects remained favorable, while at the same time inflation has accelerated. The GDP data in the first quarter showed a growth rate of 2.5% y-o-y,

Economic growth and current account

Annual change, percent

	2020	2021(f)
GDP	-0.6	4.5
Domestic demand	-2.7	5.9
Gross capital formation	-4.5	14.2
Gross fixed capital formation (GFKF)	6.3	14.8
Total consumption	-2.2	3.7
Private consumption	-3.5	3.9
Public consumption	5.2	3.0
Exports of goods and services	-10.2	6.9
Imports of goods and services	-17.0	12.1
Current account (% of GDP)	2.3	2.3
GFKF (% of nominal GDP)	20.1	20.2

Source: Central Bank of Paraguay

(f): Forecast.

while in the second quarter, the short-term indicators verified a growth rate of 13.6% inter-annually in May, explained largely by the low comparison levels observed in the same month in 2020. In a similar manner, the industrial production indicator exhibited a high growth rate, reaching 30.2% inter-annually. In this context, the economic growth prospects for 2021 remained at 6.0%. As regard prices, a new acceleration of inflation has been observed, reaching a rate of 50.2% y-o-y in June. The Central Bank of the Republic of Argentina (BCRA) has maintained the lower limit of the LELIQ rate at 38% annually, ever since November 2020.

Domestic Situation and Monetary Policy

In the first quarter of 2021, economic activity continued to exhibit a positive dynamism, in line with the gradual reopening of the economy, the greater mobility of the population, the improvement of the employment, the adaptation of both businesses and individuals to the new forms of work, and the favorable external boost. During this period, GDP registered a growth rate of 0.6% y-o-y, sustained mainly by the construction, manufacturing, and livestock production sectors. Agriculture and the electricity & water sectors showed an inter-annual contraction. Thus, GDP (excluding agriculture and the bi-national hydroelectric entities) expanded by 2.8%. On the side of expenditures, the positive incidence of gross fixed capital formation is highlighted, whereas private consumption, while rebounding in the last few months, stood slightly below the level observed in the first quarter of 2020. It is important to point out that, during a large part of the period (January and February), the comparison base was relatively high (pre-pandemic). In March, the base effect once again became favorable, but at the same time, the worsening of the sanitary crisis and its repercussions in other spheres (both social and political) had generated greater uncertainty. Even so, the variation of the product (with seasonal adjustments) was positive as compared to the previous quarter (0.5%). According to the short-term economic activity indicators, in the second quarter, the positive dynamism of the construction and manufacturing sectors was maintained, supported also by the gradual recovery of the services sector. Likewise, the sales and investment indicators have shown positive results.

Inflation projection

Annual change, percent

	2019	2020(f)	2021(f)	2022(f)
Average CPI inflation (*)	2.0	4.2	4.0	
December CPI inflation (**)	2.2	4.0	4.0	
CPI inflation in around two years (***)				4.0
Average underlying CPI inflation(*)	2.0	4.5	4.0	
December underlying CPI (**)	2.2	4.0	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 second quarter of 2023.

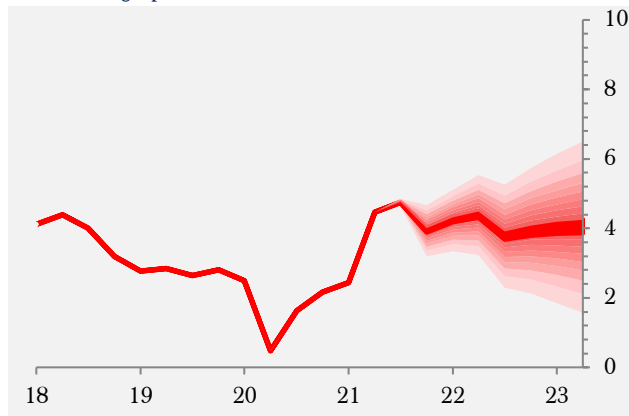
Source: Central Bank of Paraguay

The various inflation measures rebounded in the second quarter, explained by the lower base of comparison in 2020 and the increase of the prices of some food and fuel products, affected by greater external demand and the high prices of commodities in international markets. Between April and June, average inter-annual inflation was 3.6%, higher than the rate of 2.5% observed between January and March. Likewise, underlying inflation and core inflation averaged rates of 3.9% and 2.5%, respectively, above the rates registered in the first quarter (2.3% and 1.9%). In addition to the lower comparison base, the inter-annual rates also reflect the effects of greater external demand for Paraguayan beef as well as the impact of increase of the prices of oil and other commodities at the international level. When excluding the prices of energy and food items from the Consumer Price Index (IPCSAE), inter-annual inflation in the second quarter was 2.2%, even lower than the rate reported in the first quarter (2.5%), reflecting to a large extent the reduced inflation rate of services and the still meager second-round effects on general inflation.

The Monetary Policy Committee (CPM) maintained the MPR reference range at 0.75% annually during the second quarter. The Committee highlighted that at the international level the prospects for economic growth had improved for both the world economy and the country's main trade partners. As regards the evolution of the COVID-19 pandemic, progress in the vaccination processes in various countries has been observed, albeit with an uneven pace in different countries. As regards the region, the short-term economic activity indicators evolved favorably, in the midst of a rebound of inflation due to the increase of food and energy prices, particularly in the neighboring countries. At the domestic level, the CPM highlighted the gradual recovery of economic activity, although it continued to point out that the main risk for economic performance stems from the deepening of the sanitary crisis. As for inflation, a rebound in the inflation of food items and fuel was observed, due mainly to the improvement of external demand and the increase of commodity prices at the international level. However, total inflation remained contained due to the lower variation of the prices of services. At the same time, the Committee stated that a rebound in inter-annual inflation is expected to be registered, due to the lower comparison base. In this regard, and in line with the different projection models,

CPI inflation forecast

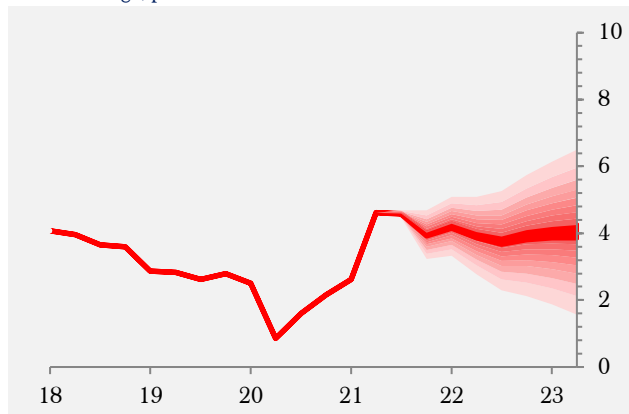
Annual change, percent



Source: Central Bank of Paraguay.

Underlying CPI inflation forecast

Annual change, percent



Source: Central Bank of Paraguay.

inflation is expected to decrease again towards the end of the year and would remain around the target within the relevant monetary policy horizon. On the other hand, median inflation expectations for the monetary policy horizon remained anchored to the 4% inflation target.

The initiation of the normalization of monetary conditions may take place in the near future. In a scenario of better economic prospects, the recent rebound of monthly inflation, while explained largely by the improvement of external demand (especially beef) and the high prices of commodities at the international level (particularly oil), could eventually represent some source of risk derived from the second round effects. Although this has yet been observed, the potential de-anchoring of inflation expectations could become more relevant. Regarding what has been pointed out before and considering that changes of monetary policy act with time lags upon the relevant macroeconomic variables, the withdrawal of monetary stimuli should be initiated in the shortest time possible, in order to guarantee the achievement of the inflation target in the medium term, and consequently generate once more the margins for maneuverability to mitigate eventual adverse shocks in the future.

Baseline Scenario Projections

The central projection of GDP annual growth for 2021 was adjusted from 3.5% to 4.5%, explained by a better economic performance than had been foreseen, and a favorable change in the overview of the sanitary crisis. In the last few months, registered economic activity data stand above the level foreseen in the previous report, due mainly to the favorable results observed in construction, livestock production, and manufacturing. Since the last revision, the number of cases of COVID-19 contagion was significantly reduced, giving some relief to the healthcare sector. In addition, expectations about the evolution of the pandemic have improved substantially with a notable progress in immunization starting in July. Taking into account this change in the sanitary situation, it is foreseen that the economic dynamism observed recently will continue to take hold in the following months. As regards the external sector, the boost has continued to be positive, which has had a favorable incidence on the results of livestock production, manufacturing, and trade. On the side of expenditures, a

higher growth for investment is foreseen, boosted by construction and the purchases of machinery and equipment. Private consumption will also have a greater expansion, supported by the gradual recovery of the labor market and the more favorable expectations of economic agents.

Inflation projection for 2021 was adjusted from 3.8% to 4.0%, consistent with the recent behavior of prices and the better economic prospects. In the second quarter, observed inflation data stood above the level forecasted for this period, which also implies a higher starting point for the projections. On one hand, the better results that are expected in terms of economic activity will mean a close of the output gap faster than anticipated. This scenario, together with laxer real monetary conditions, due to a greater depreciation of the real exchange rate, contributed to the projection that inflation will stand at a higher level than presented in the March IPoM. Taking into account the most likely assumptions about the future behavior of the internal and external macroeconomic variables, inflation would stand slightly above 4% in the first semester of 2022, and would later converge towards the target starting in the third quarter. It is expected that inflation would remain at those levels until the relevant horizon of monetary policy.

Risk Scenarios

At the international level, the growth prospects of the world economy were revised upwards for 2021 and 2022, although the risk related to the evolution of the pandemic persists. While advances in vaccination have been noteworthy, the new variants could reduce the efficacy of vaccines, which might make it necessary to implement additional efforts in the future that would imply new restrictions or the prolongation of certain measures to contain contagions. In particular, the Delta variant has generated a notable increase of cases in countries with a great percentage of vaccinated people, which compounds the uncertainty about the global prospects.

Longer duration of the sanitary crisis would pressure fiscal accounts even more, especially those of the emerging countries and developing ones that already face limited fiscal space. In addition, the cost of funding could rise, if inflation in the United States were more persistent than

tolerated by the Federal Reserve (Fed), deriving in an increase of the federal funds rate quicker than foreseen and worsening the international financial conditions. In turn, the effect could be exacerbated, if consequently there is greater risk aversion and a potential capital outflow in the emerging countries.

As regards the prices of commodities, the recent recovery of world demand, together with a limited output capacity and continual disruptions in the production chains, has exerted important inflationary pressures. At the moment, it is expected that this will be a temporary phenomenon, according to whether or not the supply of products normalizes, as in the case of petroleum. However, it cannot be discarded that an increase in the costs faced by businesses could have more lasting effects on inflation. On the other hand, an eventual comeback of restrictive measures on mobility could suddenly deteriorate the prices of determined commodities such as crude oil.

In the region, even though Paraguay's main trade partners presented greater dynamism in their economies, the risks increased for prices. In Brazil, despite the impact of the second wave of contagion, the economic activity indicators continued to advance favorably, which implied upward revisions of its growth forecasts. In this sense, the risks about economic recovery have been reduced. However, the persistence of inflation was more intense than expected, especially that of manufacturing goods, due to difficulties in the acquisition of inputs, the recovery of demand, and an increase of electricity tariffs. While a reversion, even a partial one, of commodity prices (measured in Brazilian reales) would produce a downward revision of inflation, an extension of the fiscal stimuli could further worsen the situation of public finances generating an increase of the risk premium and exerting pressure on the exchange rate. Given the greater weight of the latter within the balance of risks of Brazil, this could mean a higher external inflation risk of relevance for Paraguay. Argentina also presented a recovery that was more rapid than foreseen, while its inflation levels increased as a result of the economic reactivation and a macroeconomic policy that has remained lax. However, uncertainty about its future persists. In addition to the sanitary situation, the new advances in the restructuring of its debt and the inherent risks of an upcoming electoral



period represent factors that could bear incidence on the economy.

In the domestic context, the sanitary situation has improved remarkably in the recent months, although latent risks stemming from the appearance of new coronavirus variants persist. The number of new contagion cases, hospitalized persons, and deaths caused by COVID-19 has dropped significantly since the beginning of June, to which the massive inoculation of the population is added. To the extent that this process of immunization continues with the same pace, the expectations of the economic agents might improve rapidly, while allowing greater openness of the sectors that still encounter restrictions for operating in relatively normal conditions. However, one factor that could again slow down the process of the reopening of the economy is related with the appearance of new variants of the virus –especially the Delta variant– against which the efficacy of the vaccines is substantially reduced.