



MONETARY POLICY REPORT

June
2022



CENTRAL BANK OF PARAGUAY

Federación Rusa y Augusto Roa Bastos

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Asunción - Paraguay

Executive Summary*

World growth

Annual change, percent

	March 2022			June 2022		
	2021	2022	2023	2021	2022	2023
World	5.9	3.5	3.4	6.1	3.2	3.2
United States	5.7	3.3	2.2	5.7	2.5	1.9
Eurozone	5.3	3.0	2.5	5.4	2.7	1.4
China	8.1	5.0	5.2	8.1	4.1	5.2
Brazil	4.8	0.5	1.6	4.8	1.2	1.1
Argentina	10.3	2.7	2.0	10.4	2.8	1.7
Trading partners	7.7	1.4	1.9	7.7	1.5	1.5
Mercosur partners	7.6	1.8	1.9	7.7	2.1	1.5

Source: Bloomberg

International and Regional Economy

The growth prospects of the world economy for 2022 have deteriorated compared to those verified in the March Monetary Policy Report (IPoM), and inflation has continued to accelerate. The prolongation of the war between Russia and Ukraine, the acceleration of the monetary policy normalization process in the main advanced economies, and the confinements to contain the expansion of COVID-19 contagions in China are factors that have affected the global economic outlook. Since the previous IPoM report, the prices of energy and food commodities have remained high, thus applying pressure on world inflation. In the region, the economic prospects of the trade partners have improved, as compared to the March IPoM, mainly due to an upward revision of the growth forecast for the Brazilian economy. Inflation has continued to rebound, forcing the monetary authorities to continue rising the benchmark interest rates.

In the United States, the Federal Reserve (Fed) has accelerated the withdrawal of monetary stimuli due to more persistent inflationary pressures than foreseen. Since the previous report, inflation has increased to stand at 9.1% y-o-y in June. In this context, the Fed has continued to increase the target range for the federal funds rate to 2.25% - 2.50% in July (0.25% - 0.50% in the March IPoM). As regards economic activity, in the first quarter of 2022, GDP exhibited a quarterly annualized growth rate of -1.6%, below the 6.9% rate recorded in the previous quarter, mainly due to a deceleration in consumption and private investment. The most recent data of the Purchasing Managers' Index (PMI) showed that the manufacturing sector decreased its expansion pace in June compared to the level observed in March, registering a level of 52.7. Given this scenario, the growth prospects were revised downward from 3.3% to 2.5% for 2022.

In the Eurozone, the European Central Bank (ECB) has initiated its cycle of interest rate hikes, given the continuous

* The Spanish version prevails.

Gross Domestic Product by sectors

Annual change, percent

	2021	2022(f)	2022(i)
Primary Sector	-11.6	-9.0	-0.9
Agriculture	-18.1	-13.0	-0.9
Livestock	6.0	-2.5	-0.1
Forestry, fishery and mining	6.7	4.1	0.0
Secondary Sector	4.7	1.2	0.4
Manufacturing	6.7	-0.1	0.0
Construction	12.8	3.5	0.3
Electricity & water	-8.6	2.8	0.2
Tertiary Sector	6.9	1.4	0.7
Public Administration	-2.9	-0.5	0.0
Trade	15.3	-2.5	-0.3
Other Services	7.3	3.5	1.0
Taxes	9.0	0.2	0.0
GDP at market prices	4.1	0.2	0.2
GDP w/o agriculture and binationals	7.5	1.1	

Source: Central Bank of Paraguay

(f): Forecast.

(i): Incidence.

rise in inflation. The inflation rates in the second quarter were higher than those registered in the first quarter of the year, standing at 8.6% y-o-y in June. Given this scenario, at its July meeting, the ECB initiated the adjustment of its three official interest rates with an increase of 50 basis points, a greater adjustment than anticipated. As regards economic activity, in the first quarter of 2022, there was a 0.6% increase in GDP as compared to the previous quarter, driven mainly by the positive contributions of net exports and inventories. On the other hand, the manufacturing PMI showed a deceleration of the expansion pace in the second quarter, as compared to the levels verified in the first quarter, standing at 52.1 in June. As regards the growth prospects for 2022, these decreased from 3.0% annually to 2.7%, given the continuation of the armed conflict in the European continent.

In China, the measures implemented to contain the expansion of COVID-19 have weighed down on recent economic activity, negatively impacting economic growth prospects for 2022. The GDP for the second quarter decreased 3.6% compared to the previous quarter, in line with the confinements instated by the government to curb the cases of COVID-19 contagion. The effect of these contention measures was also reflected in a deceleration of the manufacturing sector's PMI in April and May, although there was a rebound in June when the quarantines imposed in the main Chinese cities were lifted, reaching a level of 51.7. Thus, the growth forecasts for 2022 were reduced from 5.0% to 4.1%.

In Brazil, the growth prospects have been revised upwards, and there were new adjustments of the monetary policy rate. In the first quarter of 2022, the GDP showed a growth rate of 1.0% compared to the previous quarter, explained mainly by the positive incidences of consumption, external demand, and public spending. In the second quarter of the year, the manufacturing PMI showed an acceleration as compared to March, standing at 54.1 in June. As regards price levels, inflation remained high, reaching a rate of 11.9% y-o-y in June. The Central Bank of Brazil's Monetary Policy Committee (Copom) has increased the SELIC rate by 150 basis points since March 2022 (at two different meetings) to stand at 13.25% annually in June. In this context, as compared to the March IPoM, the growth projections for the Brazilian economy were revised upwards, increasing from 0.5% to 1.2% for 2022.

Economic growth and current account

Annual change, percent

	2021	2022(f)
GDP	4.1	0.2
Domestic demand	10.0	3.5
Gross capital formation	26.3	10.8
Gross fixed capital formation (GFKF)	18.6	3.6
Total consumption	5.6	1.2
Private consumption	5.7	2.6
Public consumption	5.3	-5.5
Exports of goods and services	2.2	-14.0
Imports of goods and services	21.4	-3.4
Current account (% of GDP)	-0.3	-5.0
GFKF (% of nominal GDP)	22.7	23.9

Source: Central Bank of Paraguay

(f): Forecast.

In Argentina, inflation has continued to accelerate; notwithstanding, the economic activity has exhibited a positive performance. The GDP data in the first quarter of 2022 showed a growth rate of 0.9% as compared to the previous quarter. According to available data for 2022, economic activity continued with an important dynamism, registering an expansion rate of 7.4% y-o-y in May. During this same month, the industrial production indicator exhibited an inter-annual increase of 11.9%. As regards price levels, an acceleration of inter-annual inflation was observed, standing at 64.0% in June (55.1% y-o-y in March). The Central Bank of the Republic of Argentina (BCRA) increased the minimal LELIQ rate during the period April to June 2022 by 500 basis points to stand at 52% annually.

Domestic Situation and Monetary Policy

In the first quarter of 2022, the GDP contracted 2% y-o-y, while the GDP (excluding agriculture and the bi-national hydro-electrical entities) grew 4.3%. On the supply side, the inter-annual drop in the product was explained by the negative incidences of agriculture (-4.4 p.p.), the electricity & water sector (-0.8 p.p.), and livestock production (-0.3 p.p.). On the other hand, positive incidences were registered for services (1.8 p.p.), manufacturing (0.8 p.p.), and construction (0.7 p.p.). On the side of expenditures, the positive contributions of investment (3.8 p.p.), private consumption (1.9 p.p.), and government consumption (0.4 p.p.) are highlighted, while net exports had an important negative incidence (-8.1 p.p.). Between April and May, the Monthly Indicator of Economic Activity (IMAEP) registered an average inter-annual variation of -5.4%, while the IMAEP that excludes agriculture and the bi-national hydro-electrical entities registered an average inter-annual variation of -1.6%. At the end of May, aggregate economic activity accumulated a contraction of -3.8%, although when considering the IMAEP that excludes agriculture and the bi-national entities, the cumulative rate of variation was 2.5%.

Since the last IPoM, inflation has continued to be boosted by increases in the prices of food items and fuels, affected mainly by the increased prices of commodities. Likewise, some second-round effects on the prices of services have continued to be observed. In the second quarter, the inter-annual average of total inflation was 11.6% (9.1% in the first

Inflation projection

Annual change, percent

	2021	2022(f)	2023(f)	2024(f)
December CPI inflation (*)	6.8	8.8	4.1	
CPI inflation in around two years (**)				4.0
December underlying CPI (*)	6.9	8.6	4.1	
Underlying CPI inflation in around 2 years (**)				4.0

(f) Forecast

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

(**) Corresponds to the projected inflation for the second quarter of 2024.

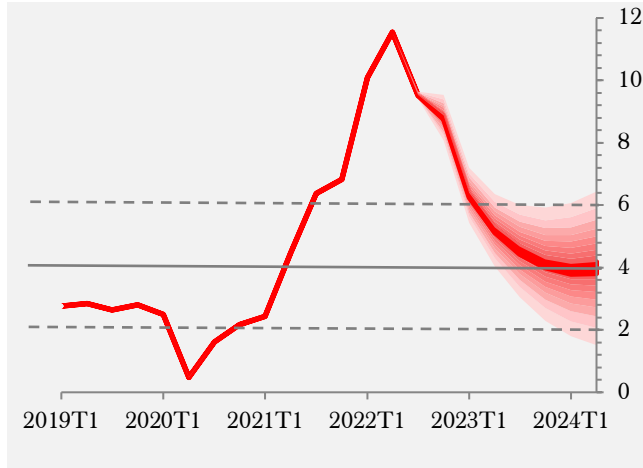
Source: Central Bank of Paraguay

quarter), explained by food items (5 p.p.), energy (3.3 p.p.), services (1.8 p.p.), and other goods (1.5 p.p.). The CPI excluding Agriculture and Energy (IPCSAE) registered an average inter-annual variation of 5.2% in the second quarter, above the 4.1% verified in the previous quarter. Underlying X1 inflation (which excludes the prices of fruit & vegetables, fuels, and tariffed services) averaged an inter-annual rate of 8.2%, above the 6.7% recorded in the previous quarter. Core inflation registered an average inter-annual rate of 6.9% between April and June, above the 5.6% observed in the period January-March 2022.

Since the publication of the last IPoM, the Monetary Policy Committee (CPM) has continued with the cycle of upward adjustments of the reference rate. As regards the international scenario, the Committee highlighted the increase of commodity prices, at its May and June meetings. However, at the last CPM meeting, a moderation of commodity prices was observed, explained by the greater probability of a deceleration of the global economy. Likewise, the CPM highlighted the swift process of the normalization of the Federal Reserve's monetary policy and its effects on international financial markets. As regards the region, it was pointed out that an increase of inter-annual inflation and inflation expectations was observed in the majority of the countries with inflation targets, a context in which the monetary authorities have continued to increase monetary policy rates. At the local level, the CPM emphasized that the IMAEP contracted in the last few months, mainly due to the weak results of agriculture, and to a lesser extent, the less favorable performances of the manufacturing, services, and construction sectors. As regards inflation, the Committee once again pointed out the increase of the prices of food and fuels, affected by the high prices of commodities that continue to be pressured by the prolongation of the conflict between Russia and Ukraine. The private sector inflation expectations over the monetary policy horizon increased in the period March to May, reaching 4.8%, a context in which the CPM adjusted the reference rate by 50 basis points at its May and June meetings. Nevertheless, starting in June a reduction and stabilization of inflation expectations over the monetary policy horizon was observed, to stand at 4.5%, a situation which, together with the decrease of both commodities prices and their projections, generated sufficient space for a deceleration of the pace of MPR adjustments by 25 basis points at the July meeting. Thus, the MPR increased by 125

CPI inflation forecast

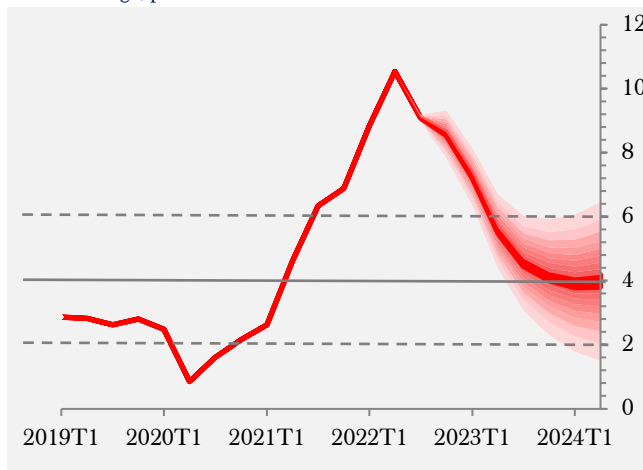
Annual change, percent



Source: Central Bank of Paraguay.

Underlying CPI inflation forecast

Annual change, percent



Source: Central Bank of Paraguay.

basis points between May and July, standing currently at 8.0% per annum.

Baseline Scenario Projections

In the baseline scenario, the GDP annual growth projection for 2022 remained at 0.2%, although there was a sectorial recomposition according to expenditure components. The severe drought experienced towards the end of 2021 and the beginning weeks of 2022 caused heavy losses in the harvest of soybeans and other agricultural crops. However, since the end of the first quarter weather conditions improved significantly, favoring the harvest of *zafriña* soybeans and corn produced through relay-planting, which allowed for a certain buffering of the significant losses sustained by crop producers. Thus, the forecast of the variation in agricultural output was revised upwards from -21.5% to -13%. Livestock production was adjusted downwards, from -1.5% to -2.5%, due to an expected drop in the pace of slaughterhouse operations during the second semester of the year, given the reduction of cattle herd. In the secondary sector, the manufacturing and construction sectors forecasts were adjusted downwards, while the projections for the electricity & water sector were revised upwards. Likewise, it is foreseen that the tertiary sector will have a slower pace of expansion, explained by a drop in general governmental services and a deceleration of other services[†]. In contrast, trade is expected to show less contraction as compared to the data released in the previous report. On the side of demand, private consumption and investment continue with the same growth rates projected in April, 2.6% and 3.6%, respectively. Public consumption is expected to register negative growth of around -5.5%, in line with the Ministry of Finance's fiscal convergence plan. The prospects for both exports and imports have improved, as decreases are foreseen to be below those expected in April.

The inflation projection for 2022 was adjusted upward from 8.2% to 8.8%, while for 2023, the forecast was revised downward from 4.2% to 4.1%. As foreseen, total inflation and its trend measures continued to increase during the second quarter. However, the magnitude of these increases surpassed expectations due to the persistent external pressures on the prices of commodities observed until the

[†] The category Other Services includes financial intermediation, housing rentals, services provided to businesses, hotels & restaurants, and services provided to households.

end of the quarter. This situation raised the starting point for projections, resulting in a greater inter-annual inflation rate than projected in the March IPoM. On the other hand, the lower pressures on external prices, observed recently, as well as the moderate dynamism of local economic activity – the negative output gap – would contribute towards the containment of the pressures on domestic inflation in the medium-term. Thus, starting in the third quarter, a moderation of inflation continues to be foreseen until the end of 2022, with a rate of 8.8%; inflation is expected to stand at 4.1% in 2023 and then converge to the target during the first quarter of 2024.

Risk Scenarios

At the international level, some of the main risk factors are a new escalation of the conflict between Russia and Ukraine, stricter financial conditions, and greater probabilities of a recession of the main advanced economies. The intensification of the armed conflict is a risk that could signify additional pressures for an upward adjustment of global inflation due to the higher prices of commodities, including petroleum, wheat, and corn. The extension of geopolitical tensions would affect the supply of gas from Russia to Europe, impacting both the inflation and economic prospects of the European continent. Likewise, the persistent inflation in the United States and the Eurozone has implied an acceleration of the monetary policy normalization processes. It is assumed that there will be stricter financing conditions for the emerging economies which might be exacerbated by the rebound of risk premiums in the case of countries with high levels of indebtedness and an elevated percentage of debt denominated in foreign currency. In addition, the health situation at the world level represents some risk. Recent increases of the contagion of new Omicron sub-variants have been observed in different regions, and if this situation were to occur in China it is assumed that strict confinements that would deter economic activity will be implemented again. In this context of high inflation and the accelerated withdrawal of stimuli (both monetary and fiscal), the probabilities of an economic slowdown and even a recession of the main world economies have increased. This scenario, in contrast to the escalation of war between Russia and the Ukraine, could contribute towards the contention or reduction of commodities prices.

As regards the country's main trade partners in the region, the risks stemming from the fiscal overview remain latent. In Brazil, the approval of the suspension of the public spending cap could deteriorate the fiscal prospects, exerting a negative incidence on sovereign risk and the value of Brazilian currency. In Argentina, there has been an important increase in public spending, which has exacerbated the perception of its country risk. Furthermore, the market foresees less probability of the country's compliance with the targets established in the agreement with the International Monetary Fund.

In the domestic context, the risks for economic activity, especially agriculture, derive mainly from the evolution of climatic conditions and a sufficient availability of fertilizers. The weather has evolved favorably in the last few months, which has benefitted the harvest of *zafriña* soybeans and corn. In addition, there are positive prospects for the production of wheat. However, as regards the next campaign for the 2022/2023 soybean crops, there are probabilities of drought due to the La Niña weather phenomenon. On the other hand, according to foreign trade data, the volumes of farming fertilizer imports in recent months stand below the historical averages. The lack of fertilizers is a situation, which, unless normalized, could have a negative influence on soybean crop yields.