MONETARY POLICY REPORT

Ñeembucú

CENTRAL BANK OF PARAGUAY
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Asunción - Paraguay

Executive Summary

International and Regional Economy

The growth prospects for the world economy have improved slightly for this year compared to those presented in the December 2022 Monetary Policy Report (IPoM), in a context in which inflation rates remain high, even though less inflationary pressures have been registered in certain countries. A moderate growth rate is foreseen for the main advanced economies due to the persistence of risks stemming from turbulences in the financial sector, greater costs of indebtedness, and the uncertainty caused by armed conflict in the Ukraine. Since the previous report, the prices of determined agricultural commodities have decreased while crude oil quotes have continued to show volatilities in the period. Inflation in the leading advanced economies remains high, and the respective monetary authorities in these countries have continued to adjust upward their reference rates. In the region, the economic prospects of Paraguay's principal trading partners have been maintained for 2023, with moderate prospects for 2024. Inflation has attenuated in some countries within the region and has continued at high levels in others, whereby some central banks have maintained their monetary policy rates and others have continued with their cycle of adjustments.

In the United States, while inflation has been decelerating, it remains at high levels with respect to the target; the Federal Reserve (Fed), at its last meeting in March, continued with increases of the target range of its referential rates, highlighting potential risks derived from recent developments in the banking system. Since the previous report, inflation registered lower rates, standing at 5.0% y-o-y in March, but still above the 2% target. At both its February and March meetings, the Fed increased the target range for federal funds rates, by 25 basis points (bps), to stand currently at 4.75% - 5.00%. As regards economic activity, in the fourth quarter of 2022, GDP exhibited a quarterly annualized growth rate of 2.6%, surpassing the market's forecasts, mainly due to increases in private inventory investment, consumer spending, non-residential fixed investment, and public spending. The most recent data of the Purchasing Managers' Index (PMI) showed that the sector decelerated in the first quarter of 2023, standing in the contraction zone in March (49.2). Notwithstanding, the growth prospects have been revised upwards for 2023, increasing from 0.4% to 0.9%.

In the Eurozone, the European Central Bank (ECB) again increased its referential interest rates at its March meeting, maintaining the magnitude of the adjustment with respect to the previous meeting. Although total inflation continues with a downward trajectory, it remains above the target value. Furthermore, the core measure has continued to accelerate. Total inflation decelerated in the first quarter of 2023, showing lower rates compared to the average in the fourth quarter of the previous year. However, inflation continues at high levels, standing at 6.9% inter-annually in March. Given this scenario, the European Central Bank (ECB) raised the three official interest rates by 50 bps, at its last meeting. As regards economic activity, in the fourth quarter of 2022, GDP expanded by 1.8% compared to the previous quarter, driven mainly by the positive contributions of net exports, general government final consumption expenditure, and, to a lesser extent, the variation of inventories. On the other hand, the manufacturing PMI has remained in the contraction zone during the first quarter of the year, standing at a level of 47.3 in March. However, the growth prospects for 2023 have been revised upward, going from -0.1% in the previous IPoM to a 0.5% expansion of GDP, despite the prolongation of the war in the Ukraine and the hardening of financial conditions.

In China, an improvement of the growth prospects for 2023 has been observed, following the termination of the restrictive measures imposed in the framework of the COVID-19 pandemic. China's GDP, at the end of the fourth quarter of 2022, grew 2.9% y-o-y, as anticipated in the previous report, falling below the rate registered in the third quarter. This economic behavior is due, on the one hand, to the zero COVID tolerance policy, which ended in December, and, on the other hand, to prevailing difficulties in the real estate market. In March 2023, the manufacturing PMI registered a neutral level (50.0), below the 51.6 observed in February.

Notwithstanding, growth estimates for the Chinese economy were adjusted upward by 0.4 percentage points for this year, compared to the previous estimate. Thus, growth prospects stand at 5.3% annually, as it is expected that the end of confinement measures will foster a swift economic recovery.

In Brazil, the growth forecasts for 2023 have remained limited, although with a slight upward adjustment at the margin, while inflation has continued to decelerate. In the fourth quarter of 2022, there was a 0.2% contraction of GDP compared to the previous quarter, given the negative incidence of gross fixed capital formation and industrial activities. In the first quarter of 2023, the deterioration of the manufacturing sector's PMI stands out; the index stood in the contraction zone (47.0) due to drops in output, new orders, and foreign sales caused by the economic and political uncertainty that has restricted customer purchases, together with the harsher economic conditions at the international level. Notwithstanding, growth estimates for 2023 have been revised upward (from 0.8% to 0.9%), explained mainly by the favorable performance of the tertiary sector. On the other hand, inter-annual inflation has decelerated significantly, largely due to the reduction of prices in the transportation category, registering a rate of 4.7% in March (5.8% y-o-y in December). Since the last report, the Central Bank of Brazil's Monetary Policy Committee (Copom) has maintained the SELIC rate at 13.75% annually.

In Argentina, the growth prospects for 2023 point toward a contraction of the economy, while inflation has continued to increase. In the fourth quarter of 2022, GDP grew 1.9% inter-annually, above the expected level, driven largely by the tertiary sector. In the first quarter of this year, the short-term economic activity and manufacturing output indicators registered mixed behaviors. For 2023, a more complex external scenario continues to be foreseen, in a context of high uncertainty about the domestic political overview in which the GDP growth forecast was adjusted downwards by 1.1 p.p., compared with the previous estimate, to stand at -0.4% annually. Regarding price levels, inter-annual inflation continued to accelerate, reaching 104.3% in March (94.8% y-o-y in December). After maintaining its referential rate for some time, at its February meeting the Central Bank of the Argentine Republic (BCRA) increased the minimum LELIQ rate to 78.0% annually.

Domestic Situation and Monetary Policy

Since the last IPoM, total inflation and its different trend measures have followed a downward trajectory in inter-annual terms; however, in monthly terms, they have registered a slight increase. Average inter-annual inflation in the first quarter of 2023 was 7.0%, below the level observed in the fourth quarter last year (8.2%). In monthly terms, average inflation in the same period verified an increase, rising from 0.3% to 0.7%. This increase was explained by the price increases registered within the food category, the utility services for provision of electrical power (due to the finalization in December 2022 of the agreement between the public entities, Itaipu and Ande), and educational goods and services that are typically adjusted at the beginning of educational activities. On the other hand, the inflation trend indicators (underlying, underlying X1, and core inflation) in the first quarter averaged inter-annual rates of 7.6%, 7.1%, and 6.1%, respectively (7.8%, 7.1%, and 6.2% in the fourth quarter of 2022). In addition, less diffusion of inflation has been observed in the first months of the year.

In the fourth quarter of 2022, GDP registered a growth rate of 1.7% inter-annually, thus completing two consecutive quarters of recovery of the economy following the negative inter-annual rates registered in the first and second quarters of the year, due to the impact of severe drought. The positive data was explained by the favorable results of agriculture, particularly soybean crops, according to the latest estimates of the 2022/2023 agribusiness campaign, as well as the favorable performances in the generation of electric power, livestock production, and the services sector. Manufacturing and the construction sector, on the other hand, showed an inter-annual contraction. On the expenditures side, GDP expansion was due to the positive incidence of external demand (5.3 p.p.) due to the favorable dynamics of exports and the reduction of imports, while domestic demand registered a negative incidence (-3.6 p.p.) explained by the reduction recorded for gross capital formation. With these results, GDP in 2022 accumulated a 0.1% variation.

During the first quarter of 2023, the Monetary Policy Committee (CPM) decided to maintain the MPR at 8.50% annually. The Committee has decided, based on a prospective analysis, to keep the reference rate at the same level considering that the convergence of inflation to the target over the monetary policy horizon is subject to potential risks that could stem from a scenario of high uncertainty. At the last CPM meetings, it has been pointed out that this uncertainty has originated from the constant changes of global growth prospects for 2023, even pointing out probabilities of a global recession, the volatilities in commodity prices, mainly oil prices, and the recent tensions in the international financial markets of the advanced economies, which have had to adopt measures to preserve the stability of their financial systems. As regards the recent evolution of external prices, the inter-annual inflation rates in the United States and the Eurozone have continued to moderate, even though the annualized monthly inflation trend measures continued to show results that are above the central banks' inflation targets. Given this scenario, it is foreseen that external inflation will remain at high levels in 2023, for which reason the market expects the monetary authorities of these economies to maintain a contractionary monetary policy stance until the end of the year. In the region, some central banks have continued to raise their monetary policy rates, while others have decided to maintain them. As regards their inflation forecasts, certain central banks have made upward revisions. At the local level, total inflation has been showing a downward trajectory during several consecutive months. Furthermore, inflation expectations over the monetary policy horizon have remained at the 4% target.

Baseline Scenario Projections

In the baseline scenario, the GDP growth projection for 2023 remains at 4.5%; notwithstanding, changes in some economic sectors have been registered. The rebound of economic growth estimated for 2023 is explained by the recovery of agriculture and its associated sectors, after the meager performance in 2022, and greater generation of electrical power by the bi-national hydroelectric entities, in line with the registered favorable weather conditions and positive prospects for the coming months. Likewise, favorable dynamism is expected in the tertiary sector, mainly trade and other services. Thus, the baseline scenario envisions GDP growth for 2023 that remains similar to the last projection of 4.5%, made in December 2022. Nevertheless, some changes have been registered in the projections for certain sectors (Table A). In particular, the improvement of the Parana River's water flow and expectations of greater electrical power output has allowed for an upward revision of the projection for the electricity & water sector, increasing from 4.8% to 7.9%. This improvement is attenuated by a downward correction for the construction sector (decreasing from 0.5% to -2.6%), due to a slower pace in the execution of both public and private sector works. In the primary sector, even though agricultural growth remained with no changes (30%), livestock production was revised slightly downward, decreasing from 2.3% to 1.9% due to a lower-than-expected cattle slaughter rate, offset by greater production of other meat products (pork and poultry). As regards the tertiary sector, a slightly higher expansion is expected, increasing from 3.2% to 3.3% compared to the previous estimate, highlighted by the positive dynamism of restaurants and hotels. From the GDP perspective on the side of expenditures, greater dynamism of net external demand is foreseen, driven by an upward revision in exports, increasing from 12.4% to 18.3% (Table B). The factors that contributed to this change are the estimate of greater electric energy exports, the positive dynamics observed in maquila output, and an upward adjustment in re-export operations. In relation to domestic demand, a negative incidence in investment is expected, compatible with the foreseen trajectory for the construction sector and the lower-than-anticipated import of machinery and equipment, although attenuated by growth in both public and private consumption. The improvement of consumer confidence, in line with the rebound of activity indicators and the deceleration of inflation, supports the upward adjustment in private consumption, increasing from 2.8% to 3.2%.

The inflation projection for the end of 2023 was adjusted upward compared to the previous IPoM, increasing from 4.1% to 4.5%. This adjustment of the projection of inflation is explained by a greater-than-expected persistence of high prices for food items and the depreciation of the Guarani currency, registered particularly at the beginning of the year, which caused the prices of imported products to rise. At the same time, greater uncertainty regarding potential new external shocks and eventual adjustments in domestic output costs increased the variability of inflation forecasts. Thus, in consideration of the most likely assumptions about the future behavior of both the internal and external macroeconomic variables, inflation is expected to continue its process of deceleration, albeit at a more moderate pace than foreseen. In addition, it is expected that inflation will converge towards the center of the 4% target range early in the upcoming year, remaining at that level until the end of 2024 (Table C).

Table A
Gross Domestic Product by sectors
Annual change, percent

	2022	2023(f)	2023(i)
Primary Sector	**-8,7**	**19,9**	**1,8**
Agriculture	-12,7	30,0	1,8
Livestock	-0,3	1,9	0,0
Secondary Sector	**0,4**	**2,2**	**0,7**
Manufacturing	0,1	2,0	0,4
Construction	-4,3	-2,6	-0,2
Electricity & water	6,8	7,9	0,5
Tertiary Sector	**1,6**	**3,3**	**1,6**
Public Administration	-0,5	3,7	0,3
Trade	3,4	3,2	0,4
Other Services[1]	1,6	3,2	0,9
Taxes	0,5	4,0	0,3
GDP at market prices	**0,1**	**4,5**	**4,5**
GDP w/o agriculture and binationals	**0,7**	**2,5**	

(f) Forecast, (i) Incidence.
Source: Central Bank of Paraguay.

Table B
Economic growth and current account
Annual change, percent

	2022	2023 (f)
GDP	**0,1**	**4,5**
Domestic demand	**2,5**	**-0,9**
Gross capital formation	**7,1**	**-12,6**
Gross fixed capital formation	-2,3	-2,5
Total consumption	**1,0**	**3,0**
Private consumption	2,2	3,2
Public consumption	-5,7	2,4
Exports of goods and services	**-1,6**	**18,3**
Imports of goods and services	**5,6**	**1,0**
Current account (% of GDP)	-6,6	0,2
GFKF (% of nominal GDP)	21,8	21,1

(f) Forecast
Source: Central Bank of Paraguay.

Table C: Inflation projection
Annual change, percent

	2022	2023(f)	2024(f)	2025(f)
December CPI inflation (*)	**8,1**	**4,5**	**4,0**	
CPI inflation in around two years (**)				4,0
December underlying CPI (*)	7,9	4,3	4,0	
Underlying CPI inflation in around 2 years (**)				4,0

(f) Forecast includes data as of March 2023.
(*) Corresponds to end-of-period inflation.
(**) Corresponds to the projected inflation for the first quarter of 2025
Source: Central Bank of Paraguay

[1] Transportation, financial intermediation, housing rentals, business services, hotels and restaurants, and domestic services are all included.

Risk Scenarios

At the international level, there is a complex scenario, and a panorama of uncertainty persists which could affect economic prospects and world inflation. The recent turbulences that have shaken the financial systems of some advanced economies – if persistent – might represent a risk for world financial conditions that could deteriorate global economic growth. Notwithstanding, this scenario would imply lesser pressures on inflation, which could condition the currently restrictive monetary policy stance of central banks. On the other hand, the reopening of the Chinese economy could generate a greater demand for commodities, which, in combination with supply restrictions stemming from an intensification of the ongoing war between Russia and Ukraine, could push upward the prices of raw materials. In this scenario, external inflation that is more persistent than expected could delay the convergence of domestic inflation to the target. In terms of growth, the uncertainty about global growth prospects could have a negative impact of the dynamics of economic activity due to less external demand. Nevertheless, this might be attenuated by greater revenues from commodities exports, due to higher commodity prices than those foreseen in the previous IPoM.

Regarding the region, a deceleration of growth is expected compared to last year. In addition, it is forecast that inflation will surpass the targets established by the central banks. Regional economic activity is projected to exhibit more moderate growth, due in part to tighter external financing conditions and less favorable exchange terms than those observed in recent years. As for inflation, while there has been a deceleration of inter-annual inflation in some countries of the region, it remains above the monetary policy targets. Consequently, regional central banks have announced that they will maintain a contractionary monetary policy stance until assured that the evolution of prices is consistent with achieving their respective inflation targets. In Brazil, at the end of the first quarter of the year, less pessimism has been observed in the consumers and business entrepreneurs' confidence indexes, even though the uncertainty stemming from the external context, the high costs of domestic financing, and the advance of the announced fiscal sector reforms persists. As regards Argentina, growth prospects have worsened while inflation continues to accelerate. Furthermore, uncertainty persists with respect to meeting the objectives agreed upon with the International Monetary Fund. Given this panorama, a smaller than expected growth rate of the main regional trade partners could weaken growth prospects for this year, due to less external demand.

At the local level, the main risks for economic activity derive from the evolution of the weather. In the last few months, the climate conditions have been favorable, benefiting soybean, corn, and wheat crops. However, the occurrence of the weather phenomenon "El Niño" is likely in the next few months, which would have implications on economic activity, especially in the construction and livestock production sectors. In addition, in recent months there have been administrative difficulties that could affect the transport of commercialized products, which would negatively impact the value of such goods. Finally, a greater volatility of inflation compared to pre-pandemic periods has been observed, which represents a risk factor for the trajectory of anticipated inflation.