MONETARY POLICY REPORT

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CENTRAL BANK OF PARAGUAY
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Executive Summary*

International and Regional Economy

The growth prospects for the world economy have improved for the year compared to those presented in the March 2023 Monetary Policy Report (IPoM). Inflation has moderated and a lower inflation rate is expected for the end of 2023. In the United States, the Eurozone, and China an improvement of the growth prospects is foreseen as compared to those pointed out in the previous report, due to the reduction of the financial risks caused by turbulences in the financial sector, the dynamism of the services sector, and swifter than expected recovery of demand in China. Since the previous report, the prices of agricultural commodities have shown mixed behaviors, while crude oil quotes have continued to decrease. Inflation in the leading advanced economies has continued to show signs of moderation, even though it stands above the respective inflation targets; the 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, excepting Argentina, have improved for 2023, with moderate prospects for 2024. Inflation has decelerated in most of the countries within the region. Notwithstanding, their core inflation measures remain at high levels, whereby the central banks have continued to maintain a contractionary monetary policy.

In the United States, while inflation has continued to decelerate, it remains above the medium-term target. The Federal Reserve (Fed) increased the target range of its referential rates at its May meeting, maintained the target range at its June meeting, and then increased the range again at its July meeting. Since the previous report, the inter-annual variation of the prices index registered lower rates, and in June inflation was 3.0% y-o-y, although it still stands above the 2% target. Thus, at its May meeting, the Fed increased the target range for federal funds rates, by 25 basis points (bps), to stand at 5.00%-5.25%. It maintained the same target range in June, and then increased the range again, in July, by 25 bps, to stand at 5.25%-5.50%, the maximum rate in the last twenty-two years. As regards economic activity, in the first quarter of 2023, GDP exhibited a quarterly annualized growth rate of 2.0%, surpassing the market's forecasts, mainly due to increases in consumer spending, exports, residential fixed investment, and public spending. The most recent data of the Manufacturing Purchasing Managers' Index (PMI) have shown that the sector remains in the contraction zone in the second quarter, standing at 46.3 in June. Notwithstanding, given the greater dynamism registered in the services sector, the growth prospects have been revised upwards for 2023, increasing from 0.9% to 1.3%.

In the Eurozone, the European Central Bank (ECB) continued increasing its referential interest rates at its July meeting, maintaining the magnitude of the 25-bps adjustment with respect to the previous meeting. Total inflation decelerated in the second quarter of 2023, showing lower rates compared to the average in the first quarter of the year. However,

*The Spanish version prevails

inflation remains above the target value, standing at 5.5% inter-annually in June, while the core inflation measure (which excludes food items and energy) has remained persistent. As regards economic activity, in the first quarter of 2023, GDP expanded by 1.0% inter-annually, driven mainly by the positive contributions of net exports and, to a lesser extent, expenditures for final consumption by households and gross fixed capital formation. On the other hand, the manufacturing PMI remained in the contraction zone during the second quarter, standing at a level of 43.6 in June. However, given the recent favorable performance of the services sector, the GDP growth prospects for 2023 have been revised slightly upward, going from 0.5% in the previous IPoM to an expansion of 0.6%, in this report.

In China, an improvement of the growth prospects for 2023 has been observed, boosted by the services sector after the end of the restrictive measures imposed in the framework of the COVID-19 pandemic. China's GDP grew 4.5% inter-annually by the close of the first quarter of 2023, surpassing the market's estimates (4.0% y-o-y), and above the rate registered in the fourth quarter of 2022 (2.9% y-o-y). This economic behavior is due to the strengthening of the services sector, favored by the finalization of the zero COVID tolerance policy. In June 2023, the manufacturing PMI stood in the expansion zone (50.5), although below the figure observed in May (50.9). Notwithstanding, growth prospects for the Chinese economy have been revised upward to 5.5%, standing 0.2 percentage points above the figure reported in the previous IPoM.

In Brazil, the growth forecasts for 2023 have been adjusted upward, while inflation has continued to decelerate. In the first quarter of 2023, there was a 1.9% expansion of GDP compared to the previous quarter, explained by the positive incidence of household consumption and government spending. In the second quarter, the deterioration observed in the manufacturing sector's PMI stands out; the index stood in the contraction zone (46.6) due to drops in new orders and foreign sales, caused by the more restrictive domestic demand conditions and less dynamism in the international trade of goods. Notwithstanding, the growth estimates for 2023 were revised upward (from 0.9% to 2.1%), explained mainly by a positive performance of the primary and tertiary sectors. On the other hand, inter-annual inflation has decelerated significantly, largely due to the reduction of prices in the transportation category, standing at 3.2% in June (4.7% in March). However, the core inflation measure, which excludes food items and energy, continues above total inflation, standing at 6.9% inter-annually in June (8.6% in March). In line with the registered persistence of inflation since the last report, the Central Bank of Brazil's Monetary Policy Committee (Copom) has continued to maintain 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. GDP grew 1.3% inter-annually, in the first quarter of 2023, although it fell below the expected level, driven largely by the manufacturing industry and the mining sector, despite the unfavorable performance of the agricultural and livestock sectors which contracted for the second consecutive quarter. In the second quarter of this year, the short-term economic activity and manufacturing output indicators registered mixed behaviors. However, it is expected that the past drought's transitory impact on GDP will be concentrated in this quarter, although it is expected that economic activity in the non-farming sectors, as a whole, will continue to increase. For the third quarter, a rebound in agricultural and livestock activity is foreseen, due to the double effect of a boost in agricultural output accounting and a reversal of adverse weather conditions, thus assuring favorable moistness of soil at the beginning of the sowing season, in light of the upcoming agricultural campaign. For 2023, given the context of high uncertainty about the domestic political scenario and the persistent situation of macroeconomic instability, the GDP growth forecast was adjusted downwards by 1.8 p.p., compared with the previous estimate, to stand at -2.2% annually. Regarding price levels, inter-annual inflation has continued to accelerate, standing at 115.6% in June (104.3% y-o-y in March). Thus, the Central Bank of the Argentine Republic (BCRA) has continued the cycle of increases of the referential LELIQ interest rate, to stand at 97.0% annually.

Domestic Situation and Monetary Policy

Since the last IPoM, total inflation and the different trend measures have followed a downward trajectory in both inter-annual and monthly terms. Average inter-annual inflation in the second quarter of 2023 was 4.9%, below the level observed in the first quarter (7.0%). In monthly terms, average inflation in the same period showed a decrease, dropping from 0.7% to 0.0%. This reduction was explained mainly by the price decreases registered within the transportation category, specifically fuel prices. To a lesser extent, the falls in the prices of certain food items also had an incidence. In a similar manner, the inflation trend indicators (underlying, underlying X1, and core inflation) showed lower inter-annual rates in the second quarter (5.1%, 6.3%, and 5.1%, respectively) as compared to the first quarter of 2023 (7.6%, 7.1%, and 6.1%, respectively). In addition, less diffusion of inflation was registered in the second quarter of the year, as compared to the previous quarter.

In the first quarter of 2023, GDP registered a growth rate of 5.2% inter-annually, in line with the projections for the end of the year. On the side of supply, the result was explained by the favorable performance of both agriculture and the generation of electric power, and to a lesser extent, the positive results of livestock production and the services sector. This inter-annual increase was attenuated by the falls registered in the construction and manufacturing sectors. On the expenditures side, GDP expansion was explained by the positive incidence of external demand due to the favorable dynamics of exports, while domestic demand registered a negative incidence, explained by the reduction in gross capital formation.

During the second quarter of 2023, the Monetary Policy Committee (CPM) decided to maintain the MPR at 8.50% annually. The Committee has decided to maintain the reference rate at the same level considering that, even though inflation has continued to decelerate, the convergence of inflation to the target over the monetary policy horizon remains subject to potential risks that could stem from a scenario of high uncertainty, particularly at the international level. As regards the recent evolution of external prices, the inter-annual inflation rates in the United States and the Eurozone have continued to moderate, although the annualized monthly inflation trend measures have continued to show results that are above the central banks' inflation targets. Given this scenario, it continues to be expected that external inflation will remain at high levels in 2023, whereby 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. At the local level, total inflation has been showing a downward inter-annual trajectory since the last report, standing within the target range since April 2023 and close to the center of the range since the June measurement. Furthermore, since the March 2023 IPoM, median inflation expectations for 2024 and over the monetary policy horizon have remained at the 4% target.

Baseline Scenario Projections

In the baseline scenario, the GDP growth forecast for 2023 remained at 4.5%, albeit with some recomposition. On the side of supply, changes in some economic sectors were registered as compared to the previous report, while on the side of expenditures a greater positive incidence of external demand is anticipated. As mentioned in the previous report, projected GDP growth in 2023 continues to be largely explained by the recovery of agriculture and its related sub-sectors as well as greater generation of electric energy at the bi-national hydroelectric entities. Likewise, favorable dynamism is expected in the tertiary sector, particularly business services, restaurants, and hotels. While the baseline scenario envisions GDP growth for 2023 to stand at 4.5%, the same estimate published in the March IPoM, some changes have been registered in the projections for certain sectors (Table A). Greater than anticipated electrical power output has been observed, compared to the previous revision, thus allowing for an upward revision of the projection for the electricity & water sector, increasing from 7.9% to 10.3%. Regarding the construction sector, a downward revision was registered (decreasing from -2.6% to -4.0%) due to a slower pace in the execution of both public and private sector works, as compared to the expectation recorded in the previous IPoM. In the primary sector, agricultural growth remained with no changes (30%) while livestock production was revised downward, decreasing from 1.9% to 0.9%, based on a lower-than-expected cattle slaughter rate, compared to the previous IPoM. The lower than anticipated production of beef explains, in turn, the slight downward adjustment for the manufacturing industry (decreasing from 2.0% to 1.7%). As regards the tertiary sector, it is expected that trade will show slightly less expansion, decreasing from 3.2% to 2.9%, explained by the smaller commercial margins for manufacturing endeavors. Growth for other services maintains the 3.2% projection published in the previous report. From the GDP perspective on the side of expenditures, greater dynamism of net external demand is foreseen, driven mainly by an upward revision in the export of goods and services, increasing from 18.3% to 19.1% (Table B). This adjustment is explained by the projected greater export value of soybeans, assembly & transformative services (maquila), and transportation (international freight services offered by Paraguayan residents). Imports were also adjusted upward, increasing from 1.0% to 1.5%, in line with recent data that show the greater than anticipated import of agricultural machinery and equipment, as compared to the previous revision. As regards domestic demand, a greater contraction of gross fixed capital formation is expected, with a downward adjustment (decreasing from -2.5% to -3.0%), due to the greater than expected fall in the projection for the construction sector, although attenuated by the upward correction of the projection for machinery and equipment imports. As regards public and private consumption, growth rates of 3.2% and 2.4%, respectively, are anticipated, as forecasted in the previous IPoM.

The inflation projection for the end of 2023 was adjusted from 4.5% to 4.1%, while for 2024 and over the monetary policy horizon the forecasts remain at 4%. This downward adjustment of the projection for inflation was due mainly to a greater-than-expected deceleration of inflation during the second quarter, thus diminishing the starting point for the medium-term projections. The greater than expected moderation of domestic prices is explained by the decrease of the international quotes of the principal commodities, both the agricultural ones and petroleum, which mitigated the pressures for higher prices for food items and fuels. It must be noted that fuel prices registered negative variations in the last few months. Furthermore, the greater stability of the nominal exchange rate as compared to the previous quarter allowed for less pressure on the prices of imported products. In this sense, in consideration of the most likely assumptions about the future behavior of both the internal and external macroeconomic variables, inter-annual inflation is expected to continue its process of deceleration and to converge towards the center of the 4% target range in the upcoming months, remaining at that level until the end of 2024 and over the monetary policy horizon (Table C).

While certain latent risks continue, mainly in the international scenario, these risks have recently been mitigated at the margin as compared to the previous IPoM. It is important to highlight that a monetary policy rate with a restrictive stance has been maintained during several quarters. This monetary policy strategy has contributed to the deceleration of inflation, standing close to the center of the target range in June. In line with this recent behavior, the inflation projection has been revised downward for 2023. Although potential risks persist, particularly risks in the international sphere, which could affect convergence to the target, these risks have been mitigated at the margin. In this context, the Monetary Policy Committee (CPM) will continue to closely monitor the local and international environment and its implications on inflation prospects, to implement the most appropriate measures for assuring the anchoring of expectations and compliance with the 4% target over the monetary policy horizon.

Table A. Gross Domestic Product Growth by sectors. Annual change, percent.

	2022	2023(f)	2023(i)
Primary Sector	**-8,7**	**19,7**	**1,8**
Agriculture	-12,7	30,0	1,8
Livestock	-0,3	0,9	0,0
Secondary Sector	**0,4**	**2,2**	**0,8**
Manufacturing	0,1	1,7	0,3
Construction	-4,3	-4,0	-0,3
Electricity & water	6,8	10,3	0,7
Tertiary Sector	**1,6**	**3,2**	**1,6**
General government	-0,5	3,7	0,3
Trade	3,4	2,9	0,3
Other Services	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**	**2,3**	

(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**	**-1,0**
Gross capital formation	**7,1**	**-13,0**
Gross fixed capital formation	-2,3	-3,0
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**	**19,1**
Imports of goods and services	**5,6**	**1,5**
Current account (% of GDP)	-6,6	0,4
GFKF (% of nominal GDP)	21,8	20,9

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

Table C. Inflation projection. Annual change, percent.

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

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

Risk Scenarios

At the international level, the uncertainty about the economic prospects, world inflation, and international conflicts persists. The improvement of the growth prospects for 2023 as compared to the previous IPoM would imply an improvement of external demand. However, a much more restrictive monetary policy stance by the central banks of the main advanced economies, due to more persistent than expected inflation, would imply more restrictive international financial conditions for a longer period, which could affect growth expectations. Higher interest rates might also have a negative impact on capital flow to the emerging economies, depreciation of their respective currencies, and pressures on the fiscal accounts, especially of those countries with high levels of indebtedness expressed in foreign currency. The continuation of the armed conflict between Russia and the Ukraine generates uncertainty regarding the prices of some commodities. One recent event is the suspension of the agreement for the export of grain through the Black Sea, which could push up food prices. On the other hand, this situation might imply an improvement in the exchange relations of the countries that export agricultural commodities. In addition, the OPEC Plus agreement to reduce the production of petroleum and the reduction of the crude oil inventory in the United States might continue to exert pressure on the price of fuels.

As regards the region, uncertainty about the starting of monetary policy rate cuts has increased, while growth has remained moderate as compared to 2022. In Brazil, while total inflation has decreased, the Central Bank of Brazil has stated that inflation projections remain above the target, whereby the beginning of the process of lowering the Selic monetary policy rate might be postponed. As regards Argentina, the measures to contain the pressures on the exchange market and expectations about the results of the Presidential elections condition the trajectory of the main macroeconomic variables, which could impact the exchange gap between the official dollar rate and the parallel dollar. In this respect, a greater than expected moderation of the growth rate of Paraguay’s main regional trade partners could weaken economic growth for this year, due to less external demand.

At the local level, the weather factor continues to be one of the main risks for economic activity. The probability of the occurrence of the climatic phenomenon “El Niño” will continue in the next few months, which would have negative implications on economic activity, especially in the construction and livestock production sectors. On the other hand, although total inflation is decreasing, underlying X1 inflation (which excludes fruit, vegetables, tariffed public utility services, and fuels) still stands above the target range (inter-annual average of 6.3%). Regarding this, the food items index (excluding fruit and vegetables) shows high rates, in inter-annual terms, due to the observed increases in the prices of most of the food categories included in the consumer basket.