6 Central Bank eases stance of monetary policy and for the rest of the year we anticipate a pause

The Board of the Central Bank of Paraguay (BCP) decided in May to reduce the interest rate of monetary policy by 25 basis points (bps), to 5.75%, which took the market by surprise (see Figure 6.1). The statement accompanying the decision shows that the main reason for doing so was an improvement in the inflation outlook and the slowdown in certain sectors of the economy. In this context, the BCP was considering the timely adoption of a more accommodative monetary policy profile.

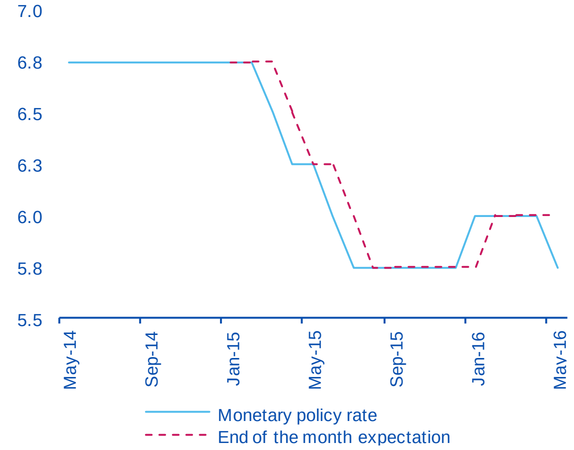
Why were we surprised by this decision? Two elements suggested the need for additional demand stimulus and that there was room on the price side to do so. In March economic activity, measured by the IMAEP, contracted by -0.2%. The set of sectors that responds to supply items such as power generation (bi-national) and agriculture continued to show positive results. Nevertheless, the IMAEP, which excludes agriculture and bi-nationals and better reflects the behaviour of the activities most closely linked to domestic demand, such as trade and industry, fell by -1.9%. Thus, as mentioned previously, in the first three months the expansion of activity was only 1.3%. However, it was joined by a more favourable inflationary panorama, linked to the fall in prices of domestic transport services as a result of lower fuel costs and lower upward pressures on the exchange rate. This context, however, did not appear very different from that faced by the BCP in previous months (the IMAEP without agriculture or bi-nationals has been relatively stagnant since July 2015), opportunities in which however it did not lower the rate.

What is prompting the BCP to opt for cuts? In our opinion, the BCP on balance is showing greater concern about the deterioration of economic activity. As explicitly stated in the release, the entity estimates that inflation would continue to slow in the margins in the coming months and ‘economic activity continues at a moderate pace of expansion’.

What can we expect going forward? Our central scenario assumes that activity will begin a process of recovery from the second quarter, which together with the increased valuation of local performance by the BCP, reinforces the monetary pause. In addition, recently the probability has increased of a scenario in which the FED adjusts its rates somewhat. This scenario would result in episodes of exchange rate volatility, lower prices of raw materials, and would have an impact on the risk appetite of investors. This context reduces the window of opportunity for the BCP to reduce its benchmark rate again. Finally, while we estimate that in the coming months there will be a reduction in inflation in year-on-year terms, during the latter part of the year inflation will record an upward trend. In this way, we maintain the view that in the remainder of 2016 there will be no change in the benchmark interest rate (see Figure 6.2).

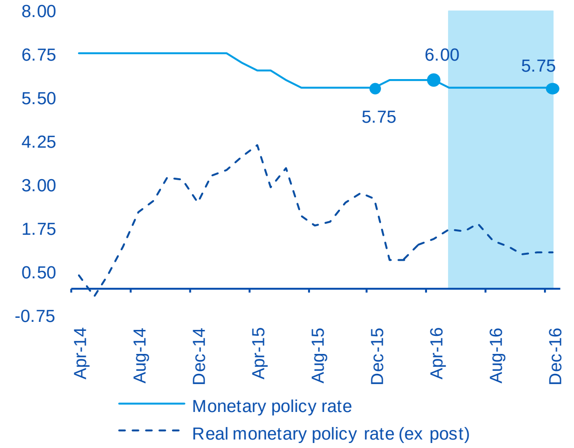
For 2017, our forecast is that the Central Bank will apply an increase of 25bps and the rate would end the year at 6%. This assumes that the expectations will remain anchored at 4.5%, despite the prospect of adjusting to the Fed rate and its effect on the exchange rate remaining controlled. Going forward, we expect a gradual increase in the monetary policy rate, in line with more growth potential.

Figure 6.1
Policy Monetary Rate and expectations
(%)



Source: BCP and BBVA Research

Figure 6.2
Policy Monetary Rate
(%)



*Inventories not included. Source: BCP and BBVA Research

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This report has been produced by the Peru Unit:

Chief Economist for Peru
Hugo Perea
hperea@bbva.com
+51 1 2112042

Francisco Grippa
fgrippa@bbva.com

Yalina Crispin
Yalina.crispin@bbva.com

Vanessa Belapatiño
Vanessa.belapatino@bbva.com

Ismael Mendoza
Ismael.mendoza@bbva.com

Marlon Broncano
Marlon.broncano@bbva.com

BBVA Research

Group Chief Economist
Jorge Sicilia Serrano

Developed Economies Area
Rafael Doménech
r.domenech@bbva.com

Spain
Miguel Cardoso
miguel.cardoso@bbva.com

Europe
Miguel Jiménez
mjimenezg@bbva.com

US
Nathaniel Karp
Nathaniel.Karp@bbva.com

Emerging Markets Area

Cross-Country Emerging Markets Analysis
Alvaro Ortiz
alvaro.ortiz@bbva.com

Asia
Le Xia
le.xia@bbva.com

Mexico
Carlos Serrano
carlos.serranoh@bbva.com

Turkey
Alvaro Ortiz
alvaro.ortiz@bbva.com

LATAM Coordination
Juan Manuel Ruiz
juan.ruiz@bbva.com

Argentina
Gloria Sorensen
gsorensen@bbva.com

Chile
Jorge Selaive
jselaive@bbva.com

Colombia
Juana Téllez
juana.tellez@bbva.com

Peru
Hugo Perea
hperea@bbva.com

Venezuela
Julio Pineda
juliocesar.pineda@bbva.com

Financial Systems and Regulation Area
Santiago Fernández de Lis
sfernandezdelis@bbva.com

Financial Systems
Ana Rubio
arubiog@bbva.com

Financial Inclusion
David Tuesta
david.tuesta@bbva.com

Regulation and Public Policy
María Abascal
maria.abascal@bbva.com

Digital Regulation
Álvaro Martín
alvaro.martin@bbva.com

Global Areas

Economic Scenarios
Julián Cubero
juan.cubero@bbva.com

Financial Scenarios
Sonsoles Castillo
s.castillo@bbva.com

Innovation & Processes
Oscar de las Peñas
oscar.delaspenas@bbva.com

Contact details:

BBVA Research
Azul Street, 4
La Vela Building - 4 and 5 floor
28050 Madrid (Spain)
Tel.: +34 91 374 60 00 and +34 91 537 70 00
Fax: +34 91 374 30 25
bbvaresearch@bbva.com
www.bbvaresearch.com