

Monetary policy response to COVID-19 and challenges ahead

Adrian Armas*

Central Reserve Bank of Peru

September 2021

* The opinions expressed are those of the author and should not be attributed to the BCRP.



BANCO CENTRAL DE RESERVA DEL PERÚ

Content

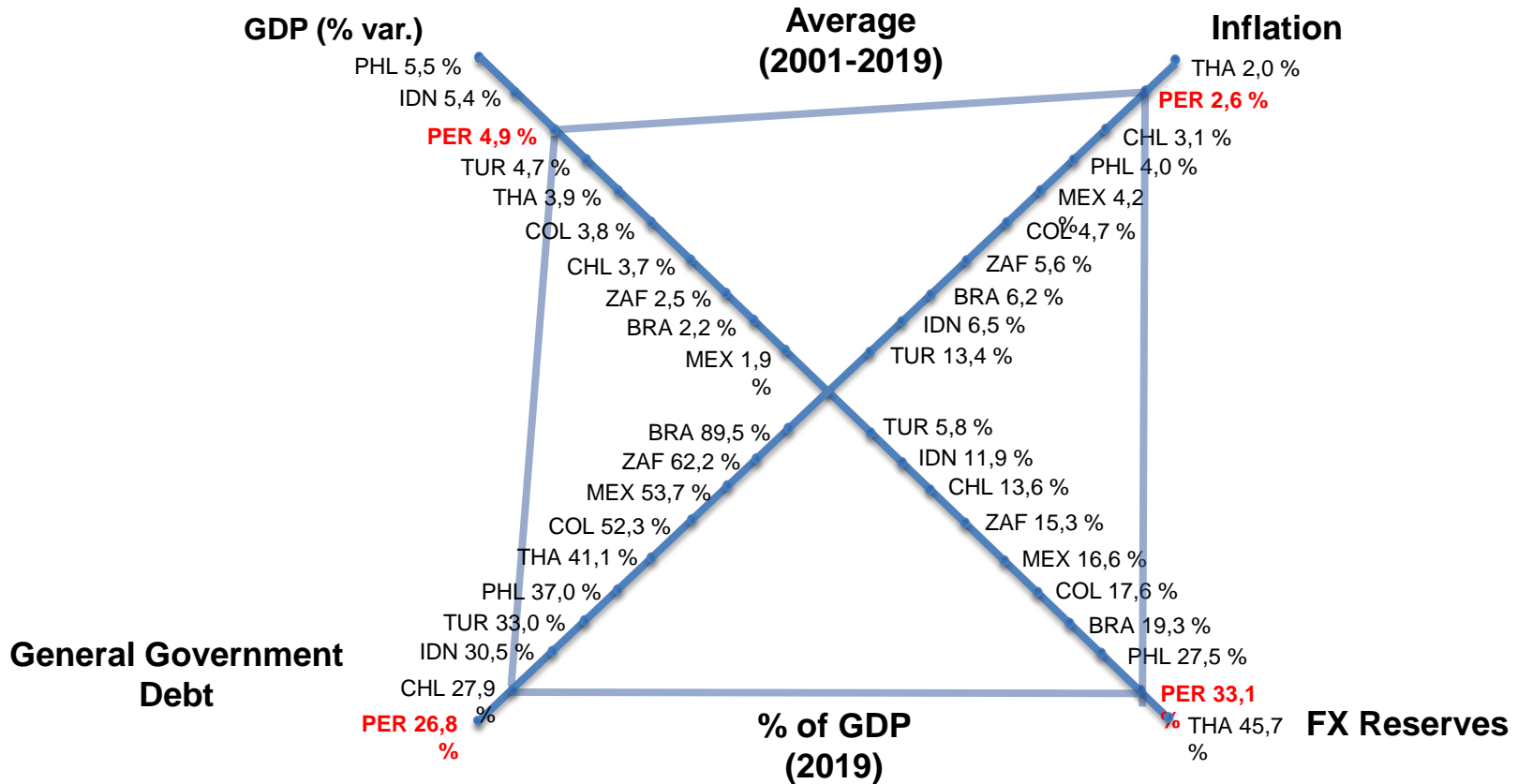
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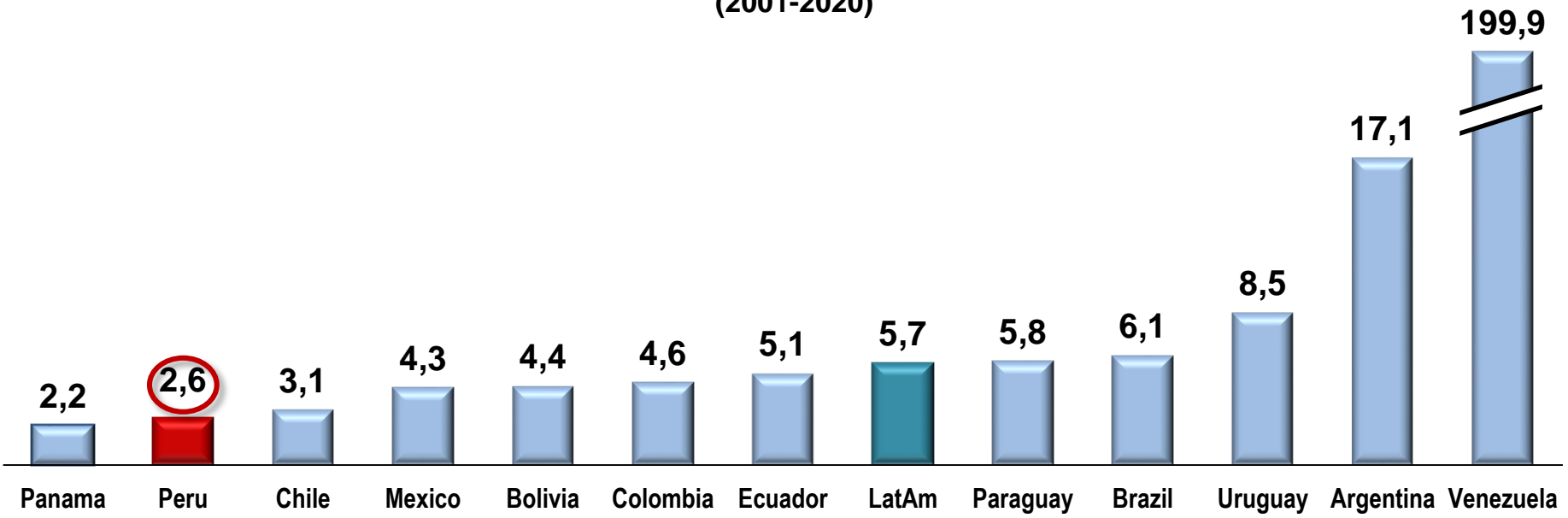
Peru's fundamentals were strong at the outset of the COVID-19 crisis.



Source: Trading Economics, IMF and BCRP.

Peru's adoption of an inflation targeting (IT) scheme resulted in one of the lowest and less volatile inflation rates in LatAm.

**Average Annual Inflation Rate
(2001-2020)**



Standard Deviation

2.5	1.2	1.7	1.0	3.1	1.8	8.2	1.3	3.4	2.7	3.2	14.7	15 011
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Note: Calculated with annual average CPI.
Source: IMF (World Economic Outlook Database, April 2021).

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**Peru's Macroeconomic
Background**

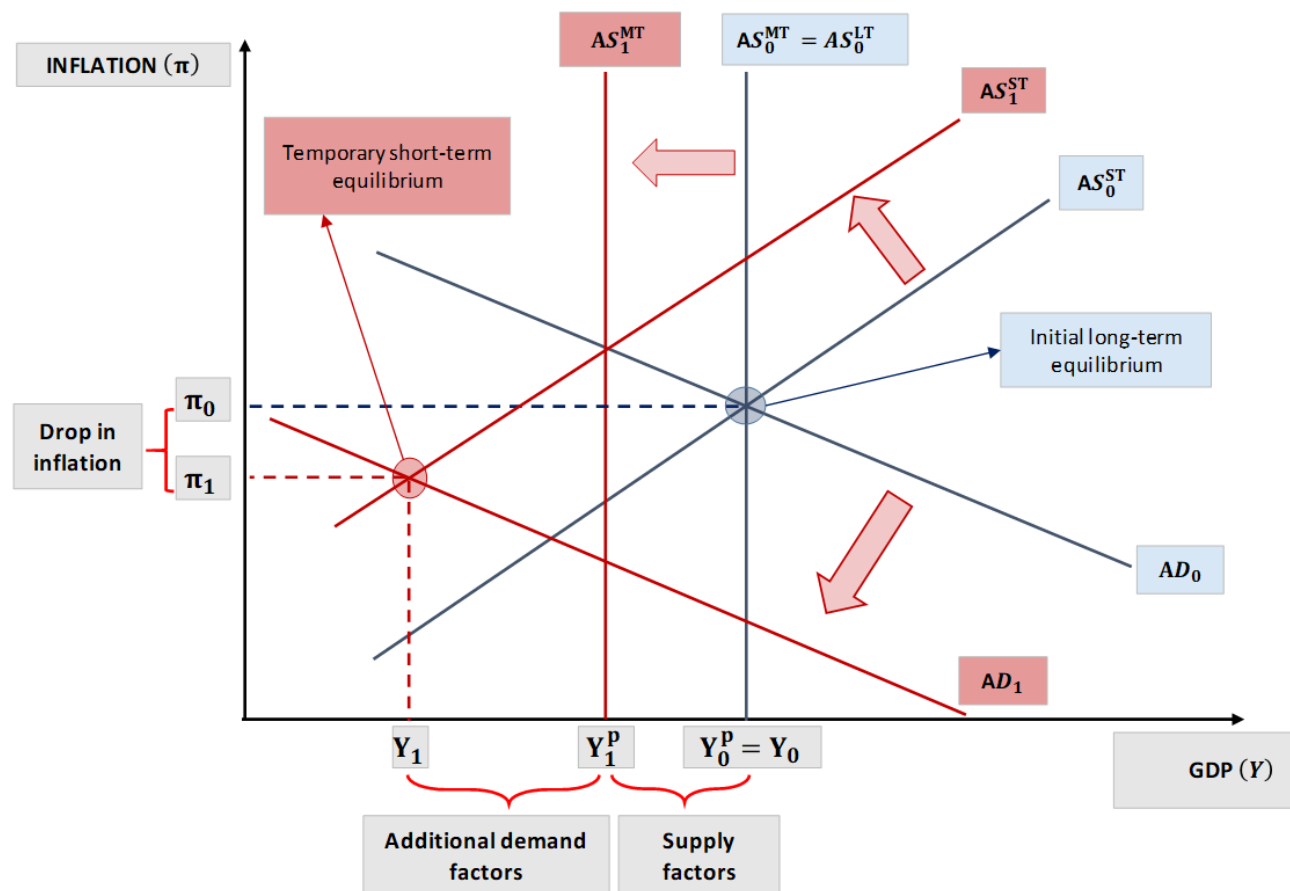
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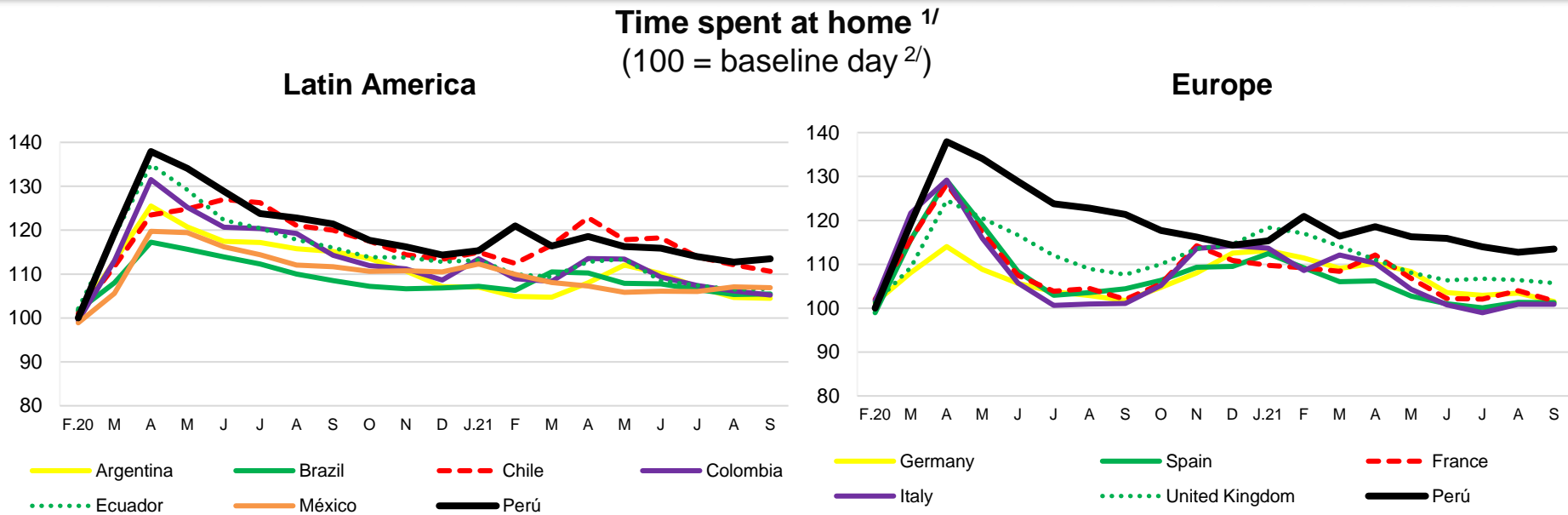
Challenges ahead

Aggregate Supply (AS) - Aggregate Demand (AD) in the context of the COVID-19 pandemic

- Economic activity drops due to supply-side factors (represented by a displacement of the short- and medium-term AS curves).
- AS contraction in turn leads to DA contraction, which further reduces economic activity.
- On the other hand, the net effect of these supply- and demand-side factors is lower inflation in the new short-term transitory equilibrium.



Peru's quarantine restrictions imposed in 2020 were among the strictest worldwide.



	Argentina	Brazil	Chile	Colombia	Ecuador	Mexico	Peru	Germany	Spain	France	Italy	UK
Index (100=baseline day)												
Mar.-Jun.20	119	114	122	123	126	115	130	109	118	117	118	118
Jul.	117	112	126	120	120	114	124	104	103	104	101	112
Aug.	116	110	121	119	118	112	123	103	104	104	101	109
Sep.	115	109	120	114	116	112	121	102	104	102	101	108
Dec.	107	107	113	109	113	110	114	113	110	111	114	115
Sep.21	105	106	111	105	107	107	114	102	101	102	101	106

1/ Time spent in residential areas. Last information available: September 8th.

2/ The baseline day is the median value from the 5-week period Jan 3–Feb 6, 2020.

Source: Google Mobility Report

Peru's GDP fall in the second quarter of 2020 was one of the most severe worldwide. However, one year later economic activity is close to pre-crisis levels.

Real GDP*

	2020				2021			
	YoY %				YoY %		YoY % respect to 2019	
	1Q	2Q	3Q	4Q	1Q	2Q	1Q	2Q
Germany	-1,9	-11,3	-3,7	-2,9	-3,1	9,4	-4,9	-3,0
France	-5,4	-18,6	-3,6	-4,3	1,5	18,7	-4,0	-3,4
Italy	-5,8	-18,2	-5,2	-6,5	-0,7	17,3	-6,5	-4,0
Spain	-4,3	-21,6	-8,6	-8,9	-4,2	19,8	-8,3	-6,1
Holland	-0,2	-9,2	-2,6	-2,9	-2,4	9,7	-2,6	-0,4
UK	-2,2	-21,4	-8,5	-7,3	-6,1	22,2	-8,2	-4,0
United States	0,6	-9,1	-2,9	-2,3	0,5	12,2	1,1	2,0
Argentina**	-5,2	-19,0	-10,1	-4,3	2,5	18,9	-2,8	-3,7
Brazil	-0,3	-10,9	-3,9	-1,1	1,0	12,4	0,7	0,1
Chile	0,2	-14,2	-9,0	0,0	0,5	18,1	0,7	1,3
Colombia	0,7	-15,8	-8,5	-3,6	1,1	17,6	1,8	-1,0
Mexico	-1,3	-18,7	-8,7	-4,5	-3,6	19,6	-4,9	-2,8
Perú	-3,9	-29,9	-8,8	-1,4	4,5	41,9	0,4	-0,6

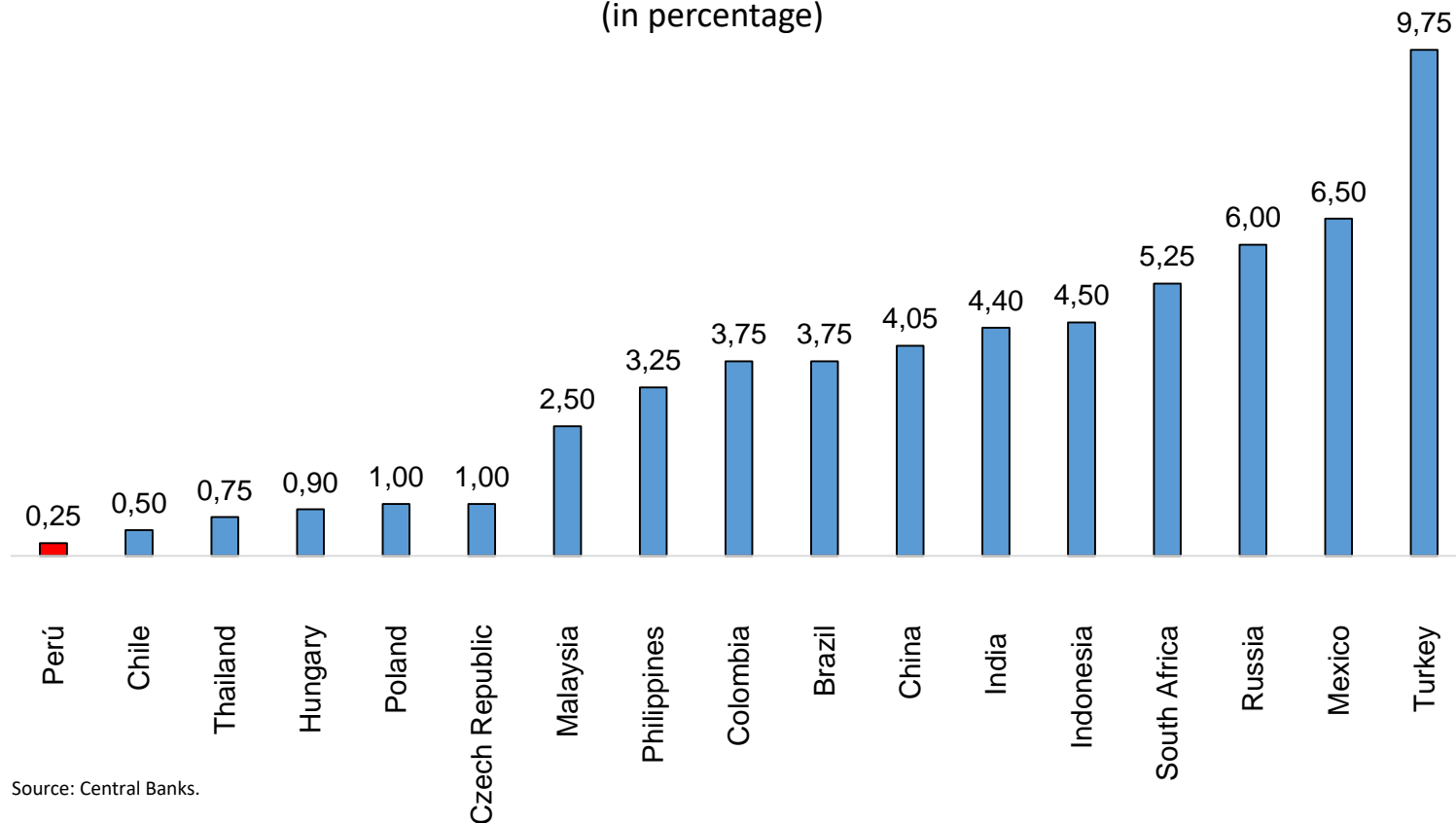
* Q: Quarter

** Annual percentage changes for the first quarter of 2021 were estimated using monthly series as of March 2021.

Source: Statistics agencies and central banks.

Between March and April 2020, the BCRP reduced its monetary policy rate by 200 basis points, to a historic low (0.25 percent, the lowest among emerging economies).

Monetary Policy Interest Rates in Emerging Economies : April 2020
(in percentage)

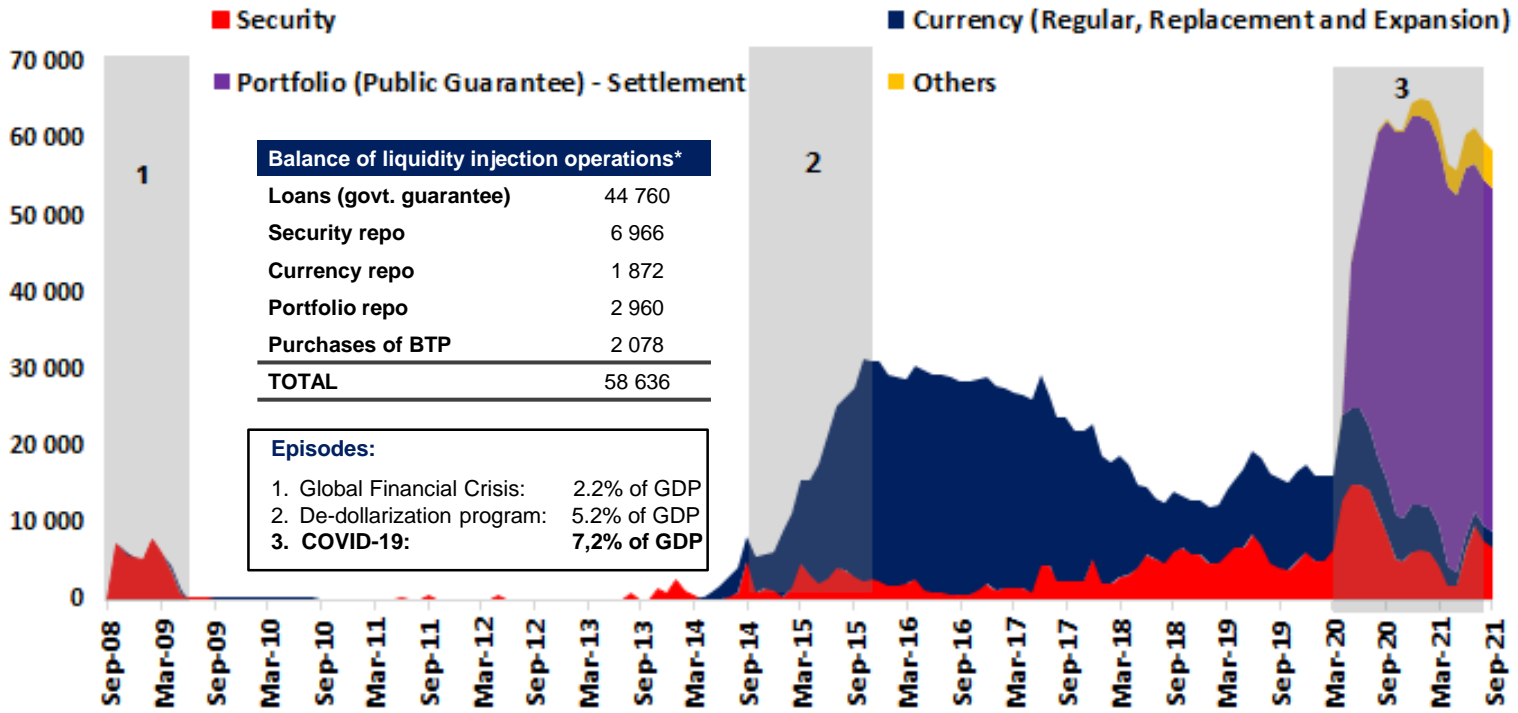


Source: Central Banks.

The BCRP conducted large liquidity operations using a range of monetary instruments, including repos under the Government Loan Guarantee Program. The balance of liquidity operations is 7.4 and 1.8 times that under the 2008 crisis and the de-dollarization program, respectively.

BALANCE OF BCRP LIQUIDITY INJECTION OPERATIONS

(Million of soles)



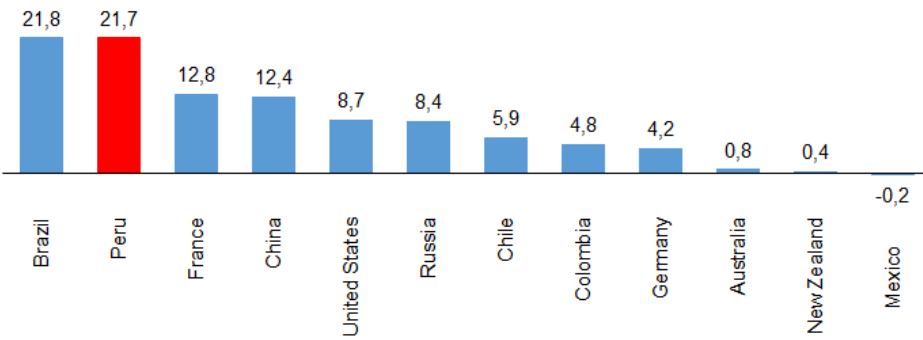
*As of September 10, 2021.

The item "Others" includes the purchases of BTPs (article 61 of the BCRP Organic Law) and credit portfolio reporting operations.

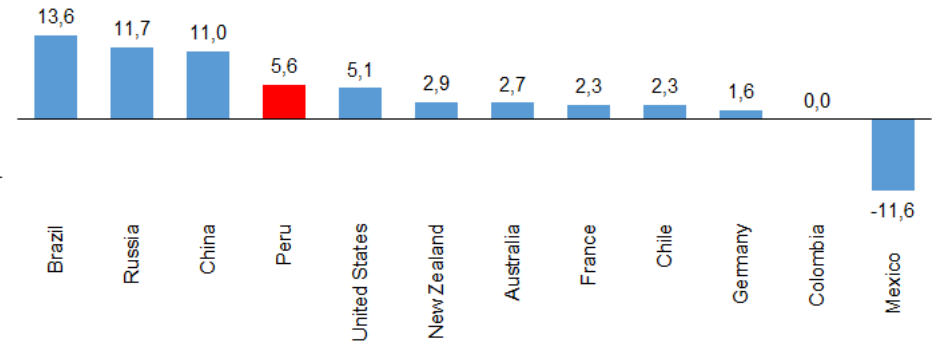
Source: BCRP.

Credit to the private sector grew counter-cyclically at one of the fastest rates worldwide.

Business Credit: As of December 2020
(yoy% change)



Business Credit: As of July 2021
(yoy% change)



Source: Central Banks

Source: Central Banks

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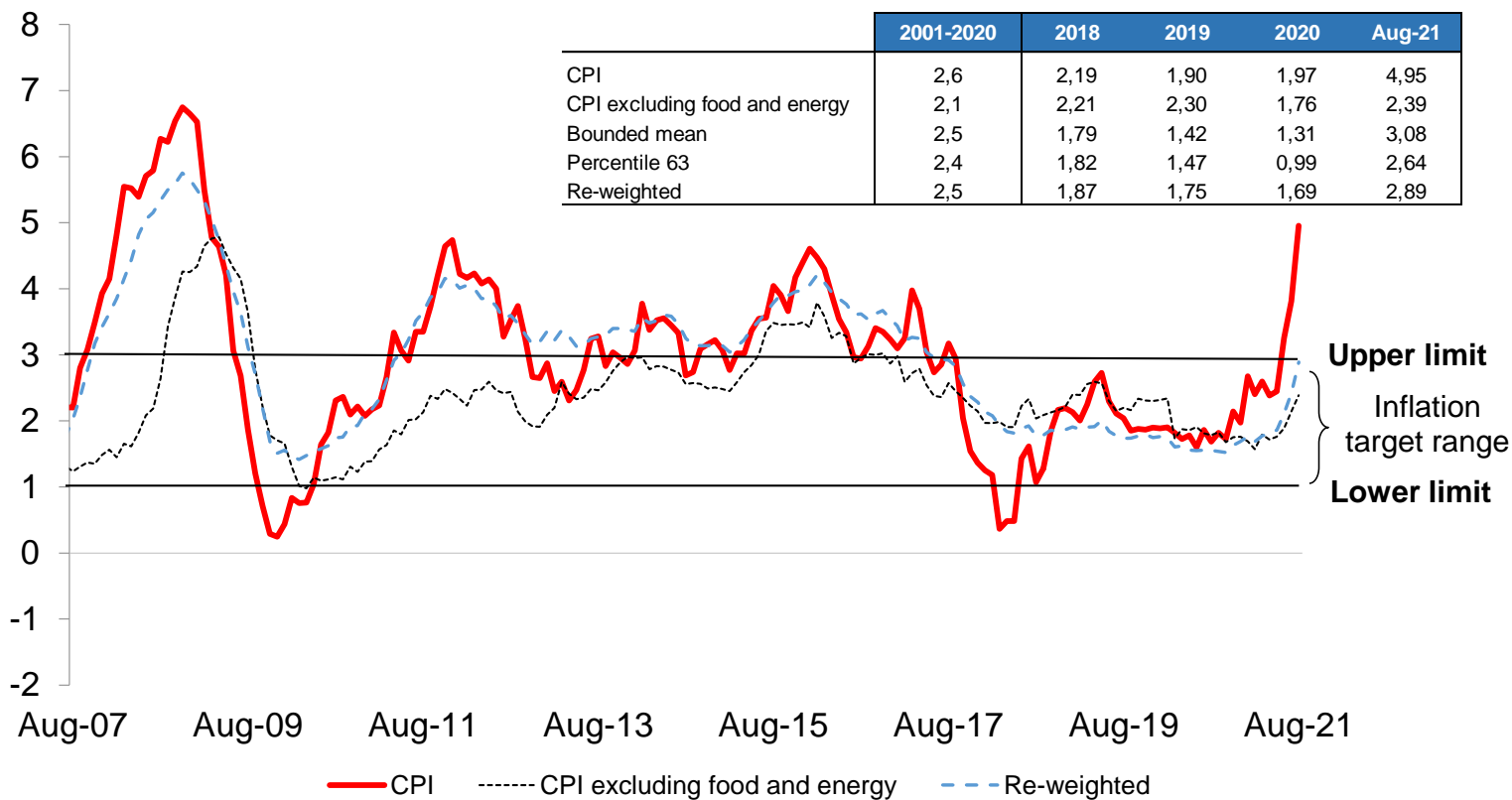
Monetary Policy Response to COVID-19

BCRP's response under the current evolving conditions

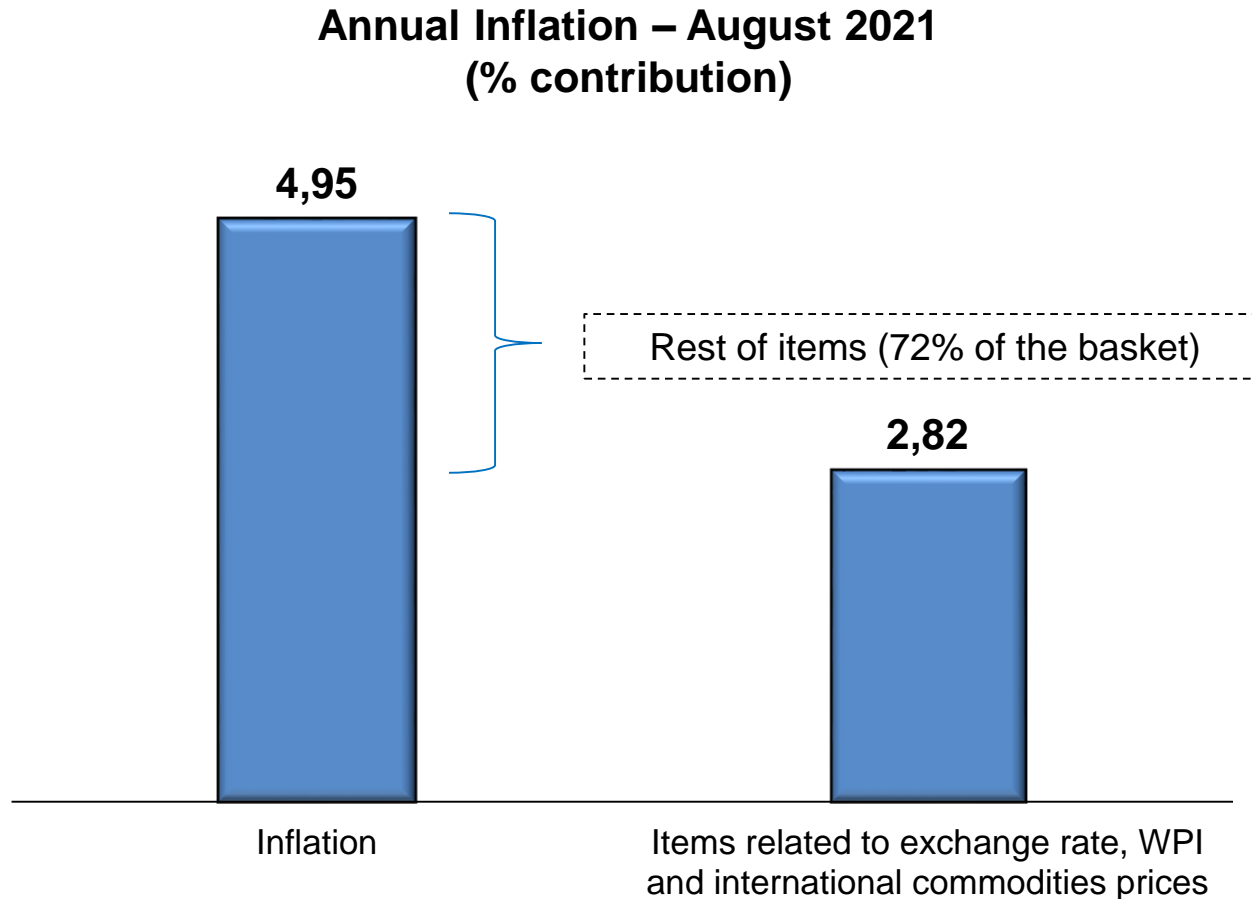
Challenges ahead

Inflation stood at 4.95% in August, the highest since February 2009 (and temporarily above the inflation target range), due to a surge in international food and fuel prices and exchange rate depreciation. All inflation indicators remained within the target range during the COVID-19 crisis.

CPI and Trend inflation indicators (Last 12 months % change)



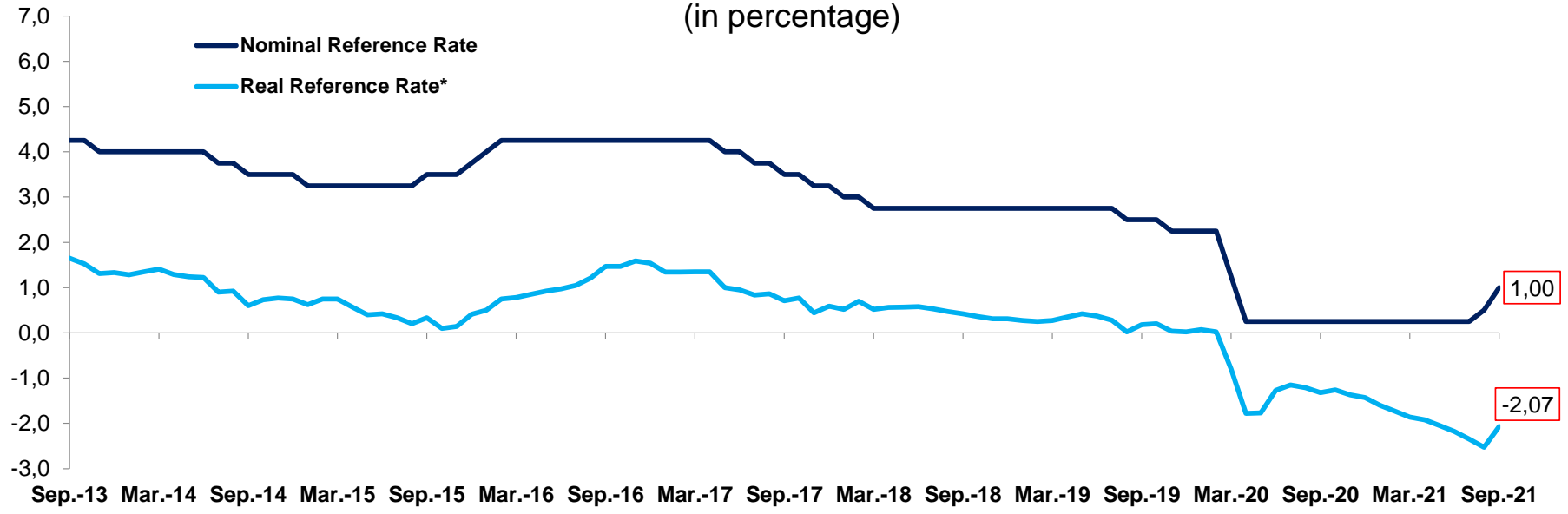
Exchange rate depreciation has affected the cost of imported supplies in local currency. Items in the basket of goods related to the exchange rate and international commodity prices, as well as contracts tied to the Wholesale Price Index (WPI), contributed 2.8 percentage points to annual inflation in August 2021.



Source: BCRP.

The BCRP began to withdraw monetary stimulus by increasing the policy rate from 0.25 to 1 percent in September. Monetary policy continues to be expansionary, with a historically low benchmark interest rate.

Reference Interest Rate (in percentage)



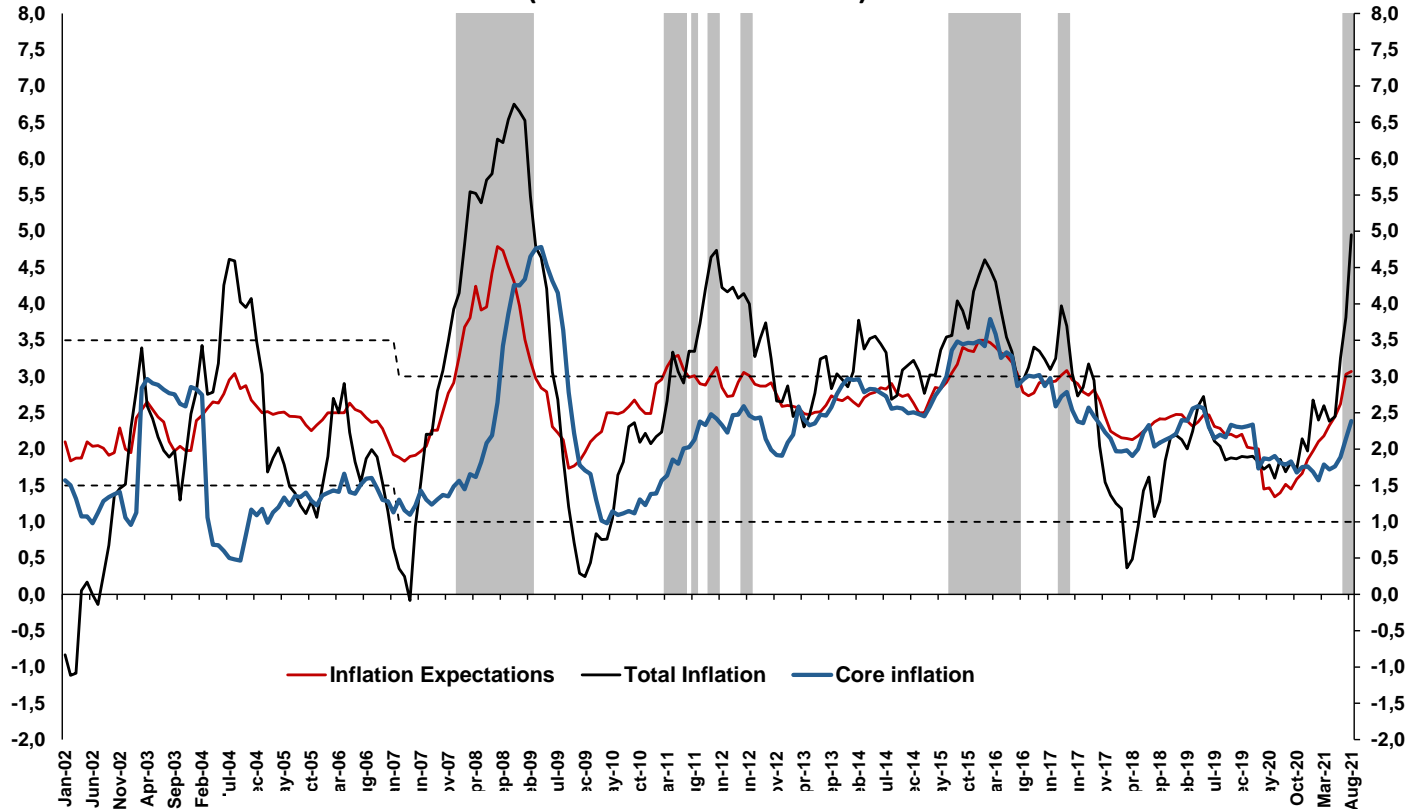
* With inflation expectations.

	May. 20	Jun. 20	Jul. 20	Aug. 20	Set.20	Oct.20	Nov. 20	Dec. 20	Jan. 21	Feb. 21	Mar. 21	Apr. 21	May. 21	Jun. 21	Jul. 21	Aug. 21	Sep. 21
(I) Nominal Rate	0,25	0,25	0,25	0,25	0,25	0,25	0,25	0,25	0,25	0,25	0,25	0,25	0,25	0,25	0,25	0,50	1,00
(II) Inflation Expectations	2,02	1,52	1,40	1,46	1,57	1,51	1,62	1,68	1,85	1,98	2,11	2,17	2,30	2,43	2,60	3,03	3,07
(III) Real Rate: (I)-(II)	-1,77	-1,27	-1,15	-1,21	-1,32	-1,26	-1,37	-1,43	-1,60	-1,73	-1,86	-1,92	-2,05	-2,18	-2,35	-2,53	-2,07

Source: BCRP.

In the past, episodes of inflation spike infected inflation expectations and rose above the target range for about one year.

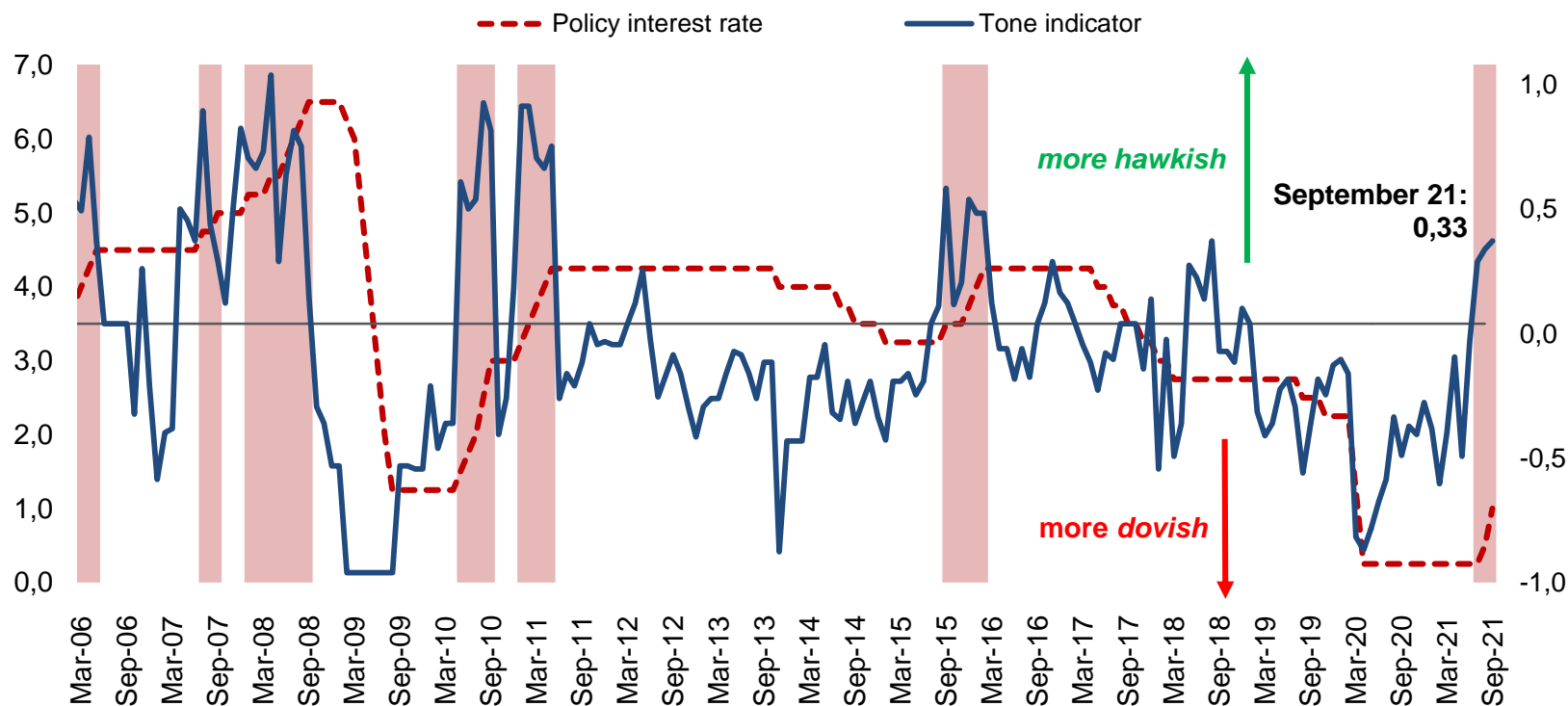
Inflation Indicators* (Var% 12 months)



Episodes	Dates	Duration	Max. Inflation Expectations	Max. Total Inflation	Max. Core Inflation	Max. Exchange Rate	Max. Depreciation 12 months
Episode 1	Jan08-Feb09	14 months	4,8	6,7	4,6	3,24	11,4
Episode 2	Mar11-Jun12	16 months	3,3	4,7	2,6	2,82	-0,9
Episode 3	Jul15-Jul16	13 months	3,5	4,6	3,8	3,51	15,1
Episode 4	Mar17-Apr17	2 months	3,1	4,0	2,8	3,26	-1,6

Monetary impulse withdrawal has been accompanied by a change in the language of policy statements.

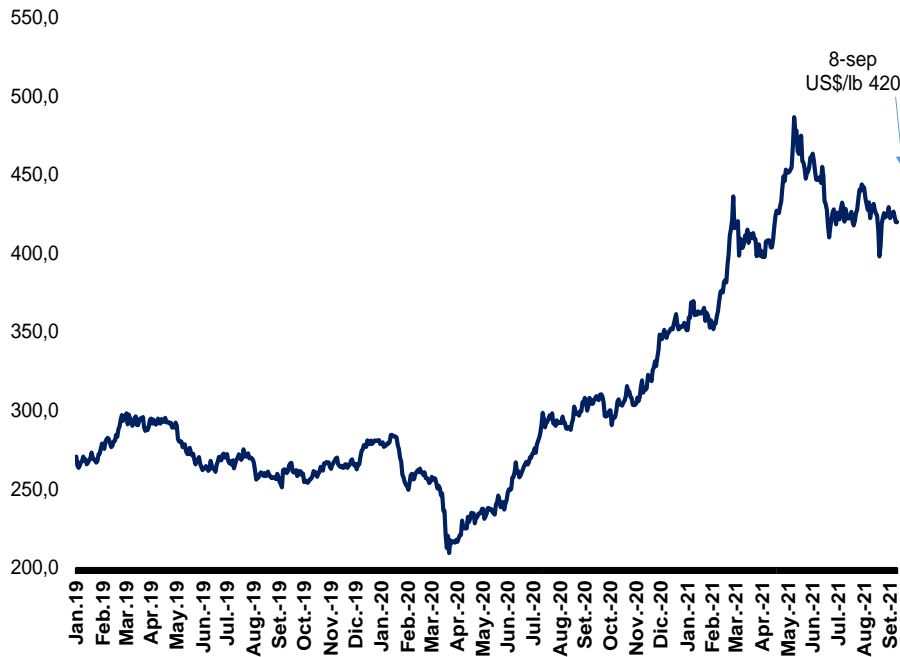
Policy interest rate and monetary policy tone indicator ^{1/} (Percentage and index value)



^{1/} Monetary policy tone indicator developed by Vega, M. and Lahura, E. on “Assesing central bank communication through monetary policy statements: Results for Colombia, Chile and Peru”. A positive value of the index is an indication of a hawkish position, while a negative value indicates a dovish stance. Shaded areas represent periods of consecutive interest rate hikes.

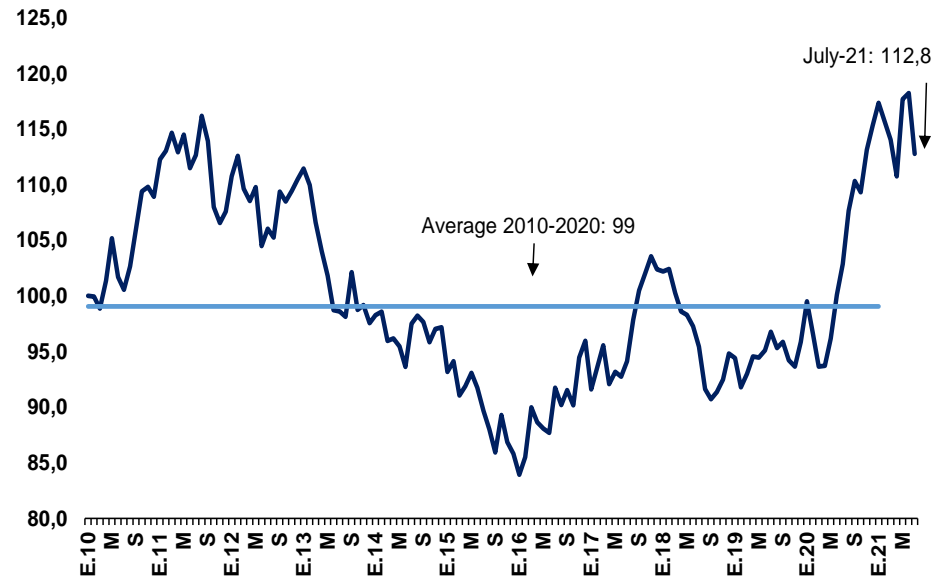
The persistent increase in the international prices of mining products (especially copper, gold, and zinc) has taken the terms of trade to historic highs.

Copper Price (US\$/lb.)

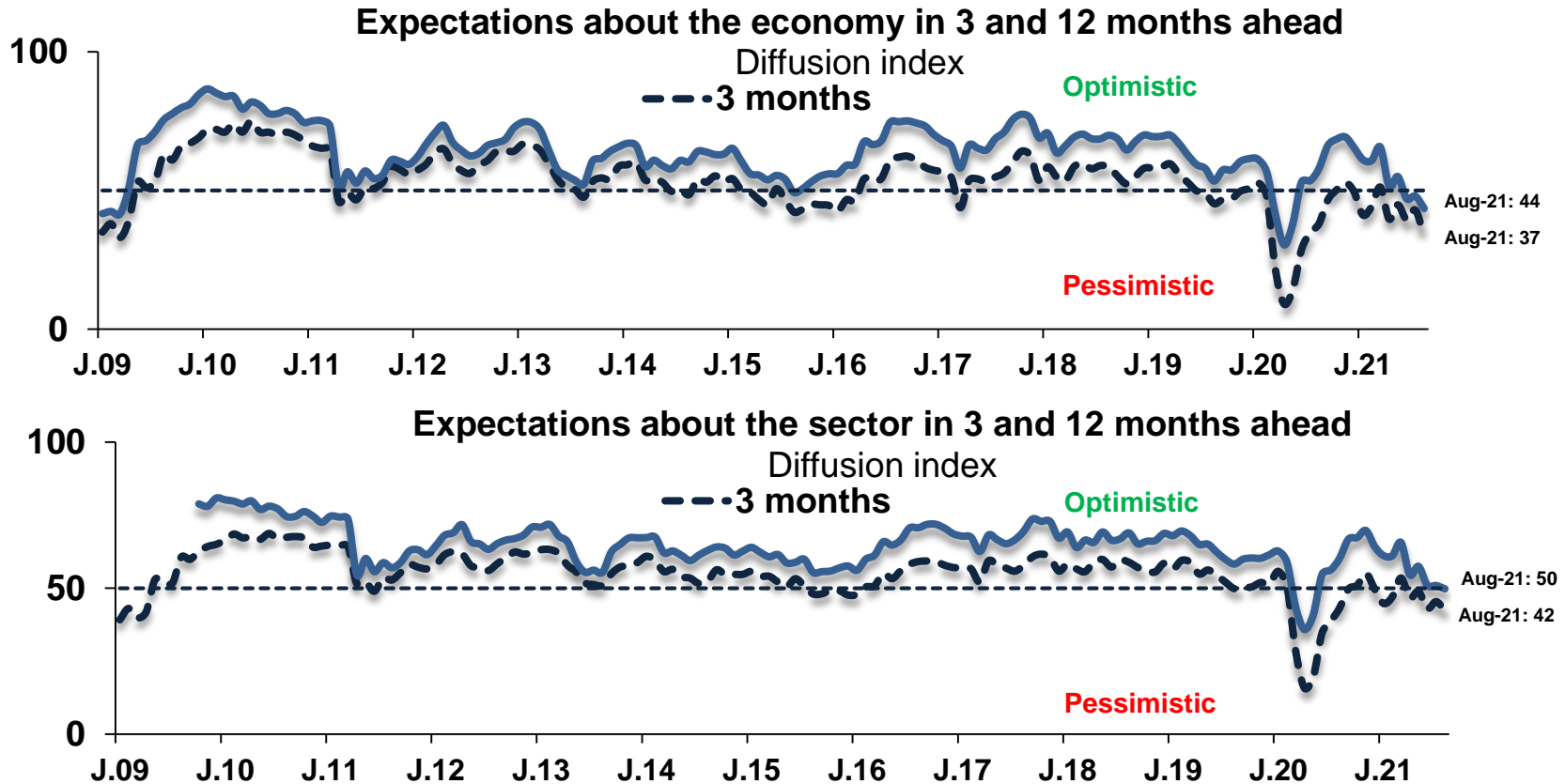


Source: Reuters

Terms of trade 2010-2021 (2007=100)

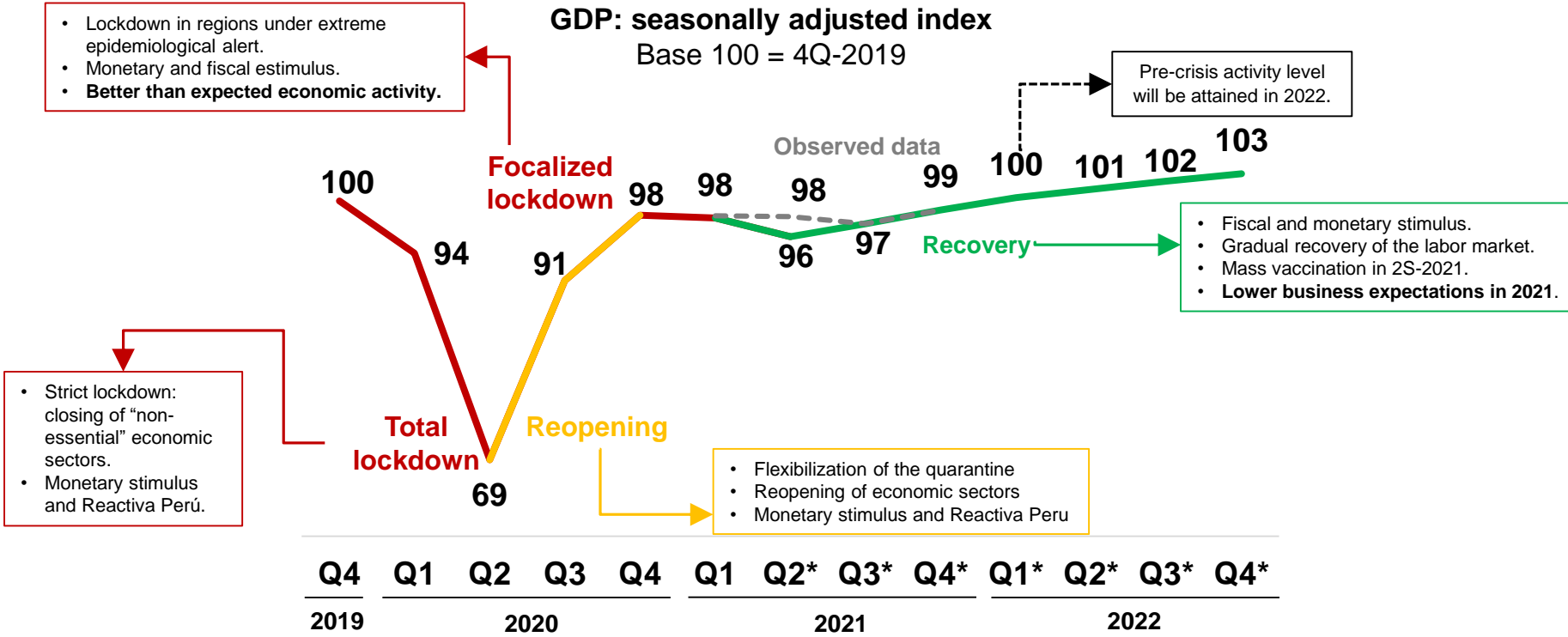


Uncertainty around the election cycle has deteriorated business confidence.



Source: BCRP.

GDP in the second quarter turned out to be higher than expected. In a context of political/social stability and recovery of business confidence, economic activity could reach pre-crisis levels in the first quarter of 2022.



* Inflation Report June 2021 forecast .
Source: BCRP.

Growth in 2021 is expected to be supported by domestic demand, which almost recovered to pre-pandemic levels in the first half of the year.

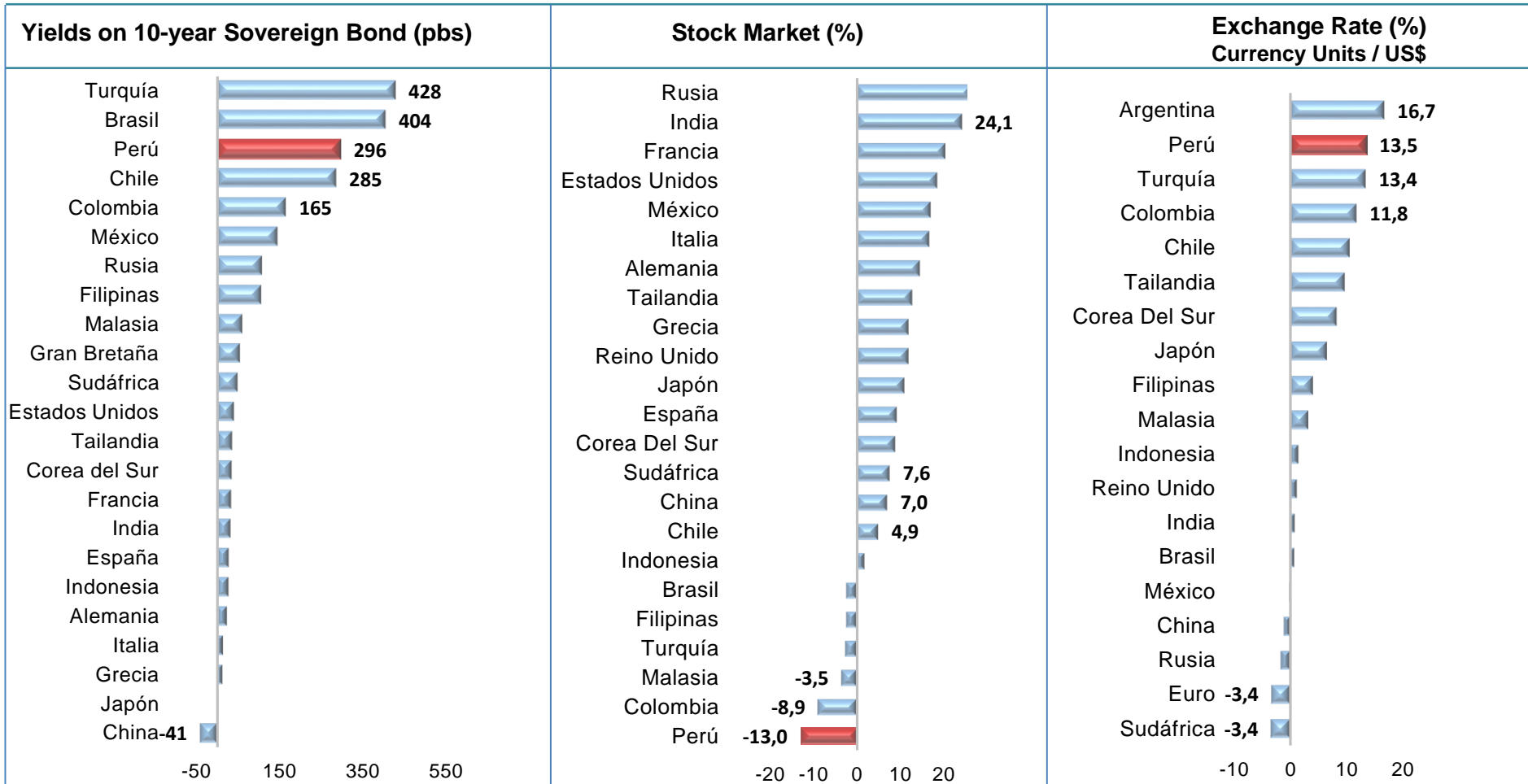
DOMESTIC DEMAND AND GDP
(real percentage change)

	2020	2021		Year*	2022*
		I semester compared to I Sem. 2020	I Sem. 2019		
Domestic demand	-9,4	21,7	3,4	10,3	4,0
Private consumption	-8,7	14,0	0,1	8,5	4,8
Public consumption	7,2	19,5	17,9	7,0	1,0
Private investment	-16,5	80,2	14,8	15,5	2,5
Public investment	-15,5	94,1	17,2	19,0	4,5
Exports	-20,8	17,5	-13,8	13,5	6,4
Imports	-15,6	20,7	-1,3	11,8	4,4
<u>GROSS DOMESTIC PRODUCT</u>	-11,0	20,9	-0,1	10,7	4,5

*Inflation Report June 2021 forecast

Most stock markets in emerging economies are benefiting from higher commodity prices.

Cumulative change (13 September, 2021 –31 December, 2020)

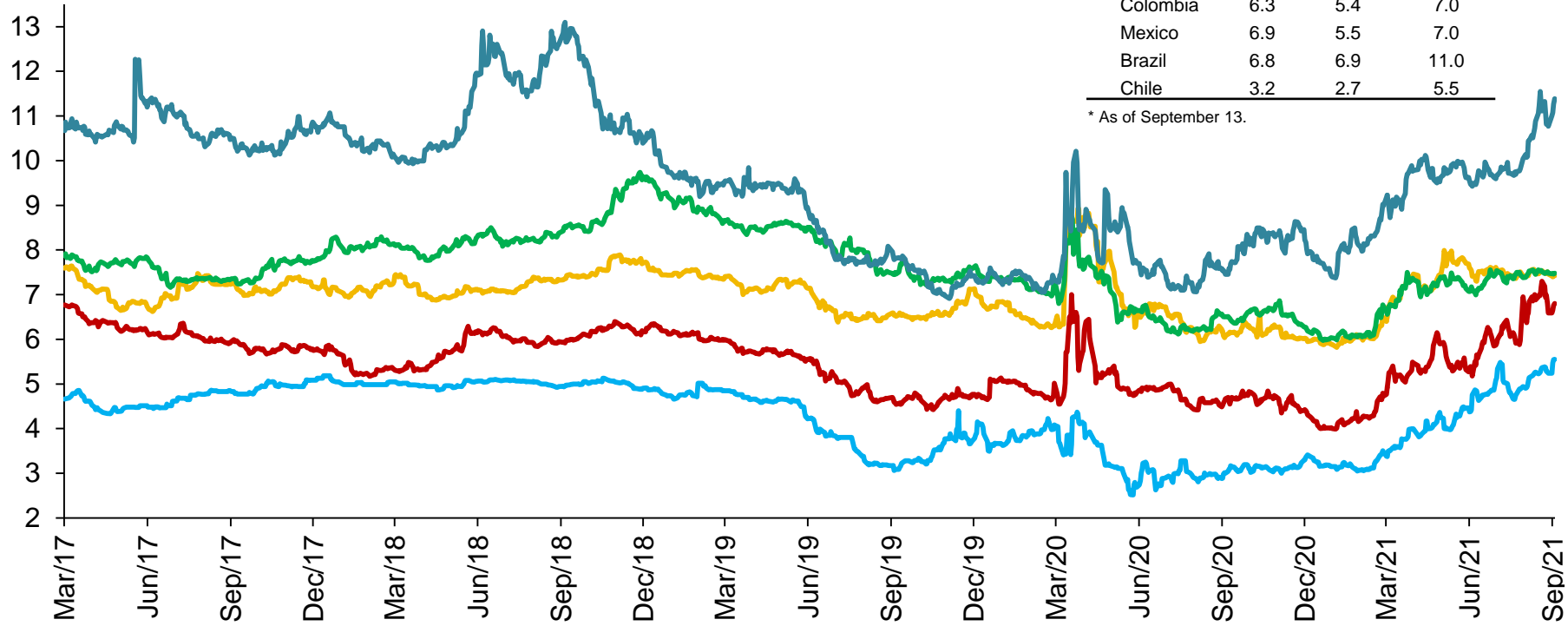


Financial conditions have changed since March 2021 due to increased international interest rates and higher local political risk.

10 YEAR SOVEREIGN BOND YIELDS (%, end of period)

	Dec. 19	Dec. 20	Sep. 21*
Peru	4.6	3.5	6.5
Colombia	6.3	5.4	7.0
Mexico	6.9	5.5	7.0
Brazil	6.8	6.9	11.0
Chile	3.2	2.7	5.5

* As of September 13.

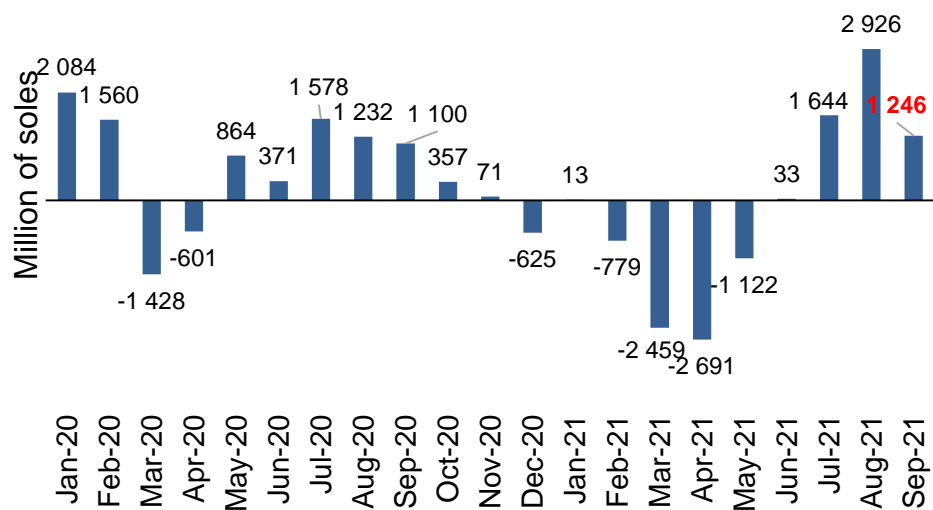


— Peru — Colombia — Mexico — Brazil — Chile

Source: Reuters.

Non-resident investors reduced their holdings of Peruvian sovereign bonds during the electoral period.

Monthly flows of non-resident bond holdings

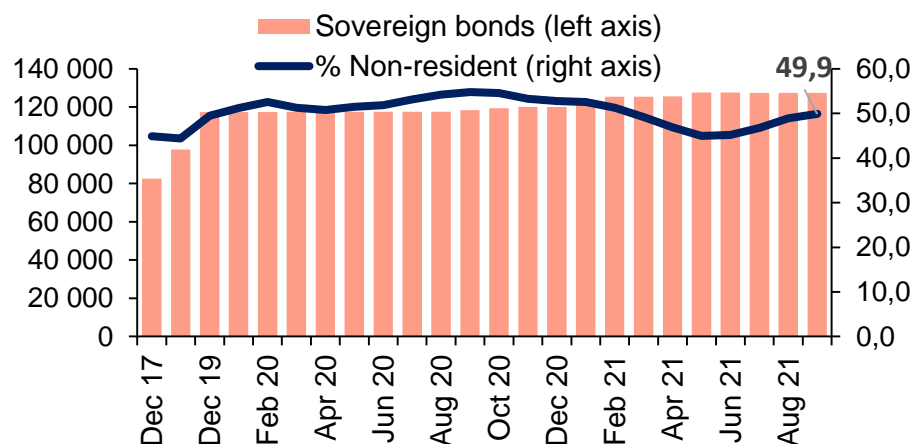


*As of September 10.

Note: Until February, it excludes inflation indexed bonds, GDN and transactions of non-residents in Euroclear. As of March, nominal sovereign bonds and VAC are included, and GDN are excluded.
Source: CAVALI; MEF, SBS and BCRP.

Stock of sovereign bonds and non-resident bond holdings

(Stock in million of S/ and holdings in %)

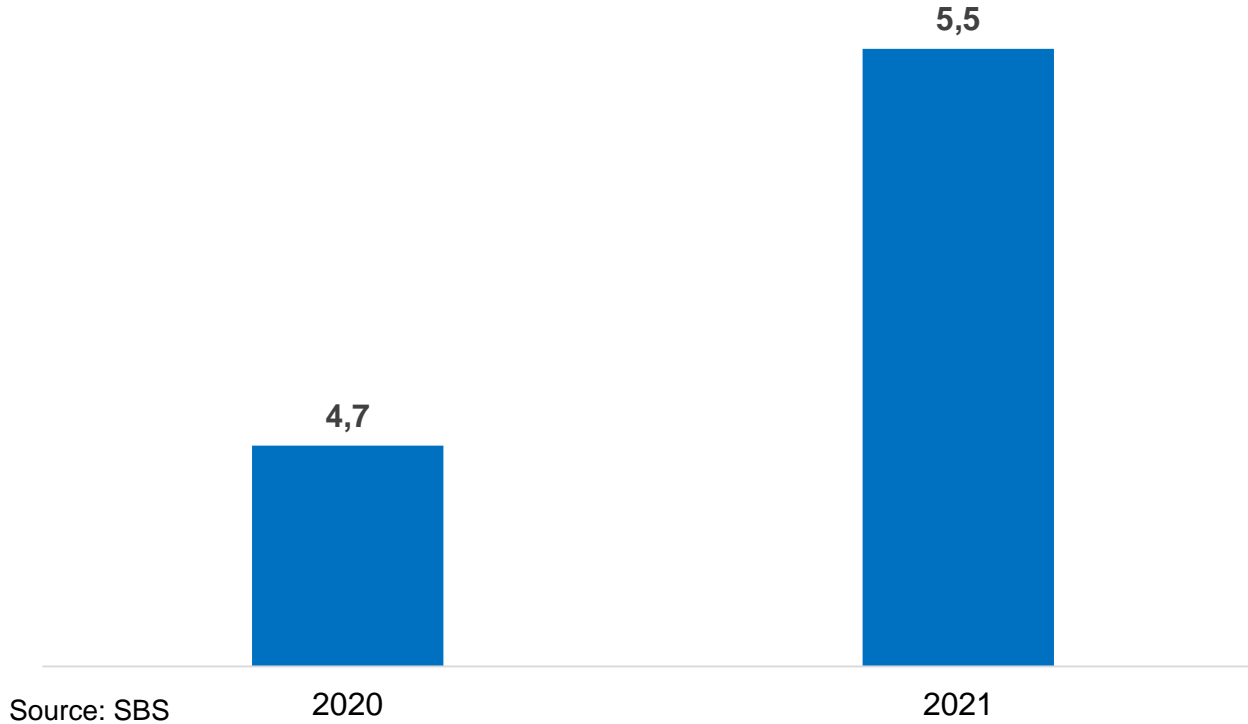


Sovereign bonds	Sep. 21 *
Non resident	62 158
Total	127 498

In million of soles.

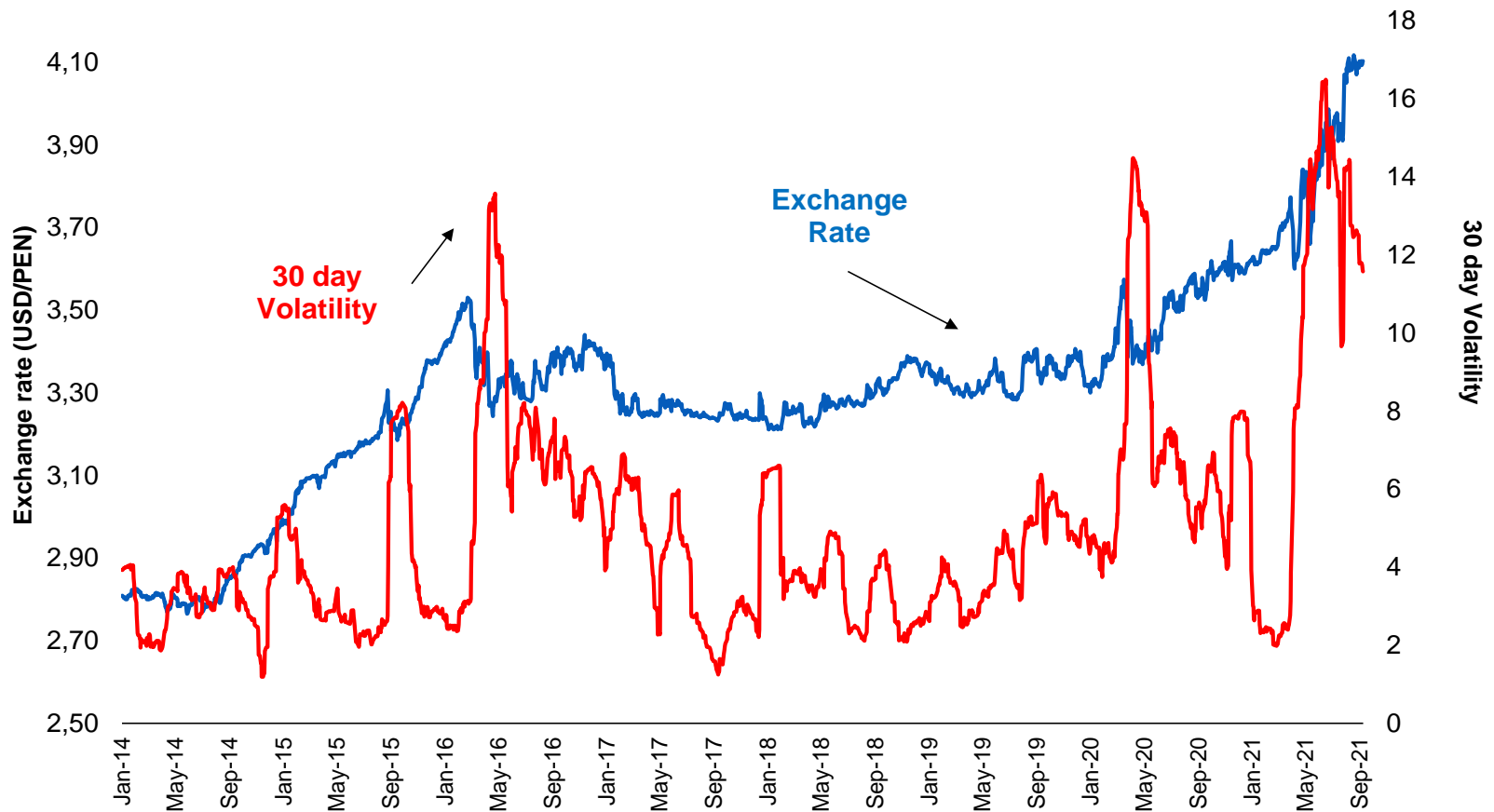
Private pension fund withdrawals amount to around 5.5 percent of GDP in 2021 (PEN 40.2 billion).

**PRIVATE PENSION FUND
WITHDRAWALS
(% GDP)**



The exchange rate has reached historic highs with increased volatility. The BCRP responded financial markets turbulence via: i) FX market intervention; ii) FX repo operations; iii) purchases of sovereign bonds.

Exchange Rate and 30-day Volatility 1/



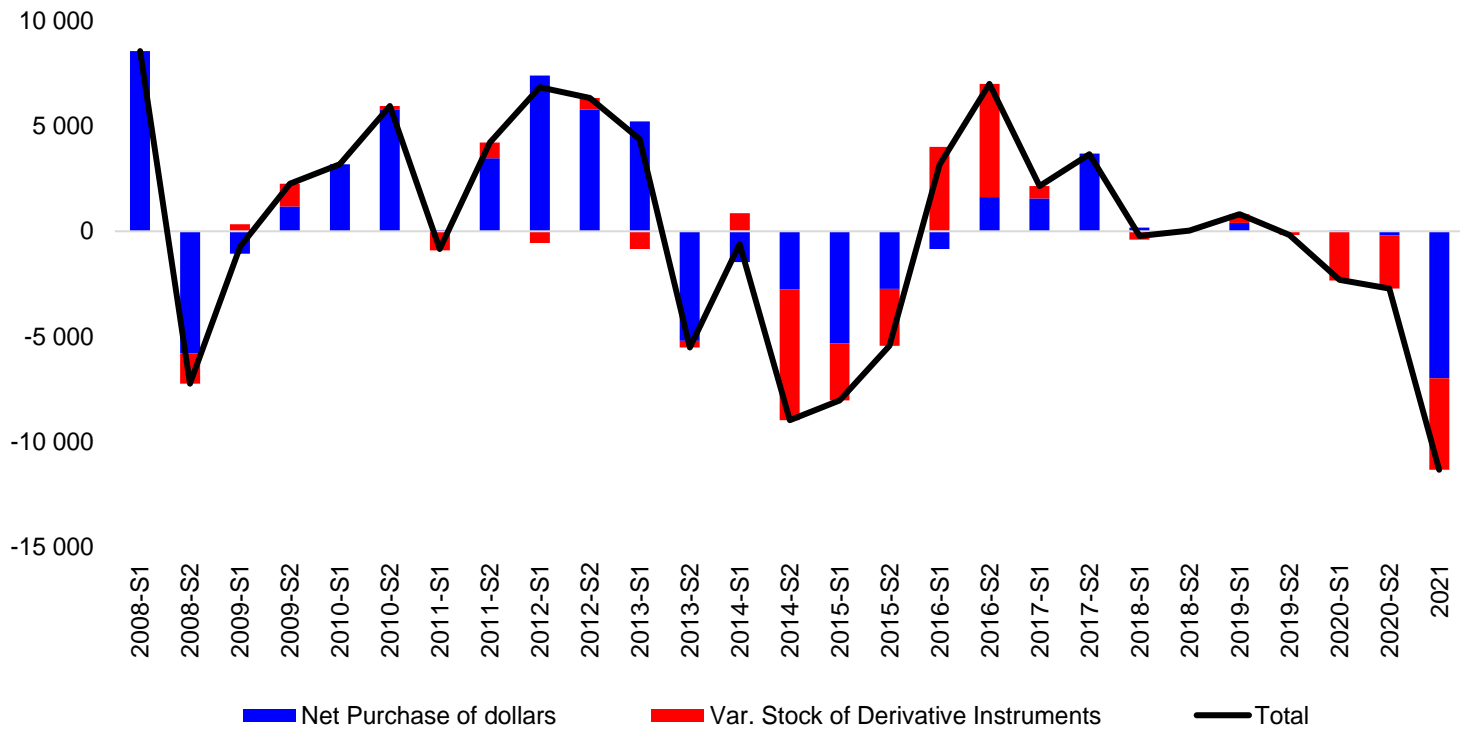
^{1/} Standard deviation of the daily percentage variation of the exchange rate in the last 30 days.

At September 13.

Source: BCRP.

BCRP intervention in the FX market this year reached historic highs via FX sales in the spot market and FX instruments (exchange swaps and exchange rate-indexed CDs).

FOREIGN INTERVENTION
(Millions of USD)



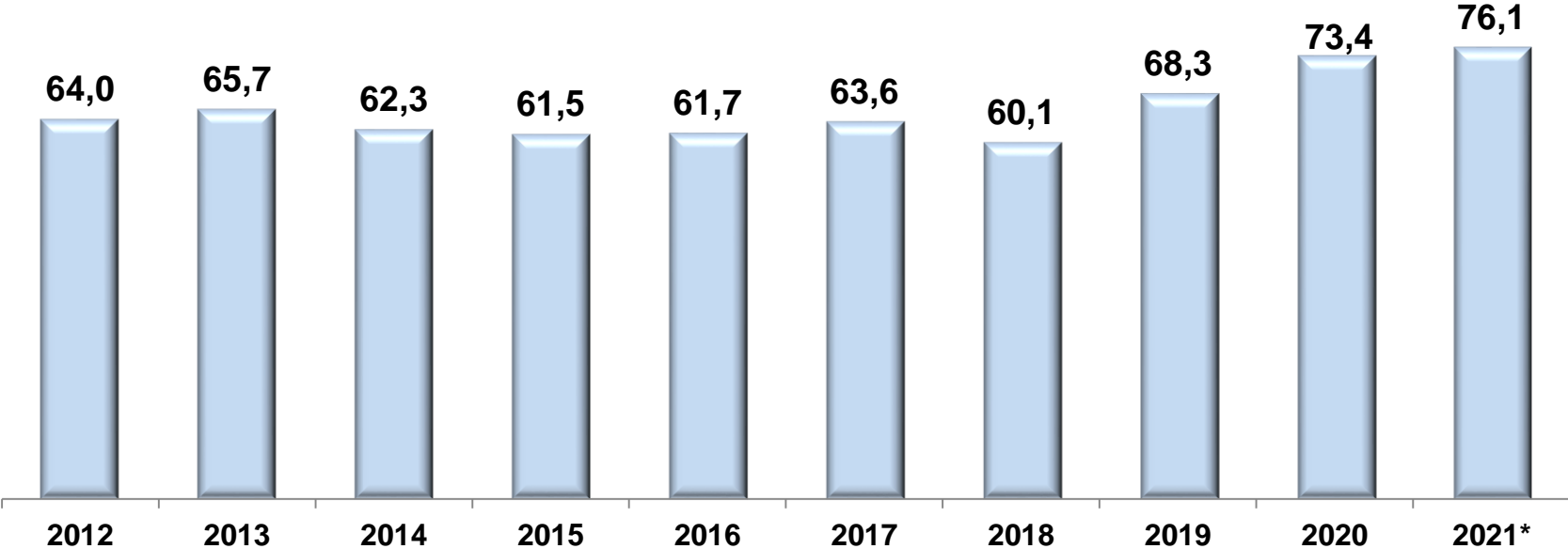
As of September 13.
Source: BCRP.

Peru's external position is strong due to a considerable FX reserve buffer; and has been reinforced by a precautionary USD 11-billion Flexible Credit Line (FCL) agreed with the IMF.

Net International Reserves (NIR)
(USD Billions)

NIR (As % of:)	2018	2019	2020	2021*
a) GDP	26.7	29.6	36.5	32.7
b) Short-term external debt ^{1/}	3.43	4.98	5.56	4.99
c) Short-term external debt plus current account deficit	2.81	4.17	6.26	5,14

*Inflation Report June 2021 forecast



* As of September 10.
Source: BCRP.

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Challenges ahead

Challenges Ahead

- 1. Monetary policy must be conducted preventively to avoid de-anchoring of inflation expectations.**
- 2. Fine-tuning in monetary policy is necessary to avoid recovery interruption.**
- 3. Considerable uncertainty persists regarding pandemic control and developments in the world economy.**
- 4. Heterogeneity in post-pandemic recovery across sectors: factor reallocation and pandemic-related economic scarring.**
- 5. Macroeconomic fundamentals remain solid.**

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