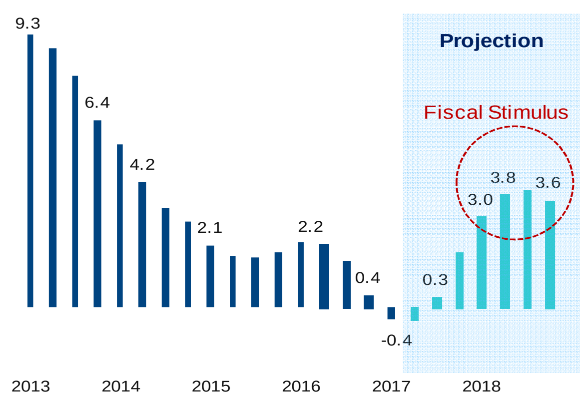
8 Monetary policy: a suitable scenario for the Central Bank to embark upon more aggressive monetary stimulus

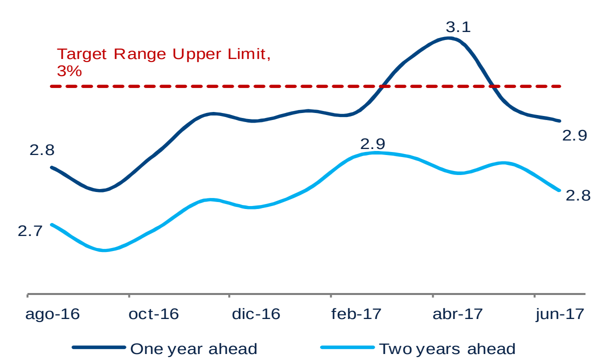
The outlook for activity and prices described in the previous sections suggests there is both a need to increase the flexibility of the monetary policy position, and room to do this. But, what do we mean when say there is a need to adopt a more expansionary monetary position? GDP growth rates have fallen below 1% YoY in the last three months. Growth in activity is weak, particularly domestic demand (see Figure 8.1). The picture in the labour market is similar: not only has the creation of new jobs slowed (see Figure 3.5), but the quality of the jobs created has deteriorated. Whilst it is true that larger anchovy catches will increase the GDP growth rate for May and June, this will be a temporary effect and does not reflect a significant improvement in spending by businesses and households. This situation is exacerbated by increased political noise. Countercyclical economic policies are therefore required to shake activity out of this lethargy, with fiscal and monetary stimuli that will pass through to businesses and households. Unfortunately, no fiscal stimulus is taking place, and it seems unlikely that there will be any major boost in the coming months. Most of the spending on reconstruction in the coast northern of the country will not impact activity until next year. And while it is true that a significant expansion in public spending is expected in the fourth quarter, this is mainly due to the basis for the year-on-year comparison being low due to the fiscal adjustment at the end of 2016, meaning that spending levels are only returning to normal. Finally, there is also no room for the state to spend more, as its revenues have fallen as a percentage of GDP and this will limit the expansion of spending, if it wishes to meet its 2017 fiscal deficit target (3% of GDP). This leads us to state that monetary policy will take centre stage in countercyclical efforts at present.

Figure 8.1 Internal demand (accumulated over the last four quarters, excluding inventories, YoY % variation)



Source: Central Reserve Bank of Peru and BBVA Research.

Figure 8.2 Inflation expectations (%)

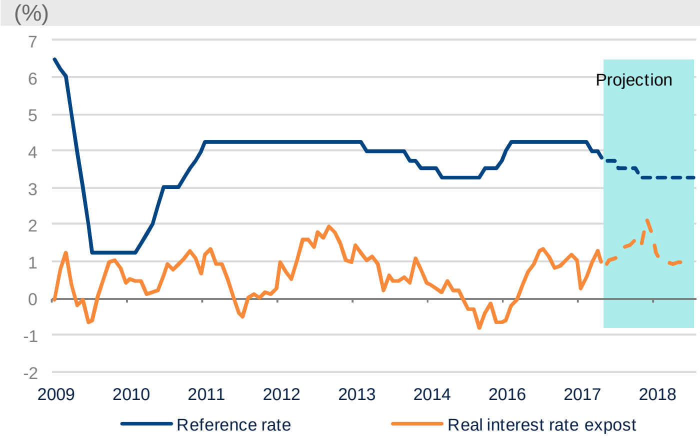


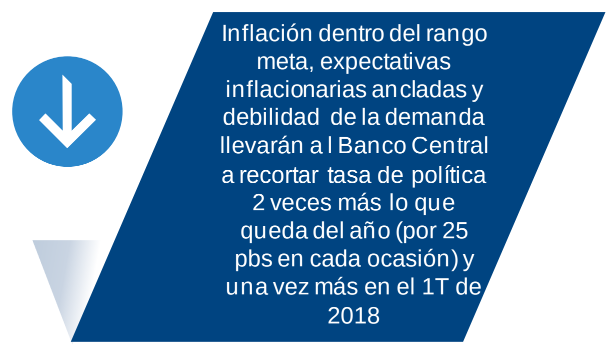
Source: Central Reserve Bank of Peru and BBVA Research.

But, does the Central Bank have room for a more expansionary monetary position? Expectations of inflation are within the target range and have continued to fall (see Figure 8.2). The picture for inflation, and inflation excluding food and energy, is similar. We are likely to see inflation fluctuating between its current level (2.7%) and the ceiling of the target range (or perhaps slightly higher than this) over the coming months, before slowing again in the fourth quarter. Demand pressures on prices are contained, the depreciation of the local currency we expect to see over the coming months is limited, and we do not expect a marked recovery in oil prices. Our inflation forecast for the end of the year is closer to the centre of the target range, and the downward trend may continue in early 2018. It appears that there is some room to increase the flexibility of the monetary position.

Against this backdrop, the Central Bank has started to relax its monetary policy position through cuts in its base rate, which it reduced by 25 bp in May, to 4.0%. However, this was followed by a surprise pause in June, when the outlook for activity and prices still seemed to be pointing to further flexibility in monetary conditions. Our baseline scenario includes two further 25 bp cuts in the base rate this year, one in the third quarter and one in the fourth. It also includes an additional cut at the start of 2018, when inflation is close to the floor of its target range and reconstruction spending in the north of the country is still only starting to kick in (see Figure 8.3).

Figure 8.3 Reference interest rate
(%)





Source: Central Reserve Bank of Peru and BBVA Research

DISCLAIMER

Este informe ha sido elaborado por la unidad de Perú

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