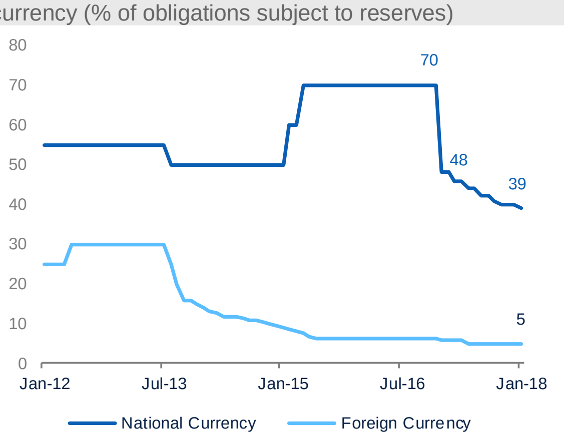
8. Monetary policy: More easing on the way?

In the environment of sharply falling inflation – which is leading inflationary expectations down the same path, albeit more slowly – and cyclical weakness of the economy, the central bank has continued with cuts to its reference interest rate. In the last quarter of last year it cut the rate by 25 bps, on top of the three previous cuts (in May, July and September). As a result, the reference interest rate ended the year at 3.25%. Furthermore, it continued to reduce reserves in dollars (see Figure 8.1), seeking to offset the rise in international interest rates and so mitigate the impact on lending.

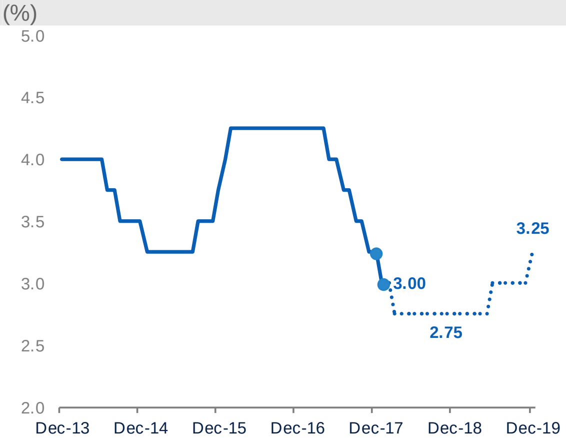
In January 2018 the central bank cut its base rate by a further 25 bps, to 3.00%. It was reasonable for the central bank to do so in view of the performance of inflation in the past few months, the room that inflationary expectations still have to continue falling (according to central bank calculations, in December they were at 2.3%), the cyclical weakness of the economy, a fiscal boost that it is taking longer than expected to make itself felt, the uncertainty engendered by the increase in political noise (already reflected in a significant decline in business confidence), and the relative stability of the exchange rate. We do not rule out the possibility of an additional cut of 25 bps in the next two or three months if GDP growth surprises the economic authorities negatively, which we think will happen with 4Q figures, if the fiscal stimulus is less than expected, if increased political noise translates into further loss of business confidence, or if inflationary expectations fall below 2% (the middle of the target range). After that, with inflation tending to move towards the middle of the target range and inflationary expectations positioned around it, with private sector spending slowly gaining traction, and with monetary policies in the US and Europe more clearly geared towards normalisation, we estimate that the central bank will opt to hold its key rate at 2.75% (see Figure 8.2) and will not start to raise it until the second half of next year.

Figure 8.1 Marginal reserve rate in domestic and foreign currency (% of obligations subject to reserves)



Source: Central Reserve Bank of Peru and BBVA Research

Figure 8.2. Reference rate (%)



Source: Central Reserve Bank of Peru and BBVA Research

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