Economic Research Department

Perú

BCR Watch

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Central Bank to keep benchmark interest rate at 1.25% in May

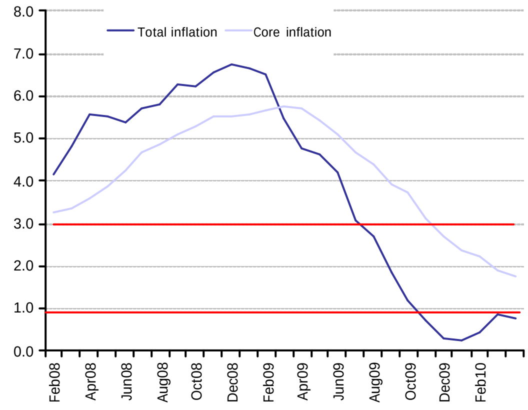
- Although the recent movement in prices has been consistent with the Central Bank target range, the speeding up seen in output reduces the need to maintain financial stimulus packages as large as the present one.
- This suggests that the Central Bank will begin to guide monetary policy towards a less expansive position in the remainder of 2Q10, attempting to ensure ordered output convergence to its potential level.
- We forecast this movement to initially be seen in greater demands for reserves, including a possible increase in the minimum fund requirements for financial institutions held in their current account at the BCR.
- We continue to estimate that the Central Bank will keep the benchmark interest rate at its current level (1.25%) until the end of the first semester to then start a gradual series of increases.

Price performance in recent months has been in line with expectations, with a higher monthly inflation rate in 1Q10 which then slowed in April. Specific factors (seasonality, changes in administered prices) explained this performance in the first part of the year. In terms of demand, inflationary pressures are in line with Central Bank targets (2%, +/- 1pp). In this sense, March core inflation came in at 1.8% yoy and we forecast April's to be at a similar level.

In output terms, however, the last months have seen an increased expansion rate which we expect to have continued in March. This growth is generalized across productive sectors and its reliance on the fiscal stimulus has decreased. This suggests that the need to maintain financial stimulus packages as large as the present one has decreased. With regards to the fiscal push, the Ministry of Economy and Finance already stated that it will cut expenses by the equivalent of 0.7% of GDP in 2010 in a setting where private demand is reactivating and in an attempt to comply with the limits established by law for 2010.

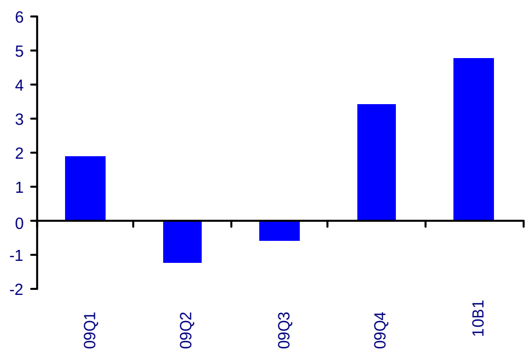
We forecast that the Central Bank will also implement short term measures to begin to guide monetary policy towards a less expansive position. This will favor an ordered convergence of output towards its potential level, reducing monetary policy volatility to do so. In turn, it will limit possible upward adjustments in inflation

Chart 1: Inflation
(yoy % change)



Source: BCRP
Prepared by: Banco Continental ERD

Chart 2: Quarterly GDP
(yoy % change)



Source: BCRP
Prepared by Banco Continental ERD

forecasts, especially after the increase in domestic fuel prices and in a setting where economic recovery is speeding up and the benchmark interest rate is at historical lows (negative in real terms ex ante).

The removal of monetary stimulus will begin with higher reserve demands in the remainder of 2Q10. This process will limit the risk of excessive appreciation in local currency (somewhat less since Brazil will increase its policy interest rate). In turn, this will mean markets are less likely to see the monetary adjustment as the beginning of an upward cycle for the interest rate (with a more vigorous impact on different term yields). This would not be desirable in a context where there is still uncertainty regarding the sustainability of global economic recovery.

Assessment

The speed and generalized performance in economic growth over recent months, as well as its lower reliance on fiscal stimulus, suggest that the Central Bank will begin to guide monetary policy towards a more neutral short term position. This will also favor inflation forecasts remaining linked to the Central Bank target. This process will begin with higher reserve demands, possibly going on to include an increase in the fund requirements that financial institutions must hold in their current account at the Central Bank.

Given the above, we maintain the forecast that the start of the upward cycle in the policy interest rate will begin in 3Q10 and be gradual.

Appendix 1: Economic indicators

	Dec-09	Jan-10	Feb-10	Mar-10	Apr-10
GDP (yoy % change)	5.6	3.6	5.9	n.a	n.a
Domestic demand (yoy % change)	3.6	5.1	6.4	n.a.	n.a.
Urban employment (at companies with 10 or more workers, change y-o-y)	0.3	0.8	2.4	n.a.	n.a.
Consumer confidence (index)	52	48	49	49	n.a.
Business confidence (index)	69	72	72	71	n.a.
Inventory index	49	51	50	49	n.a.
Electricity production (Gw/h, yoy % change)	6.8	5.9	6.5	8.3	n.a.
Domestic cement consumption (tons, yoy % change)	10.8	10.9	15.9	25.0	n.a.
Import of goods (in real terms, yoy % change)	5.0	4.7	3.2	n.a.	n.a.
Sales of new cars[1] (units, yoy % change)	8.6	28.7	27.8	37.3	n.a.
CPI (end of period, yoy % change)	0.25	0.44	0.83	0.76	0.76
Core CPI (end of period, yoy % change)	2.35	2.21	1.91	1.77	n.a.
WPI (end of period, annual % change)	-5.05	-2.81	-1.22	-0.47	0.48
Exchange rate (end of period, S/. x US$)	2.88	2.86	2.85	2.84	2.85

Source: BCR, COES, ASOCEM, ARAPER, INEI, Apoyo Consultoría S.A.

Relates to the light vehicle category