Economic Research Department

BBVA

Perú

BCR Watch

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Central Bank unexpectedly rises the policy interest rate in May (+25 bp)

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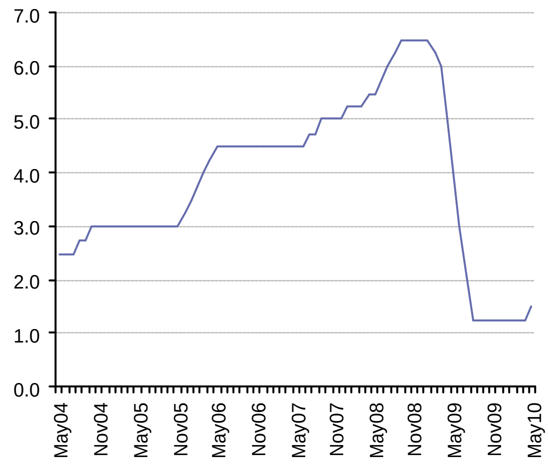
Next monetary policy meeting: June 10

The Board of the Central Bank (BCR) rose its benchmark interest rate by 25 basis points (from 1.25% to 1.50%) at its meeting held yesterday. Although the BCR insisted that there are no indications of inflationary pressures (core inflation stands at 1.85%), the statement issued indicates (i) that several current and advance indicators suggest a highly favorable trend in domestic economic activity, and (ii) that the world economy is showing signs of recovery, which has led to an upward review of growth projections. This setting allows the monetary stimulus to be reduced.

According to the Central Bank, this preventive measure does not necessarily involve the start of a series of policy interest rate rises. Possible subsequent increases would be conditional on the evaluation of the determining factors for inflation.

Finally, the statement mentions that risk factors still remain, which are related to the fiscal solvency of some developed economies.

Central Bank policy interest rate
(%)



Source: BCRP
Prepared by: Banco Continental ERD

Assessment

The decision to start withdrawing the monetary stimulus is in line with our forecast base scenario. Thus, although the inflationary pressures are consistent with the Central Bank's target (2%, +/-1 pp), we projected that the speeding up of economic activity (which has been widespread across the production sectors and is becoming less dependent on fiscal stimulus) made it less necessary to maintain such an expansive monetary policy[1], which suggested the beginning of the withdrawal of the stimulus in the short term.

However, the decision of the BCR to do so by rising the policy interest rate was unexpected[2]. On the one hand, the latest external events (policy interest rate rise in Brazil, concerns regarding fiscal solvency of some developed economies and possible contagion) may have contributed to opening a window which, considering the

[1] Until yesterday, the policy interest rate level was at its all-time low in nominal terms, and is negative in real ex-ante terms.
[2] All the economic analysts consulted by Bloomberg agreed that the Central Bank will maintain the policy interest rate at 1.25% in May, and we concur. At BBVA Research Perú we anticipated that the BCR would begin withdrawing the monetary stimulus through higher reserve requirements (seer BCRWatch of May 4, 2010).

decision made, would have been sufficient to start withdrawing the monetary stimulus through the conventional instrument (policy interest rate) instead of doing so via higher reserve requirements. On the other hand, the announcement of measures by the Ministry of Economy and Finance aimed at withdrawing the fiscal stimulus in 2010 by the equivalent of 0.7 pp of GDP has boosted the BCR's capacity to withdraw excess liquidity as a result of possible foreign exchange operations, which facilitates the rise of the policy rate.

We should point out that the Central Bank's insistence that the rate increase by 25 bp does not necessarily mean the start of the upward trend of this variable suggests that it would not be desirable to generate greater impacts on the yields required for different terms. In this context, concerns about the sustainability of the global economic recovery (including any contagion caused by fiscal factors in the economies of southern Europe) and any excessive pressures towards the strengthening of the local currency would still be significant.

Looking to the future, the accelerated growth of the activity will probably be maintained. In this regard, the Chairman of the BCR suggested a few days ago that he expected GDP to expand by between 6% and 7% in 2010 (the previous forecast was 5.5%) and that it would not be surprising to see growth above 10% in some months of 2Q10. Inflation would converge with the target range in the remainder of this quarter. Thus, we expect that from the point of view of local variables, the scene that the Board of the BCR will face in their next meetings will be at least similar to the current one, and therefore we cannot rule out that the monetary stimulus will continue to be reduced in the short term. However, these moves could still consider reserve-related restrictions, especially if the external conditions and the uncertainty in the international financial markets stabilize.

Table 1: Central Reserve Bank of Peru (BCRP) Information Notices

	December 10	January 7	February 11	March 11	April 8	May 6
Activity	".. the advance indicators of economic activity show clearer signs of recovery, although there are no indications of inflationary pressures in the short term",	"...the advance indicators of economic activity show clearer signs of recovery of the dynamism of output, although there are no indications of inflationary pressures in the short term."	"...the advance indicators of economic activity show clear signs of recovery of the dynamism of production, although there are no indications of inflationary pressures in the short term."	"...the advance indicators of economic activity show clear signs of recovery of the dynamism of the production, although there are no indications so far **of inflationary** pressures in the short term."	"...the advance indicators of economic activity show clear signs of recovery of the dynamism, without evidence of inflationary pressure."	"…several current and advance indicators of output show a highly favorable trend... Moreover, the world economy is showing signs of recovery, which has led to an upward review of growth projections."
Inflation	"… over the coming months inflation is expected to continue under the lower limit of the target range as a result of the reversal of last year's supply shocks. "		"…recent developments of inflation does not indicate demand pressure, but the temporary impact of supply shocks."	"…recent developments of inflation does not indicate demand pressure, but the temporary impact of supply shocks."	"…recent developments of inflation is mainly due to temporary impact of supply shocks and seasonal factors."	"…core inflation stood at 0.23%, accruing an annual change of 1.85%, which shows that as of today there are no inflationary pressures."
Monetary Policy	"… this decision is based on the sustained reduction in annual inflation and the continued reduction in inflationary expectations… unless there are significant changes in inflationary forecasts and their determinants, no new adjustments to the policy rate are expected".	"…this decision is based on the sustained reduction in annual inflation and on the continued reduction in inflationary expectations… unless there are significant changes in inflationary forecasts and their determinants, no new adjustments to the policy rate are expected."	"…the Board is keeping an eye on the forecast for inflation and its determinants, and will adopt, **if necessary**, preventive measures in the monetary policy that will ensure that inflation remains in the target range."	"…the Board is keeping an eye on the forecast for inflation and its determinants, and will adopt preventive measures in the monetary policy that will ensure that inflation remains in the target range."	"…The Board is keeping an eye on the forecast for inflation and its determinants to adopt preventive measures in the monetary policy that will ensure that inflation remains in the target range."	"…The rise in the policy rate is preventive in nature, given that the clear signs of output growth, in a climate with no inflationary pressures, allow the monetary stimulus to be reduced…this decision does not necessarily involve the start of a series of policy interest rate rises, which will be conditional on the evaluation of the determining factors for inflation."
Policy Rate	1.25	1.25	1.25	1.25	1.25	1.50

Relevant events for the meeting on June 10, 2010

May	
15	March GDP (INEI)
June	
1	Consumer Price Index of Lima Metropolitan Area – May (INEI)