BANCO CENTRAL DE RESERVA DEL PERÚ

Policy Panel 3: Are adjustments needed for the policy process?

BCC 12th Annual Conference: Monetary Policy in a Changed Environment

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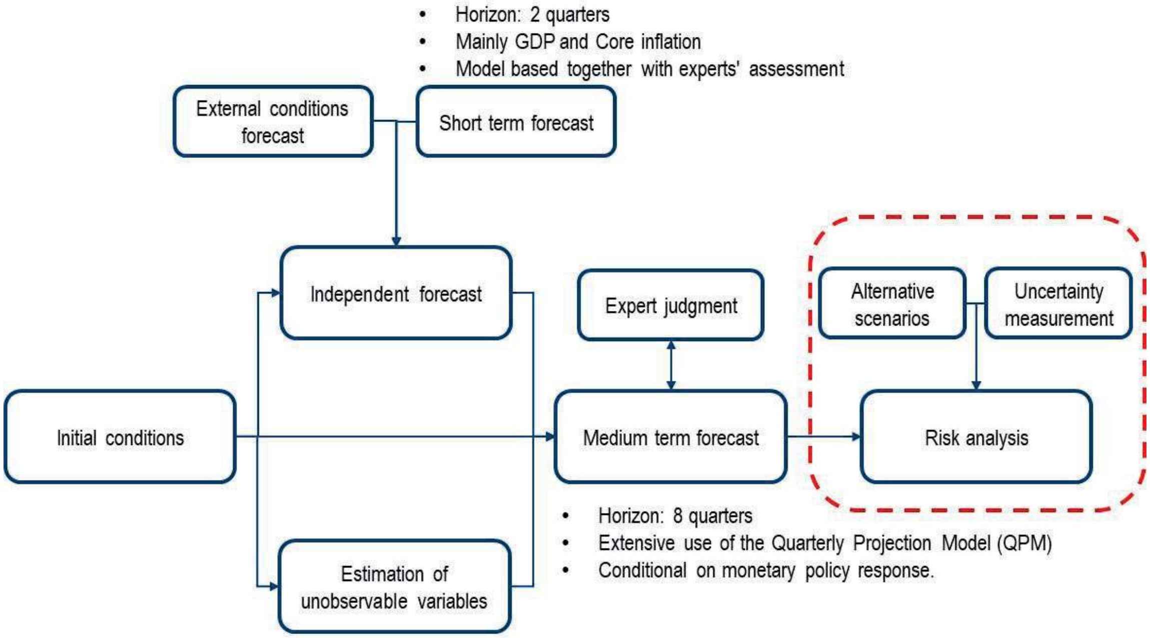
Monetary Policy Framework in Peru

Explicit constitutional mandate: **Preserve monetary stability.**

- Price stability: Inflation targeting regime adopted in 2002.
  i. Objective (final target): Maintain inflation between [1%,3%]
  ii. Intermediate target: Anchor inflation expectations
  iii. Main indicator: Conditional inflation forecast
  iv. Operational target: Interbank interest rate

- Financial stability: Manage financial risks associated to credit dollarization.
  i. Credit dollarization: limited capacity to act as a lender of last resort in dollars
  ii. Credit dollarization may induce liquidity and credit risks: sudden capital outflows & currency mismatch of balance sheets
  iii. Extra policy instruments: Higher reserve requirements in Fx, preventive accumulation of international reserves.

Forecasting process involves i) estimation of unobservable variables, which requires shock identification, ii) base line forecast, iii)risk analysis and iv) scenarios analysis.



Simulation scenarios consider alternative policy reaction functions and low-probability high impact deviations from the base line scenario.

Simulation of two type of scenarios:

- Policy scenarios: baseline assumptions under different policy responses
  - i. Taylor rule
  - ii. Deviation to the Taylor rule
  - iii. Potential nonlinearities, for instance:

    High Vs. low inflation: Different degrees of attention when forming expectations or varying persistence in core inflation trends

    Negative interest rate differentials: Different interest rate passthrough or balance sheet effects

- Risk Scenarios: low-probability, high-impact variations from baseline assumptions
  - i. External demand: lower ToT and global economic growth
  - ii. Volatility in International financial markets: higher international interest rate and country risk premium
  - iii. Domestic demand: lower business confidence, higher fiscal deficit and country risk premium
  - iv. Inflationary supply shocks: higher CPI of food an energy and lower ToT

Sequence of shocks since 2020

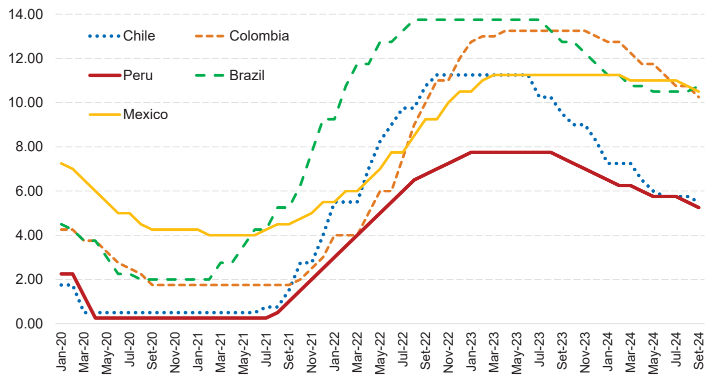
- The Peruvian economy has faced a series of shocks in recent years, leading to the most significant inflationary process since adopting explicit inflation targeting
  - The Covid-19 shock
  - Global supply and demand misalignments pos-Covid-19
  - Consequences of the Russia-Ukraine conflict
  - Capital outflow in 2021
  - Climatological events (2022 droughts and 2023 El Niño)
  - Bird flu (supply cost shock)
  - Domestic social conflicts and political instability
  - Synchronous global inflationary processes and restrictive monetary policy

- The forecasting framework enabled the central bank to robustly address these shocks by incorporating them into the four risk scenarios
  - Unconventional policy to mitigate the effects of the pandemics
  - Foreseeing long-lasting supply shocks, the central bank started to raise policy rates in Jul-2021 prior to many advanced economies
  - The accumulated credibility allowed the central bank to implement contractionary monetary policy with the lowest interest rate in the region.

Peru began raising interest rates in August 2021, reaching a peak of 7.75% in February 2023. It then started reducing rates in September 2023

Inflation reached a peak of 8.8% in June 2022, declined to 8.5% in December 2022 and to 3,2% in December 2023. Since May 2024 it has remained around 2.0%.

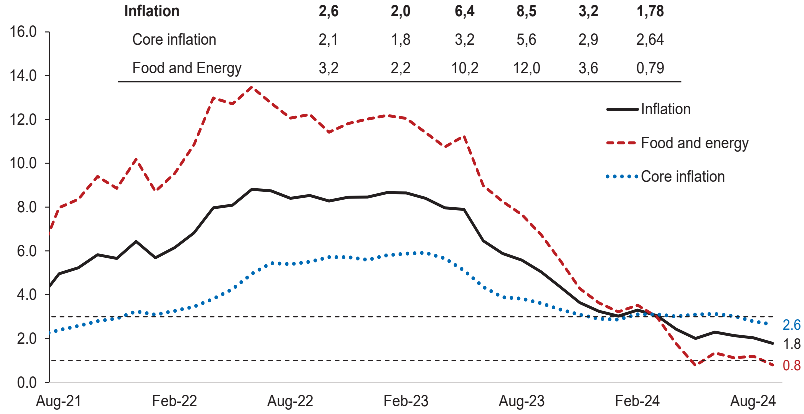
LATAM: Monetary Policy Rate(%)*
(End of period)



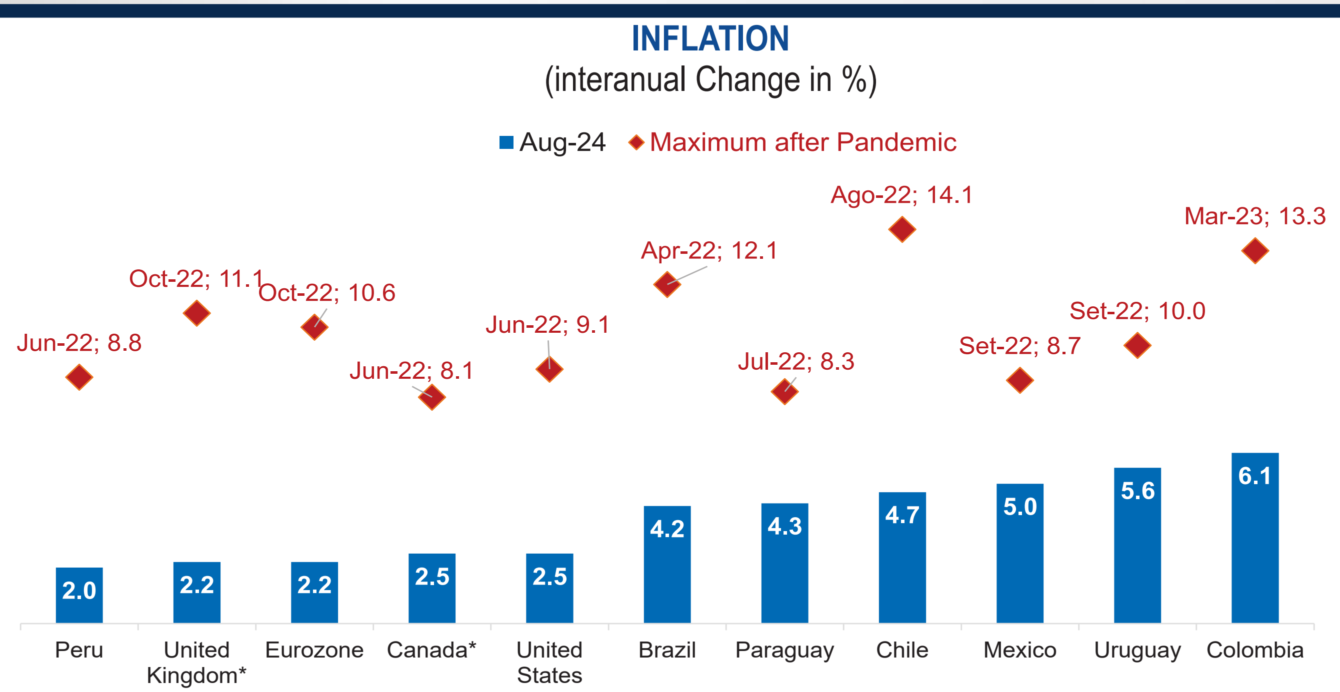
*As September 27th.
Source: Central Banks.

Inflation, 2021-2024
(Annual Change in %)

	Average 01-20	Dec. 20	Dec. 21	Dec.22	Dec.23	Set.24
Inflation	**2,6**	**2,0**	**6,4**	**8,5**	**3,2**	**1,78**
Core inflation	2,1	1,8	3,2	5,6	2,9	2,64
Food and Energy	3,2	2,2	10,2	12,0	3,6	0,79

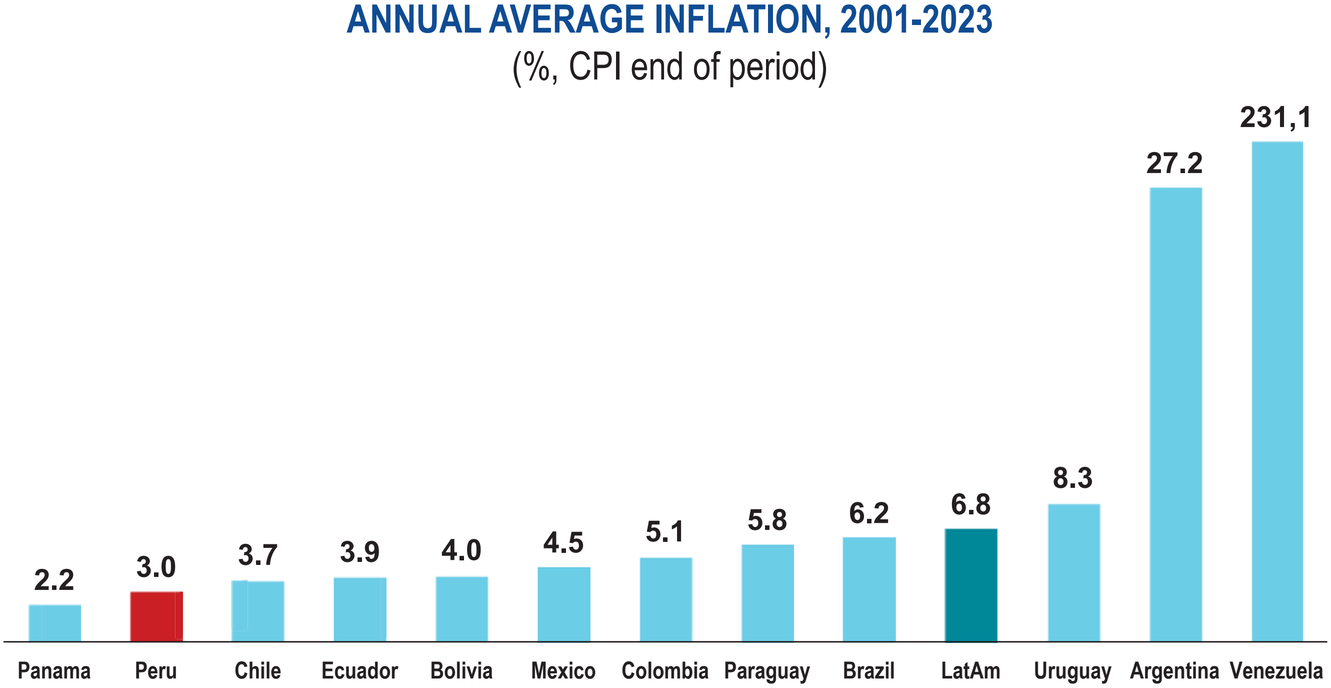


Recent Macroeconomic Performance



Note: Harmonized inflation is used for the eurozone and its member countries. *As of July 2024.
Source: Eurostat, Trading Economics, central banks, statistical institutes, and BCRP for Peru

Relative inflation Performance



Note: Calculated using end-of-period CPI. Source: IMF - WEO, April 2024.

Concluding remarks

- Maintaining credibility in monetary policy is crucial to minimize the cost of stabilizing inflation in response to supply shocks.
- Central banks may need to respond to persistent supply shocks, as these shocks can lead to second-round effects on inflation by raising inflation expectations.
- Effective communication is essential to prevent persistent supply shocks from significantly impacting inflation expectations.
- The monetary policy framework—combining inflation targeting with additional risk control tools—has proven effective.
- Flexibility in adapting monetary policy instruments is vital, especially in the face of significant economic shocks, while keeping the primary objective unchanged: **maintaining price stability**

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