Emerging Insight

Peru – Seven Lessons to Understand the Central Bank's Reaction Function

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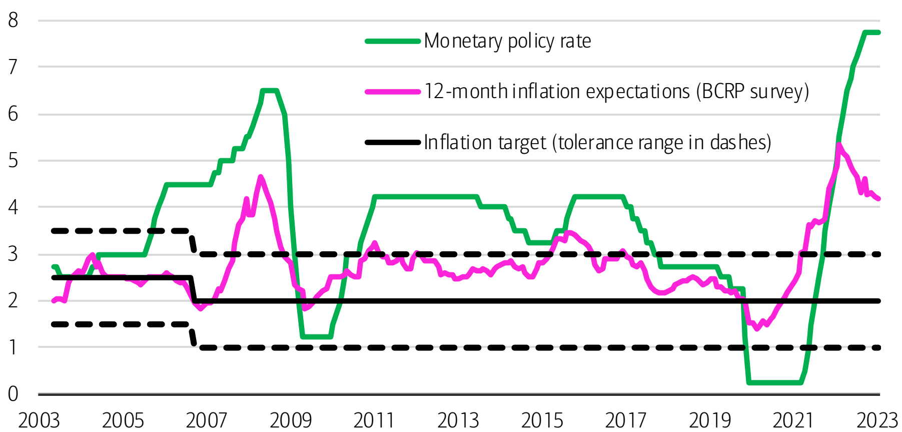
Key takeaways

- In our view, the BCRP will not cut rates in 2023. In contrast with median expectations of 125bp of cuts for 2H2023.
- We identify seven patterns which help understand the BCRP's reaction function and defend the case of no cuts.
- 1) Importance of expectations, 2) Statement to pick up signals, 3) staff-driven policy, 4) target range vs. target, and more.

By Alexander Müller

Chart of the Day: 12-month inflation expectations are crucial in BCRP's reaction fuction (%)
In over 20 years of inflation-targeting, the BCRP has only cut rates when 12-months inflation expectations (survey-based) are below or very close to the upper bound of the tolerance range (3%)



Source: Central Bank (BCRP), BofA Global Research

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Peru in Focus

Seven stylized facts about BCRP's decision framework

We have the out-of-consensus view that the Central Bank of Peru (BCRP) will not cut rates in 2023. In contrast with median expectations of 125bp of cuts in the second half of 2023, as per the BCRP's latest survey. Price-based expectations measures, such the CDBCRP yield curve, are also pricing cuts before the end of the year.

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We have identified seven stylized patterns in the BCRP's decision-framework which help understand how its policymakers think, and defend the case of no rate cuts.

1) Gives more importance to survey-based inflation expectations than other CBs
Given the lack of a liquid inflation-linked bonds markets (called "VAC" in Peru, largely held by insurance firms), the BCRP relies on its monthly survey to get information on inflation expectations. The BCRP interprets the anchorage of inflation expectations as a reflection of their credibility, with 12-month inflation expectations as the preferred measure (based on empirical regularity and guidance). They take it seriously. History shows it.

The BCRP started operating under an inflation-targeting regime in 2002. In over 20 years of this institutional arrangement, a rule that has never been broken is that the BCRP only cuts rates when 12-months inflation expectations (survey-based) are below or very close to the upper bound of the tolerance range (3%).

More specifically, they have cut rates with 12-month inflation expectations standing above the tolerance range (>3%) only on two occasions:

i) March 2009. The board cut 25bp, from 6.25% to 6%. 12-month inflation expectations were at 3.17%. But they had fallen a lot in the previous six months (from 4.65% in August 2008). It is worth recalling this was a dark moment of the global financial crisis. The BCRP was concerned about imminent recession.

ii) May 2017. The board cut 25bp, from 4.25% to 4%. 12-month inflation expectations were at 3.07%. This was a year in which there was a severe El Niño shock (far worse than 2023) and huge infrastructure projects were paralyzed because of the reported Odebrecht corruption scandal (including the US$ 5bn Southern gas pipeline). Policymakers feared the impact on activity.

We believe this rule will not be broken in 2023 either. 12-month inflation expectations are standing at 4.21% in the latest reading. We think they are unlikely to get very close to 3% until early 2024. Even if they do by December, the monetary policy meeting of that month will have inflation expectations data collected for November. There is a lag of one month. Moreover, inflation might be stickier than expected if El Niño happens in Q3 like the local climate agency is predicting (with "high probability").

2) Monthly board statement: preferred vehicle for sending the message
Communications in the BCRP have been evolving. There are no minutes of the meetings, unlike in Mexico and the South-American inflation-targeting peers. But communications have been polished over the last tightening and easing cycles. There are specific sentences and paragraphs that have become customary to mark the beginning or end of policy stances. These texts appear in the monthly board statement that accompany the monetary policy decision.

For example, the second sentence of the last statement (June): *"This decision [unchanged policy rate] does not necessarily imply an end to the BCRP's monetary tightening cycle"*. In the past, this sentence was present when the BCRP was either hiking rates or about to end the tightening cycle. But it has never, ever, been present one month before a meeting in which the board cuts rates. Hence, one obvious signal to tell we are one step closer to a rate cut will be the removal of the abovementioned sentence (italics).

In the same vein, the eighth paragraph of June's statement, preceded by numeral 2), is the customary tightening bias. It reads, *"The Board is particularly attentive to new information on inflation and its determinants, including the evolution of inflation expectations and economic activity, to consider, if necessary, changes in the monetary stance. The Board reaffirms its commitment to adopt the necessary actions to ensure the return of inflation to the target range over the forecast horizon"*. This sentence is also highly likely to change when we approach the easing cycle. Normally, what the BCRP does is swap the word "changes" for "flexibilization" and/or make a tweak that suggests the policy stance is transitioning to an easing bias.

3) Staff-driven monetary policy, not "one-man show"

If we think about the central banks of the largest inflation-targeting countries of Latin America (Bra, Mex, Col, Chi, Per) – Peru is the 6th largest economy (5th if we exclude Argentina, that has a different monetary regime) – all of them have communication strategies in which board members talk to the press an engage in public debates on monetary policy. Peru is different. The BCRP has seven board members, including Governor Velarde. But six of them seldom speak to the press about monetary policy. Instead, the Governor and the Chief Economist, Adrian Armas, have the most active role on that matter.

In our view, the BCRP's policy can be described as "staff-driven", which means the staff is more influential than the six external board members, who are not permanent employees of the BCRP. From the staff, only Velarde and Armas communicate their views publicly. Until some years ago, the former General Manager, Renzo Rossini, and the former Manager for Economic Policy, Jorge Estrella, did too.

We believe it is crucial to pay attention to what Velarde and Armas are saying to anticipate the BCRP's next moves. At the press conference of the last meeting, on Friday last week, Chief Economist Armas argued convergence to the inflation target range will be slower than they expected, and headline inflation is unlikely to fall below 3% by year-end 2023 (like projected in the BCRP's previous scenario). Several weeks before that, Governor Velarde said: *"the worst that can happen to a central banker is to cut rates only to hike it again two or three months later [...] we must be sure that inflation has been defeated"*. We interpret these comments as both saying the easing cycle is distant.

4) The tolerance/target range matters more than the 2%-target

This is something we have picked up, in fact, from listening to the remarks of Velarde and Armas. In their decision framework, the BCRP policymakers think more in terms of convergence to the "target range" (from 1% to 3%), *rango meta*, than to the inflation target (2%) itself.

The opposite than in Brazil where a common discussion is not to refer to a "target range" but to a tolerance range around the target. Brazilian central bankers tend to emphasize the target, because such stricter guidance is useful for making inflation expectations converge to the target (which the BCB has been lowering for years).

For the BCRP, the trade-off is more flexibility at the expense of a wedge in long-term inflation expectations (they are rarely anchored at the 2% target). Anyway, this is a useful consideration to have in mind when predicting BCRP actions.

5) King core is CPI excluding food & energy

Even though the BCRP publishes an indicator called "core inflation" (*inflacion subyacente*) – defined as CPI excluding perishable food, utilities, and transport – their preferred core measure is CPI excluding food & energy.

If one enters the BCRP website, the first image that will appear is the current level of four indicators: headline inflation, CPI ex food & energy (yoy), 12-month inflation expectations, and the policy rate. Also, the only core inflation measure that is mentioned in every monthly monetary policy statement is CPI ex food & energy.

In our view, three conditions must be satisfied for the BCRP to start cutting rates:

i) headline inflation must significantly fall for at least two consecutive quarters (at present the count is at 3 months);

ii) CPI ex food & energy (yoy) must fall for at least two consecutive quarters (count is at only 2 months, April and May);

iii) and 12-month inflation expectations must get very close to 3%.

6) Richness of opinions; will discuss virtually anything related to the economy

The BCRP extensively discusses – both in its reports and verbal guidance – subjects that are often taboo for other central bankers in Latam out of concern of political backlash. These subjects include, inter alia, fiscal policy (with independent forecasts that differ from the Ministry of Finance), all sorts of economic reforms (such as tax, labor, pension, mining, deregulaton, among others), and even politics (constitutional reform, political instability leading to capital outflows, etc.).

For instance, in the past years the BCRP was very vocal to speak up against withdrawals from the private pension funds (AFPs), confronting Congress. During the Humala administration they criticized the overregulation in the mining sector (*"tramitologia"*) as a government policy that was hurting private investment. To name some examples. That richness of opinions is very useful to understand the mindset of BCRP policymakers.

7) Growing tolerance for exchange rate fluctuations

Finally, we believe the BCRP has a growing tolerance for exchange rate fluctuations. They have never targeted USDPEN levels, during the twenty-one years of inflation-targeting, contrary to what some investors might think. The BCRP's FX policy has always been to lean against the wind when exchange rate volatility increases significantly, and with more force during moments of high inflation and/or capital outflows.

Nevertheless, the large drop of credit dollarization (from 80% in the early 2000s to 24% currently) and the hard-won anti-inflationary reputation (credibility) has reduced their proclivity to intervene in the FX market. Another important consideration on this respect is that the BCRP never uses interest rate policy to influence the exchange rate. They have other preferred tools for that purpose; mainly, FX swaps, spot interventions, and dollar-linked certificates of deposit.

News and Views

Brazil: Retail Sales increases in 0.1% momsa in April, with worse broad index print

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Retail Sales decelerated in April, with the 3-month moving average also down (+0.3% vs +1.5%), after a strong 1Q23. Although we saw an increase at the margin in the core index, most activities contracted, signaling a worse outlook for the sector ahead, in line with our deceleration expectations in the following months. The print had the support of a strong performance from the main activity in the index: supermarket sales. Vehicle's sales negatively impacted the broad retail index.

Retail Sales increased 0.1% momsa in April (from 0.8% momsa March), slightly below market expectations of 0.2% momsa. In yoy terms, retail sales increased 0.5%, from +3.3% previously. Only three (out of eight) activity sectors registered a monthly increase in sales, in seasonally adjusted terms. The print was mostly driven by supermarket sales (3.2% momsa, vs 0.0%), supported by Easter-related sales, followed by pharmaceutical items and books and newspapers. Negative highlights were apparel and footwear (-3.7% momsa vs -4.4%) and fuel products (-1.9% momsa vs -0.2%). Broad Retail Sales (which includes construction materials, auto and food wholesale) declined 1.6% momsa (from +3.7% momsa previously and after two months of expressive growth) and 3.1% yoy (from 8.8% yoy), amid much weaker vehicle sales.

- **To follow:** With an overall contraction in retail activity sectors, we expect a decline in retail sales in May, with tight credit conditions and high household indebtedness especially weighing down in activities more reliant on credit, such as vehicles, household appliances and electronic products. However, there is a lot of uncertainty on the numbers (particularly for the broad index), after the methodological changes made to all monthly activity series. Our forecast for April's IBC-Br remains at 3.2% yoy.

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