Emerging Insight

Peru – More space to cut rates

Key takeaways

- Decline of inflation, milder El Niño, depressed activity, and better external conditions provide more space to cut rates.
- ENFEN reduced probability of strong El Niño happening in Peru in 1Q2024 to 12%, from 43% in November and 50% in October.
- We are revising our policy rate forecast for 2024 to 4% (from 5%), and assuming a 25bp cut in every monthly meeting.

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Alexander Müller
Andean(ex-Ven) Carib Economist
BofAS
+1 646 855 5750
alexander.muller@bofa.com

David Hauner, CFA >>
Global EM FI/FX Strategist
MLI (UK)
david.hauner@bofa.com

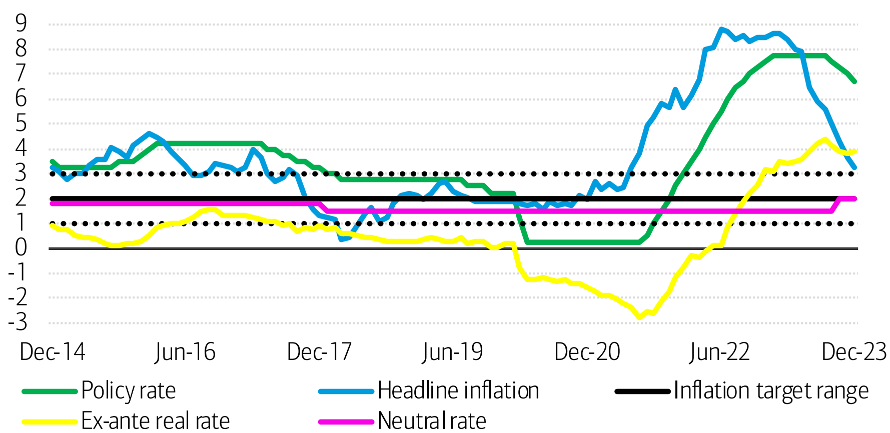
Claudio Irigoyen
Global Economist
BofAS
claudio.irigoyen@bofa.com

See Team Page for List of Analysts

By Alexander Müller

Chart of the Day: Monetary policy stance and inflation (%)

Monetary policy is still tight, with the (ex-ante) reference rate 192bp above the neutral level



Source: BofA Global Research, Central Bank (BCRP)

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Peru in Focus

Conditions are aligning for a faster easing cycle

We expect the Central Bank (BCRP) to cut the policy rate by 25bp, to 6.50%, on January 11th. The significant decline of inflation, a milder El Niño, depressed activity, and more benign external conditions provide space to continue cutting rates. Before, we thought there would be a pause of the easing cycle in Q1 when El Niño's effects on inflation and activity usually peak in Peru. But now we believe the BCRP will cut 25bp in every meeting until reaching 4% (down from a terminal rate of 5% in our previous scenario).

Substantially lower probability of a strong El Niño

The government's commission that studies El Niño – called ENFEN – has substantially reduced its estimated probability of a strong shock happening in Peru in 1Q2024, to 12% (last official statement, December 29th). This estimate was 43% in November and 50% in October. In Peru El Niño is played between December and April. That is when one can really tell whether the effects are strong or not. By January, climate scientists have more confidence in making predictions. Currently, their base-case is a moderate shock. In December the BCRP's Governor, Julio Velarde, publicly said that if El Niño is not strong, that would facilitate the reduction of inflation and the rebound of GDP in 2024.

Consistent with evidence from other countries

Other countries are also showing evidence of a milder than expected El Niño. In Panama, the Canal Authority (ACP) recently increased the number of ships that are allowed to transit through its locks, after restricting passage in the past months. In Ecuador the electricity blackouts that were implemented since October (to save energy because El Niño was putting stress on hydro generators) have been suspended until mid-January. And in Colombia there isn't evidence of a very strong El Niño either. Water levels in hydro dams have been significantly above 4Q2015-1Q2016 (last strong shock for Colombia), nor food prices have spiked because of the weather.

We forecast CPI inflation of 0.15% mom for January

With data for the first week of January, food prices are falling. Big declines in rice, corn, eggs, carrots, among other items are more than offsetting the increase in chicken prices. Conversely, wholesale gasoline prices have increased in early December. And so has the propane gas (LPG) price as adverse ocean conditions (anomalous waves) have caused temporary disruption of operations in 50 ports, according to the Peruvian navy.

Exhibit 1: BofA's inflation forecasts for Peru
We foresee headline inflation returning to the tolerance range of the BCRP (1pp around 2% target) by March

	CPI		Core (ex food & energy)	
	mom	yoy	mom	yoy
Dec-23	**0.41**	**3.24**	**0.36**	**2.91**
Jan-24	0.15	3.16	0.01	2.87
Feb-24	0.21	3.07	0.14	2.73
Mar-24	0.75	2.55	0.80	2.65
Apr-24	0.11	2.10	0.12	2.56
May-24	0.15	1.93	0.15	2.64
Jun-24	0.10	2.19	0.14	2.63
Jul-24	0.36	2.15	0.18	2.52
Aug-24	0.32	2.09	0.10	2.37
Sep-24	0.10	2.18	0.02	2.26
Oct-24	0.05	2.55	0.08	2.11
Nov-24	0.07	2.79	0.08	2.17
Dec-24	**0.17**	**2.55**	**0.35**	**2.16**
Jan-25	0.10	2.50	0.02	2.17
Feb-25	0.16	2.45	0.15	2.18
Mar-25	0.70	2.40	0.81	2.19
Apr-25	0.25	2.54	0.13	2.20
May-25	0.15	2.54	0.16	2.21
Jun-25	0.10	2.54	0.15	2.22
Jul-25	0.36	2.54	0.22	2.26
Aug-25	0.31	2.53	0.14	2.30
Sep-25	0.09	2.52	0.06	2.34
Oct-25	0.04	2.51	0.12	2.38
Nov-25	0.05	2.49	0.12	2.43
Dec-25	**0.15**	**2.47**	**0.39**	**2.47**

Source: BofA Global Research, Statistics institute (INEI)

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Exhibit 2: BofA's monetary policy rate forecasts for Peru
We forecast the terminal rate of the easing cycle at 4%

Month	Monetary policy rate (%)
Dec-23	6.75
Jan-24	6.50
Feb-24	6.25
Mar-24	6.00
Apr-24	5.75
May-24	5.50
Jun-24	5.25
Jul-24	5.00
Aug-24	4.75
Sep-24	4.50
Oct-24	4.25
Nov-24	4.00
Dec-24	4.00
Jan-25	4.00
Feb-25	4.00
Mar-25	4.00
Apr-25	4.00
May-25	4.00
Jun-25	4.00
Jul-25	4.00
Aug-25	4.00
Sep-25	4.00
Oct-25	4.00
Nov-25	4.00
Dec-25	4.00

Source: BofA Global Research, Central Bank (BCRP)

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Falling core inflation induced by FX and weak demand

On the core side (CPI excluding food and energy), we forecast a variation of 0.01% mom for January. Nominal exchange rate appreciation, 4.1% from October, is putting downward pressure on imported goods' prices such as automobiles and services that are sensitive to the exchange rate (Lima's housing rent, air tickets, regulated electricity). Moreover, the contraction of GDP has come with weak demand that is also inducing disinflation in core prices.

We estimate monthly GDP fell 0.1% yoy in November

Looking at coincident indicators, we estimate the monthly GDP indicator contracted 0.1% yoy in November, dragged by the fall of construction and manufacturing, and anemic growth in services sectors. Interestingly, the contraction of the financial sector probably subtracted around 0.5pp from GDP in 2023. Credit is weak, amid tight monetary policy, even if one excludes the repayment of the Reactiva Peru loans (that explain the contraction in credit to firms).

Terminal rate of 4% implies mildly expansionary stance

Against this backdrop, we believe the BCRP will cut rates by 25bp in each monthly meeting until reaching 4% in November 2024. That would imply a mildly expansionary stance, with a real ex-ante rate of 1.5% (4% minus 2.5% twelve-month inflation expectations), below the neutral rate of 2%. In Peru inflation expectations seldom decrease below 2.5%. We believe this happens because the BCRP says they target the "tolerance range" (from 1% to 3%) rather than the 2% target. Thus, the market assumes policymakers are satisfied with inflation in between 2% and 3%.

BCRP is unlikely to step up the pace of easing cycle

In our view the BCRP is unlikely to step up the pace of the cuts from 25bp to 50bp (or more) for four reasons: 1) in the starting point of the easing cycle rates were not really very high, unlike in LatAm peers, so the BCRP doesn't need to rush; 2) it would be a mistake to trust El Niño predictions 100%, so it's better to keep the guard high at least until April; 3) BCRP probably wants to avoid depreciation pressure on the exchange rate, that could happen if they signal a deeper and faster easing cycle; and 4) 12-month inflation expectations (a key indicator in their decision framework) returned to the tolerance in December, after almost three years outside (they will want to consolidate the anchorage).

News and Views

Brazil: Current Account posted the sixth consecutive deficit in November

David Beker	Natacha Perez
+55 11 2188 4371	+55 11 2188 4127

According to the Brazilian Central Bank's (BCB), current account (CA) posted a US$1.6bn deficit in November (from a US$0.04bn deficit in October, revised from -US$0.2bn). The deficit was above market expectations of a US$0.4bn deficit. In 12-month accumulated terms, current account deficit remained unchanged at US$ 34.0bn in November. Trade balance remains at high level with a US$6.7 bn surplus (from US$7.6 bn in October), while services balance registered a deficit of US$3.6bn (from -US$3.5bn) and income balance deficit was US$4.7bn (from -US$4.1bn).

Foreign Direct Investment (FDI) registered an inflow of US$7.8bn in November from US$3.3bn previously, above expectations of US$4.0bn. Intercompany loans recorded a net inflow of US$1.5bn (from an outflow of US$1.4bn in October) and capital holdings increased to US$6.3bn (from US$4.7bn). In 12-months accumulated, FDI totaled US$57.7bn (from US$57.5bn).

- **To follow:** For YE24, we expect current account deficit at US$41bn and FDI at US$65bn.

Brazil: Outstanding credit continues decelerating in yearly terms

David Beker	Natacha Perez
+55 11 2188 4371	+55 11 2188 4127

Total outstanding credit decelerated to 7.1% yoy in November (from 7.5% yoy in October) according to the Brazilian Central Bank (BCB). Since the beginning of the year, the bulk of deceleration came from non-earmarked loans (now at 5.0% yoy, from 15.0% yoy in January), particularly due to non-financial corporates (NFC). Overall earmarked loans decelerated as well, reaching 10.2% yoy (from 11.1% yoy in October). Regarding marginal data, originations rose 0.9% momsa, after -0.3% momsa in October. On the other hand, broad credit growth, which includes debt securities, sovereign bonds and external debt, decelerated to 7.2% yoy (from 7.7% previously), which was motivated by an external debt decline. Household debt declined to 47.6% of total income (from 47.7% in October), while the debt service ratio went to 27.2% in seasonally adjusted terms (from 27.3%). Meanwhile, Individuals NPL moved down to 3.8% (vs. 3.9%), while Corporate increased to 2.9% (vs. 2.8%).

- **To follow:** Though the picture should become less tight due to the lagged effects of the easing in monetary policy, the turning point is yet to be seen.

Brazil: IGP-DI increases 0.64% mom in December, in line with expectations

David Beker	Natacha Perez
+55 11 2188 4371	+55 11 2188 4127

IGP-DI registered a 0.64% mom change in December (vs 0.50% mom in November), the higher result since May22. The result was in line with market (0.66%) expectations. In 12-months, IGP-DI continues to accelerate, now at -3.30% (vs. -3.62% in November). Wholesale prices increased 0.79% mom (from 0.63% mom in November), with acceleration of agricultural prices (3.64% mom, vs 0.74% mom previously). On the consumer side, the increase of 0.29% mom (vs 0.27% mom previously) was led by higher Food prices (1.01% mom, vs 0.47% mom). For construction, prices continue to contribute to the upside (0.31% mom, vs 0.07% mom).

- **To follow:** PPI prints should continue to accelerate in the next months.

Brazil: November IP surprised to the upside

David Beker +55 11 2188 4371
Natacha Perez +55 11 2188 4127

November industrial production (IP) posted a 0.5% momsa increase (vs 0.0% momsa in October, revised from 0.1% momsa), above market expectations (0.3% momsa). In year-over-year terms, IP accelerated to 1.3%, against 1.1% yoy previously. Momentum moved slightly up, now at 0.2% 3mma saar (vs. 0.1% in October). The sector continues to operate below pre-pandemic levels (-0.9% from Feb2020). With November's data, statistical carry is now at 0.1% (from 0.0%). Regarding monthly gains, two out of the four main categories (vs one in October) registered increases, and 13 of the 25 industrial sectors surveyed showed monthly growth in production in November (from 14 in October). Diffusion index (number of products that recorded increase in production compared to previous year) accelerated to 46.9% (from 46.6% in October).

- **To follow:** We expect a weaker IP reading in December.

Brazil: Record trade balance in 2023

David Beker +55 11 2188 4371
Natacha Perez +55 11 2188 4127

The trade balance posted a US$9.4bn surplus in December (from a US$8.8bn surplus in November). The result was above our (US$8.0bn) and market expectations (US$7.7bn). Exports totaled US$28.8bn, increasing 27% yoy, while imports were down 5% yoy, reaching US$19.5bn. The 12-month accumulated balance was US$98.8bn, a surplus 55% above the level registered in December 2022, with exports totaling US$339.7bn and imports US$240.8bn. On the exports side, agriculture and extractive sector remains sustaining Brazilian trade balance. On the imports side, all the sectors had a decline. With this print, 2023 trade balance was consolidated as a record.

- **To follow:** Trade balance should continue strong, supported by agriculture and extractive exports, as well as decline in imports.

Brazil: Public Sector primary deficit accelerated to 1.2% of GDP in November

David Beker +55 11 2188 4371
Natacha Perez +55 11 2188 4127

The public sector posted a R$37.3bn primary deficit in November (from a R$14.8bn surplus in October), according to the Brazilian Central Bank (BCB). The result was below market expectation of R$30.7bn deficit. The Central Government contributed with a R$38.9bn deficit (vs a R$19.4bn surplus in October) and state-owned companies contributed with a R$0.3bn deficit (vs a R$0.8bn deficit), while regional governments posted a surplus of R$2.0bn (from -R$3.9bn). In 12 month accumulated terms, the primary deficit accelerated to R$114.2bn (1.2% of GDP), from R$101.9bn in October (1.1% of GDP). Also, nominal deficit went up to R$834.3bn (7.8% of GDP, from 7.7%). Gross debt/GDP went up to 73.8% of GDP (from 73.7% in Oct23) and net debt moved to 59.5% of GDP (from 59.2%).

- **To follow:** : Gross debt continues to go up, reinforcing the negative fiscal stance and the challenging scenario to the government comply with the proposed fiscal target. With interest rates still elevated, the nominal balance should remain under pressure. We expect a public sector primary deficit of 0.8% of GDP by 2023YE, with the gross debt to GDP ratio going up to 76.1%.

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Research Analysts

Global Economics

Claudio Irigoyen
Global Economist
BofAS
+1 646 855 1734
claudio.irigoyen@bofa.com

Antonio Gabriel
Global Economist
BofAS
antonio.gabriel@bofa.com

Global EM FI/FX Strategy

David Hauner, CFA >>
Global EM FI/FX Strategist
MLI (UK)
+44 20 7996 1241
david.hauner@bofa.com

Asia FI/FX Strategy & Economics

Helen Qiao
China & Asia Economist
Merrill Lynch (Hong Kong)
+852 3508 3961
helen.qiao@bofa.com

Claudio Piron
Emerging Asia FI/FX Strategist
Merrill Lynch (Singapore)
+65 6678 0401
claudio.piron@bofa.com

Adarsh Sinha
FX Strategist
Merrill Lynch (Hong Kong)
+852 3508 7155
adarsh.sinha@bofa.com

Jojo Gonzales ^^
Research Analyst
Philippine Equity Partners
jojo.gonzales@pep.com.ph

Abhay Gupta
Emerging Asia FI/FX Strategist
Merrill Lynch (Singapore)
abhay.gupta2@bofa.com

Pipat Luengnaruemitchai
Emerging Asia Economist
Kiatnakin Phatra Securities
pipat.luen@kkpfg.com

Miao Ouyang
China & Asia Economist
Merrill Lynch (Hong Kong)
miao.ouyang@bofa.com

Xiaoqing Pi
China Economist
Merrill Lynch (Hong Kong)
xiaoqing.pi@bofa.com

Benson Wu
China & Korea Economist
Merrill Lynch (Hong Kong)
benson.wu@bofa.com

Ting Him Ho, CFA
Asia Economist
Merrill Lynch (Hong Kong)
tinghim.ho@bofa.com

Janice Xue
Emerging Asia FI/FX Strategist
Merrill Lynch (Hong Kong)
janice.xue@bofa.com

Chun Him Cheung, CFA
Emerging Asia FI/FX Strategist
Merrill Lynch (Hong Kong)
chunhim.cheung@bofa.com

Kai Wei Ang
Asia & ASEAN Economist
Merrill Lynch (Singapore)
kaiwei.ang@bofa.com

EEMEA Cross Asset Strategy, Econ

Mai Doan
CEE Economist
MLI (UK)
+44 20 7995 9597
mai.doan@bofa.com

Zumrut Imamoglu
Turkey & Israel Economist
MLI (UK)
zumrut.imamoglu@bofa.com

Vladimir Osakovskiy >>
EM Sovereign FI/EQ strategist
Merrill Lynch (DIFC)
vladimir.osakovskiy@bofa.com

Jean-Michel Saliba
MENA Economist/Strategist
MLI (UK)
jean-michel.saliba@bofa.com

Merveille Paja
EEMEA Sovereign FI Strategist
MLI (UK)
merveille.paja@bofa.com

Mikhail Liluashvili
EEMEA Local Markets Strategist
MLI (UK)
mikhail.liluashvili@bofa.com

Tatonga Rusike
Sub-Saharan Africa Economist
MLI (UK)
tatonga.rusike@bofa.com

LatAm FI/FX Strategy & Economics

David Beker >>
Bz Econ/FI & LatAm EQ Strategy
Merrill Lynch (Brazil)
+55 11 2188 4371
david.beker@bofa.com

Jane Brauer
Sovereign Debt FI Strategist
BofAS
+1 646 855 9388
jane.brauer@bofa.com

Carlos Capistran
Canada and Mexico Economist
BofAS
+1 646 743 2921
carlos.capistran@bofa.com

Ezequiel Aguirre
LatAm FI/FX Strategist
BofAS
ezequiel.aguirre2@bofa.com

Pedro Diaz
Caribbean Economist
BofAS
pdiaz2@bofa.com

Christian Gonzalez Rojas
LatAm Local Markets Strategist
BofAS
christian.gonzalezrojas@bofa.com

Lucas Martin, CFA
Sovereign Debt FI Strategist
BofAS
lucas.martin@bofa.com

Alexander Müller
Andean(ex-Ven) Carib Economist
BofAS
alexander.muller@bofa.com

Natacha Perez
Brazil Economist
Merrill Lynch (Brazil)
natacha.perez@bofa.com

Sebastian Rondeau
LatAm FI/FX Strategist
BofAS
sebastian.rondeau@bofa.com

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