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Contributors

Mario Guerrero, Deputy Head Economist
+51.1.211.6000 Ext. 16557 (Peru)
mario.guerrero@scotiabank.com.pe

Peru—BCRP Raises Rates 50 bps

- **BCRP raises policy rate and signals possible pause.**

The Board of Peru's central bank (BCRP) raised its key interest rate by 50 bps to 6.50% on Thursday, August 11, in line with the market consensus (Bloomberg), the interest rate swap market at 3 months, and our Scotiabank forecast. We believe that this could be the last increase in the current tightening cycle as the BCRP initiates a pause, provided that the reversal of inflationary expectations is confirmed after inflation peaked at 8.8% in June (the highest for the month of June in 29 years).

Inflation in July remained high (0.94% m/m), but may signal the beginning of a slowdown, as it fell from 8.8% y/y in June to 8.7% y/y in July. Surprisingly, 12-month inflation expectations also moderated, going from 5.35% in June to 5.16% in July. In the past, these expectations had reflected adaptive behaviour, which tend to make a downward adjustment a slow and gradual process. The reversal of inflation expectations in July allowed the real rate to go from 0.65% to 1.34%, still in expansionary territory, although it is very close to the real neutral rate of 1.5% (chart 1).

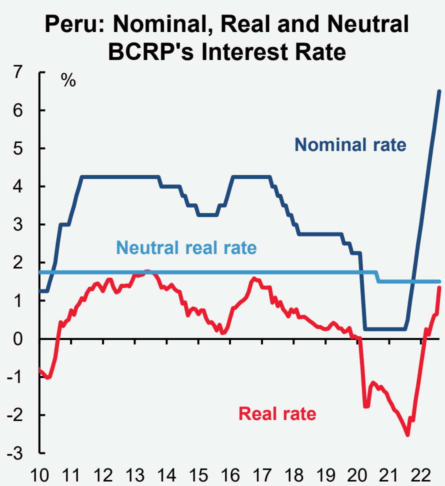
Like us, the central bank may entertain the possibility that inflation peaked in June. With this decision, and by reversing both inflation and its expectations, the interest rate hike cycle could thus be coming to an end. The key will be the speed at which inflation expectations moderate. With slowing inflation, inflation expectations, which have already been outside the target range for 13 consecutive months, would also moderate. Recent easing in international grain prices, oil and port costs increase the chances of this happening, although we assume the central bank will wait for clear evidence of easing price pressures.

The BCRP statement emphasizes that it projects a downward trend in year-on-year inflation owing to the moderation in international food and energy prices and a reduction in inflation expectations. We agree with that assessment, to which we add the influence of statistical base effects. The BCRP modified its expectation of the moment when it expects inflation to return to the target range. In the last four statements, its expectation of return to the target range was between Q2-2023 and Q3-2023. It now anticipates that it will do so during the second half of 2023 (between Q3-2023 and Q4-2023). This means that the BCRP sees a slower rate of convergence towards the target range; that is, inflation could remain high for longer than initially forecast.

In its statement, the BCRP reiterated that it will remain attentive to new information regarding inflation and its determinants, including inflation expectations and the evolution of economic activity, indicating that it is prepared to consider additional measures in the stance of monetary policy to ensure the return of inflation to the target range over the forecast horizon. This is the wording that has been used in recent statements, which would subordinate the next policy decision to the information available (data dependent). That said, to the extent that we expect inflation to have peaked in June, and given our expectation of inflation in August to be lower than in July, we see the BCRP possibly moderating the pace of monetary policy normalization, conditional on that the reversal of inflation expectations takes hold. Our forecast considers that the reference interest rate will remain at 6.50% by the year-end.

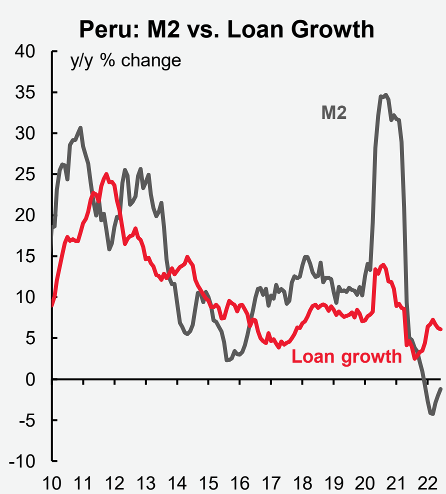
The statement also presents a more pessimistic outlook for global and local economic activity, emphasizing the decline in global growth expectations for this and next year despite some improvement in recent months. It also notes that most leading indicators and expectations for Peru's economy continue to deteriorate and remain in pessimistic territory. On the quantitative side, the growth of the quantity of money (M2) remained in

Chart 1



Sources: Scotiabank Economics, BCRP.

Chart 2



Sources: Scotiabank Economics, BCRP.

negative territory (-1.2% y/y in June) for the seventh consecutive month, although the rate of decline has moderated in the last three readings, which could reflect a greater comfort of the central bank with the current level of liquidity (chart 2). Loan growth maintained its dynamism in June, with a nominal rate above 6% y/y for the sixth consecutive month.

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