The Global Financial Crisis – Central Bank Responses in the Western Hemisphere

Monetary and Exchange Rate Policies in Peru: Responses to the Crisis

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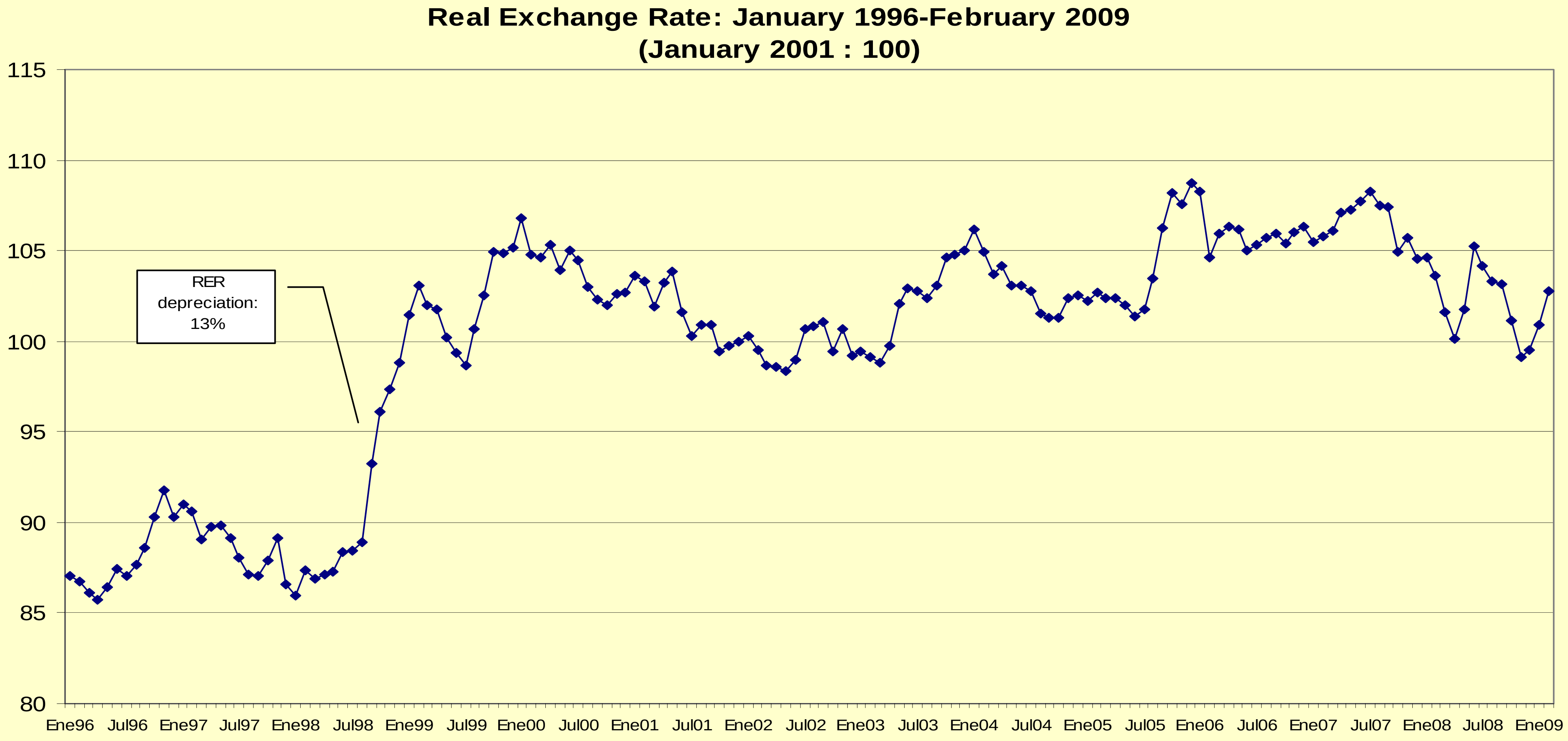
Contents

- Lessons from the Russian Crisis
- Hybrid Inflation Targeting
- The Subprime Crisis
- The Road Ahead

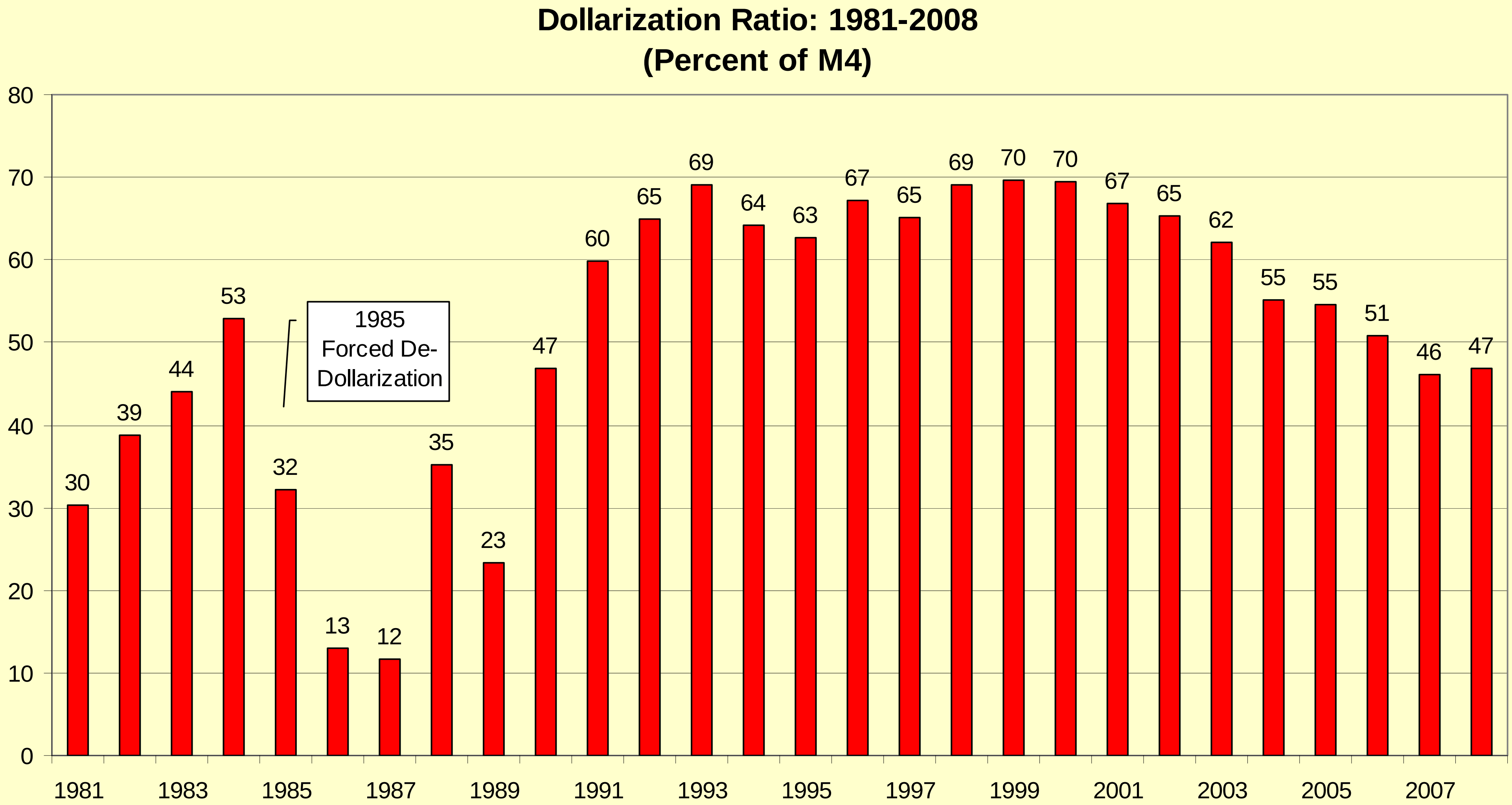
Effects of the Russian Crisis: 1998

- Credit crunch. Credit/GDP ratio declined from 28% of GDP in 1999 to 18% in 2004.
- Financial Crisis. Number of banks: from 26 in 1996 to 14 in 2004.
- Sharp decline of short-term credit lines (-50% aug99/aug98).
- Real currency depreciation (13% aug99/aug98).
- Balance-sheet effect. Greater delinquency in dollar banking loans. The bad-loans ratio increased from 5% in 1996 to 10% in 2000.
- Fear that the CB would not operate as an effective LOLR.

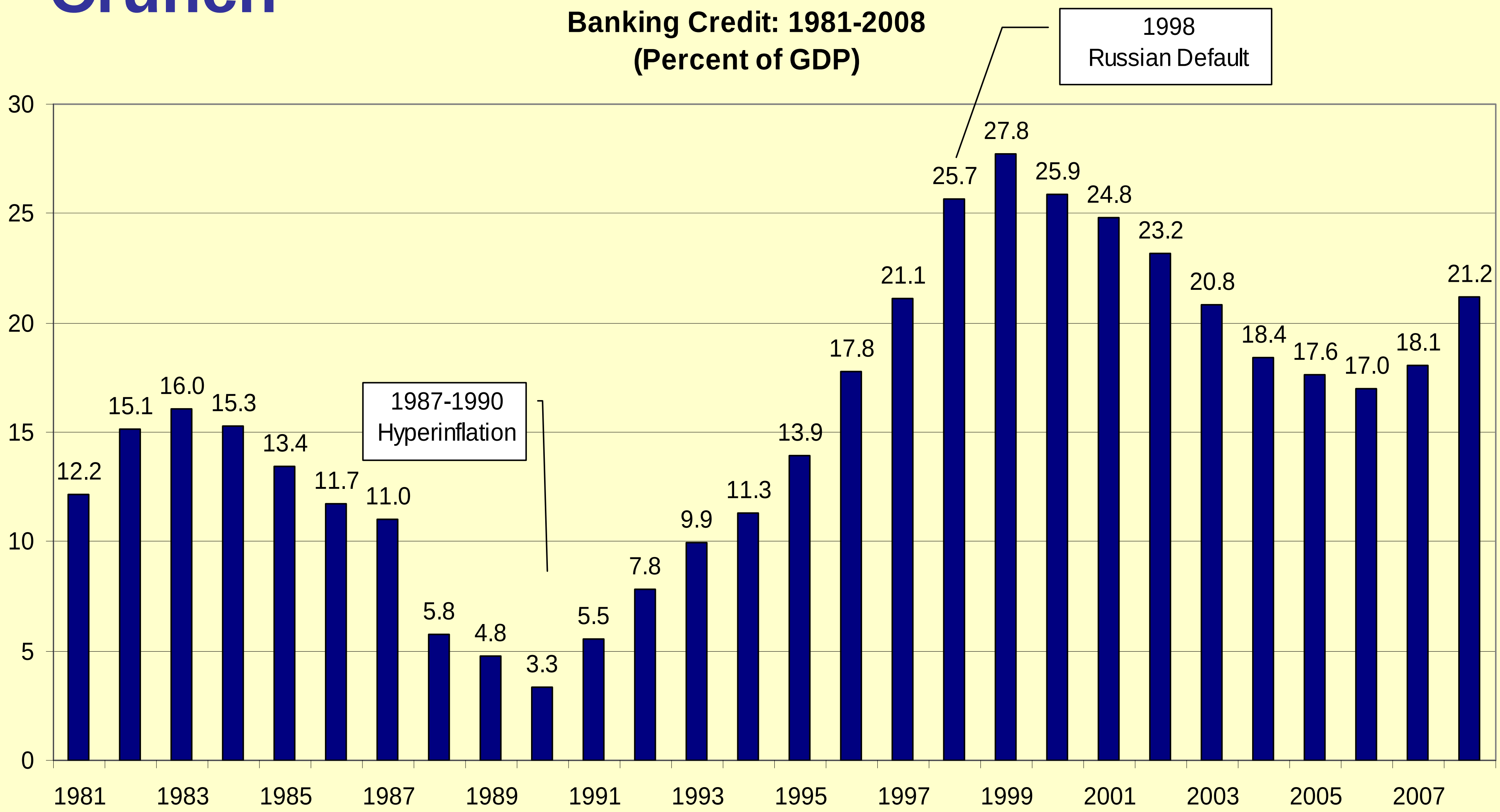
Lessons from the Russian Crisis: A sharp currency depreciation compromises the stability of the financial system.



Lessons from the Russian Crisis: Balance Sheet effect from a depreciation.



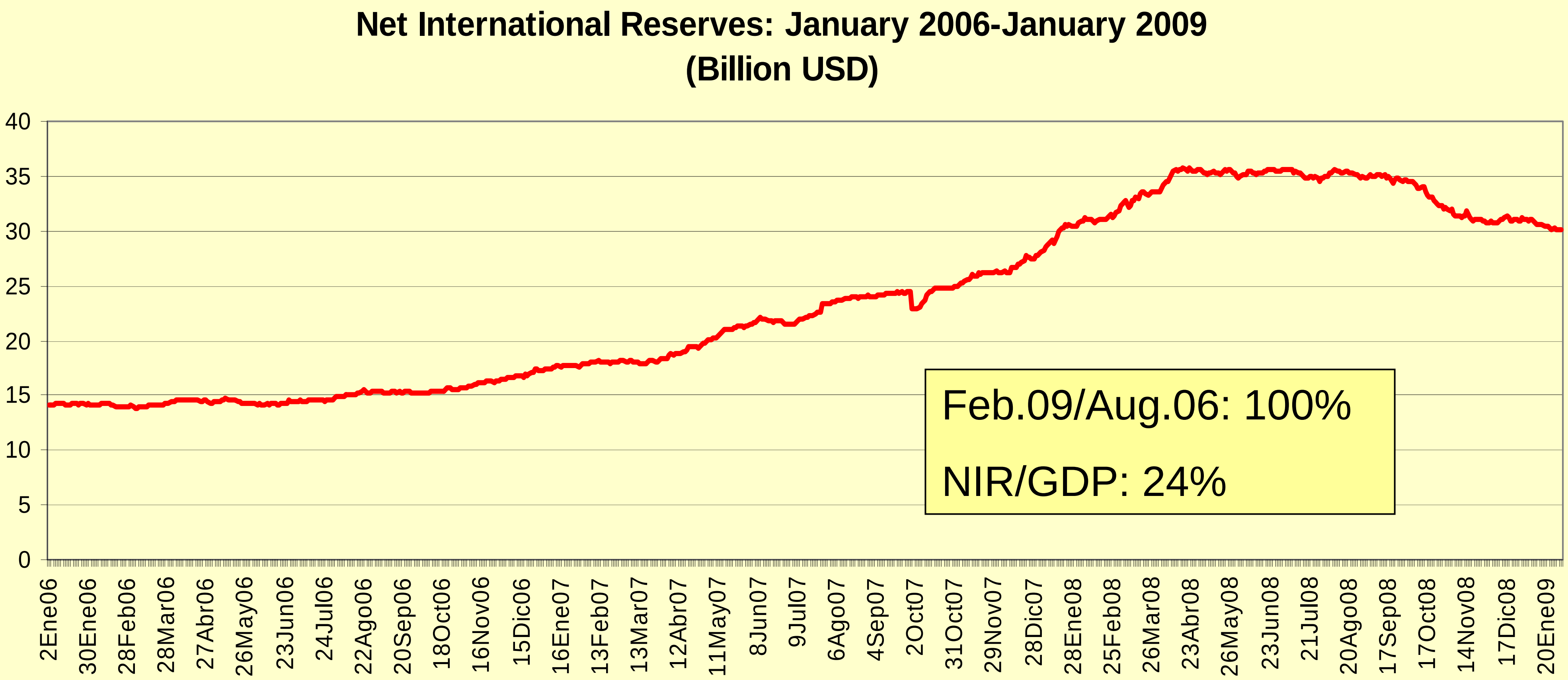
Lessons from the Russian Crisis: Credit Crunch



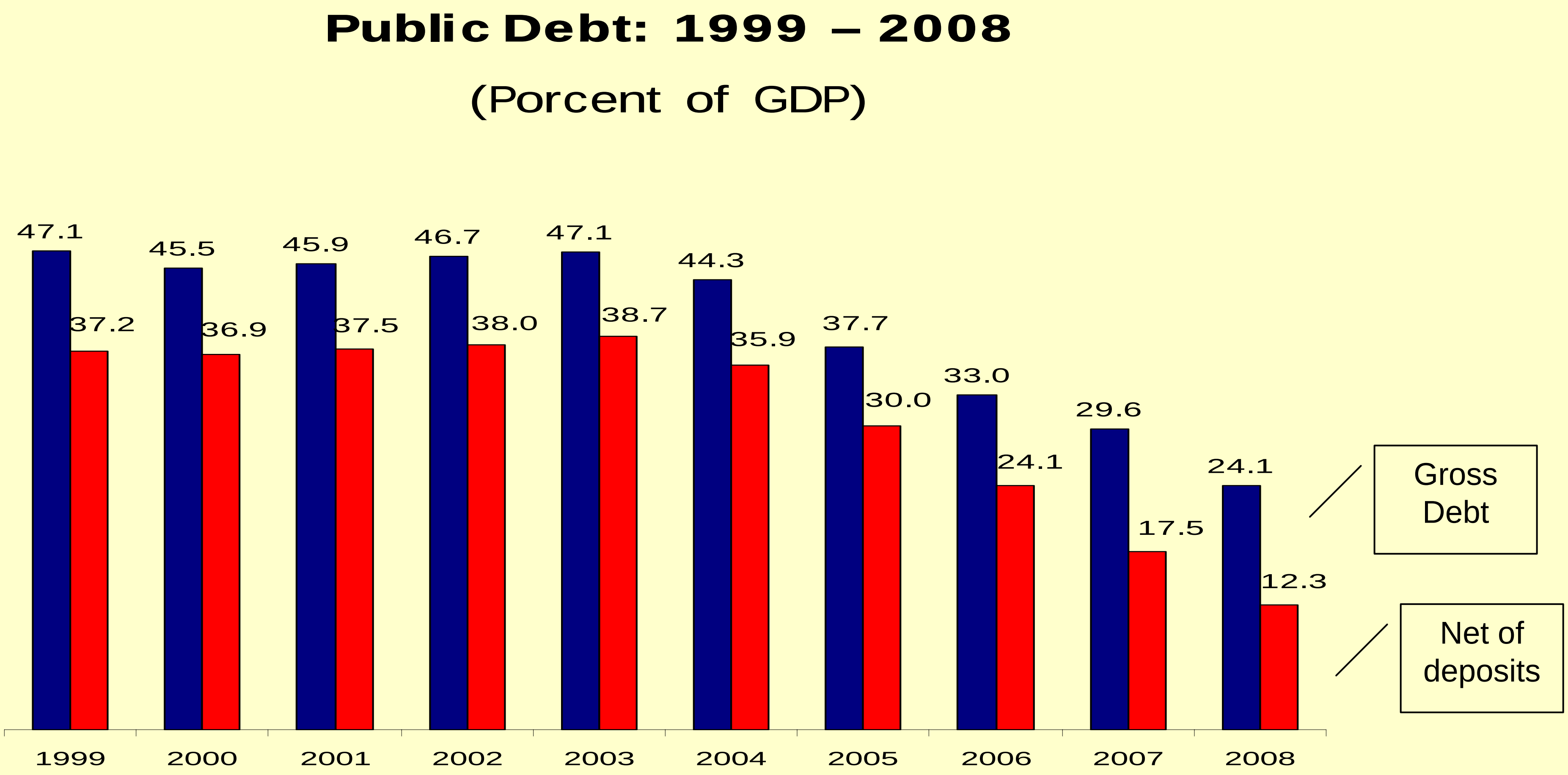
Lessons from the Russian Crisis

- Crisis Prevention:
  - ✓ Three L´s Rule: Liquidity
  - ✓ FX Intervention
  - ✓ Avoid credit-booms
- Crisis Management:
  - ✓ Act promptly (LOLR)
  - ✓ Communicate

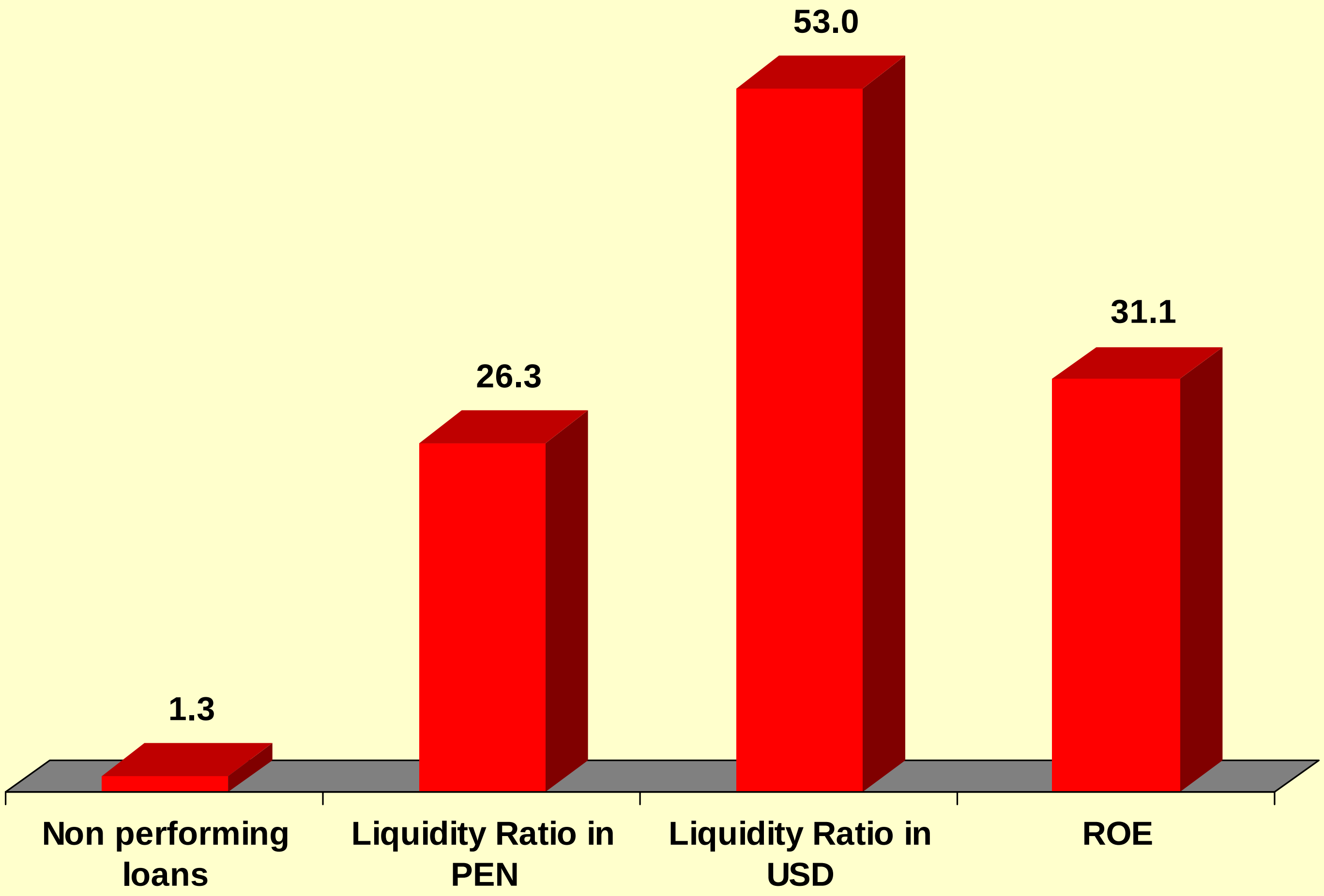
The 3 Ls Rule: High NIR



The 3 Ls Rule: Reduced Public Debt



The 3 Ls Rule: Liquid Banks



Liquidity Ratio: Liquid assets/short-term liabilities

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Hybrid Inflation Targeting

Inflation Targeting

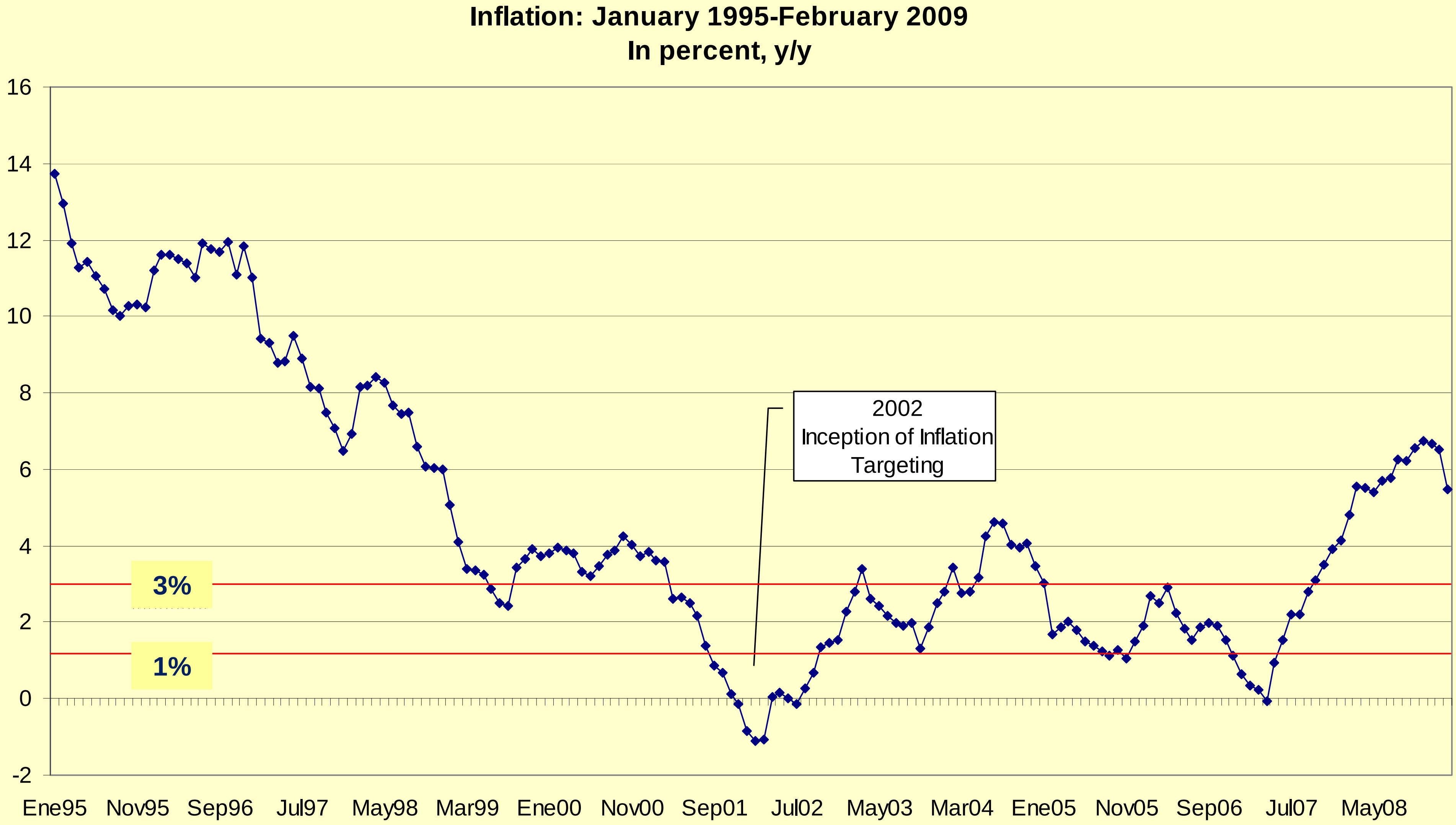
- Inflation target: 2% +/-1%
- Operational Target: Overnight interest rate

+

Control of Dollarizarion Risks

- Liquidity Risk:
  - o High reserve requirements on foreign currency liabilities
- Exchange Risk (Balance Sheet Effect):
  - o Sterilized FX Intervention to reduce volatility
  - o Preventive NIR accumulation

Hybrid Inflation Targeting



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Monetary Policy Responses. First Period (2007-August 2008): Preparing for the worst.

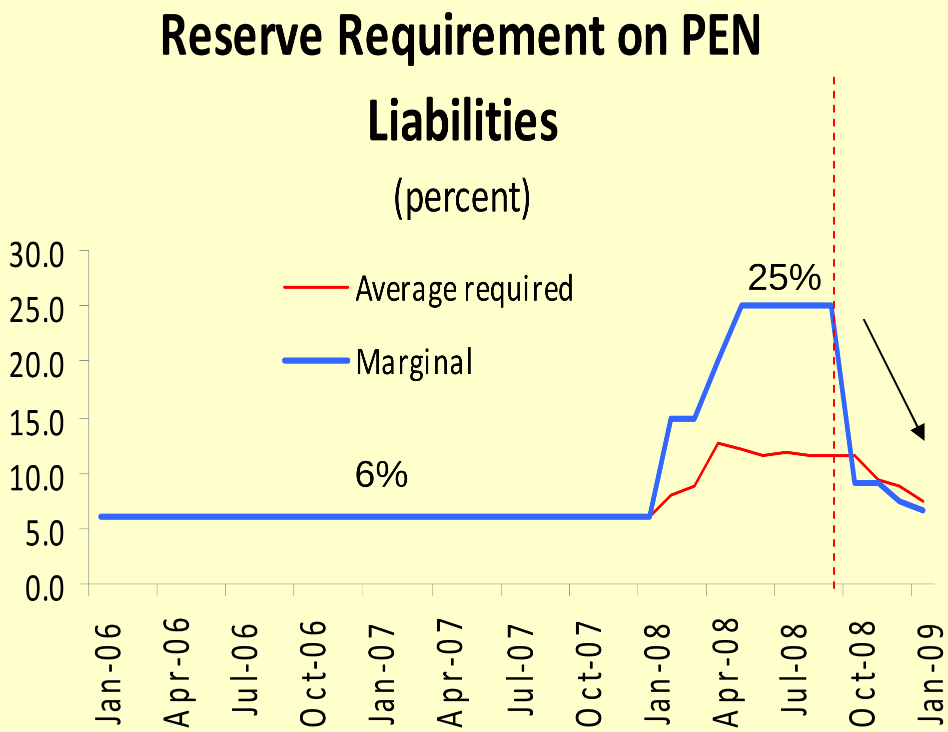
- **Money Market: tightening to reduce inflation and short-term liabilities. Reserve Requirements as a first line of defense.**
  - ✓ Higher reserve requirement on PEN and USD banks´ liabilities.
  - ✓ 120% reserve requirement on PEN liabilities with non-residents.
  - ✓ Increase of the interest policy rate.

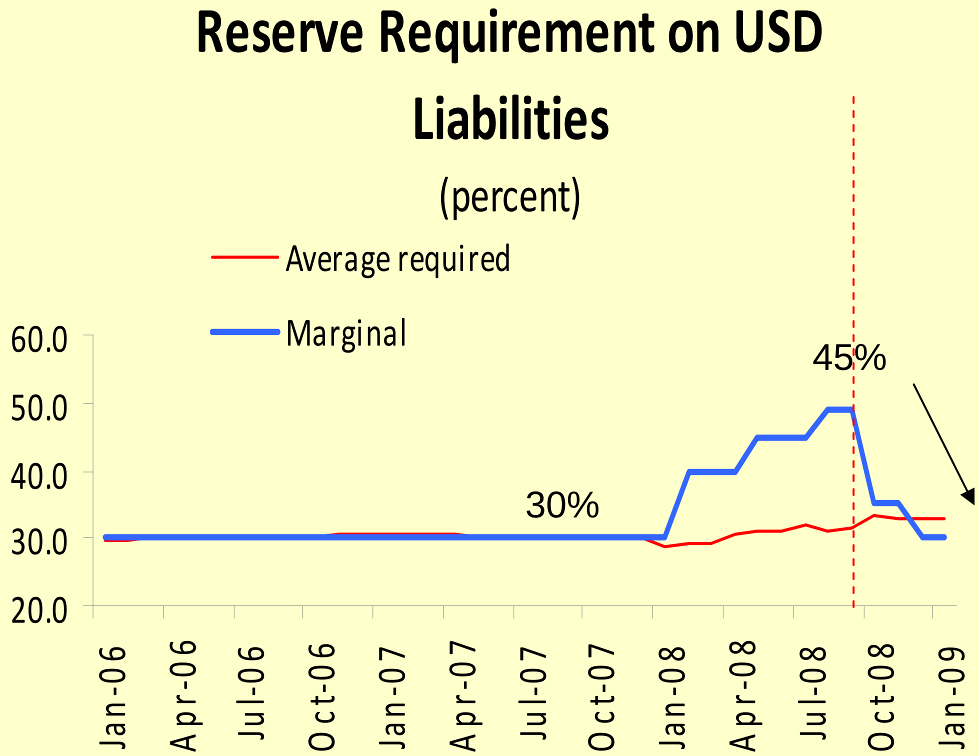
- **Exchange Market: reduction of exchange rate volatility and prudential accumulation of NIR.**
  - ✓ FX intervention: purchases of USD 8,4 billion.
  - ✓ Sterilization with CB certificates and fiscal surplus.

Monetary Policy Responses. Second Period (September 2008-2009): Avoiding the crunch.

- **Money Market: Loosening the monetary stance.**
  - ✓ Reduction of reserve requirement on PEN and USD banks´ liabilities. Reserve Requirements as a first line of defense.
  - ✓ Extension of the amount and maturity (from overnight to up to 1 year) of the REPO facility of the CB.
  - ✓ New swap facility.
  - ✓ Reduction of the stock of sterilization operations of the CB.
  - ✓ Reduction of the policy interest rate.
- **Exchange Market: reduction of exchange rate volatility and prudential accumulation of NIR.**
  - ✓ FX intervention: Sell of foreing currency by USD 6,9 billion.
  - ✓ Issue of USD indexed CB Certificates.
- **Capital Markets:** Avoiding contagion to the financial markets.
  - ✓ Intervention in the yield curve of the Treasury Bonds.

Reserve Requirements as a first line of defense





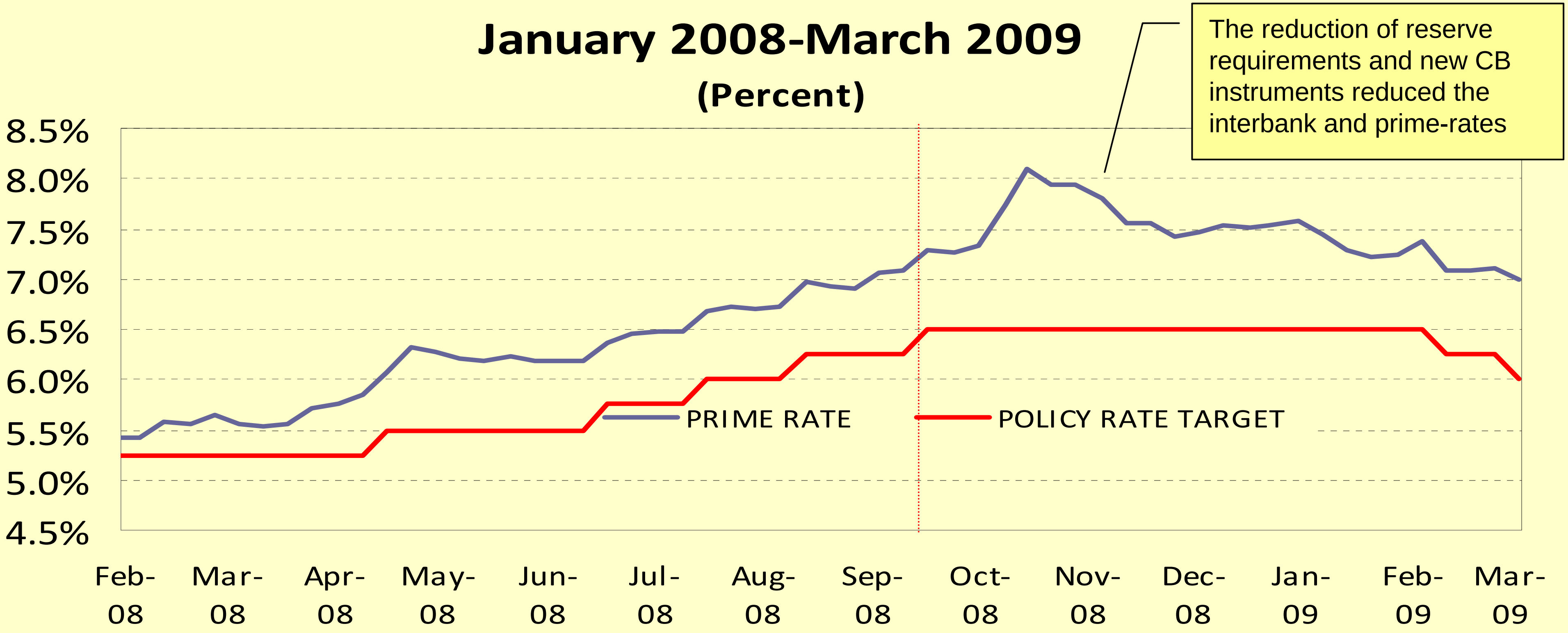
Marginal rate: applied on new liabilities.

Policy Rate neutrilized by capital inflows in the first period and by stubborn inflation at the beginning of the second period. Monetary Policy easing began in february 09.

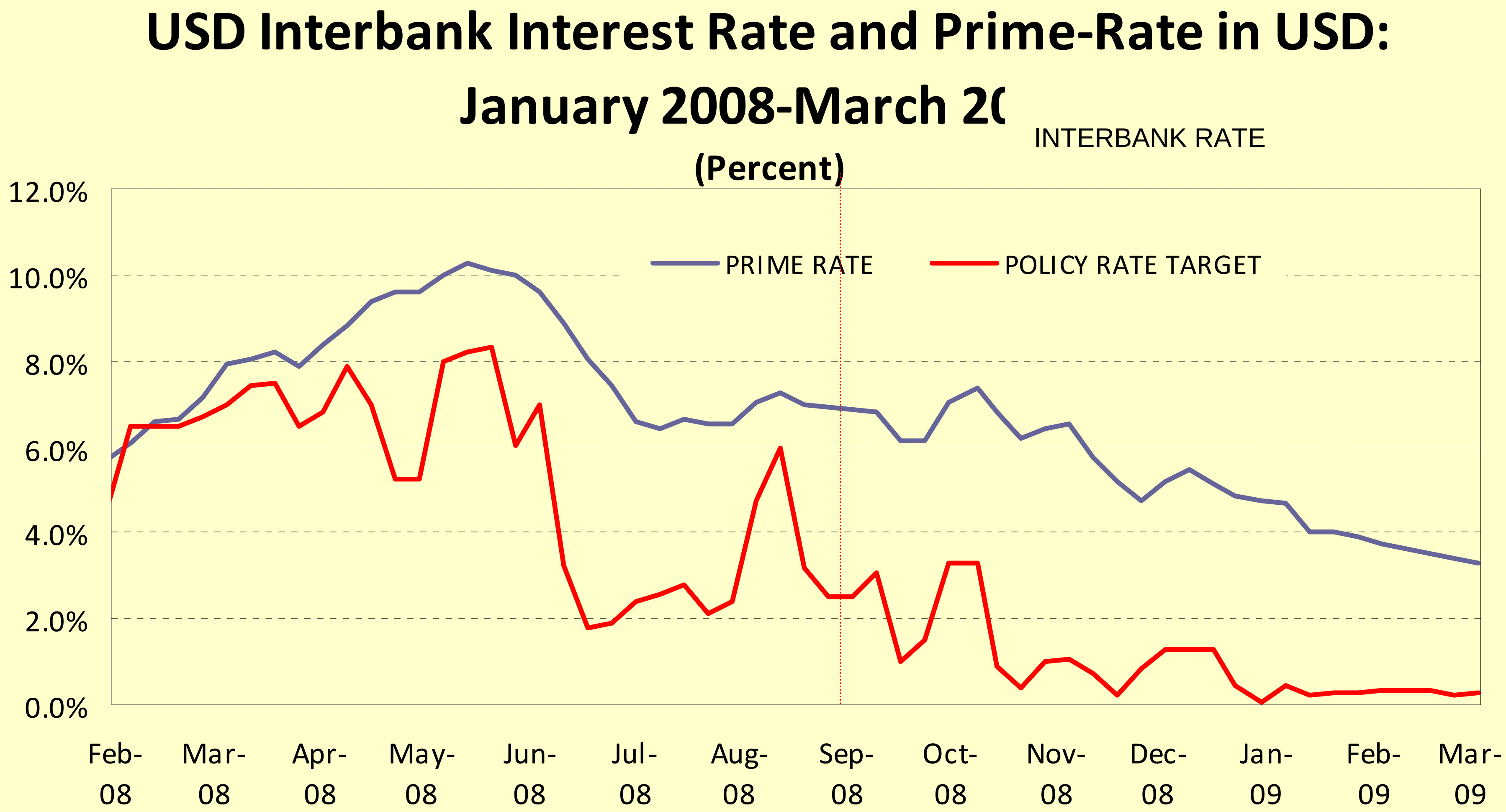
Policy Interest Rate and Prime-Rate in PEN:

January 2008-March 2009

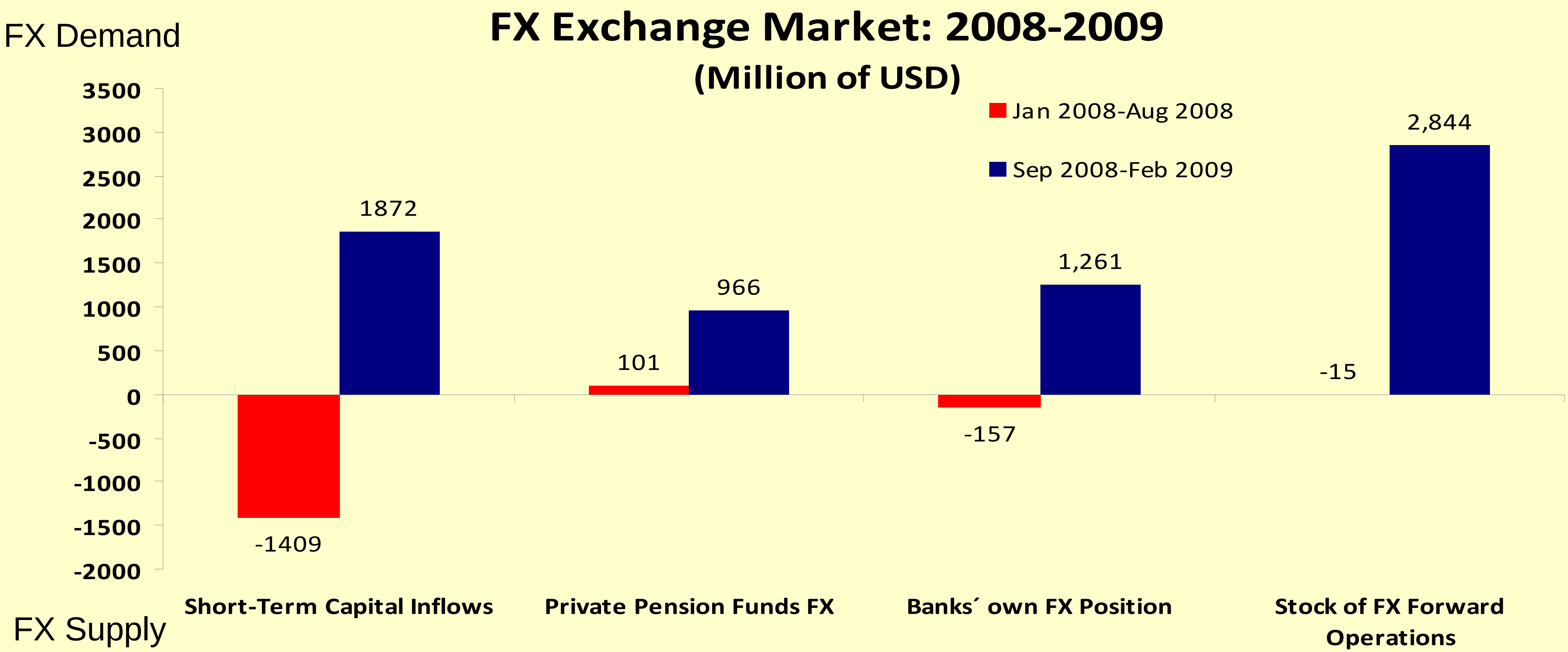
(Percent)



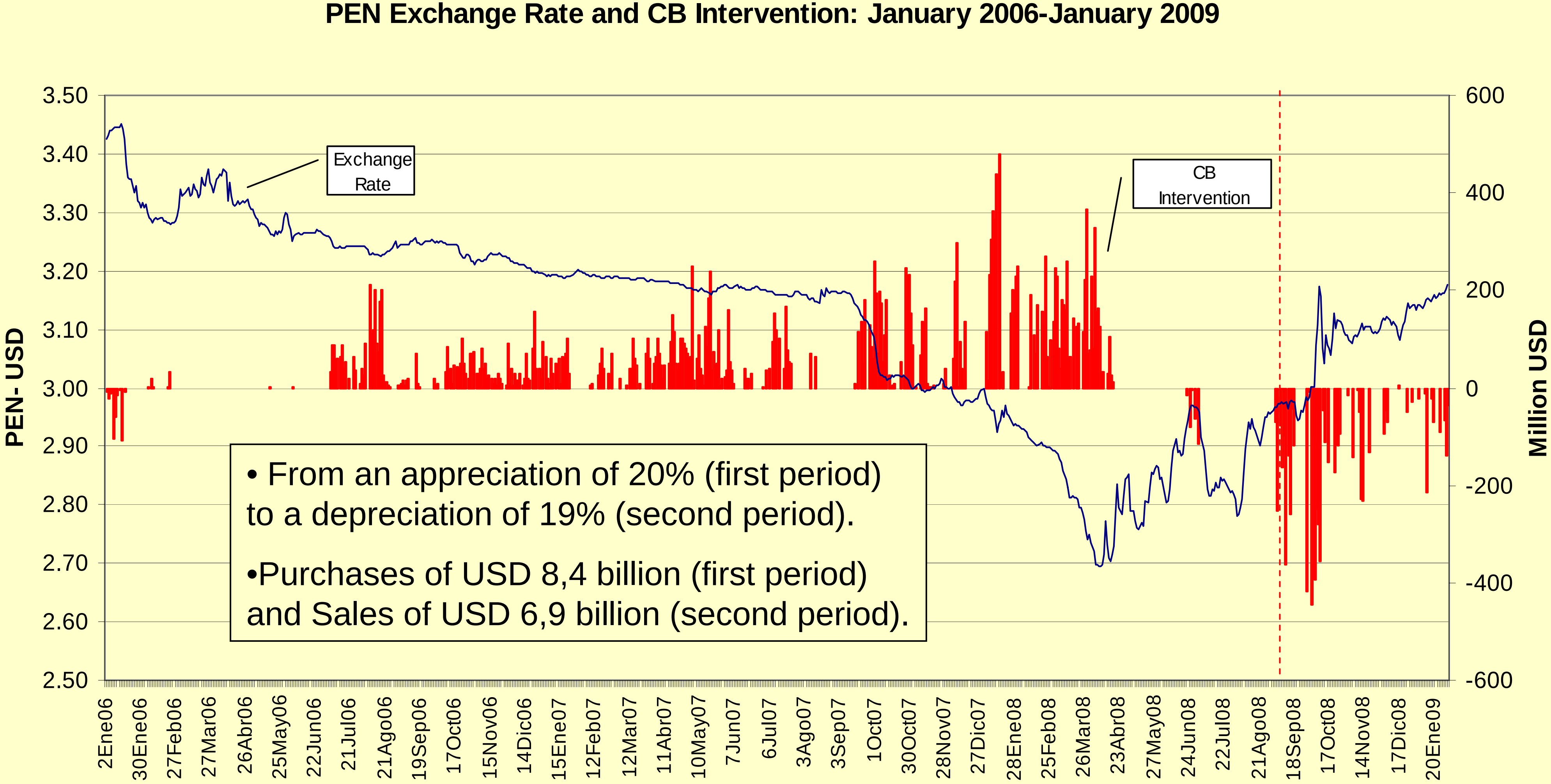
Reductions in Reserve Requirements on USD liabilities increased the liquidity during the second period



Flows in the FX Market before and after Lehman

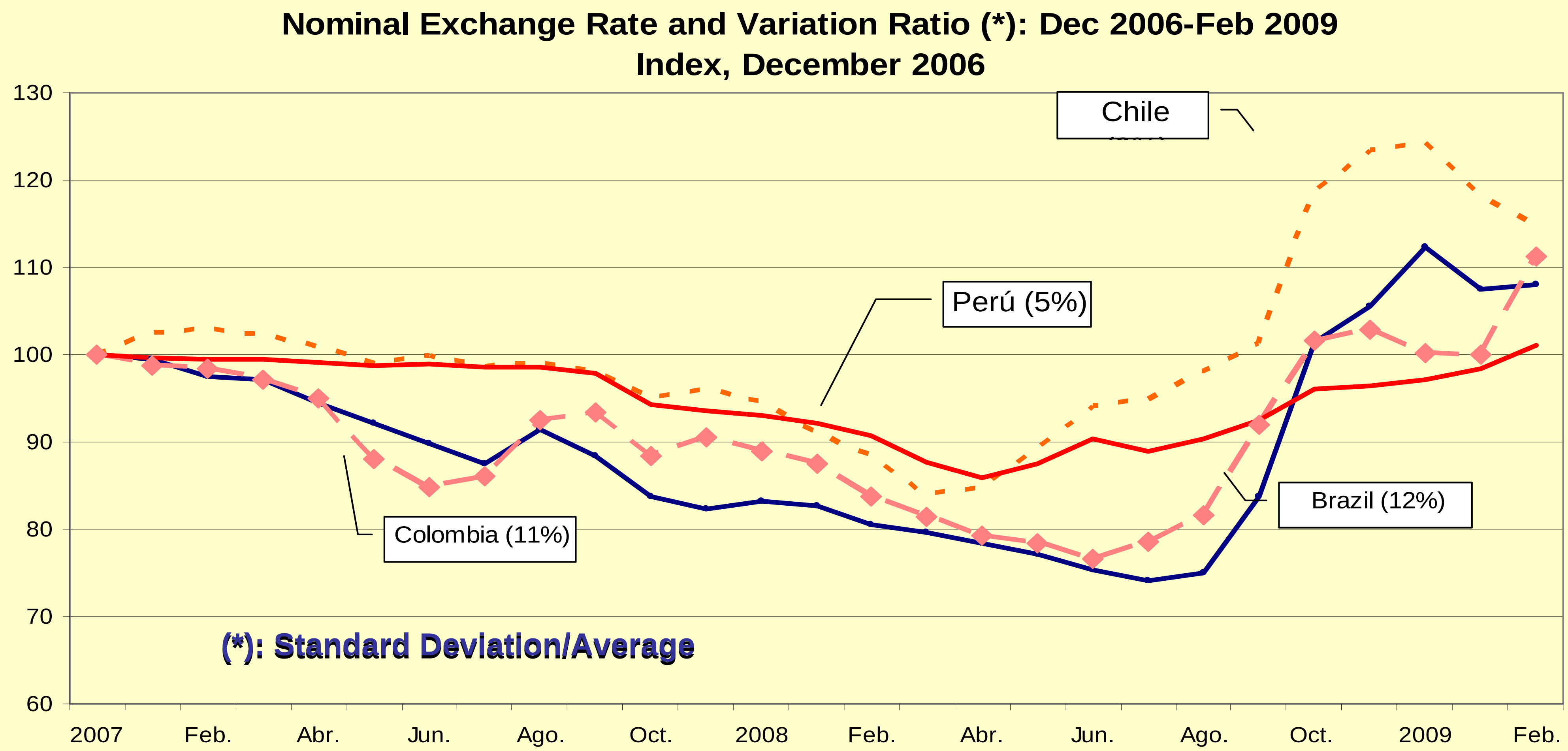


CB Intervention motivated by NIR precautionary accumulation and reduction of volatility



- From an appreciation of 20% (first period) to a depreciation of 19% (second period).
- Purchases of USD 8,4 billion (first period) and Sales of USD 6,9 billion (second period).

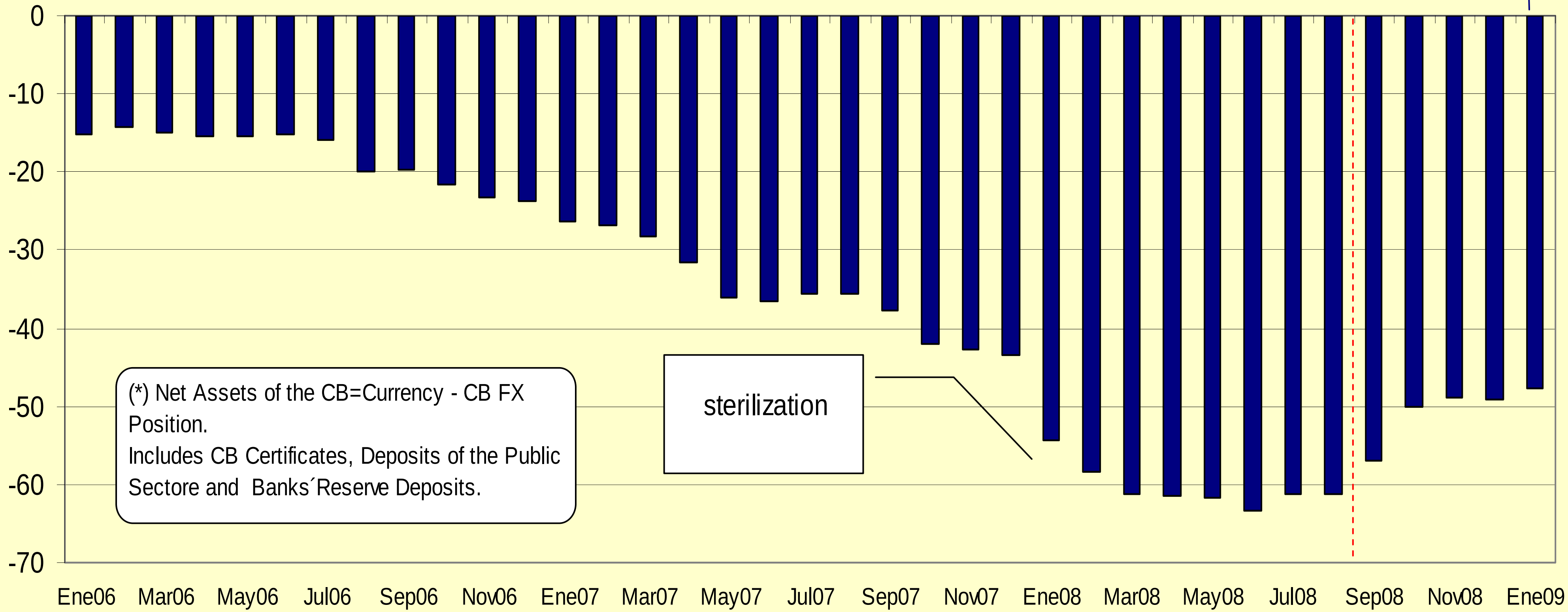
CB Intervention motivated by NIR precautionary accumulation and reduction of volatility



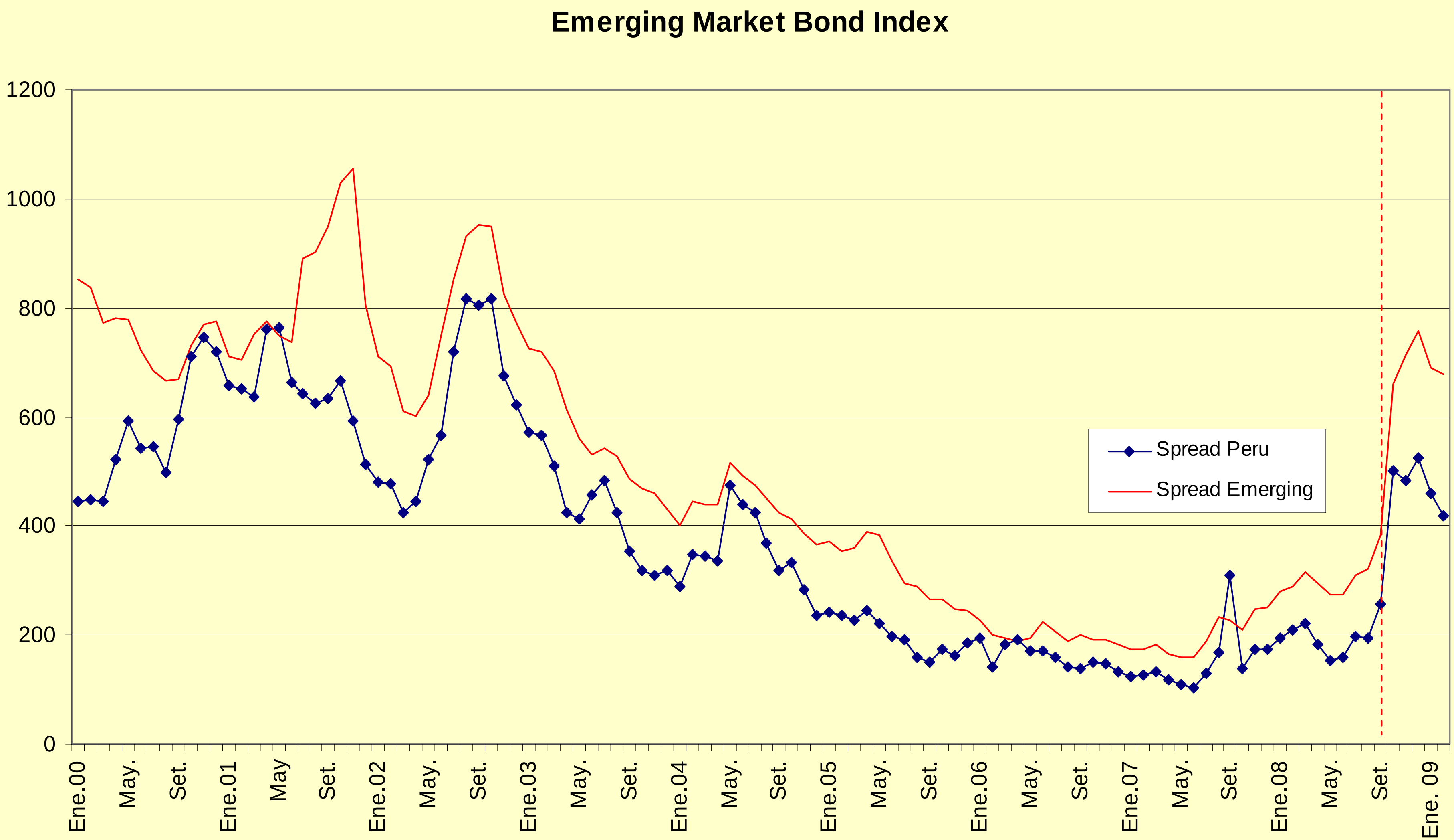
Sterilized intervention, Reserve Requirements and Public Sector Deposits provide plenty of room to inject CB liquidity

Billion USD
-Public Sector Deposits: 35
-Reserve Requirement: 25
-CB Paper (net of REPOs): 10

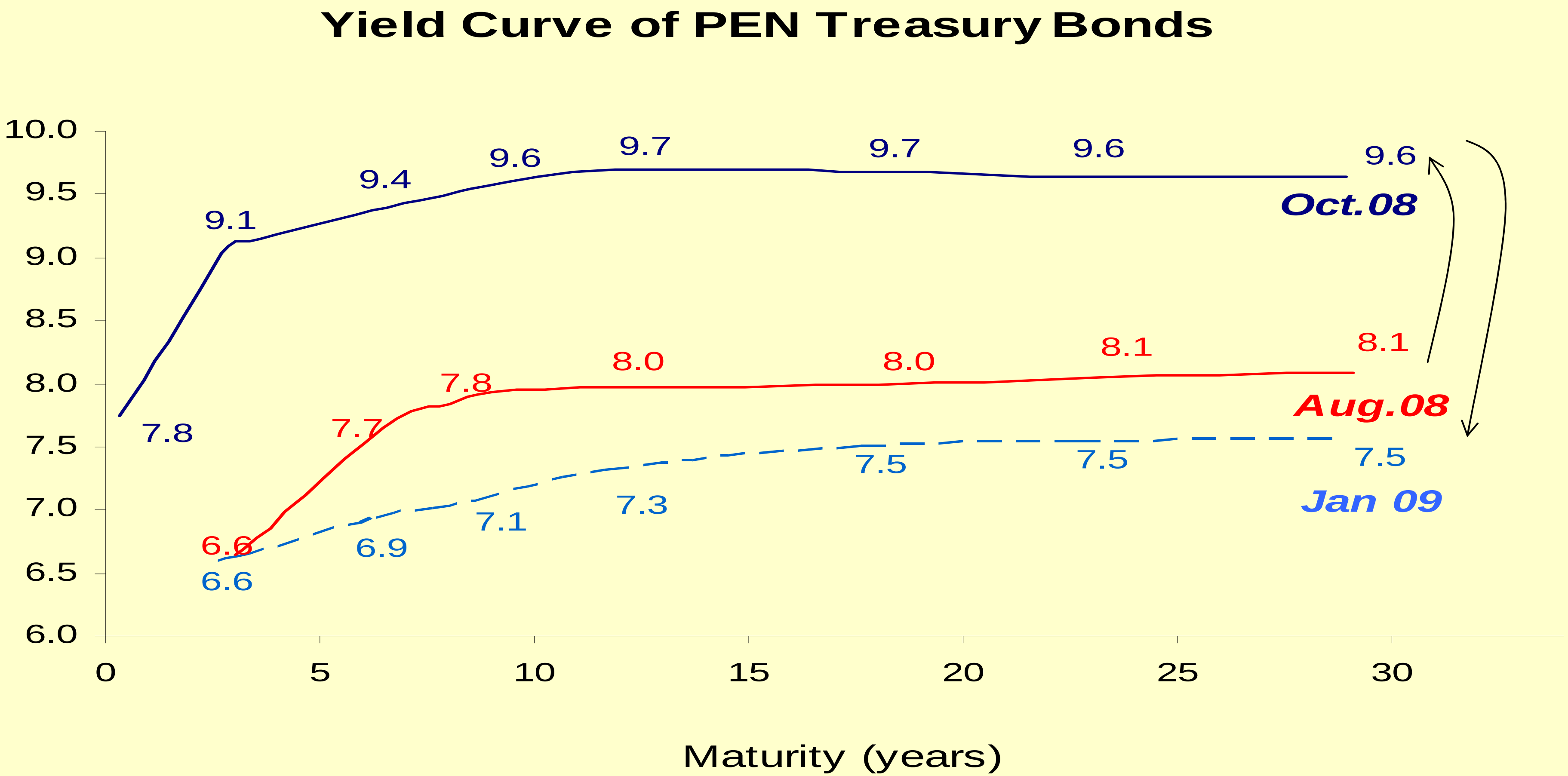
CB Net Assets (*): January 2006-January 2009
(Billion of PEN)



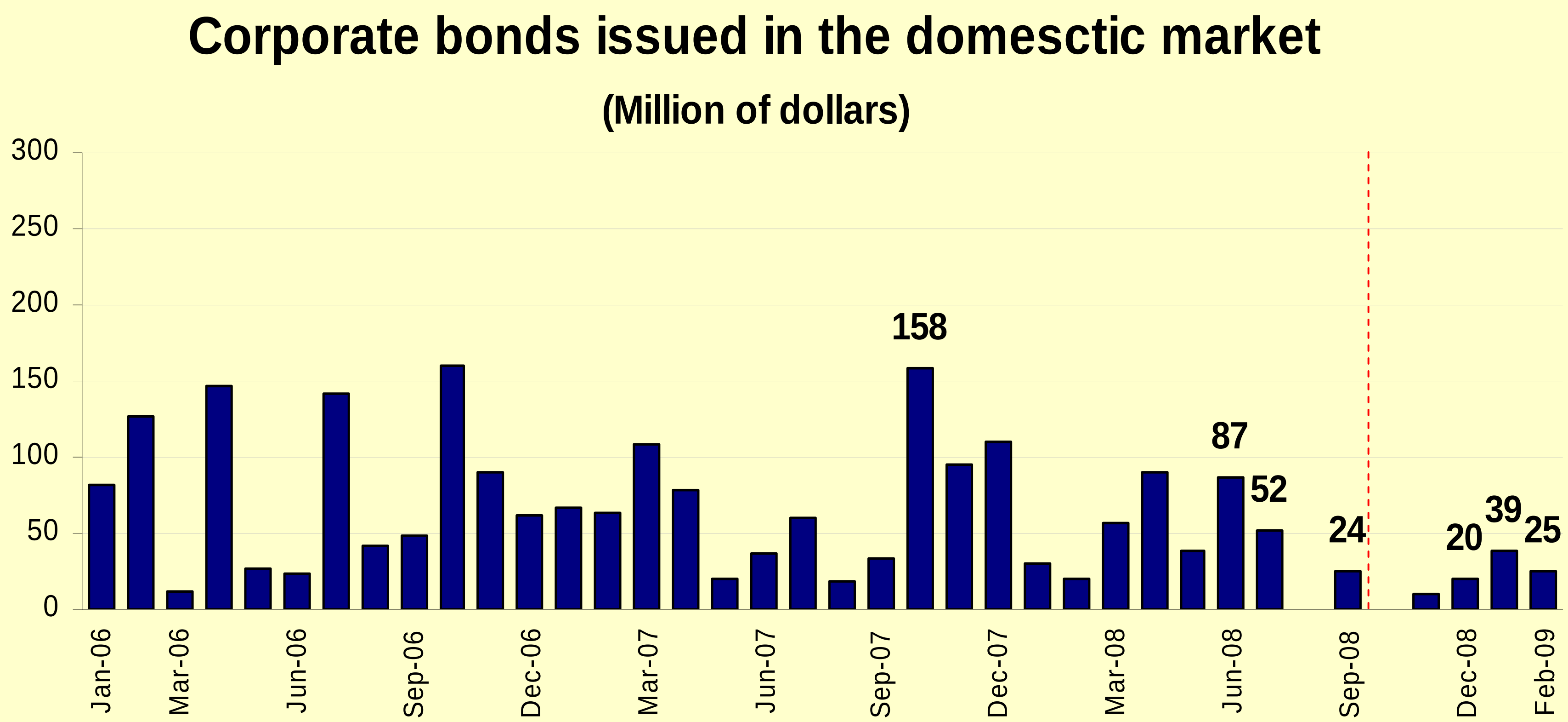
Higher spreads had an impact on the local USD long rates



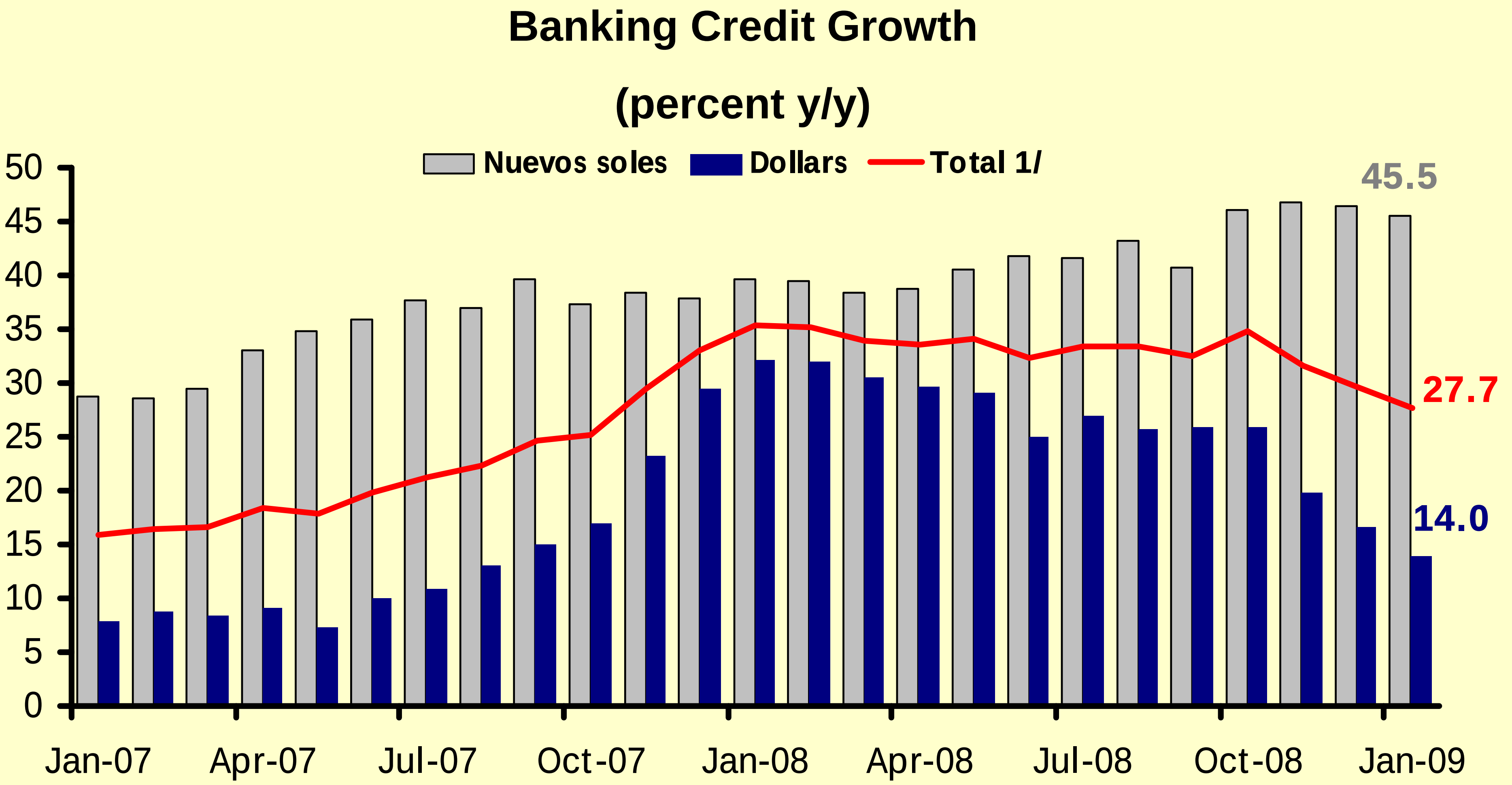
The Yield Curve recovered after the intervention of Banco de la Nacion favouring local PEN long rates



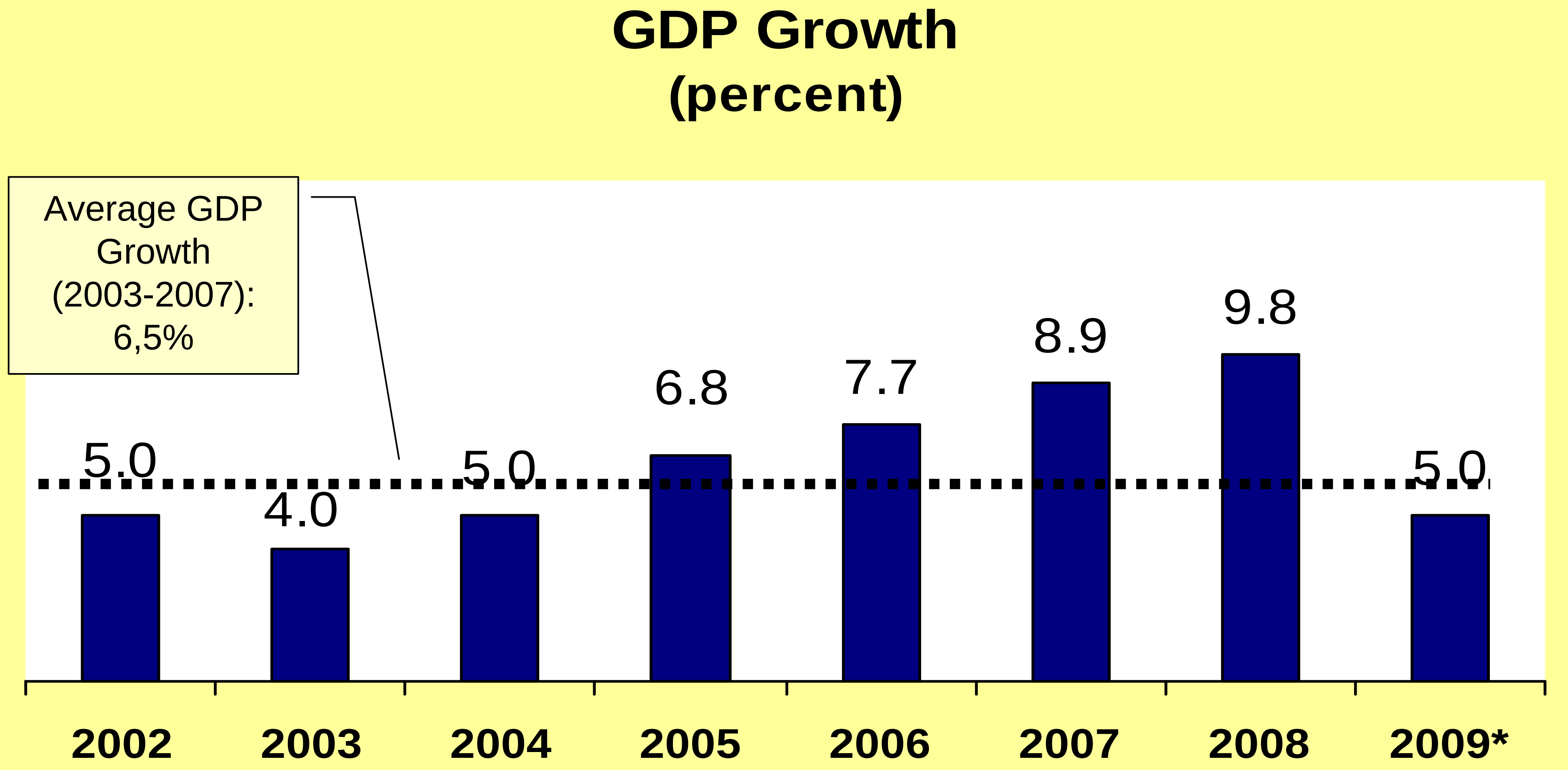
However, the issues in the corporate sector were significally reduced.



The result, so far, is that the flow of credit to the private sector has been maintained



GDP growth will decline



* CB Forecast

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Next Steps

- Continue easing the monetary policy stance.
- New collaterals for CB REPOs based on loans. Target: Non banking financial institutions.
- New regulations for the Private Pension Funds.
- New rules for Public Sector Deposits in commercial banks.
- Implementation of new anti-cyclical capitalization rules of banks.
- Development of capital markets.

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