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

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Central Reserve Bank of Peru
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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.
- 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.

Dollarization Ratio: 1981-2008
(Percent of M4)
Lessons from the Russian Crisis: Credit Crunch

Banking Credit: 1981-2008
(Percent of GDP)

1998 Russian Default
1987-1990 Hyperinflation


0 5 10 15 20 25 30

12.2 15.1 16.0 15.3 11.7 11.0 5.8 4.8 3.3 7.8 9.9 11.3 13.9 17.8 21.1 25.7 27.8 25.9 24.8 23.2 20.8 18.4 17.6 17.0 18.1 21.2
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

Net International Reserves: January 2006-January 2009
(Billion USD)

Feb.09/Aug.06: 100%
NIR/GDP: 24%
The 3 Ls Rule: Reduced Public Debt

Public Debt: 1999 - 2008
(Porcent of GDP)

Gross Debt
Net of deposits
## The 3 Ls Rule: Liquid Banks

<table>
<thead>
<tr>
<th>Non performing loans</th>
<th>Liquidity Ratio in PEN</th>
<th>Liquidity Ratio in USD</th>
<th>ROE</th>
</tr>
</thead>
<tbody>
<tr>
<td>1.3</td>
<td>26.3</td>
<td>53.0</td>
<td>31.1</td>
</tr>
</tbody>
</table>

**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 Dollarization Risks

- Liquidity Risk:
  - High reserve requirements on foreign currency liabilities
- Exchange Risk (Balance Sheet Effect):
  - Sterilized FX Intervention to reduce volatility
  - Preventive NIR accumulation
Inflation: January 1995-February 2009
In percent, y/y

Hybrid Inflation Targeting

2002
Inception of Inflation Targeting

3%

1%
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- **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.

- **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 foreign 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

Reserve Requirement on PEN Liabilities (percent)

Average required
Marginal

Reserve Requirement on USD Liabilities (percent)

Average required
Marginal

Marginal rate: applied on new liabilities.
Policy Rate neutralized 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)

The reduction of reserve requirements and new CB instruments reduced the interbank and prime-rates.
Reductions in Reserve Requirements on USD liabilities increased the liquidity during the second period

USD Interbank Interest Rate and Prime-Rate in USD:
January 2008-March 2009

(Percent)

INTERBANK RATE

PRIME RATE

POLICY RATE TARGET

Reductions in Reserve Requirements on USD liabilities increased the liquidity during the second period.
Flows in the FX Market before and after Lehman

FX Exchange Market: 2008-2009
(Million of USD)

- Short-Term Capital Inflows
- Private Pension Funds FX
- Banks' own FX Position
- Stock of FX Forward Operations

Jan 2008-Aug 2008
Sep 2008-Feb 2009

1,872
966
1,261
2,844

-1409
101
-157
-15
CB Intervention motivated by NIR precautionary accumulation and reduction of volatility

PEN Exchange Rate and CB Intervention: January 2006-January 2009

• 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

Nominal Exchange Rate and Variation Ratio (*): Dec 2006-Feb 2009
Index, December 2006

(*) Standard Deviation/Average

Chile
Perú (5%)
Colombia (11%)
Brazil (12%)
Sterilized intervention, Reserve Requirements and Public Sector Deposits provide plenty of room to inject CB liquidity

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

(*) Net Assets of the CB=Currency - CB FX Position. Includes CB Certificates, Deposits of the Public Sector and Banks’ Reserve Deposits.

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

Billion USD

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

Banking Credit Growth

(Percent y/y)

- Nuevos soles
- Dollars
- Total 1/

Jan-07 Apr-07 Jul-07 Oct-07 Jan-08 Apr-08 Jul-08 Oct-08 Jan-09

Nuevos soles: 27.7%
Dollars: 14.0%
Total: 45.5%
GDP growth will decline

Average GDP Growth (2003-2007): 6.5%

GDP Growth (percent)

<table>
<thead>
<tr>
<th>Year</th>
<th>GDP Growth</th>
</tr>
</thead>
<tbody>
<tr>
<td>2002</td>
<td>5.0</td>
</tr>
<tr>
<td>2003</td>
<td>4.0</td>
</tr>
<tr>
<td>2004</td>
<td>5.0</td>
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<tr>
<td>2005</td>
<td>6.8</td>
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<tr>
<td>2006</td>
<td>7.7</td>
</tr>
<tr>
<td>2007</td>
<td>8.9</td>
</tr>
<tr>
<td>2008</td>
<td>9.8</td>
</tr>
<tr>
<td>2009*</td>
<td>5.0</td>
</tr>
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</table>

* 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.
- Development of capital markets.
The Global Financial Crisis – Central Bank Responses in the Western Hemisphere

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