Response to the Covid-19 Pandemic

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Abstract

The BCRP's response to the COVID-19 pandemic aimed to preserve the payment chain and support the recovery of economic activity. Policies focused on reducing financing costs, providing adequate liquidity to the financial system and reducing exchange rate and long-term interest rate volatility. The BCRP lowered its reference rate by 200 basis points to a historic low of 0.25% and performed significant liquidity operations. The latter increased by 7.1% of that year's GDP, mainly through repo operations associated with a government-guaranteed loan programme known as *Reactiva Perú*. This response sustained credit flows, thereby avoiding a credit crunch due to a breakdown in the payment chain, which could have exacerbated the pandemic's economic impact. The BCRP also provided the monetary boost necessary to spur recovery starting in mid-2020, while keeping inflation and inflation expectations close to the middle of the BCRP's target range (1–3%).

JEL classification: E43, E58, E65.

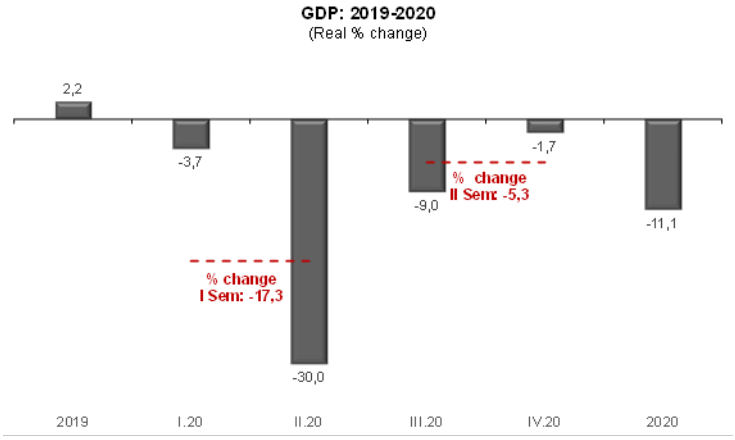
Keywords: Covid-19, emerging economies, monetary policy, conventional and unconventional policies.

1. Introduction

At the beginning of the Covid-19 pandemic, the confinement measures implemented by the Peruvian authorities were among the most rigorous in the world. On 16 March 2020, the government introduced strict sanitary measures, including mandatory social isolation nationwide and a halt to many activities deemed non-essential, including public works and e-commerce, causing the GDP to contract by 17.3% during the first half of the year (contracting by 30.0% in the second quarter).

After the pandemic started, monetary policy adopted an unprecedented expansionary stance – a record low policy rate (0.25%) and massive repo operations with a horizon of up to four years – which was feasible due to the credibility built up by the BCRP for over 30 years. The authorities implemented fiscal stimulus via a range of policies, including cash transfers to households (2.0% of GDP) and – starting in October 2020 – more public investment, which led to a greater-than-expected recovery of GDP in the last quarter of the year (-1.7%) and brought economic activity closer to pre-pandemic levels.

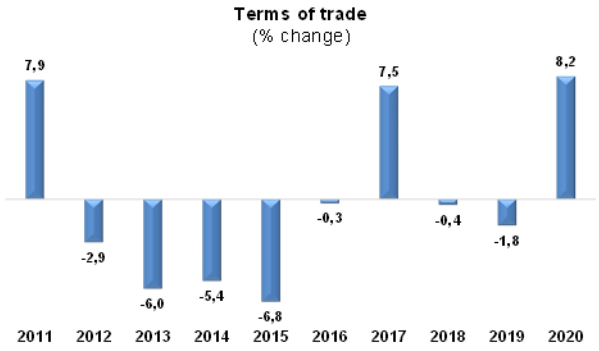
The Covid-19 recession and bounce back — Graph 1



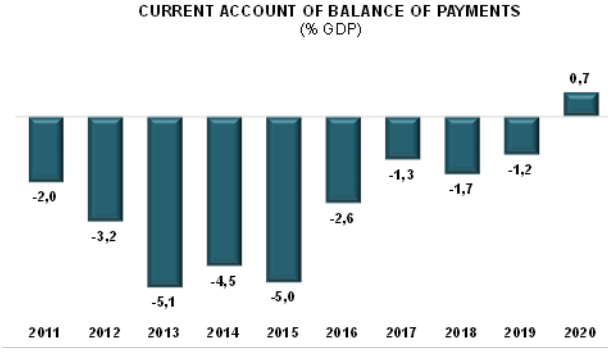
As a result of this uneven quarterly performance, the GDP contracted by 11.1% in 2020, the greatest contraction since 1989 (12.3%) after 21 consecutive years of growth.

External sector developments — Graph 2

Peak-to-trough change in value added, in per cent



Pre-crisis peak, T = 100

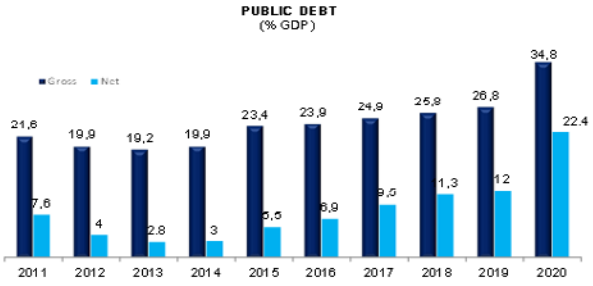


The rapid recovery during the second half of the year was also driven by the greatest recovery in terms of trade in the last 10 years (8.2%), caused by a rise in the prices of Peru's export commodities (mainly minerals) and a drop in the prices of imports such as oil and industrial inputs. The resulting positive impact on the trade balance, along with lower import volumes due to weak domestic demand, led to a balance of payments surplus (0.7% of GDP) in 2020. The financial account stood at 3.6% of GDP, mainly due to an increase in net portfolio investment in public assets, which offset the drop in private sector financing. Net International Reserves (NIR) increased by USD 6.4 billion in 2020, to a total of USD 74.7 billion (37% of GDP).

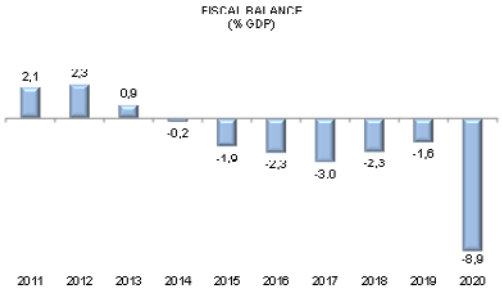
The expansionary fiscal policy included support to households (cash transfers) and companies (reduced/suspended tax payments). Higher pandemic-related expenses and lower tax revenue due to a contraction in local economic activity led to a fiscal deficit of 8.9% of GDP in 2020 (7.3 percentage points greater than in 2019 and the largest since 1990). By end-2020, public debt had risen by 8.0 percentage points to 34.8% of GDP, largely due to global bond issuances, credit from international organisations and, to a lesser extent, an increase in sovereign bonds (domestic currency-denominated debt).

Fiscal expansion — Graph 3

Peak-to-trough change in value added, in per cent



Pre-crisis peak, T = 100



Sources: BCRP, MEF and SUNAT.

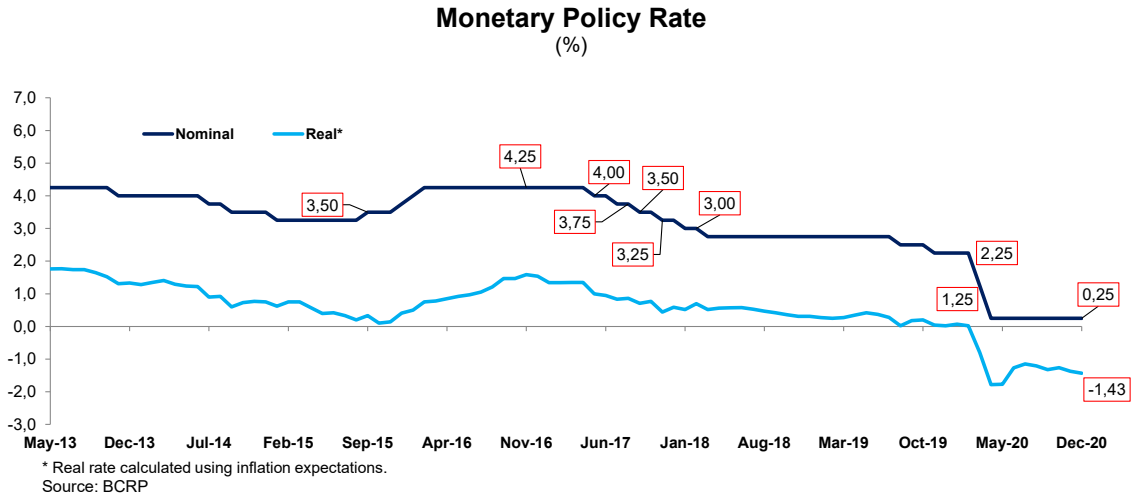
2. Monetary response

Monetary policy aimed to preserve the payment chain and support the recovery of economic activity, mainly by reducing financing costs, providing adequate liquidity to the financial system, and moderating exchange rate and long-term interest rate volatility. To that end, monetary policy adopted an unprecedented expansionary stance. The BCRP cut its reference rate by 200 basis points to a historic low of 0.25%, the lowest policy rate in the region and one of the lowest among emerging market economies (EMEs). Moreover, the BCRP provided forward guidance on the monetary outlook, indicating that "it considers it appropriate to maintain a strongly expansionary monetary stance for a prolonged period and as long as the negative effects of the pandemic on inflation and its determinants continue." Given the magnitude of the shock and its impact on the economy, the monetary impulse was augmented with additional quantitative measures.

The BCRP took the necessary steps to sustain the payments system and credit flows. In order to ease financial conditions, the maturities of liquidity operations were

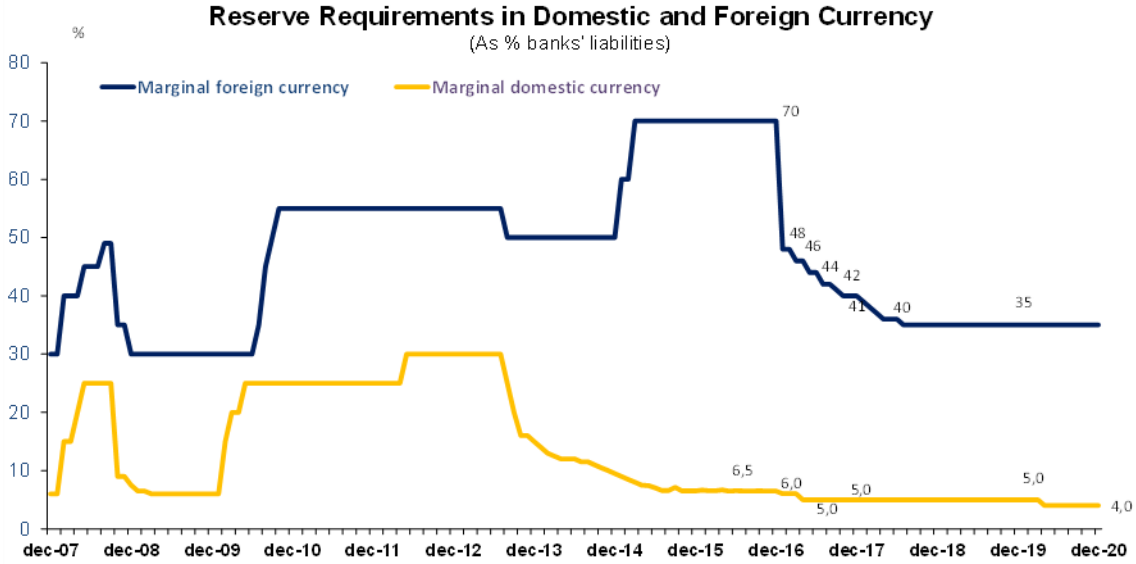
extended (up to four years) and the range of guarantees and collaterals that financial entities can use for repo operations was expanded. For example, financial entities can use part of their loan portfolio (subject to appropriate credit standards) as collateral to receive liquidity from the BCRP. This instrument was created in 2009 in the context of the Global Financial Crisis (GFC), but it was used for the first time during the pandemic in April 2020. Reserve requirement rates (RRRs) were also reduced, thereby releasing resources amounting to 0.3% of GDP (PEN 2 billion).[1]

Monetary policy response: the interest rate — Graph 4



Source: BCRP.

Monetary policy response: reserve requirements — Graph 5



[1] For a discussion on the use of reserve requirements in Peru, see Armas, A, P Castillo and M Vega (2014); Montoro, C and R Moreno (2011); and Pérez-Forero, F and M Vega (2014).

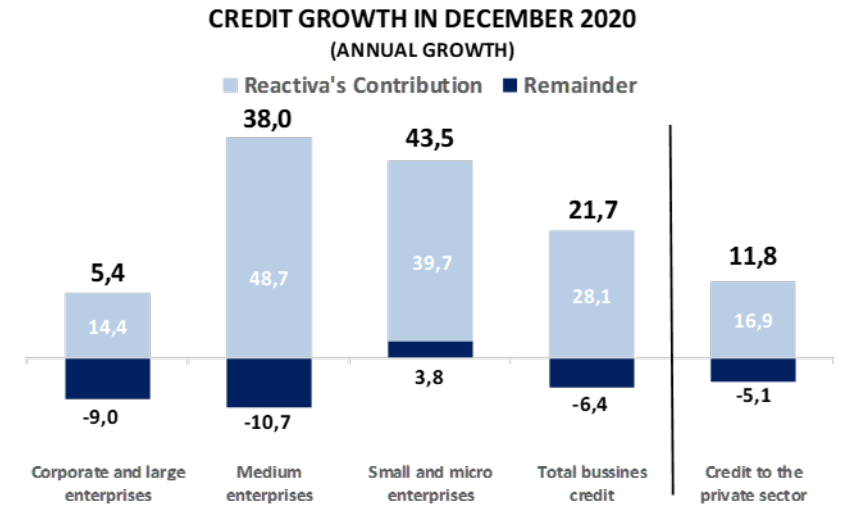
The BCRP's monetary injections found their way into the economy via two programmes that aimed at boosting credit conditions: *Reactiva Perú* (by far the larger one) and repo operations conditional on loan portfolio rescheduling.

2.1 The *Reactiva Perú* Programme

The main challenge during the first half of 2020 was preserving the payment and credit chain. The Covid-19 outbreak was a sudden, transitory and major shock. It triggered a contraction in global demand, which reduced Peru's exports and caused widespread uncertainty among consumers and firms. Moreover, the strict measures introduced to contain the spread of Covid-19 seriously disrupted the supply chain. This affected household incomes and firms' cash flows, thereby limiting their capacity to pay obligations such as salaries, rents and debts owed to suppliers. This vicious cycle of shrinking supply and demand is drawing out the initial shock and could potentially drag the economy into a depression (ie a long and deep recession with negative inflation rates). If allowed to expand, the ripple effect across the payment chain may lead to massive bankruptcies, in turn causing an abrupt drop in production, employment and incomes.

Certain externalities can exacerbate the credit risk associated with a disruption of the payment chain; eg risk-averse financial entities' concerns about their capacity to meet their own obligations may become a self-fulfilling prophecy if they react by contracting credit out of fear that debtors will not be able to repay loans. In this context, government intervention becomes necessary to prevent a disruption of the payment chain by providing adequate liquidity to the financial system.

Impact on credit expansion — Graph 6



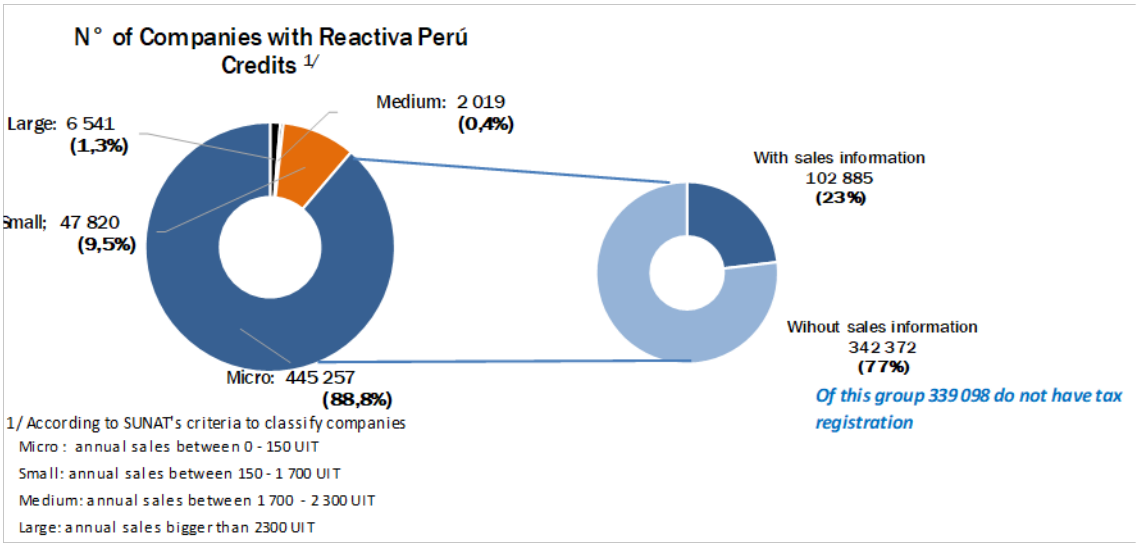
Note: Show the annual growth rates as a result of maintaining the dassification of companies as of December 2019.

In this context, marked by an abrupt drop in economic activity, the government-guaranteed loan programme known as *Reactiva Perú* was created. Under the programme, the BCRP provides liquidity through repo operations to the financial entities have granted the loans and receives high-quality assets as collateral, ie the government-guaranteed loan portfolio. The loans were granted for three years with

a one-year grace period. The programme sought to partially absorb the increased risk from the pandemic by creating incentives for financial entities to provide companies with the necessary working capital to cover their obligations during the lockdown, thereby improving their viability and reducing market uncertainty.

The programme quickly injected liquidity into the financial system, sustaining credit flows and avoiding a credit crunch and a breakdown in the payment chain. It also provided the monetary boost needed for recovery starting in the second half of 2020. This time, unlike other crisis episodes, such as the sudden stop in capital flows in September 1998 induced by the Russian crisis, credit evolved countercyclically. Business credit grew 22% year-on-year in 2020, instead of the negative growth that likely would have occurred had the programme not been put in place. The programme is one of the largest of its kind in the region (around 8.5% of GDP) and has the highest rate of implementation – defined as actual execution relative to the initial announcement of the programme (around 90%) – among both advanced countries and EMEs.[2]

Coverage of the *Reactiva Perú* programme Graph 7



The three elements of the programme's success are simplicity, scope and competition.

Simplicity: It was simple and easy to verify that participants met the conditions for accessing the programme, eg the loan amount was proportional to the sales declared to the tax authority (SUNAT) the previous year and there were no pre-qualification conditions (apart from not being involved in certain prohibited or unlawful activities).[3]

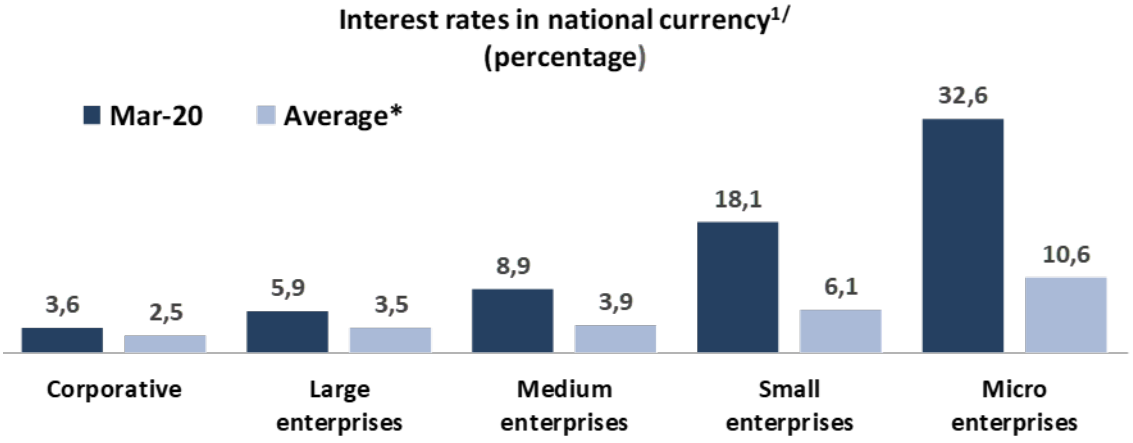
[2] At end-2020, the BCRP also created a liquidity injection mechanism conditional on the expansion of long-term credit in order to help transmit the monetary impulse to long-term interest rates. Participating entities that expand their long-term loans in compliance with certain criteria can access repo operations for up to three years and interest rate swaps up to seven years. As of March 2021, total repo operations under this programme amounted to just PEN 200 million.

[3] For more details about the *Reactiva Perú* programme, see Montoro (2020) and BCRP (2020), Box 5, available at https://www.bcrp.gob.pe/docs/Publicaciones/Reporte-Inflacion/2021/marzo/ri-marzo-2021-recuadro-5.pdf.

Scope: Business operating in informality was able to participate in the programme. Peru has one of the highest informality ratios (about two thirds of the labour force are informal workers) among economies with similar levels of per capita income. Micro-enterprises without sales statements had access to the programme and the size of the loan corresponded to the amount they owed to the financial system (with a ceiling of up to PEN 40,000, equivalent to USD 12,000). Of half a million companies that received a loan from *Reactiva Perú*, 98% were micro- or small enterprises and 77% had no sales record.

Competition: The BCRP established a repo rate of 0.5% over a three-year period, and resources were allocated to financial entities charging the lowest interest rates to borrowers. This mechanism led to competition between financial entities, helping to speed up the effect that the reduction in the policy rate had on other interest rates. The latter fell to historic lows, especially for smaller companies with higher credit risk premia.

Impact on borrowing rates — Chart 8



[1] Active interest rates in annual terms of the operations carried out in the last 30 business days for banks. * Average of the interest rates between May and November 2020. Period in which most of the Reactiva Peru credit were disbursed.

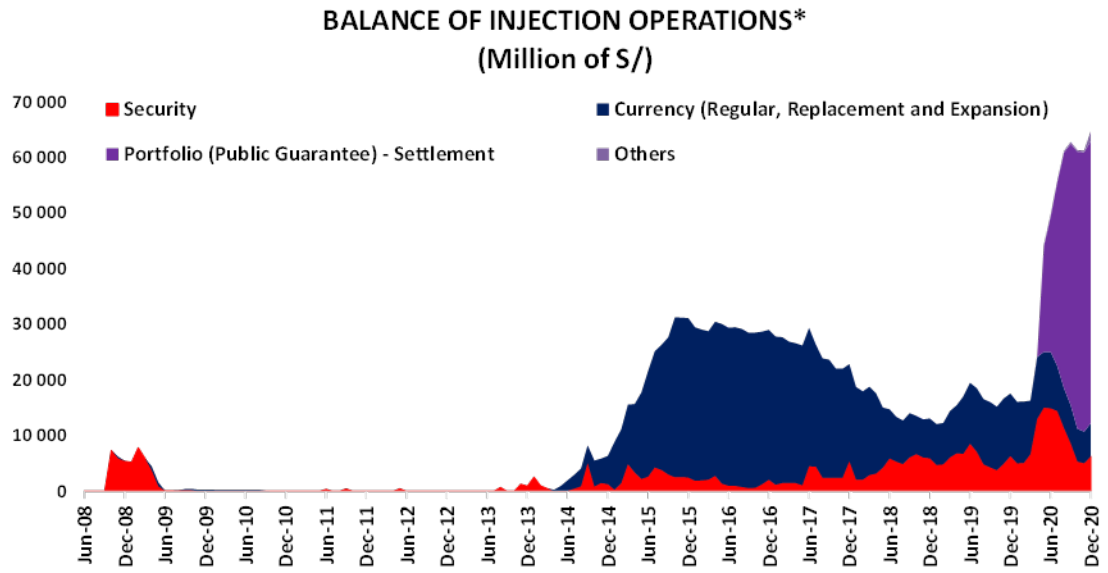
2.2 Repo operations with loan portfolio rescheduling

The second repo programme, created in June 2020, aimed to promote loan rescheduling at lower interest rates and longer maturities. Through these operations, financial entities could obtain liquidity in exchange for high-quality collateral (securities, FX or even loan portfolios) on the condition that they refinanced their clients' loans to maturities between 6 and 48 months and set interest rates lower than those initially agreed. This improved conditions for debtors to the financial system, who could thus recover more quickly from the negative shock. As of March 2021, total repo operations under this rescheduling programme amounted to 0.2% of GDP (PEN 1.5 billion).

Between March and December 2020, the balance of liquidity operations reached historic highs, from 2.1% of GDP (PEN 14.8 billion) at end-February to 9.1% of GDP (PEN 64.8 billion) as of end December. Of the latter, PEN 50.7 billion correspond to repo operations with government-guaranteed loans. The BCRP is not unfamiliar with long-term repo operations, but the magnitude, range of collaterals used and financial

characteristics (being conditioned on the extension new loans or reprogrammeming of existing ones) of this programme are new. The total balance of liquidity operations as of end-2020 was 8 times higher than that during the GFC (PEN 7.9 billion) and twice that of the 2013–16 drop in commodity prices and the de-dollarisation programme (PEN 31.8 billion). One of the advantages of using repo operations is that the withdrawal of monetary stimulus is automatic and determined by the maturities built into such operations.

Monetary policy response: liquidity injection — Chart 9



* As of Dec 31

3. Policies to moderate exchange rate and long-term interest rate volatility

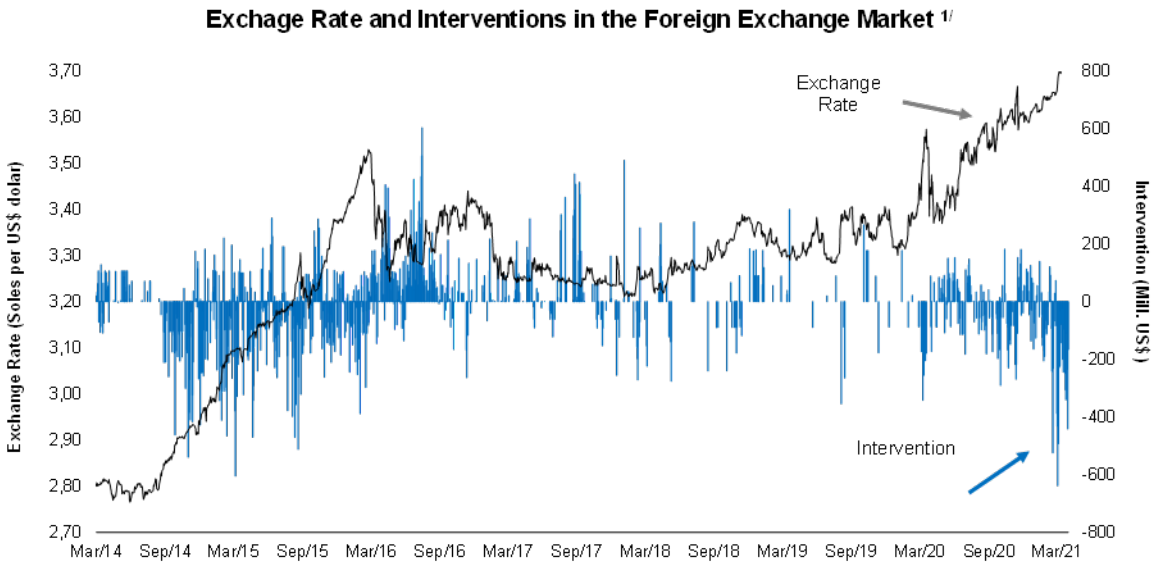
The Covid-19 pandemic exacerbated currency volatility in EMEs by triggering capital flow volatility in 2020 and an increase on US Treasury bonds yield during the first quarter of 2021. Additionally, local factors such as political uncertainty associated with the vacant presidency in November 2020 and the presidential election cycle in early 2021 resulted in pressures on the exchange rate.

Monetary policy transmission channels are weakened when FX and financial markets experience high exchange and interest rate volatility. Additionally, given that financial dollarisation is still prevalent in the Peruvian economy, reducing excessive exchange rate volatility helps to prevent risks associated with dollarisation (such as FX liquidity risks or credit risks induced by currency mismatches) from materialising.[4]

[4] For more details about financial dollarisation and the Peruvian experience with unconventional monetary policy tools, see Castillo, P, H Vega, E Serrano and C Burga (2016), and Rossini, R, A Armas, P Castillo and Z Quispe (2019).

Given exchange rate developments, the BCRP participated in the FX market using the instruments at its disposal to deal with excessive volatility. Thus, between March 2020 and March 2021, the BCRP sold USD 2.6 billion in the FX market to offset pressures on the currency. FX derivative instrument sales amounting to USD 9.7 billion, including BCRP exchange rate swap sales(SCV-BCRP) and certificates of deposit indexed to the dollar (CDR-BCRP), were used to meet FX demand for exchange rate hedging purposes.

Central bank interventions in currency market — Graph 10



[1] Includes: Net purchases/sales of dollars in the spot market and net maturity of instruments: CDLD BCRP, CDR BCRP and FX swaps.

Source: BCRP

During the pandemic, the government (and shortly afterwards, Congress) passed legislation authorising a series of fund withdrawals from the Private Pension System (AFPs) to reduce the impact the pandemic had on household's income. AFPs paid out such withdrawals, amounting to 4.5% of GDP (PEN 33 billion), mainly by selling external assets and Peruvian sovereign bonds. In response, the BCRP carried out monetary operations with AFPs to ensure that financial markets functioned normally and to prevent upward pressures on sovereign bond interest rates. If it hadn't, the disorderly sale of sovereign bonds to cover pension fund withdrawals would have lowered bond prices threatening the recovery (by pushing up the interest rate) and the value of affiliates' funds. In this context, the BCRP carried out repo operations with AFPs amounting to 0.7% of GDP (PEN 4.9 billion) for the first withdrawal (May 2020) and 0.2% of GDP (PEN 1.3 billion) for the second withdrawal (November 2020). The BCRP also purchased Peruvian sovereign bonds worth 0.18% of GDP (PEN 1.3 billion) from AFPs throughout December 2020. By law, the BCRP can make annual purchases of government securities for up to 5% of the monetary base as of the end of the previous year.

4. Concluding remarks

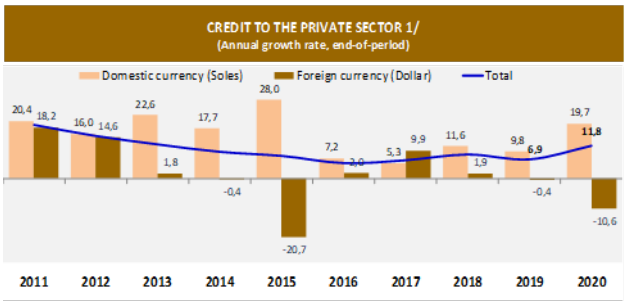
The BCRP's response to Covid-19 preserved credit flows, thereby avoiding a breakdown in the payment chain that would have worsened the pandemic's economic impact. The BCRP also provided the monetary boost necessary to spur an economic recovery starting in mid-2020.

As a result of the BCRP's expansionary monetary policy and liquidity injection operations associated with the government-guaranteed loan programme, growth of credit to the private sector accelerated from 6.9% in 2019 to 11.8% in 2020. As a percentage of GDP, the balance of credit to the private sector rose from 43.1% in 2019 to 52.9% in 2020. PEN credit expansion was greater as a result of the *Reactiva Perú* programme.

Longer term perspective on credit

Graph 11

Peak-to-trough change in value added, in per cent



1/ Balances in U.S. dollars are valued at constant exchange rates as of December 2019. Includes receivables from foreign branches of local banks.

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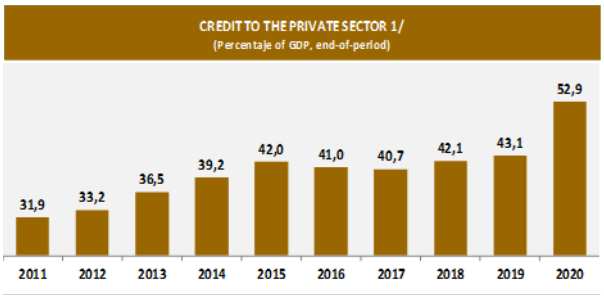
Pre-crisis peak, T = 100



1/ Balances in U.S. dollars are valued at the average end-of-period buying and selling exchange rates. Includes receivables from foreign branches of local banks.

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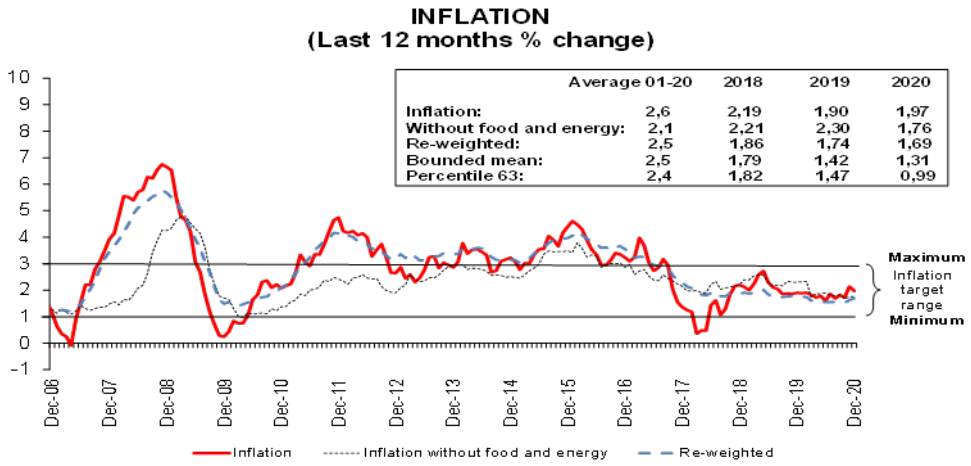
Inflation rose slightly between 2019 and 2020, from 1.90% to 1.97%, closer to the middle of the BCRP's inflation target range (1–3%), and inflation expectations stayed around 2%. Inflation was higher as a result of increasing costs due to sanitary measures, supply-side factors affecting certain food prices, and a depreciation of the national currency. At the same time, economic performance below potential was reflected in lower core inflation (headline inflation excluding food and energy), which decreased from 2.30% in 2019 to 1.76% in 2020.

Inflation developments

Graph 13



Source: BCRP

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