PERU: Coordination between debt management and monetary policy

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FINANCIAL MARKET PARTICIPANTS

MINISTRY OF ECONOMY AND FINANCE (MEF)
- Funding and debt rollover
- Minimize debt cost at prudential risk levels
- Debt Local market development.
- Appropriate distribution of public resources

CENTRAL BANK (BCRP)
- Monetary stability (inflation targeting, use of monetary tools)
- Financial Stability (acting as a lender of last resort and ensuring a fluent functioning of the payments system.
- Exchange Rate stability (direct and indirect interventions)

PERUVIAN ECONOMY

MARKET DEVELOPMENT

Financial Entities
Regulatory Agencies
Investors
Sustainable and responsible management of public finance, aiming to (i) reduce the cost of government liabilities and increase the return on the government assets, and (ii) deepen the development of government securities market in local currency as the main tool to meet financial requirements associated with the management of the debt, savings and cash balances.
<table>
<thead>
<tr>
<th>STRATEGY FOR GLOBAL ASSET AND LIABILITY MANAGEMENT</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>ASSET MANAGEMENT</strong></td>
</tr>
<tr>
<td>Maintain liquid reserves to deal with financial instability</td>
</tr>
<tr>
<td>Improve asset management promoting competition, and increasing diversification and transparency</td>
</tr>
<tr>
<td>Buyback facility for government securities available when market liquidity dries up</td>
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<tr>
<td><strong>LIABILITY MANAGEMENT</strong></td>
</tr>
<tr>
<td>Reduce dollarization of government gross debt</td>
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<tr>
<td>Diversify the investor base</td>
</tr>
<tr>
<td>Mitigate liquidity risk arising from the excessive concentration of debt redemptions</td>
</tr>
<tr>
<td><strong>CASH MANAGEMENT</strong></td>
</tr>
<tr>
<td>Increase return on savings through collateralized deposits and repo operations with government securities</td>
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<tr>
<td>Minimize the impact of treasury auctions on the liquidity of the financial system</td>
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<tr>
<td>Collect tax obligations directly on the Treasury’s account</td>
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<tr>
<td><strong>MARKET STRUCTURE</strong></td>
</tr>
<tr>
<td>Optimize the functioning of the infrastructure of the government securities market in local currency</td>
</tr>
<tr>
<td>Increase the level of competition, transparency and liquidity in pricing of contestable markets</td>
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<tr>
<td>Facilitate access to the public debt market for retail investors</td>
</tr>
<tr>
<td>Establish a sovereign index fund</td>
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</tbody>
</table>
MINISTRY OF ECONOMY AND FINANCE : Evolution of the Government Debt Profile

Public Debt Structure by Currencies
(% gross public debt)

<table>
<thead>
<tr>
<th>Year</th>
<th>PEN</th>
<th>USD</th>
<th>Others</th>
</tr>
</thead>
<tbody>
<tr>
<td>2004</td>
<td>34</td>
<td>56</td>
<td>10</td>
</tr>
<tr>
<td>2009</td>
<td>11</td>
<td>49</td>
<td>41</td>
</tr>
<tr>
<td>2014</td>
<td>5</td>
<td>45</td>
<td>51</td>
</tr>
</tbody>
</table>

Public Debt Structure by interest rate
(% gross public debt)

<table>
<thead>
<tr>
<th>Year</th>
<th>Variable</th>
<th>Fixed</th>
<th>2014</th>
</tr>
</thead>
<tbody>
<tr>
<td>2003</td>
<td>46</td>
<td>54</td>
<td>54</td>
</tr>
<tr>
<td>2009</td>
<td>63</td>
<td>37</td>
<td>37</td>
</tr>
<tr>
<td>2014</td>
<td>76</td>
<td>24</td>
<td>24</td>
</tr>
</tbody>
</table>

Public Debt Structure by tenor
(% GDP)

Average Life
(years)

<table>
<thead>
<tr>
<th>Year</th>
<th>Short Term</th>
<th>Medium and long term</th>
</tr>
</thead>
<tbody>
<tr>
<td>1999</td>
<td>56</td>
<td>41</td>
</tr>
<tr>
<td>2002</td>
<td>40</td>
<td>50</td>
</tr>
<tr>
<td>2005</td>
<td>30</td>
<td>70</td>
</tr>
<tr>
<td>2008</td>
<td>20</td>
<td>80</td>
</tr>
<tr>
<td>2011</td>
<td>10</td>
<td>90</td>
</tr>
<tr>
<td>2014</td>
<td>7.2</td>
<td>10.2</td>
</tr>
</tbody>
</table>

Source: BCRP, MEF.
*Data as of 30-jun-14
CENTRAL BANK: Main objective and policy instruments

**OBJECTIVE:** MONETARY STABILITY

**CENTRAL BANK**

**INFLATION TARGET BAND:** 1% - 3%

**OPERATIVE TARGET:** Interbank Interest Rate

**Measures to control risks from financial dollarization**

- High reserve requirements on FX obligations to:
  - Moderate credit cycles associated with capital inflows.
  - Keep adequate FX liquidity in the banking system.

**FX market intervention to:**

- Reduce extreme exchange rate volatility, particularly associated with domestic agents' transitory portfolio shifts.

Central bank has been adjusting reserves rates according to economic cycle

**Local Currency:** Boost credit on expectations of slow economic activity and contract when there are signs of overheating.

**Foreign Currency:** Pursue financial de-dollarization: reduce growth of dollar loans by making its short-term funding more expensive.
CENTRAL BANK: interventions to control exchange rate volatility

Exchange Rate and Central Bank net Purchases of USD

Central bank has avoided sharp fluctuations of exchange rate
In the case of a loss, the Central Bank will use a reserve fund to cover it. If the reserve is insufficient, within thirty days of the approval of the BCRP Balance Sheet, the Public Treasury shall issue and deliver to the Bank nonnegotiable and interest-bearing debt titles equivalent to the outstanding amount.

As of December 31, 2013, the reserve fund was zero.
COORDINATION BETWEEN DEBT MANAGEMENT AND MONETARY POLICY

Controversial issues between MEF and BCRP: FX financing under capital inflows

Expectations of Positive NPV from Debt Operations

Incentives for cheap foreign exchange funding

Sterilization Pressures

Foreign Exchange Inflows Environment

Quasi-Fiscal Cost Increase

Increase Liabilities for Exchange Rate stability

Lower Future Cash Flows

MEF

BCRP

MEF

BCRP

Sterilization monetary policy can generate such losses that they will force the central bank to ask Treasury for capital contributions, increasing the quasi fiscal cost.
Controversial issues between MEF and BCRP: Potential Competition in the Primary Market

**Treasury Bills**
- **Objective**: Develop short term government securities market
- **Outstanding**: PEN 547 MM (31-oct)
- **Target**: Mainly retail investors
- **Frequency**: According to an issuance schedule.
- **Others**: Government budget cap bills outstanding for this fiscal year at PEN 600 MM
  - Concentration limits at issuance

**Central Bank Certificates**
- **Objective**: Ensure adequate levels of liquidity
- **Outstanding**: PEN 16,450 MM (31-oct)
- **Target**: Resident Entities linked to financial activities
- **Frequency**: According to the need for intervention
- **Others**: Fees for ownership transfer

**Slow pace development of capital markets**

**Market Fragmentation**

**Less liquidity of securities**

Affects the transmission of monetary policy
### Controversial issues between MEF and BCRP

<table>
<thead>
<tr>
<th>Controversial issues</th>
<th>MEF Focus</th>
<th>BCRP Focus</th>
</tr>
</thead>
<tbody>
<tr>
<td>Exchange rates and interest rates affect debt management</td>
<td>Debt management strategy focus on long term macroeconomic stability goals. Avoid financial instability by matching assets and liabilities. Continue avoiding volatility of exchange rate due to higher dollarization of the economy.</td>
<td>Avoid higher volatility in exchange rates through direct and indirect FX market interventions. Target rate management according to economic cycle.</td>
</tr>
<tr>
<td>Poor structure and lack of liquidity of public debt market</td>
<td>Recent strong efforts to deep government market securities and diversify holdings. Establish joint efforts for the development of government securities market. Coordinated actions when issuing bills that don’t affect monetary policy.</td>
<td>Main objective is to manage the financial liquidity rather than developing public debt market. Establish joint efforts for the development of government securities market. Coordinated actions when issuing bills that don’t affect monetary policy.</td>
</tr>
<tr>
<td>Single instrument with single issuer</td>
<td>Limited use of Bills and bonds due regulations.</td>
<td>Central Bank issue its own instruments for only monetary purposes instead of government bills. International experience suggests using Treasury instruments for monetary policy. There is an open discussion under development.</td>
</tr>
</tbody>
</table>
COORDINATION BETWEEN DEBT MANAGEMENT AND MONETARY POLICY

ACTIONS TO IMPROVE COORDINATION BETWEEN DEBT MANAGEMENT AND MONETARY POLICY

- Reduce financial dollarization of financial system through coordinated actions between Treasury and Central Bank and keep the current strategy to the de-dollarization of the government debt.
- Development of local public debt market is a priority for the Treasury: it is a policy approved by the government to reform the Peruvian Capital Market.
- The fragmentation of public debt with two issuers hinders the development of the domestic debt market: it inhibits the formation of a single yield curve and segregates the investor base as banks prefer BCRP securities.
- A consolidated market would emerge if BCRP could use government securities for its monetary operations rather than their own.
- A committee of MEF and BCRP could be appointed to define the mechanisms to transition to BCRP using government securities for its monetary operations.

ONGOING NEGOTIATIONS WITH BCRP

- Adequate rate of return on local currency public deposits, according to market rates.
- Better offer yields on foreign currency public deposits, through tight the spread near to market offer rates
- Improvements on negotiation process with the active participation of both entities.
- Initial conversations aiming to use Peruvian treasury bills for monetary purposes.
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