BANGKO SENTRAL NG PILIPINAS

HIGHLIGHTS OF THE MEETING OF THE MONETARY BOARD ON MONETARY POLICY ISSUES HELD ON 31 JULY 2014[1]

I. Monetary Policy Decision

The Monetary Board (MB) decided to:

a) Increase the BSP's key policy interest rates by 25 basis points (bps) to 3.75 percent for the overnight RRP (borrowing) facility and 5.75 percent for the overnight RP (lending) facility;

b) Adjust the interest rates on term RRPs and RPs accordingly;

c) Maintain the current interest rate on the special deposit account (SDA) facility; and

d) Maintain the current reserve requirement ratios.

II. Key Considerations in the Formulation of the Monetary Policy Stance

- In deciding to raise its key policy rates, the MB intended to send a reinforcing signal that it is maintaining a tightening bias amid signs of inflation pressures and elevated inflation expectations. Latest baseline forecasts indicate that the inflation target could be at risk, as the forecasts have shifted closer toward the higher end of the target range of 3±1 percent for 2015. Moreover, while inflation expectations remain within target, they are seen to be settling toward the upper end of the inflation target range, particularly for 2015.

- At the same time, the MB noted that the balance of risks to the inflation outlook continued to be tilted toward the upside, with price pressures emanating from higher food prices, short-term volatility in international oil prices, and pending petitions for adjustments in power rates and transport fares.

- The MB also saw the increase in policy rates as a preemptive measure in the context of the eventual normalization of monetary policy in some advanced economies.

- Meanwhile, the MB decided to maintain the SDA rate as domestic liquidity growth continues to ease in line with the path projected by the BSP. The moderation in M3 growth reduces the need for an additional increase in the SDA rate. The MB is of the view that the continued favorable outlook for domestic demand allows some scope for a measured adjustment in key policy rates without adversely affecting the country's economic growth prospects.

[1] The discussions presented reflect the assessment made by the Monetary Board based on the information available at the time of the policy meeting. A comprehensive set of economic information was provided by the Technical Secretariat of the Advisory Committee (AC). The AC is composed of the Governor of the BSP as Chairman and four members, namely: the Deputy Governor of the Monetary Stability Sector, the Deputy Governor of the Supervision and Examination Sector, the Assistant Governor of the Monetary Policy Sub-Sector, and the Assistant Governor of the Treasury Department. The highlights of the discussions on the 31 July 2014 meeting were approved by the Monetary Board during its regular meeting held on 20 August 2014. The next meeting of the Monetary Board on monetary policy issues is scheduled on 11 September 2014.

- The MB emphasized that an increase in the BSP's policy rates will moderate inflation pressures and arrest potential second-round effects by helping anchor inflation expectations. Going forward, the MB reiterated that the BSP will remain vigilant against risks to price and financial stability and stands ready to undertake further policy actions as necessary.

III. Recent Developments and Inflation Outlook

The MB considered the following developments in deciding its policy stance:

A. Domestic price conditions

- Year-on-year headline inflation edged lower in June due largely to slower increases in the prices of non-food items. Meanwhile, food inflation increased further as most food commodities, particularly rice, meat, eggs, oils, vegetables, and sugar posted higher prices due to limited domestic supply. Other indicators decreased, including the official measure of core inflation, all alternative measures of core inflation estimated by the BSP, seasonally-adjusted month-on-month headline and core inflation rate, seasonally-adjusted 3-month moving average annualized core inflation rate, and the number and weight of above-threshold items. By contrast, the seasonally-adjusted 3-month moving average annualized headline inflation rate increased in June.

- The MB, however, noted that inflation for the bottom 30 percent of the income distribution is higher than the inflation for all income groups, breaching the upper limit of the inflation target for the past four consecutive months. These developments bear watching given their impact on inflation expectations.

B. Inflation expectations

- Mean inflation forecasts of private analysts continue to increase, as inflation expectations remain elevated. Results of the July 2014 Consensus Economics survey showed higher inflation forecasts of 4.3 percent (from 4.2 percent) for 2014 and 4.0 percent (from 3.9 percent) for 2015. Similarly, the BSP's survey of private sector economists for June 2014 yielded higher but still within-target mean inflation forecasts of 4.3 percent (from 4.1 percent in May) for 2014, 4.0 percent (from 3.8 percent) for 2015, and 3.9 percent (from 3.8 percent) for 2016. Results of the Q2 2014 Business Expectations Survey likewise showed that respondents who expected inflation to go up continued to outnumber those that held the opposite view in the current and next quarters. Meanwhile, results of the Q2 2014 Consumer Expectations Survey (CES) showed that lower inflation is expected over the next 12 months from 8.4 percent to 6.1 percent.

C. Inflation outlook

- Average annual inflation for 2014 and 2015 is projected to settle above the midpoint of the target range of 3-5 percent for 2014 and 2-4 percent for 2015. However, the inflation target for 2015 appears to be at risk from cost-side pressures and rising inflation expectations. Compared to the previous forecast round, the average baseline inflation forecast for 2015 has edged closer to the upper end of the target range due mainly to higher oil prices, a slight increase in liquidity, as well as changes in the assumed implementation date of petitioned adjustments in electricity rates and transport fares.

- The balance of risks to prices remains tilted toward the upside. Potential price pressures continue to come from a possible uptick in oil and food prices and pending petitions for increases in electricity rates. Volatility in international oil prices is seen to be offset by rising global inventories. Meanwhile, the downside risks to inflation could come from slower global economic activity.

D. Demand conditions

- While real sector activity is likely to moderate in Q2 2014, the Philippine economy is expected to continue to grow above its historical average rate. Economic activity will continue to be supported by firm private consumption, some recovery in external demand, and the implementation of reconstruction projects in areas affected by typhoon Yolanda. Vehicle and electricity sales remain brisk, capacity utilization of the manufacturing sector has remained consistently above 80 percent, and the composite PMI has stayed firmly above the 50-point neutral threshold. Lending for production activities also continues to expand, indicating that the pick-up in private investment is broadly on track.

E. Supply-side indicators

Developments in Agriculture

- The near-term outlook on rice prices continues to depend largely on how the National Food Authority (NFA) will act to stabilize supply. On 17 February 2014, the NFA Council approved the importation of additional 800 thousand metric tons of rice from Vietnam, which is scheduled to be completed by end-August 2014. The retail prices of regular-milled and well-milled rice rose in June 2014 from their respective levels in the previous month, reflecting in part relatively tight supply conditions.

- The FAO Food Price Index (FPI) decreased in June 2014 from its month- and year-ago levels, driven largely by the decline in the prices of cereals, vegetable oil, sugar, and dairy amid favorable production prospects. Meanwhile, meat prices held steady.

Oil Price Developments

- Global oil prices increased in June amid escalating insurgency in Iraq, which fueled market concerns of oil supply disruption in the Organization of Petroleum Exporting Countries' second-largest oil producer. Meanwhile, for the period 1-16 July, the average price of Dubai crude oil declined after the reopening of two terminals in Libya, easing supply concerns in the Middle East. Meanwhile, oil demand forecasts for 2014 by global energy authorities were unchanged relative to previous assessments.

- The MB noted that near-term volatility in oil prices is seen to be mitigated by buoyant supply conditions in the US. There is also evidence of lower pass-through of oil price changes to general inflation in recent decades, including the Philippines.

Developments in the Utilities Sector

- The overall cost of electricity was higher in July 2014. Generation charges rose as the scheduled and unscheduled outages in several power plants resulted in tight power supply. The increase in generation charges offset the decline in the price of power purchased from the Wholesale Electricity Spot Market (WESM), which was due partly to the implementation of the Energy Regulatory Commission's secondary price cap in the WESM. Subsidies and system loss charges also increased. Meanwhile, distribution charges and taxes inched down.

F. Financial market developments

- The PSEi breached the 6,900 level for the first time in 13 months in early July on the back of a lower-than-expected inflation outturn in June. Investor confidence improved on reports that unemployment in the US fell to its lowest level in six years. However, concerns over the high valuation of local equities tempered market sentiment.

- Similarly, the peso was broadly stronger in early July on expectations that improving employment conditions in the US and a modest recovery in the manufacturing sector in China will spur regional exports. Moreover, the sustained inflows of foreign exchange from overseas Filipinos and from foreign direct and portfolio investments, as well as the ample level of the country's gross international reserves, continued to provide broad stability to the peso.

- For the period 1-11 July, debt spreads tightened further as market sentiment continued to improve on the back of upbeat economic indicators overseas. Market confidence also strengthened after Japanese credit rating agency R&I upgraded the Philippines' credit rating from BBB- to BBB on 9 July.

G. Domestic liquidity and credit conditions

- Domestic liquidity or M3 grew by 23.0 percent year-on-year in June 2014 to ₱7.1 trillion. This pace of increase was slower than the 28.4-percent expansion recorded in the previous month. On a month-on-month (m-o-m) basis, seasonally-adjusted M3 declined by 0.4 percent, following a zero growth a month earlier. The slowdown in M3 growth is in line with the path projected by the BSP.

- The outstanding loans of commercial banks, net of RRP placements with the BSP, expanded by 20.1 percent in June 2014, slightly lower than the previous month's increase of 21.0 percent. On a seasonally-adjusted basis, commercial bank lending increased by 0.2 percent m-o-m.

H. Fiscal developments

- The fiscal surplus for the period January-May 2014 was ₱8.5 billion, reversing the ₱42.8-billion budget deficit incurred during the same period in 2013. Revenue collections increased by 12.0 percent while expenditures were higher by 5.0 percent.

I. External developments

- The MB noted that global economic activity is expected to expand at an uneven pace. Leading indicators point to a recovery in economic activity in Q2 2014. However, the moderation in growth in Q1 2014, particularly in the US, as well as tighter financial conditions and geopolitical tensions in the Middle East and Russia, could dampen the overall momentum for the rest of 2014. Nevertheless, global economic growth is projected to strengthen in 2015 in both advanced economies and emerging markets.