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HIGHLIGHTS OF THE MEETING OF THE MONETARY BOARD ON MONETARY POLICY ISSUES HELD ON 20 OCTOBER 2011[1]

I. Monetary Policy Decision

The Monetary Board (MB) decided to:

a) Maintain the BSP's policy rates at 4.5 percent for the overnight RRP (borrowing) rate and 6.5 percent for the overnight RP (lending) rate;

b) Maintain the current interest rates on term RRPs, RPs, and special deposit accounts (SDAs); and

c) Maintain the current reserve requirement ratios.

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

- The MB's decision to maintain the policy rates is based on its assessment that current monetary policy settings are appropriate given the latest inflation outlook and emerging economic developments. Latest average baseline forecasts show a lower inflation path, consistent with the 3-5 percent target range for 2011-2013. The within-target inflation outlook is also in line with the latest BSP and private sector surveys, which indicate declining and well-contained inflation expectations.

- The MB also noted that the risks surrounding the inflation outlook over the policy horizon are slightly tilted to the downside. Since the previous policy meeting, the international growth outlook has become significantly more uncertain, while conditions in global financial markets have become highly unsettled, given interlocking sovereign debt and banking concerns in Europe and the prospects of stalled economic recovery in the United States. As a result, demand-side factors driving global commodity prices have abated. Nevertheless, the MB continues to be mindful of the remaining upside risks, including potential increases in liquidity due to sustained capital inflows.

- At the same time, the MB is of the view that monetary easing may not be warranted for the time being as domestic demand remains firm. Growth in monetary

[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 20 October 2011 meeting were approved by the Monetary Board during its regular meeting held on 10 November 2011. The next meeting of the Monetary Board on monetary policy issues is scheduled on 1 December 2011.

aggregates has also continued to be firm. These conditions require maintaining a prudent monetary policy stance to contain upward pressures on asset prices.

- The MB also considered the current settings of monetary policy to be well-placed, given the evolving global and domestic economic conditions. In particular, domestic economic growth could be tempered by the slowdown in the global recovery and the weaker-than-expected domestic public spending. Thus, with manageable inflationary pressures amid prospects of slower global recovery, there is scope for the BSP to pause and assess the outlook for inflation and growth as further information becomes available from the domestic and international fronts.

III. Recent Developments and Inflation Outlook

The MB considered the following developments in coming up with its policy decision:

A. Domestic price conditions

- Year-on-year headline inflation rose in September, driven mainly by higher inflation for food, particularly fruits and vegetables. Other indicators also reflected a slight uptick, including the following: the year-on-year core inflation, seasonally-adjusted month-on-month headline inflation, two out of three alternative measures of core inflation estimated by the BSP, and the number and weight of above-threshold items. Meanwhile, the seasonally-adjusted month-on-month core inflation was unchanged.

- The MB, however, noted that the upticks in the headline and core inflation numbers in September were due mainly to temporary weather-related food price shocks, which are not expected to lead to broad-based inflationary pressures. In particular, core inflation, which eliminates the volatility caused by food and energy prices, has remained relatively subdued since July.

B. Inflation expectations

- Inflation expectations appear to be well contained, staying within the target band for 2011-2013. Results of the BSP's survey of private sector economists and the Asia Pacific Consensus Survey showed lower and within-target inflation forecasts for 2011-2013.

C. Inflation outlook

- The latest baseline inflation projections are on a lower path relative to the previous policy meeting, with average headline inflation rates for 2011-2013 projected to settle within the 3-5 percent inflation target range. The downward adjustment in the forecast path could be attributed mainly to lower oil price assumptions.

- The balance of risks to inflation appears to be skewed slightly to the downside. The downside risks to the inflation outlook have intensified due to concerns over the strength of the global economy and its implication on the pace of economic activity and oil demand. At the same time, the broadly stable peso could help temper the prices of imported commodities. Meanwhile, the upside risks to inflation could emanate from the liqudity impact of strong capital inflows, pending and any additional petitions for electricity rate adjustments, and possible higher global rice prices.

D. Demand conditions

- While renewed uncertainty over the strength and pace of the global economic recovery could continue to pose downside risks to the domestic economy, most recent demand indicators suggest that domestic demand appears to be intact. Results of the Q3 2011 Consumer Expectations Survey showed an improvement for the current quarter while outlook turned bullish for the next quarter and the year ahead. Latest survey on industrial activity also indicates that the largest proportion of the establishments in the manufacturing sector operated consistently above 80 percent. Reflecting the demand of the industrial as well as the commercial sector, energy sales also picked up in August, posting the highest growth registered in 2011 so far. In the property sector, office space take-up rates have remained consistently strong, supported by BPO demand, while residential stock was boosted with the completion and turnover of new units. Meanwhile, vehicle sales, particularly for passenger cars, slightly recovered in August after being affected by supply disruptions with the disaster in Japan earlier this year.

E. Supply-side indicators

Developments in Agriculture

- After growing robustly in the first half of 2011, the production outlook on agriculture could be lower in the second half due to the series of typhoons that hit the country. In particular, the production losses due to typhoons Pedring and Quiel are expected to affect the domestic supply outlook for rice.

- Meanwhile, the MB noted that agriculture damages due to severe flooding, particularly in Thailand, may threaten global rice supply. Amid these concerns, Thailand reportedly raised the support price of rice for local farmers.

- Given this supply outlook, the MB is of the view that there is a need for timely government-to-government negotiation to step up the country's rice inventory.

Oil Price Developments

- The impact of a slower global recovery on oil demand has already been reflected in the slight pullback in international oil prices. After recovering slightly in September, oil prices have declined on reports of increased downside risks to the US economy as well as greater risk aversion in financial markets. Over the near term, the outlook for crude oil prices remains generally weighted towards the downside as persistent fears from the EU debt crisis and signs that global growth is slowing are likely to keep crude oil prices under pressure.

Developments in the Utilities Sector

- Lower generation costs offset the increase in the universal charge[2] component of the electricity bill in September. Meralco noted that the decrease was primarily due to the lower charges by some Independent Power Producers (IPPs) due to improved utilization levels. The price of electricity from the Wholesale Electricity Spot Market (WESM) also declined. However, initial reports indicated that electricity rates were higher in October due to higher charges by the IPPs and as price of electricity from the WESM increased.

F. Financial market developments

- The 364-day T-bills fetched an average interest rate of 1.750 percent at the 18 October auction, 61.7 basis points higher than the 1.133 percent fetched at the 19 September auction. However, all bids for the 91-day and 182-day T-bills were rejected as bids were deemed too high, reflecting investors' caution amid developments in the Eurozone. The auction continued to be oversubscribed.

- Lingering concerns about the European debt crisis spreading and global recovery slowing down also put pressure on the stock, bond, and foreign exchange markets. The PSEi dipped in September, falling to its lowest during the year at 3,721.22 index points on 26 September, while the peso depreciated as investors sought safe-haven assets amid the heightened risk aversion. In September, debt spreads widened with credit spreads peaking on 26 September, the widest since June 2009. In October, investors maintained a cautious outlook, following Moody's downgrade of Italy's credit rating for the first time in two decades.

G. Domestic liquidity and credit conditions

- Domestic liquidity or M3 grew at a faster pace of 9.4 percent in August 2011 from 8.3 percent in July 2011 to reach ₱4.3 trillion. Higher growth in net foreign assets (NFA) continued to fuel the expansion of domestic liquidity. Net domestic assets, meanwhile, decreased further by 10.6 percent in August from the 6.3 percent contraction in July, given the faster expansion in the net other items account (which includes, among other things, revaluation and capital and reserve accounts as well as SDA placements of trust entities). However, net domestic credits expanded further by 8.9 percent with the sustained increase in credits extended to the private sector

[2] The Energy Regulatory Commission (ERC) has approved provisionally the NPC-Small Power Utilities Group's (NPC-SPUG) petition to recover through the Universal Charge (UC) the shortfalls in the Missionary Electrification (ME) subsidy for calendar years 2003 to 2009.

by 14.9 percent, consistent with the continued strong growth of bank lending to businesses and households. By contrast, credits extended to the public sector declined anew.

- Bank lending growth, net of banks' reverse repurchase (RRP) placements with the BSP, accelerated in August to 19.8 percent from the previous month's expansion of 19.1 percent. Commercial banks' loans have been growing steadily at double-digit growth rates since January 2011. The growth in loans for production activities—which comprised more than four-fifths of commercial banks' total loan portfolio—grew steadily at 21.5 percent in August from 20.5 percent a month earlier. Meanwhile, the growth in consumer loans decelerated to 13.4 percent from 15.6 percent in July due mainly to the slowdown in auto loans.

- Corporate issuers continue to tap the equity and bonds market. Capital raising activities in the Philippine Stock Exchange reached ₱64 billion for the period January-August 2011, ₱10 billion higher than last year's level. Corporate bond issuances for the same period also increased by almost ₱18 billion to ₱142 billion.

H. Fiscal developments

- The fiscal deficit in January-July 2011 was ₱43.71 billion, 81.0 percent lower than the ₱229.4 billion deficit during the same period last year. The lower deficit figure is attributed to increased revenue collections (13.5 percent year-on-year) coupled with lower government spending (-10.0 percent year-on-year).

I. External developments

- The global growth outlook has become significantly more uncertain since the previous policy meeting. Global economic recovery appeared to weaken further as growing downside risks continued to erode market confidence. Reflecting this outlook in its September 2011 World Economic Outlook (WEO), the IMF has reduced its growth projections on account of downside risks.

- With demand-pull pressures expected to ease on prospects of slower global activity, global inflationary pressures may recede. The MB noted that, although global commodity prices have remained elevated, food and energy prices have eased on renewed concerns over the weakening US recovery and the ongoing debt crises in the euro area.