BANGKO SENTRAL NG PILIPINAS

# HIGHLIGHTS OF THE MEETING OF THE MONETARY BOARD ON MONETARY POLICY ISSUES HELD ON 25 JULY 2013[1]

## I. Monetary Policy Decision

The Monetary Board (MB) decided to:

a) Maintain the BSP's policy interest rates at 3.5 percent for the overnight RRP (borrowing) rate and 5.5 percent for the overnight RP (lending) rate;

b) Maintain the current interest rates on term RRPs, RPs and SDA; 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 BSP's policy interest rates was based on its assessment of a manageable inflation environment over the policy horizon amid robust domestic growth. The latest baseline forecasts indicate that inflation will remain within target for 2013-2015, while inflation expectations remain firmly anchored. The MB noted that the Philippine economy continued to be driven by favorable domestic demand, supported by buoyant market confidence. Growth in domestic liquidity and bank lending likewise provided solid support to domestic economic activity.

- The MB considered the prevailing risks to the inflation outlook to be broadly balanced. Global economic prospects were seen to likely stay subdued going forward, thus tempering upward pressures on commodity prices. Nonetheless, upside risks to the inflation outlook remained, including pending utility rate adjustments as well as the recent depreciation of the peso.

- The MB also considered that financial market volatility continued to persist owing to concerns over the timing of the tapering of monetary stimulus in advanced economies, and this suggested caution in assessing the policy stance.

- On balance, the MB was of the view that prevailing monetary policy settings remain appropriate. The manageable inflation outlook and strong domestic growth support keeping policy settings steady amid renewed market volatility. Going forward, the BSP will continue to monitor evolving price and output developments to ensure that the monetary policy stance remains consistent with ensuring price and financial stability while supporting sustainable economic growth.

[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 25 July 2013 meeting were approved by the Monetary Board during its regular meeting held on 15 August 2013. The next meeting of the Monetary Board on monetary policy issues is scheduled on 12 September 2013.

## 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 increased in June due largely to higher non-food inflation. Likewise, other indicators went up such as the seasonally-adjusted month-on-month headline inflation, and seasonally adjusted 3-month moving average annualized headline and core inflation. By contrast, the official core inflation, all alternative measures of core inflation estimated by the BSP, seasonally-adjusted month-on-month core inflation, and the number and weight of above-threshold items fell in June.

- The higher inflation in June was attributed largely to the increase in non-food inflation, particularly education, transport, and electricity, gas, and other fuels. Inflation on educational services went up due to the approved tuition fee increases for the new academic year. Likewise, prices of gasoline and diesel increased during the month, reflecting the higher oil prices in the international market. Upward adjustments in electricity rates, due to higher generation and transmission charges, also contributed to the rise in non-food inflation. Meanwhile, food inflation held steady as increases in the prices of vegetables and rice were offset by the lower inflation rates for meat, milk, fruits, oils and fats, and sugar.

### B. Inflation expectations

- The benign inflation outlook is supported by well-anchored inflation expectations. Inflation expectations based on forecast surveys of private sector economists by the BSP and by Consensus Economics remain within the target band for 2013-2014. Results of the June 2013 BSP forecast survey showed generally steady mean inflation forecasts for 2013-2015. Meanwhile, results of Consensus Economics' July 2013 Asia Pacific Consensus Forecasts survey yielded a lower mean inflation forecast for 2013 and a steady mean inflation forecast for 2014.

### C. Inflation outlook

- Latest baseline projections continue to indicate that headline inflation will likely fall within the 4.0 percent ± 1.0 percentage point target range for 2013-2014 and the 3.0 percent ± 1.0 percentage point target range for 2015. The inflation forecasts are slightly higher compared with the projections in the previous policy meeting mainly due to the following factors: (a) higher inflation outturn in June relative to the mean forecast; (b) peso depreciation; (c) faster M3 growth; and (d) incorporation of the estimated impact of water rate adjustment.

- The risks to the inflation outlook remain broadly balanced. Downside risks to the inflation outlook continue to persist owing to uncertainty over the strength of the global economy and its impact on international commodity prices. Meanwhile, the upside pressures could emanate from the likelihood of higher electricity rates, continued strong liquidity growth and peso depreciation.

## D. Demand conditions

- Indicators of domestic demand conditions remain firm. The monthly survey of purchasing managers by the Philippine Institute for Supply Management (PISM) suggests that the Philippine economy was still in expansion phase in the second quarter, supporting the results of the latest business cycle analysis of the BSP and various leading economic indicators monitored by the BSP and National Statistical Coordination Board which all point to a continued economic upturn. Six out of the ten BSP leading and coincident indicators and six out of the eleven NSCB composite leading economic indicators suggest continued positive economic growth in Q2 2013. Moreover, survey results suggest bullish consumer and business sentiments for Q2 2013 and continued optimism for the succeeding quarters.

## E. Supply-side indicators

<u>Developments in Agriculture</u>

- Domestic rice inflation remains well-behaved. In June 2013, year-on-year rice inflation stood at 1.8 percent while month-on-month seasonally-adjusted inflation was only about 0.5 percent. The recent uptick in rice prices largely reflects the seasonal increase in prices which can be attributed to the onset of the lean season for rice production. In Metro Manila, the price of regular-milled rice rose in July due to increased transport costs as a result of the implementation of truck load restrictions by the Department of Public Works and Highways (DPWH). Nevertheless, the intensified rice distribution by the NFA is expected to help moderate the seasonal increase in rice prices. In addition, rice prices are expected to normalize with the subsequent lifting of the truckload restrictions by the DPWH.

- Meanwhile, supply conditions appear favorable in the domestic rice market. In June 2013, the domestic rice inventory level was higher than the year- and month-ago levels due to substantial local procurement of rice traders as well as higher household stocks from the summer harvest. This is despite the Bureau of Agricultural Statistics' forecast (as of April 2013) that output would decline in Q2 2013.

- Meanwhile, the FAO food price index (FPI) was relatively unchanged compared to its month-ago value, as lower dairy and sugar prices was offset by the increase in cereal prices.

<u>Oil Price Developments</u>

- Oil prices were broadly steady in June as signs of economic recovery in the US were tempered by expectations that the US Federal Reserve may start to scale down its quantitative easing (QE) stimulus measures later in the year and on concerns that the Chinese economy would also slow down amid a possible credit crunch. However, prices advanced by mid-July on market concerns that the political unrest in Egypt might spread to other countries and disrupt oil supply coming from the Middle East.

- Meanwhile, the impact of the US shale oil boom, as a result of sustained high world crude oil prices and key technological advances, could result in potentially lower oil prices as supply could outstrip demand in the near term. The Philippines could then stand to benefit greatly since crude oil accounts for about 31 percent of the Philippines' total energy mix and is used primarily for transport.

Developments in the Utilities Sector

- Electricity rates were lower in July 2013 due to the reduction in generation charges (from Meralco's Power Supply Agreements and Wholesale Electricity Spot Market) and other bill components such as system loss charge, power act reduction[2] and universal charges. Generation rates were lower as demand for power supply eased with the onset of the rainy season. The said reduction offset the increase in power rates of Independent Power Producers and the National Power Corporation.

**F. Financial market developments**

- The Philippine Stock Exchange Index (PSEi) dropped in June as bearish market sentiment persisted overseas amid growing concerns about the early scaling back of the US Fed stimulus measures, worries over a Chinese economic slowdown and disappointment over the BOJ's holding off from taking fresh stimulus measures. These factors prompted investors' flight to US safe-haven assets such as corporate bonds and equities.

- Accordingly, the peso continued to weaken in June as it averaged ₱42.96/US$1 on lingering fears over US Fed unwinding of its QE program, along with liquidity concerns in China. For the period 1-22 July, the peso further depreciated to average ₱43.38/US$1 as investors turned cautious of positive US employment data that may signal an earlier-than-expected scaling back of US Fed monetary stimulus. Nonetheless, the country's strong balance of payments position provided fundamental support in tempering the further depreciation of the peso. Fears of QE tapering off also drove the general widening in debt spreads in June, with a sell-off in the fixed income market expanding spreads to levels last seen in June 2011. Worries over a liquidity crisis in China's interbank market also added to the market's risk-off trading sentiment.

- In July, however, debt spreads narrowed significantly back to levels seen in the early part of 2013. Some degree of calm returned as most financial markets began reversing their losses when the announcement of a weaker-than-expected Q2 2013 GDP in the US eased QE tapering concerns. In the Philippines, the continued sound macroeconomic fundamentals as evidenced by the IMF's raising its growth forecast for the Philippines, alongside with the markets' pricing-in of an expected credit rating upgrade by Moody's, further eased widening pressures in the country debt spreads. By the third week of July, the PSEi was able to recover, climbing back to 6,600 as global markets reassessed earlier expectations on the US Fed's tapering of an aggressive asset buyback program. The index was likewise boosted by optimism over the forthcoming second quarter local corporate earnings reporting season and by mostly firmer regional market activity.

[2] Under Section 72 of Republic Act 9136, the National Power Corporation is mandated to reduce its rates for residential end-users by ₱0.30 per kilowatt hour (kWh) upon effectivity of the said law on 26 June 2001.

## G. Domestic liquidity and credit conditions

- Domestic liquidity or M3 grew by 16.3 percent (preliminary) year-on-year in May 2013, faster than the 13.3 percent (revised) expansion in April 2013. Money supply growth was driven by the expansion of net domestic assets (NDA) following the sustained increase in credits to the private sector consistent with the robust lending activity of commercial banks. Meanwhile, net foreign assets (NFA) moderated to 0.9 percent y-o-y in May following the 2.9-percent growth in April owing to the continued decline in banks' NFA as their foreign liabilities continued to increase due in part to higher placements and deposits made by foreign banks with other banks. Meanwhile, banks' foreign assets continued to contract due to the decline in their loan receivables from and deposits with foreign banks. On the other hand, the BSP's NFA position increased by 4.4 percent, supported by steady foreign exchange inflows from overseas remittances and BPO receipts.

- The growth of outstanding loans of commercial banks, net of banks' reverse repurchase (RRP) placements with the BSP, grew by 13.1 percent in May from the previous month's expansion of 12.0 percent. Commercial banks' loans have been growing steadily at double-digit growth rates since January 2011. Loans for production activities—which comprised more than four-fifths of banks' aggregate loan portfolio—grew by 13.3 percent in May from 12.0 percent a month earlier.

- The MB noted that the increase in liquidity and credit growth is in line with financial deepening and the improving absorptive capacity of the economy. The growth in liquidity, therefore, would enable the country's financial system to continue to channel credit to the productive sectors of the economy. In addition, M3- and credit-to-GDP ratios are still lower by regional standards, suggesting that the current growth may also be a part of a catch-up process.

## H. Fiscal developments

- The fiscal deficit in the period January-May 2013 was ₱42.8 billion, significantly higher than the ₱22.7 billion deficit incurred during the same period in 2012. This represented 35.1 percent of the ₱84.7 billion programmed deficit for Q1-Q2 2013. Revenue collections increased by 9.7 percent while expenditures were higher by 12.4 percent.

## I. External developments

- Prospects for global economic growth remain modest. The recovery in the US has continued on improved business and consumer sentiment, while economic activity in Japan gains further traction. Meanwhile, the downturn in the euro area continues. The pace of growth in emerging economies also remains robust, although recent indicators suggesting weaker domestic demand in major emerging economies somewhat dampen the global growth outlook. At the same time, the IMF has reduced its global growth projections in its July 2013 WEO update relative to its estimates in April.