HIGHLIGHTS OF THE MEETING OF THE MONETARY BOARD ON MONETARY POLICY ISSUES HELD ON 26 JULY 2012[1]

I. Monetary Policy Decision

The Monetary Board (MB) decided to:

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

b) Reduce accordingly the current interest rates on term RRPs, RPs and SDAs; and

c) Maintain the current reserve requirement ratios.

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

- The MB's decision was based on its assessment that price pressures have been receding, with risks to the inflation outlook slightly skewed to the downside. Latest baseline forecasts indicated that inflation is likely to settle within the lower half of the 3-5 percent target for 2012 and 2013, as pressures on global commodity prices are seen to continue to abate amid weaker global growth prospects. Inflation expectations continued to moderate at levels consistent with the inflation target. Nevertheless, the MB also noted the potential sources of upside risks, including pending electricity adjustments, expectations of higher prices for some food products due to adverse weather conditions in major cereal-producing countries, and firm domestic demand pressures.

- The MB believed that a reduction in policy rates can serve as a pre-emptive move against the risk associated with the global slowdown. The MB was of the view that the world economy has continued to lose momentum and prospects for global economic activity are likely to remain weak. In the advanced economies, financial markets stress continues to build up, and there remain concerns about the prospects for urgent fiscal adjustments and reforms. Therefore, while the Philippine economy can rely on the resilience of domestic spending to sustain growth, additional policy support would serve as buffer against strong global headwinds.

[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 26 July 2012 meeting were approved by the Monetary Board during its regular meeting held on 16 August 2012. The next meeting of the Monetary Board on monetary policy issues is scheduled on 13 September 2012.

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 decelerated further in June, driven mainly by lower inflation for non-food items, particularly gasoline and diesel. Other indicators also reflected a downtrend, including the following: seasonally-adjusted month-on-month headline and core inflation, and the number and weight of above-threshold CPI components.

- In contrast, year-on-year core inflation has been stable. On a year-to-date (YTD) basis, however, the official measure of core inflation, which excludes some food and energy items, remained higher than headline inflation for the sixth consecutive month in June but lower than the midpoint of the target of 4 percent. Meanwhile, the alternative measures of core inflation estimated by the BSP showed mixed trends. In particular, the weighted median was below the headline on a YTD basis while the net of volatile items measures and trimmed mean measures were broadly in line with headline inflation.

B. Inflation expectations

- Inflation expectations based on the BSP and private sector forecast surveys continued to be steady but remained within the 3-5 percent target range over the policy horizon. Results of the July 2012 survey from the AP Consensus showed lower inflation forecasts for 2012 and 2013 compared to June. Meanwhile, results of the July 2012 BSP survey of private sector economists showed an unchanged mean inflation forecast for 2012 and lower average forecasts for 2013 and 2014.

C. Inflation outlook

- The latest baseline forecasts continue to point to within-target inflation for 2012 and 2013. Compared to the previous policy meeting, the projected inflation path for 2012 was unchanged while the slight downward adjustment for 2013 could be attributed mainly to the lower-than-projected actual inflation in June and the decline in domestic oil prices.

- The downside risks to the inflation outlook include concerns over the strength of the global economy and its implications on the pace of domestic economic activity and international commodity prices. Meanwhile, the potential sources of upside risks include pending electricity adjustments, expectations of higher prices for some food products due to adverse weather conditions in major cereal-producing countries, and firm domestic demand pressures.

D. Demand conditions

- Domestic demand conditions remained robust based on available leading economic indicators. Both BSP and NSCB leading economic indicators indices point to economic upturn in Q2. At the same time, employment conditions improved in Q2, energy and auto sales recorded gains, manufacturing activity as measured in the MISSI continued to grow, albeit at a slower rate, and the latest Philippine PMI readings indicated expansion for manufacturing, services, and retail and wholesale sectors. Merchandise exports also posted strong performance while the book-to-bill ratio has continued to remain above one since February 2012. Meanwhile, the Q2 2012 Consumer Expectations Survey showed a lower consumer confidence index for the current and the next quarter but broadly steady outlook for the year ahead.

E. Supply-side indicators

Developments in Agriculture

- The retail price of rice increased slightly in June-July 2012, reflecting the end of the summer harvest and the start of the lean season. Nevertheless, favorable supply conditions have kept prices of meat, fish and fruits generally stable. Meanwhile, prices of refined sugar inched up in a number of trading centers due to increased demand during the summer season.

- On the international front, the FAO food price index was lower in June relative to May. Continued economic uncertainty and generally adequate supply prospects kept international prices of most commodities under downward pressure but growing concerns over adverse weather conditions in some key producing countries sustained prices of some crops towards the end of the month.

- In recent weeks, international cereal prices—mainly for corn and wheat—have increased due to severe drought in the US (the world's top exporter of corn).

Oil Price Developments

- Oil prices fell sharply in June on concerns that the European debt crisis was deepening. Signs of economic slowdown in China and the US, adding to speculation of faltering oil demand, also pushed oil prices lower. However, oil prices recovered somewhat in July as Norway, Western Europe's largest crude oil exporter, faced a shutdown of its oil production platforms due to an energy strike. Signs that central banks in Europe and China may ease monetary policy and speculation that sanctions against Iran will curb supply also exerted upward pressure on oil prices.

Developments in the Utilities Sector

- In July, there were three new rate petitions filed by various power industry players with ERC. Meralco submitted a petition to increase rates due to under-recoveries for generation, transmission and lifeline subsidies in January to December 2011 while the National Power Corporation (NPC) is seeking an increase in the universal charge for missionary electrification (UCME) to augment its budget in the delivery of electricity in off-grid areas. The Power Sector Assets and Liabilities Management (PSALM) also filed its second petition for True Up Adjustments of Fuel and Purchased Power Costs (TAFPPC), and Foreign Exchange Related Costs (TAFxA) by the NPC.

F. Financial market developments

- In July, the PSEi continued to trade above the 5,200 mark as investor sentiment was boosted by the robust Q1 GDP growth, strong Q1 corporate earnings, positive growth in merchandise exports, and S&P's raising of the country's debt rating to BB+, the highest level since 2003 and one step below investment grade. The market's positive reaction to the agreements reached during the Euro Summit on 28/29 June and monetary easing by the ECB, BOE and PBOC also boosted trading sentiments. However, tempering the market upswing were concerns over indications that the IMF will lower its estimate for global growth this year, tepid employment growth in the US, and reports of China's weakest growth in three years. The PSEi recorded a new all-time high of 5,369.98 index points on 5 July and closed at 5,161.80 index points on 25 July, higher YTD by 18.07 percent.

- In July, the peso also continued to strengthen on sustained foreign exchange inflows and export receipts. The credit rating upgrade from S&P also supported market sentiment on the peso.

- Meanwhile, debt spreads have eased since the previous review of the policy stance on expectations of further monetary policy easing across the globe. On the domestic side, S&P's credit upgrade on Philippine sovereign bonds likewise buoyed market risk appetite.

G. Domestic liquidity and credit conditions

- Domestic liquidity or M3 expanded at a slower pace of 7.9 percent year-on-year in May from the 9.1-percent growth recorded in April. Money supply growth continued to be driven by the sustained expansion of net foreign assets (NFA) at 9.6 percent in May. On the other hand, net domestic assets (NDA) decelerated to 2.9 percent in May from 4.6 percent a month earlier due to the slightly faster increase in the net other items account (which includes, among others, revaluation and capital and reserve accounts as well as placements of authorized counterparties in the BSP's SDA facility), combined with the slower growth in lending to the private sector.

- Likewise, the growth of outstanding loans of commercial banks, net of banks' reverse repurchase (RRP) placements with the BSP, grew at a slower pace of 14.7 percent in May from the previous month's expansion of 19.2 percent. Loans for production activities—which comprised more than four-fifths of banks' aggregate loan portfolio—grew by 14.7 percent in May from 19.7 percent a month earlier. Meanwhile, the growth of consumer loans slowed down to 16.8 percent from 17.5 percent in the previous month.

- Corporates continued to tap capital markets for financing. Corporate bond issuances for the period January-May 2012 reached ₱165.0 billion, more than double the 2011 level of ₱74.6 billion. Meanwhile, the total equity raised in the Philippine Stock Exchange (PSE) during the same period amounted to ₱47.5 billion, 21 percent lower than the year-ago level.

H. Fiscal developments

- The fiscal deficit in the period January-May 2012 was ₱22.8 billion, ₱13.2 billion higher than the deficit incurred during the same period last year. This represented 20.8 percent of the ₱109.3 billion programmed deficit for Q1-Q2 2012. Revenue collections increased by 11.0 percent while expenditure was higher by 13.1 percent. Meanwhile, the public sector external debt-to-GDP ratio in Q1 2012 was 21.0 percent, lower by 1.5 percentage points compared to the level in the same period in 2011.

I. External developments

- The world economy appeared to have lost some momentum since the previous policy meeting. The JP Morgan Global All-Industry Output Index fell further to 50.3 in June from 52.1 in May as economies outside the euro area also started to slow down due to weak demand.

- Economic conditions in the euro area have continued to weaken, fueling uncertainty and posing downside risks to economic activity in the rest of the world through trade and financial channels. The larger emerging economies such as China and India appear to have also slowed down in recent months as domestic demand and exports moderated. The US has continued to recover gradually, with potential spillovers from the euro area and China likely to hamper overall US economic growth and employment amid uncertainties in the scope for fiscal stimulus going forward.