Bangko Sentral ng Pilipinas

HIGHLIGHTS OF THE MEETING OF THE MONETARY BOARD ON MONETARY POLICY ISSUES HELD ON 8 SEPTEMBER 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 remain appropriate given a manageable inflation environment and subdued economic outlook. Latest baseline forecasts continue to indicate that average annual inflation is likely to settle within the 3-5 percent target range for 2011-2013 while inflation expectations remain firmly anchored given the moderating commodity prices and the recent string of stable inflation rates. The growth of domestic output has moderated in the first half of 2011 as external demand weakened and public spending was below target.

- The MB is of the view that the risks to the inflation outlook may be receding as global inflationary pressures are expected to ease with the slowdown in the recovery of advanced economies. Food prices have also remained tame with favorable supply conditions in both domestic and international markets. The abating price pressures give monetary authorities sufficient room to keep policy rates on hold.

- A pause in the policy stance allows for careful assessment of inflation risks amid signs of sluggish global economic growth. The MB believes that the current

[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 8 September 2011 meeting were approved by the Monetary Board during its regular meeting held on 22 September 2011. The next meeting of the Monetary Board on monetary policy issues is scheduled on 20 October 2011.

monetary policy stance remains in line with the need to safeguard price stability and support sustained economic growth.

- Nevertheless, the MB also noted that liquidity expansion and bank credit activity continue to grow at a strong pace. Therefore, while emerging liquidity and credit conditions could help promote economic activity, they should also warrant close attention as they could stoke inflationary pressures going forward.

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 slowed down to 4.3 percent in August from the July level of 4.6 percent, using the 2000-based Consumer Price Index (CPI) series. Similarly, the new 2006-based CPI series showed a lower headline inflation rate for August at 4.7 percent from 5.1 percent in July. Year-on-year headline inflation decelerated in August driven mainly by lower inflation for food, particularly sugar and vegetables. The drop in international oil prices, which translated into reduced prices of domestic petroleum products, also helped pull down inflation.

- Using the 2000-based CPI series, core inflation, which excludes some food and energy items to measure generalized price pressures, decreased to 3.4 percent in August 2011 compared with 3.7 percent in July 2011.

- The MB, however, noted that inflation pressures are easing indicating reduced risks of broad-based pressures. Inflation momentum has moderated with both headline and core inflation slowing down on an annualized month-on-month deseasonalized basis. The year-to-date average at 4.3 percent using the 2000 basket and 4.8 percent using the 2006 basket remain within the Government's target range of 3-5 percent for 2011.

B. Inflation expectations

- Inflation expectations appear to be well contained and within the target band for 2011-2013. Results of the BSP's survey of private sector economists showed lower and within-target inflation forecasts for 2011-2013 while results of the Asia Pacific consensus forecast in August 2011 showed broadly steady and within-target inflation forecast for 2011 and 2012. Meanwhile, results of the Q3 2011 Business Expectations Survey (BES) indicated that lower inflation is expected over the next 12 months.

C. Inflation outlook

- The latest baseline inflation projections are on a lower path relative to that from 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 the lower-than-projected inflation outturn for July and August 2011, slower liquidity growth, lower domestic output expansion, and decline in global growth. The slowdown in the forecasted liquidity growth reflects the impact of the 2.0-percentage point increase in the reserve requirement and the 50-basis point hike in the BSP's policy rates since March.

- The inflation outlook is also supported by the receding risks to inflation. Price pressures are expected to ease in the near term as global inflationary pressures are likely to be held back by a weaker global economic recovery. Food prices have also remained subdued supported by favorable supply conditions in both domestic and international markets. At the same time, the sustained strengthening of the peso is likely to lead to lower prices of imported commodities. However, monetary authorities continue to face inflation risks from the volatility in oil prices. The upside risks to inflation also include the impact of ample domestic liquidity, pending petitions for electricity rate adjustments, and possible uptick in global rice prices.

D. Demand conditions

- GDP growth continued to decelerate in Q2 2011, driven by weaker external demand and government underspending. Nevertheless, household consumption and private construction continued to expand robustly, indicating resilience and underlying strength in private demand. However, risks to domestic economic activity in the second half could be on the downside if government spending remains unsupportive. Slower global economic activity in the second half could also imply increased downside risks for external demand. Taken together and considering strong global headwinds to growth, this suggests that the balance of risks for output conditions leans toward a slower pace of economic activity going forward.

E. Supply-side indicators

Developments in Agriculture

- Domestic agriculture supply conditions are more favorable as production expanded robustly in Q2 2011. The recovery of the sector was driven mainly by the strong growth of palay, corn and sugarcane. As a result, palay and corn production in 2011 are expected to exceed their 2010 levels.

- Meanwhile, international prices of corn and wheat declined in July due to improved supply conditions but the price of rice rose. In international rice markets, the price of the benchmark Thai 100% B rice advanced further in July due largely to expectations of an increase in the Thai government's purchase price of rice from local farmers.

Oil Price Developments

- Oil prices increased in July on optimism that the US would be able to increase its debt ceiling and eurozone leaders would succeed in convincing investors that plans to contain the region's debt crisis would be adequate. However, oil prices dipped in August following Standard & Poor's downgrade of the US credit rating, which stoked concerns that the US economic slowdown would worsen and cut fuel demand in the world's largest energy-consuming nation.

Developments in the Utilities Sector

- 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. The ERC directed all distribution utilities and the National Grid Corporation of the Philippines (NGCP) to collect UC-ME charge in the amount of ₽0.0709/kwh per month starting August 2011.

F. Financial market developments

Government Securities Market

- During the 5 September auction, the interest rate for the 91-day, 182-day, and 364-day T-bills declined by 54.1 basis points, 31.8 basis points, and 55.6 basis points, respectively, relative to previous auction levels. T-bill rates dropped on the back of ample market liquidity, expectations of manageable inflation, and anticipation that policy rates would be kept unchanged when the Monetary Board meets on 8 September. Flight to safe assets, amid fears of a new global recession, also supported the decline in T-bill rates. The auction was oversubscribed, with total tenders reaching ₽42.8 billion or around 4.8 times the total original offered amount of ₽9.0 billion.

- On 31 August 2011, the Auction Committee awarded in full the ₽9.0 billion re-issuance of 7-year T-bonds at 4.936 percent, which is 8.1 basis points lower than the highest bid rate during the last auction for the same tenor. The market was very liquid as indicated by the total tenders of ₽24.0 billion against the ₽9.0 billion offering.

- Although the secondary market yields and term spreads declined across all tenors on 6 September 2011 relative to end-July 2011, the bigger decline in the yields for shorter tenors led to a relatively steeper yield curve. Yields on government securities in the secondary market were lower, driven by the country's sound economic fundamentals given the peso appreciation, contained inflation, and recent Philippine credit rating upgrades, in addition to the ample market liquidity. Shorter-dated instruments, however, declined more significantly than longer-term instruments, reflecting the rush of investors toward safe-haven, short-term assets in response to the heightened level of uncertainty in financial markets. This was brought on by concerns about the US and European fiscal health and growth prospects.

<u>Stock Market</u>

- The local bourse fell in August notwithstanding the surprising highs in early August on expectations of healthy second-quarter corporate earnings, lower fiscal deficit, and the easing of inflation in July. The Philippine Stock Exchange index (PSEi) dropped on mounting evidence of a slowdown in global growth, the impact of the US credit rating downgrade on global markets and the US economy, ongoing eurozone debt troubles, and the pick-up in China's inflation.

<u>Foreign Exchange</u>

- In August, the peso strengthened amid heightened global risk aversion arising from S&P's downgrade of the US rating, the eurozone debt crisis, and concerns over a subsequent global economic slowdown. The peso also appreciated as most hedge funds took long positions on emerging Asian currencies on optimism that the US debt stalemate has been resolved and additional data showing strong economic growth in the region. However, news on the National Government's below-target revenue collection tempered the peso's further appreciation.

<u>Global Bond and Credit Default Swap Spreads</u>

- Debt spreads of most emerging market bonds widened to record highs in August after S&P downgraded the US long-term credit rating to AA+. Spreads further expanded following reports of Moody's lowering of Japan's sovereign credit rating by one step to Aa3. Persistent worries over global economic slowdown and euro zone's fiscal crisis spurred flight from riskier emerging market assets, increasing pressures for spreads to widen. Towards the end of the month, however, spreads eased on positive speculation that the US Fed would intervene to spur economic growth. As of end-August, the EMBI+ Philippine spread and the Philippine 5-year sovereign CDS widened against end-July levels.

- Nevertheless, it is important to note that the expansion in most of Asia's CDS spreads appeared to be muted compared with the sharp fallout in the Asian equities markets. Such investors' retreat from stocks towards less risky assets, such as US Treasuries (which remained attractive as a safe-haven instrument despite the recent downgrade), has driven the value of the global bonds to record highs and has subsequently pushed bond yields to historic lows. Against this trend, the widening in the EMBI spreads may be attributed to the decline in US Treasury yields, apart from the rise in the risk premium component from holding emerging market debt.

G. Domestic liquidity and credit conditions

- Domestic liquidity or M3 grew at a slower pace of 8.3 percent in July 2011 from 11.4 percent in June 2011. The steady expansion in net foreign assets (NFA)—recorded at 17.5 percent in July—continued to fuel the expansion of domestic liquidity. Net domestic assets (NDA), meanwhile, contracted further by 6.3 percent in July due to the faster expansion in the net other items account (which includes revaluation and capital and reserve accounts as well as SDA placements of trust entities). By contrast, the growth in net domestic credits continued to expand by 7.2 percent with credits extended to the private sector expanding at a faster pace of 14.0 percent. This trend is in line with the faster growth of bank lending to the productive sectors of the economy. Meanwhile, credits extended to the public sector declined further given the continued increase in NG deposits with the BSP and other banks during the month.

- Bank lending growth, net of banks' reverse repurchase (RRP) placements with the BSP, accelerated in July to 19.1 percent from the previous month's expansion of 18.8 percent. The increase is the highest growth rate recorded since April 2009. 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 20.5 percent in July. This was driven largely by increased lending to electricity, gas and water (which grew by 54.2 percent); real estate, renting and business services (23.3 percent), and manufacturing (15.5 percent).

- Corporate issuers also continue to tap the equity and bonds market. Capital raising activities in the Philippine Stock Exchange reached ₱68 billion for the period January-July 2011, ₱24 billion higher than last year's level. Corporate bond issuances for the same period also increased by almost ₱26 billion to ₱142 billion.

H. Fiscal developments

- The fiscal deficit in January-June 2011 was ₱17.2 billion, 91.2 percent lower than the ₱196.7 billion deficit incurred during the same period last year. This represents 11.3 percent of the ₱152.1 billion programmed deficit for Q1-Q2 2011. Revenue collections increased by 15.1 percent to ₱681.6 billion in January-June 2011 compared to ₱592.1 billion in the same period last year and accounted for 99.3 percent of the program amounting to ₱686.4 billion for Q1-Q2 2011. Expenditures in January-June 2011 amounted to ₱698.9 billion, 11.4 percent lower than the disbursements in the same period in 2010, reaching 83.3 percent of the Q1-Q2 2011 program of ₱838.5 billion.

I. External developments

- Growth remains subdued in many advanced economies, while many emerging economies are operating at close to full capacity. Global headline inflation has continued to increase, mainly on account of higher inflation in emerging economies where price pressures are clearly more pronounced due to elevated commodity prices and strong domestic demand, while fiscal risks have been complicating the task of rebalancing growth in most advanced economies. In fact, the recent downgrade in US sovereign debt ratings reflected increased global tail risks as a result of fiscal weaknesses and the unsustainable debt levels in advanced economies. These developments strengthen the need for a more well-defined medium-term fiscal policy framework and the clear communication of fiscal policies in advanced economies in order to limit the deterioration in global financing conditions.