BANGKO SENTRAL NG PILIPINAS

HIGHLIGHTS OF THE MEETING OF THE MONETARY BOARD ON MONETARY POLICY ISSUES HELD ON 13 DECEMBER 2012[1]

I. Monetary Policy Decision

The Monetary Board (MB) decided to:

a) Maintain the BSP's policy interest rates at 3.50 percent for the overnight RRP (borrowing) rate and 5.50 percent for the overnight RP (lending) rate;

b) Maintain 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 to maintain policy interest rate settings was based on its assessment that current monetary settings remained appropriate, as the cumulative 100-basis-point reduction in policy rates in 2012 continued to work its way through the economy. The latest baseline forecasts followed a slightly lower path but remained near the lower bound of the target over the policy horizon. Risks to the inflation outlook were considered to be evenly balanced around the baseline forecasts, with inflation expectations broadly aligned with the inflation target range.

- Moreover, the MB was of the view that global economic activity had stabilized in recent months, although fiscal consolidation and financial market stresses in advanced economies continued to temper overall market sentiment. Global economic prospects, therefore, were expected to stay subdued, thus mitigating upward pressures on commodity prices.

- At the same time, the MB noted that the domestic economy has gained pace on the back of strong domestic demand and buoyant business sentiment. The growth of real gross domestic product (GDP) was stronger than expected at 7.1 percent in Q3 2012, driven by private spending and fiscal stimulus. In the months ahead, adequate liquidity and strong bank lending are expected to continue to support domestic economic activity and sustain the economy's momentum.

[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 13 December 2012 meeting were approved by the Monetary Board during its regular meeting held on 3 January 2013. The next meeting of the Monetary Board on monetary policy issues is scheduled on 24 January 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 slowed down in November, driven mainly by lower inflation for food. Other indicators such as year-on-year core inflation, two out of the three alternative measures of core inflation estimated by the BSP, number of above-threshold items, and weight of above-threshold items also reflected a downtrend. Meanwhile, seasonally-adjusted month-on-month headline and core inflation were steady in November.

- Lower food inflation due to ample domestic supply of selected food items, particularly vegetables and oils, led to lower headline inflation in November. Likewise, slower price increases for non-food items, due largely to the reduction in gasoline and diesel prices, helped push down inflation for the month.

B. Inflation expectations

- Inflation expectations based on the AP Consensus and BSP's private sector forecast surveys were within the 3-5 percent target range over the policy horizon. Results of the BSP private sector survey showed lower inflation forecasts for 2012 and 2013 and a steady inflation forecast for 2014. Meanwhile, results of the November 2012 AP Consensus survey yielded a steady inflation forecast for 2012 and a slightly lower forecast for 2013.

C. Inflation outlook

- The latest baseline forecasts followed a lower path compared to the path from the previous policy meeting, keeping near the lower bound of the target over the policy horizon. The downward shift in the forecasted inflation path for 2012-2014 was attributed mainly to the lower-than-projected actual inflation rates in October and November, the decline in oil prices, and changes in assumptions on M3 and rice prices. These factors offset the impact of the higher GDP growth rate and NG deficit assumptions for 2012.

- The risks to future inflation were deemed to be broadly balanced. Downside risks to inflation outlook continue to persist owing to uncertainty over the strength of the global economy, while the continued appreciation of the peso is expected to temper imported inflation. Meanwhile, the upside pressures on non-oil commodity prices in the international market, pending petitions for domestic utility rate adjustments and continued ample liquidity in the financial system constitute the key upside risks to inflation.

D. Demand conditions

- Domestic economic activity has gathered further momentum on the back of strong private spending and ongoing macroeconomic stimulus, implying scope to keep policy settings unchanged. GDP growth in Q3 was stronger than expected at 7.1 percent, bringing year-to-date growth of GDP to 6.5 percent. Solid gains were recorded across the three major sectors on the production side, with services contributing more than half of Q3 growth. Agriculture production grew as palay and corn output increased robustly while industry was supported by the growth in the manufacturing sector. Continuing strength in consumer demand, accelerated government spending, strong growth in construction, and recovery in exports also contributed to GDP growth on the demand side.

- Meanwhile, recent indicators of activity in Q4 2012 suggest that the economy will continue to benefit from domestic drivers of growth. Vehicle and energy sales have been strong at the start of Q4. Similarly, the Purchasing Managers' Index (PMI) readings in October indicated expansion in the manufacturing, retail/wholesale, and services sectors. Latest business expectations survey results for Q4 2012 also suggest more buoyant business sentiment for the current quarter.

E. Supply-side indicators

<u>Developments in Agriculture</u>

- The Agriculture, Hunting, Forestry and Fishing (AHFF) sector expanded at a faster pace of 4.1 percent in Q3 2012 from a growth of 2.2 percent in Q3 2011 and 0.6 percent in Q2 2012. The expansion in the production of palay, corn and coconut as well as livestock and poultry more than offset the slight decline in fisheries. For the first nine months of 2012, the AHFF sector expanded by 1.8 percent from 4.9 percent in the same period last year.

- The monthly FAO food price index dipped in October due largely to lower international prices of cereals and oils/fats which more than offset increases in sugar and dairy prices. The slide in the prices of oils/fats reflected ample supply combined with weak world import demand. Meanwhile, higher prices of sugar indicated short-term export tightness in Brazil, the world's largest sugar exporter, but prospects of sufficient supply in the current 2012/13 marketing season limited the gain. Moreover, a seasonal tightening of supplies and low stocks drove dairy prices higher.

<u>Oil Price Developments</u>

- Oil prices further decreased in November as superstorm Sandy dampened demand for crude oil. Mounting concerns over how the US budget deficit will be resolved, i.e., avoiding the fiscal cliff also exerted downward pressure on oil prices. Meanwhile, oil demand forecasts for 2012 by global energy authorities were generally lower relative to previous assessments.

Developments in the Utilities Sector

- The generation charge of Meralco registered an uptick in November due to the higher cost of electricity from power producers (e.g., National Power Corporation and Wholesale Electricity Spot Market). The increase in the WESM settlement rate was driven by generating companies relying more on expensive oil-fired power plants to compensate for the unavailability of some coal and gas-fired power plants. The lower output of hydroelectric power plants also contributed to higher WESM rates.

F. Financial market developments

- The PSEi surpassed the 5,600 mark for the first time in November 2012 on upbeat investor sentiment on account of the following: Moodys' upgrade of the Philippine sovereign credit rating in the previous month; the lower-than-expected inflation data in October; positive corporate earnings reported for Q3, particularly for banks; and the strong growth of Philippine exports in September.

- The peso further appreciated in November, supported by strong inflows and positive market reactions to the country's favorable macroeconomic fundamentals. On a year-to-date basis, the peso appreciated in nominal terms against the US dollar by 7.2 percent on 28 November 2012, moving in tandem with other Asian currencies except for the Indonesian rupiah and the Japanese yen, which depreciated vis-à-vis the US dollar.

- Debt spreads tightened further in November amid more signs of economic stabilization in the US and China. In Europe, recent policy announcements have likewise calmed the market. Meanwhile, the Philippines' faster-than-expected economic expansion in Q3 2012 supported the further tightening in debt spreads as premiums for holding the country's debt papers declined significantly.

G. Domestic liquidity and credit conditions

- Domestic liquidity or M3 grew at a faster pace of 8.6 percent year-on-year in October from 7.5 percent in September. Money supply growth was driven by the expansion of net domestic assets (NDA). The increase in the NDA, in turn, was due to the sustained increase in net domestic credits along with the slower rise in the net other items account (which includes, among other things, revaluation and capital and reserve accounts as well as placements of authorized counterparties in the BSP SDA facility). Likewise, net foreign assets (NFA) continued to rise in October, supported by steady foreign exchange inflows from overseas remittances and portfolio investments.

- The growth of outstanding loans of commercial banks, net of banks' reverse repurchase (RRP) placements with the BSP, expanded at a brisker pace of 15.8 percent in October from the previous month's expansion of 13.5 percent. Loans for production activities—which comprised more than four-fifths of banks' aggregate loan portfolio—grew by 16.4 percent in October from 13.9 percent a month earlier. Meanwhile, the growth of consumer loans eased slightly to 13.9 percent from 14.6 percent in September due mainly to the slowdown in auto loans.

- Strong domestic demand is also reflected in the latest survey results of the Q3 2012 Senior Loan Officers' Survey (SLOS) which point to an increase in overall demand for loans. This has coincided with the sustained expansion in private credit.

- Corporates continue to tap capital markets for financing. Corporate bond issuances for the period January-October 2012 reached ₱237.4 billion, 34 percent higher than the 2011 level of ₱176.7 billion. Likewise, the total equity raised in the Philippine Stock Exchange (PSE) during the same period amounted to ₱192.9 billion, more than double compared to the previous year's level.

H. Fiscal developments

- Government spending continued to gain some momentum. The fiscal deficit in the period January-October 2012 was ₱115.7 billion, ₱41.5 billion higher than the deficit incurred during the same period in 2011. This represented 41.5 percent of the ₱279.1 billion programmed deficit for Q1-Q4 2012. Revenue collections increased by 11.8 percent while expenditure was higher by 14.5 percent.

I. External developments

- Global economic activity has broadly stabilized and turned positive in recent months. The Global PMI reached an eight-month high in November while economic recovery in the US has continued to gain momentum, with growth in GDP and consumption showing a modest pickup in Q3 2012. US unemployment fell below 8 percent for the first time in nearly four years for three consecutive months starting September 2012. Consumer sentiment has also improved with the stronger labor market despite cautious business sentiment due to concerns on the fragile global economy. Nevertheless, positive growth prospects remain contingent on the positive resolution of the uncertainty over the extent and effect of fiscal consolidation in 2013.

- Likewise, the pace of growth in China showed signs of stabilizing as a result of fiscal and monetary stimulus. The manufacturing PMI in China for November estimates rose to a 13-month high of 50.5 (from 49.5 in October), moving above the 50 threshold for the first time since October 2011.

- In contrast, economic activity in the euro area has remained weak. Euro area GDP contracted for the second time in Q3 2012, bringing the economy back into recession. Household and business sentiments continue to be at low levels across the region. Confidence among consumers remained weak as unemployment rate reached a record high at 11.7 percent in October 2012. Nevertheless, recent policy announcements in Europe have helped to bolster financial market conditions. Euro area composite PMI estimate for November also showed a very slight increase given the modest increase in PMI manufacturing.