HIGHLIGHTS OF THE MEETING OF THE MONETARY BOARD ON MONETARY POLICY ISSUES HELD ON 19 JUNE 2014[1]

I. Monetary Policy Decision

The Monetary Board (MB) decided to:

a) Increase the interest rate on the special deposit account (SDA) facility by 25 basis points from 2.0 percent to 2.25 percent;

b) 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;

c) Maintain the current interest rates on term RRPs and RPs; and

d) Maintain the current reserve requirement ratios.

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

- In deciding to maintain policy rates, the MB noted that the future inflation path is likely to stay within target over the policy horizon. Moreover, inflation expectations continue to be within the target bands for 2014 and 2015.

- At the same time, the MB noted that the balance of risks to the inflation outlook continued to lean toward the upside, with potential price pressures emanating from the possible uptick in food prices as a result of changing weather conditions, and pending petitions for adjustments in power rates.

  The key downside risk for inflation is linked to the risk of slower-than-forecasted global economic activity.

- Meanwhile, the MB decided to adjust the SDA rate to counter risks to price and financial stability that could emanate from ample liquidity, noting that a modest upward adjustment in interest rates would be prudent amid robust credit growth. The MB believes that solid domestic growth prospects allow some scope for a measured adjustment in the SDA rate to ensure that monetary and credit conditions continue to be appropriate.

- Going forward, the MB emphasized the need to pay close attention to the potential build-up in inflation expectations and financial imbalances. The MB reiterated that it stands ready to undertake further policy actions as necessary to safeguard price and financial stability.

[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 19 June 2014 meeting were approved by the Monetary Board during its regular meeting held 10 July 2014. The next meeting of the Monetary Board on monetary policy issues is scheduled on 31 July 2014.

III. Recent Developments and Inflation Outlook

The MB considered the following developments in deciding its policy stance:

A. Domestic price conditions

- Year-on-year headline inflation rose further in May due largely to higher food prices and electricity rate charges. Food inflation has remained elevated at more than 5.0 percent since December 2013. Increases were also noted in other indicators, particularly in the official core inflation, two out of three alternative measures of core inflation estimated by the BSP, seasonally adjusted month-on-month and 3-month moving average annualized headline and core inflation, and the number and weight of above-threshold items.

B. Inflation expectations

- Inflation expectations remain within the target ranges over the policy horizon but are near the upper end of the target band for 2015. Results of the BSP's survey of private sector economists for May 2014 yielded slightly higher but still within-target mean inflation forecasts of 4.1 percent (from 4.0 percent in April) for 2014, while the mean inflation forecast for 2015 was steady at 3.8 percent. Results of the May 2014 Consensus Economics inflation forecast survey showed a steady mean inflation forecast of 4.1 percent for 2014 and a slightly higher mean inflation forecast of 3.9 percent (from 3.8 percent) for 2015.

C. Inflation outlook

- Average annual inflation forecasts for 2014 and 2015 are projected to settle in the upper half of the target range of 3-5 percent for 2014 and 2-4 percent for 2015. Compared to the previous forecast round, the latest baseline inflation forecasts are higher due mainly to the higher inflation outturn in May and the inclusion of the potential impact of a possible El Niño episode on food and utility prices.

- The balance of risks to prices remains tilted toward the upside. Potential price pressures continue to come from pending petitions for increases in electricity rates and possible uptick in food prices. In addition, the likelihood of a continued strong liquidity growth is still seen as posing a risk to future inflation. Nevertheless, the recent adjustments in the reserve requirement ratios are seen to help mitigate inflation risks from strong liquidity growth.

- The downside risk to inflation could emanate from potential growth slowdown in key emerging markets and risk of deflation in advanced economies.

D. Demand conditions

- Philippine GDP grew by 5.7 percent in Q1 2014, slower than the 7.7-percent expansion in the same quarter a year ago and lower than the Government's growth target of 6.5-7.5 percent for the year. The weaker-than-expected growth in Q1 2014 reflected the lingering effects of typhoon Yolanda that hit the country in the previous quarter. Slower growth in government spending and investments in capital formation on the expenditure side as well as the weaker growth in manufacturing on the production side also contributed to the slowdown. Nonetheless, the Philippine economy continued to expand at an above-average rate in Q1 2014, driven by robust consumer spending and exports on the expenditures side, and by solid gains in the services sector on the production side.

- The outlook for economic activity continues to be favorable on the strength of consumer spending, as evidenced by the trend of various demand indicators. Vehicle and electricity sales remain brisk, the composite PMI has stayed firmly above the 50-point neutral threshold, and the outlook by consumers and businesses continues to be generally upbeat. Meanwhile, manufacturing activity and exports have remained broadly steady. The outlook for domestic demand conditions is also likely to benefit from continued typhoon-related reconstruction and rehabilitation spending in 2014.

E. Supply-side indicators

Developments in Agriculture

- The Agriculture sector posted a modest growth of 0.9 percent in Q1 2014 from an expansion of 3.2 percent in Q1 2013, driven mainly by growth in *palay* and sugarcane output. *Palay* output increased due to availability of irrigation water and usage of high-yielding varieties, while sugarcane production recovered from a contraction in the previous year as a result of increased harvested area and fertilizer usage.

- Based on farmers' planting intentions, domestic *palay* output is expected to grow by 4.5 percent in Q3 2014 as a result of increased harvest area. However, the near-term outlook on rice prices continues to depend largely on how the National Food Authority (NFA) will act to stabilize supply. On 17 February 2014, the NFA Council approved the importation of additional 800 thousand metric tons of rice from Vietnam, which is scheduled to be completed by August 2014. The retail prices of regular-milled and well-milled rice rose in May 2014 from their respective levels in the previous month, reflecting in part relatively tight supply conditions.

- The FAO Food Price Index (FPI) decreased in May 2014 from its month- and year-ago levels, driven largely by the decline in dairy and vegetable oil prices amid favorable production expectations. Cereals prices were also broadly lower on improved supply prospects for maize and wheat owing to favorable weather conditions. Rice prices were little changed. By contrast, sugar prices inched up as early forecasts for the 2014/15 season point to a possible production deficit, with the possible occurrence of El Niño likely to exacerbate the decline in output. Meanwhile, the FAO meat price index was nearly unchanged.

Oil Price Developments

- Global oil prices increased in April as tensions between Ukraine and Russia escalated, fueling concerns of oil supply disruption in the region. Oil prices further picked up in May as US crude oil stockpiles in Cushing, Oklahoma fell to their lowest since December 2008. Meanwhile, oil demand forecasts for 2014 by global energy authorities were unchanged relative to previous assessments.

Developments in the Utilities Sector

- The overall cost of electricity was lower in June 2014. Generation charges fell after the cost of power from all generation sources registered downward adjustments. Despite tight generation supply, the cost of purchases from the Wholesale Electricity Spot Market (WESM) decreased partly due to the implementation of the Energy Regulatory Commission's secondary price cap in the WESM. Likewise, the average cost of power sourced by Meralco from its Power Supply Agreements (PSAs) went down due to the appreciation of the peso, coupled with a reduction in coal prices. Other bill components also inched down in June 2014.

F. Financial market developments

- The PSEi breached the 6,800 level and reached an 11-month high in May on bullish trading. Investor confidence improved after Standard and Poor's (S&P) raised the country's credit rating to BBB from BBB- with a stable outlook on 8 May 2014. The continued political tensions in Ukraine and Thailand partly tempered market sentiment. Despite reports of rising inflation in May 2014 and slower-than-expected GDP growth in Q1 2014, the PSEi rallied in early June amid investors' search for bargains and positive news from overseas, including solid US employment figures and the announcement of additional monetary stimulus measures from the European Central Bank.

- Similarly, the peso was broadly stronger in May and early June due mainly to improved investor sentiment. Moreover, the sustained inflows of foreign exchange from overseas Filipinos and the ample level of the country's gross international reserves continued to provide broad stability to the peso.

- For the period 1-13 June, debt spreads tightened further as market sentiment improved on the back of favorable developments overseas such as upbeat Chinese manufacturing outturns and higher-than-expected growth in Japan. However, the narrowing trend was tempered by concerns over Iraq unrest.

G. Domestic liquidity and credit conditions

- Domestic liquidity or M3 grew by 32.1 percent year-on-year in April 2014 to ₱6.9 trillion. This pace of increase was slower than the revised 34.7-percent expansion recorded in the previous month. Month-on-month (m-o-m), seasonally-adjusted M3 rose by 0.2 percent, following the revised 1.1-percent growth a month earlier.

- The strong M3 growth reading in April continued to reflect the broad decline in the SDA placements of trust entities compared to their levels a year ago, in line with the BSP's operational adjustments in the SDA facility. Money supply continued to expand due to the sustained demand for credit in the domestic economy, with domestic claims increasing by 12.3 percent in April. Meanwhile, public sector credit grew at a slower pace of 1.5 percent as the deposits with the BSP of the National Government increased, reflecting in part the proceeds from the auction of government securities as well as revenue collections from various agencies.

- The outstanding loans of commercial banks, net of RRP placements with the BSP, expanded by 20.9 percent in April 2014 from 20.0 percent in March 2014. On a seasonally-adjusted basis, commercial bank lending increased by 1.1 percent m-o-m in April.

H. Fiscal developments

- The fiscal deficit in Q1 2014 was ₱84.1 billion, higher than the ₱66.5-billion deficit incurred during the same period in 2013. Revenue collections increased by 9.0 percent while expenditures were higher by 12.0 percent.

I. External developments

- The MB noted that global growth prospects have remained broadly stable. Advanced economies continue to support the global growth momentum, driven by brisk economic activity in the US and the strengthening recovery in the euro area. However, the sales tax hike in Japan could dampen domestic demand in the near term. Meanwhile, the pace of growth in major emerging markets remains subdued.