BANGKO SENTRAL NG PILIPINAS

HIGHLIGHTS OF THE MEETING OF THE MONETARY BOARD ON MONETARY POLICY ISSUES HELD ON 25 OCTOBER 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 3.50 percent for the overnight RRP (borrowing) rate and 5.50 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 considered two sets of arguments concerning the stance of monetary policy. The arguments for keeping policy rates steady included allowing the monetary stimulus from the previous 75-basis point cumulative reduction in policy rates to continue to work its way through the economy. At the same time, domestic demand conditions continue to be favorable, as adequate domestic liquidity, robust bank lending growth, and buoyant business confidence provide ample support to economic activity.

- Meanwhile, the arguments to reduce interest rates revolved around the benign inflation outlook and the continued downside risks to demand from external headwinds. The MB's decision to reduce the BSP's policy interest rates was based on its assessment that the inflation environment continued to be benign. Latest baseline forecasts indicated that the future inflation path remained within target for 2012-2014, with inflation expectations aligned to the inflation target within the policy horizon. A rate cut would also be consistent with a symmetric response to the risk of below-target inflation.

- The MB noted that the risks to the inflation outlook continue to be broadly balanced. Potential upside risks to inflation remain, including pending power rate adjustments and higher global prices for some grains. Nonetheless, subdued global demand could moderate upward pressures on international commodity prices, thus tempering the overall outlook for inflation.

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[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 October 2012 meeting were approved by the Monetary Board during its regular meeting held on 15 November 2012. The next meeting of the Monetary Board on monetary policy issues is scheduled on 13 December 2012.

- Moreover, the MB agreed that global economic prospects continue to face considerable headwinds. World economic conditions are likely to remain tepid as fiscal and financial sector stresses in advanced economies continue to dampen market confidence. While the domestic underpinnings of Philippine economic growth remain firm, additional policy support could help ward off the risks associated with weaker external demand by encouraging investment and consumption.

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 in September, driven mainly by lower inflation for electricity. Other indicators such as year-on-year core inflation, seasonally-adjusted month-on-month headline and core inflation, and the weight of above-threshold items were also lower. By contrast, the number of above-threshold items increased in September, while the alternative measures of core inflation estimated by the BSP showed mixed trends.

- The lower September headline inflation was traced mainly to the slower increases in the prices of non-food items, particularly housing, water, electricity, gas, and other fuels. Lower charges for household electricity rates due to weaker demand and the return to normal operations of some of the country's natural gas-fired plants pushed down non-food inflation. Meanwhile, food inflation went up as price increases in vegetables and fruits more than offset the lower prices of fish, and oils and fats.

B. Inflation expectations

- Inflation expectations based on the AP Consensus and BSP's private sector forecast surveys was within the 3-5 percent target range over the policy horizon. Results of the October 2012 survey from the AP Consensus showed steady inflation forecasts for 2012 and 2013 compared to September. Results of the September 2012 BSP survey of private sector economists showed higher inflation forecasts for 2012-2014 relative to the August survey.

C. Inflation outlook

- The latest baseline forecasts continue to point to within-target inflation for 2012-2014. The slight downward shift in the forecasted inflation path compared to that in the previous policy meeting was due mainly to the lower-than-projected actual inflation in September, slightly lower assumptions for oil price and world GDP growth, and slower endogenously-determined liquidity growth.

- The risks to future inflation appeared to be broadly balanced. Downside risks to inflation outlook persist owing to weak prospects for global economic activity. Meanwhile, the upside pressures on non-oil commodity prices in the international market as well as pending petitions for domestic utility rate adjustments constituted the key upside risks to inflation.

D. Demand conditions

- Indicators suggest continued economic growth in H2 2012. Overall growth momentum is still expected to remain at a fairly robust level, supported by strong business and consumer confidence levels and other growth drivers. Strong domestic demand has been reflected in the healthy expansion in private credit. Growth is also likely to be supported by election-related spending and the government's accelerated spending plans particularly for infrastructure. PMI readings for manufacturing, retail/wholesale and services sectors have also remained in expansion territory.

- Domestic output growth, however, could be hampered by tenuous global economic conditions. Growth in H2 2012 as a whole could be dampened by the weak external environment as reflected in the recent weak export growth performance in August. Both BSP and NSCB leading economic indicators accordingly point to a moderation in economic growth in Q3. Nevertheless, domestic demand prospects remained intact and buoyant.

E. Supply-side indicators

<u>Developments in Agriculture</u>

- Favorable supply conditions have kept prices of meat, fish, sugar and fruits generally stable in September. The Bureau of Agricultural Statistics (BAS) projects palay and corn production to grow considerably in the third and fourth quarters of 2012 due to higher harvest area and yield, with the expected favorable wet weather conditions brought by the La Niña episode.

- In addition, the MB noted that the FAO food price index was higher in September. Following two months of stability, the FPI rose slightly, due largely to higher dairy, meat, and cereal prices. The increase in meat prices was driven largely by higher feed costs. Meanwhile, the uptick in dairy prices could be attributed to a combination of firm demand for milk products and increasing feed costs. Prices of sugar and oils fell.

<u>Oil Price Developments</u>

- Oil prices increased in September after the US Fed pledged additional stimulus to boost the US economy and on renewed concerns of oil supply disruptions amid unrest in the Middle East and North Africa.

- Meanwhile, in October, oil prices trended downwards following the release of reports showing US crude oil inventories increased for four consecutive weeks. The failure of euro area leaders to agree on further aid for Spain during a summit in Brussels also exerted downward pressure on oil prices.

Developments in the Utilities Sector

- The generation charge of Meralco registered a slight uptick in October as prices from the Wholesale Electricity Spot Market (WESM) increased brought about by the reduction in available generation capacity and the output of coal-fired plants, which have undergone repairs and maintenance. Moreover, higher ancillary generation costs affected by the WESM charges also caused transmission and other pass-through charges to increase.

F. Financial market developments

- In September, the PSEi rallied on announcement of new stimulus measures by the ECB and US Fed. The index continued to advance in October on the back of upbeat outlook for the Philippine economy. The stock market reached an all-time high on 4 October at 5,443.77 index points, reflecting improved investor sentiments following the release of higher 2012 economic growth forecasts for the Philippines by the World Bank and Asian Development Bank.

- The peso appreciated in September on account of robust foreign exchange inflows from OF remittances, foreign portfolio investments, foreign direct investments, and export receipts. The peso also strengthened on the back of the major central banks' decision to ease monetary policy stance which spurred investor's risk appetite for emerging market assets. The peso continued to strengthen toward mid-October as stronger-than-expected US corporate earnings and retail data boosted risk appetite for emerging market assets.

- Similarly, debt spreads tightened to their lowest levels in over a year in September as monetary easing from major central banks boosted demand for the region's higher yielding assets. However, debt spreads widened during the last week of September as concerns over Spain's hesitancy to request a bailout and renewed geopolitical tensions between China and Japan over a territorial dispute in the East China Sea drove down market sentiment. Spreads reversed their widening trend toward mid-October following reports of the US showing signs of recovery and EU risks tapering off. On the domestic side, the signing of the peace treaty agreement between the government and the Moro Islamic Liberation Front (MILF) was also welcomed by investors.

G. Domestic liquidity and credit conditions

- Domestic liquidity or M3 grew in August by 6.2 percent year-on-year from 8.7 percent in July. Money supply growth continued to be driven by the sustained expansion of net foreign assets (NFA). Similarly, net domestic assets (NDA) accelerated in August, albeit at a slower pace, buoyed by the steady expansion in claims on the private sector. The growth in claims on the public sector slowed down due to the larger increase in deposits of the National Government (NG) coinciding with the NG's increased revenue collection during the month.

- The growth of outstanding loans of commercial banks, net of banks' reverse repurchase (RRP) placements with the BSP, grew at a slower pace of 14.0 percent in August from the previous month's expansion of 16.0 percent. Loans for production activities—which comprised more than four-fifths of banks' aggregate loan portfolio—grew by

14.1 percent in August from 16.4 percent a month earlier. Meanwhile, the growth of consumer loans rose slightly to 15.8 percent from 15.4 percent in July due mainly to the increase in auto loans and other consumer loans.

- Corporates continue to tap capital markets for financing. Corporate bond issuances for the period January-August 2012 reached ₱211.8 billion, 34 percent higher than the 2011 level of ₱158.1 billion. Likewise, the total equity raised in the Philippine Stock Exchange (PSE) during the same period amounted to ₱91.1 billion, 48 percent higher than the year-ago level.

H. Fiscal developments

- The fiscal deficit in the period January-August 2012 was ₱71.2 billion, ₱36.7 billion higher than the deficit incurred during the same period in 2011. This represented 38.8 percent of the ₱183.3 billion programmed deficit for Q1-Q3 2012. Revenue collections increased by 11.1 percent while expenditure was higher by 14.5 percent.

I. External developments

- Downside risks to output growth remain. The IMF reduced its economic growth projections to reflect greater downside risks to the world economy. Over the near term, a deepening of the euro area crisis and the threat from the so-called fiscal cliff in the US continue to pose considerable risks to the global outlook.

- In emerging Asia, prospects remain mixed. Economic activity in China remains weak amid subdued domestic and external demand. Nevertheless, while growth is expected to remain sluggish in advanced economies, output growth appears to be relatively solid in many emerging economies.

- Nevertheless, there are tentative signs of a turnaround. In the US, consumer confidence has risen while employment data have somewhat improved in September with unemployment easing to its lowest rate for the year at 7.8 percent. Meanwhile, China's exports surged in September and preliminary PMI rose for the second month in October. Global PMI also showed modest improvements in September. Recent policy actions in Europe (e.g., the Outright Monetary Transactions program of the ECB, Spain's fiscal austerity measures) and in the US (i.e., QE3) have also helped lift market sentiment for the period under review.