BANGKO SENTRAL NG PILIPINAS

HIGHLIGHTS OF THE MEETING OF THE MONETARY BOARD ON MONETARY POLICY ISSUES HELD ON 8 MAY 2014[1]

I. Monetary Policy Decision

The Monetary Board (MB) decided to:

a) 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;

b) Maintain the current interest rates on term RRPs, RPs and SDA; and

c) Raise the reserve requirements by 1 percentage point effective on 30 May 2014.

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 the target ranges of 4±1 percent for 2014 and 3±1 percent for 2015. Inflation expectations also remain broadly aligned with the target ranges over the policy horizon.

- At the same time, the MB noted that the balance of risks to the inflation outlook continued to lean toward the upside, suggesting narrower policy headroom going forward. Potential price pressures are still coming mostly from the supply side, notably possible increases in power rates and higher food prices resulting from an expected El Niño episode in the second half of 2014. These factors highlight the continued risk of second-round effects, which however are not yet evident. In addition, the likelihood of a continued strong liquidity growth is still seen as posing a risk to future inflation.

  The downside risks to inflation are seen to emanate from the potential growth slowdown in key emerging markets and the risk of deflation in advanced economies.

- Meanwhile, the MB decided to raise the reserve requirements by 1 percentage point to help mitigate potential risks to price and financial stability that could arise from the strong growth in domestic liquidity. The MB believes that solid domestic economic activity provided room for the hike in the reserve requirements.

- Going forward, the MB emphasized the need to pay close attention to the outlook for inflation and growth to ensure that monetary policy settings remain consistent with price and financial stability. The MB reiterated that it remains prepared to implement policy actions as needed to prevent a potential build-up in inflation expectations and financial imbalances.

[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 May 2014 meeting were approved by the Monetary Board during its regular meeting held 29 May 2014. The next meeting of the Monetary Board on monetary policy issues is scheduled on 19 June 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 was higher in April due largely to higher prices of food, electricity, and domestic petroleum products. Food inflation has remained elevated at more than 5.0 percent since December 2013. Other indicators also increased such as the official core inflation, all alternative measures of core inflation estimated by the BSP, seasonally adjusted month-on-month headline and core inflation, and the weight of above-threshold items. By contrast, the 3-month moving average annualized headline and core inflation, and the number of above-threshold items declined.

B. Inflation expectations

- Inflation expectations are generally lower and in line with the target ranges for 2014-2016. Results of the BSP's survey of private sector economists for April 2014 yielded generally lower and within-target mean inflation forecasts of 4.0 percent (from 4.1 percent in March) for 2014 and 3.7 percent (from 3.8 percent) for 2016. The mean inflation forecast for 2015 was steady at 3.8 percent. Similarly, respondents to the Consensus Economics inflation forecast survey expected inflation to average at 4.1 percent (from 4.2 percent) in 2014 and 3.8 percent (from 3.9 percent) in 2015, which is at the upper end of the 3.0 percent ± 1.0 target range.

C. Inflation outlook

- Average annual inflation forecasts for 2014 and 2015 are projected to settle near the mid-point 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 rise in domestic oil prices and the inclusion of the estimated impact of the possible increase in jeepney fares.

- The balance of risks to prices remains tilted toward the upside. Potential price pressures are still coming mostly from the supply side, notably potential increases in power rates and higher food prices resulting from an expected El Niño episode in the second half of 2014. These factors highlight the continued risk of second-round effects, which however are not yet evident. In addition, the likelihood of a continued strong liquidity growth is still seen as posing a risk to future inflation.

- 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

- Domestic demand continues to be robust as evident in the fairly strong expansion in bank lending activities as well as in private spending. Trends in high-frequency demand indicators have remained generally positive: volume sales of automobiles and electricity are still rising, the composite PMI has stayed above the 50-point threshold, and both business and consumer outlook continue to be favorable. The fiscal stimulus from reconstruction and rehabilitation spending could also provide a boost to domestic activity in 2014. GDP growth is projected to converge to 6.5-7.5 percent in 2014 supported by relatively strong domestic growth dynamics and largely favorable global demand.

E. Supply-side indicators

Developments in Agriculture

- The retail prices of rice rose in March 2014 amid the lean season. The price of regular-milled rice (RMR) increased to ₱37.80 per kilo nationwide in March 2014 from the previous month's level of ₱36.85 per kilo. The average price of well-milled rice (WMR) also rose to ₱41.08 per kilo in March 2014 from the ₱40.12 per kilo recorded in the previous month. In Metro Manila (MM), the average prices of RMR and WMR likewise inched up to ₱38.00 per kilo and ₱40.00 per kilo, respectively, from the month-ago levels of ₱36.50 per kilo and ₱38.50 per kilo.

- The FAO Food Price Index (FPI) was higher in March 2014 from its month-ago level, driven largely by unfavorable weather conditions affecting some crops as well as the geopolitical tensions in the Black Sea region. The increase in prices was observed across food categories except those of dairy products, which fell due to reduced demand from China as well as favorable supply conditions. Vegetable oil prices went up due largely to continued concerns over the impact of protracted dry weather on palm oil production in Southeast Asia. The increase in meat prices was driven by weather-related concerns in both Australia and the US as well as concerns over the Porcine Epidemic Diarrhea virus in the US. Meanwhile, supply-related concerns in Brazil and Thailand due to drought and reduced sugarcane output, respectively, pushed sugar prices higher.

Oil Price Developments

- In March, international oil prices declined as US crude oil production rose to the highest level in almost 26 years. According to the US Energy Information Administration, shale oil production has accelerated by 15 percent compared to 2013. Meanwhile, there was an uptick in global oil prices in April as tensions between Ukraine and Russia escalated, fueling concerns of oil supply disruption in the region. Oil prices rose by US$0.37 per barrel in April relative to the previous month.

Developments in the Utilities Sector

- The overall cost of electricity was higher in April 2014 as Meralco reported a month-on-month increase in its generation charge. Tight supply conditions brought about by the outage of several large power plants and the increased demand for power compelled Meralco to source its power supply from the Wholesale Electricity Spot Market (WESM). With the increase in demand, WESM prices rose during the supply month of March. Likewise, average cost of power sourced by Meralco from its Power Supply Agreements (PSAs) also increased but was offset by the reduction in power rates from the Independent Power Producers (IPPs). Other bill components likewise inched up in April 2014.

F. Financial market developments

- In April, the PSEi breached the 6,700 level on bullish trading on the back of a better-than-expected 3.9 percent Philippine inflation in March, as well as the US Fed Chair's statement before the Economic Club of New York on 16 April, that US interest rates will remain low for some time after the tapering ends. Partly tempering the rally are signs of a cooling Chinese economy and the ongoing crisis in Ukraine.

- Similarly, the peso strengthened in April due mainly on higher exports receipts. Moreover, the sustained inflows of foreign exchange from overseas Filipinos, foreign portfolio investments, direct investments and the ample level of the country's gross international reserves continued to provide broad stability to the peso.

- For the period 1-23 April, debt spreads continued to narrow as market sentiment improved on the back of easing speculation of a US rate hike following dovish comments from the US Fed Chair. The statement from Fed Chair Janet Yellen that interest rates will likely stay at current low levels "for a considerable time after asset purchases end" calmed the market, resulting to renewed demand for emerging market assets, which in turn tightened debt spreads. At the same time, investors' fear of a hard landing in China may have been assuaged with authorities' announcement of targeted measures in response to recent weak data and to address financial imbalances and rising default risks from China's corporate sector.

G. Domestic liquidity and credit conditions

- Domestic liquidity or M3 grew by 34.8 percent year-on-year at end-March 2014 to reach ₱7.0 trillion. This increase was slower than the revised 36.1-percent expansion recorded in February. Month-on-month, seasonally-adjusted M3 rose by 1.3 percent, following the revised 0.4-percent growth in the previous month.

- The strong M3 growth reading in March 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 that were completed in November 2013. Money supply continued to expand due to the sustained demand for credit in the domestic economy with domestic claims increasing by 12.4 percent in March. Meanwhile, public sector credit grew at a slower pace of 3.5 percent as the deposits of the NG 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 20.0 percent in March 2014 from 19.4 percent in February 2014. On a seasonally-adjusted basis, commercial bank lending increased by 1.5 percent m-o-m in March.

H. Fiscal developments

- The fiscal deficit in the period January-February 2014 was ₱43.9 billion, higher than the ₱31.3-billion deficit incurred during the same period in 2013. Revenue collections increased by 7.0 percent while expenditures were higher by 11.0 percent.

I. External developments

- The MB noted that prospects for global economic growth have improved but remained fragile. The outlook for the advanced economies is generally upbeat, as economic activity in the US and Japan remains brisk, while recovery in the euro area continues to gain more traction. Meanwhile, the pace of growth in major emerging markets, particularly in China and India, has remained subdued.