Bangko Sentral ng Pilipinas

HIGHLIGHTS OF THE MEETING OF THE MONETARY BOARD ON MONETARY POLICY ISSUES HELD ON 5 MAY 2011[1]

I. Monetary Policy Decision

The Monetary Board (MB) decided to:

a) Raise the BSP's policy interest rates by 25 basis points to 4.50 percent for the overnight RRP (borrowing) rate and 6.50 percent for the overnight RP (lending) rate;

b) Adjust 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

- In deciding to increase policy rates anew, the MB took into consideration the latest baseline inflation forecasts which continue to suggest that the 3-5 percent inflation target for 2011 remains at risk, mainly as a result of expected pressures from oil prices. The MB was of the view that the prevailing inflation outlook provides the main impetus for further monetary policy action.

- The MB agreed that the risks to the inflation outlook remain tilted to the upside, with the volatility in global oil prices representing the principal upside risk to inflation. The Monetary Board also noted that, while domestic liquidity and credit grew at a reasonable pace, sustained strong foreign capital inflows warrant careful attention to ensure that they do not lead to surging domestic liquidity growth and fan inflationary pressures in the future.

[1] The discussions presented reflect the assessment made by the Monetary Board based on the information available at the time of the policy meeting. The sets of economic information were 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 5 May 2011 meeting were approved by the Monetary Board during its regular meeting held on 19 May 2011. The next meeting of the Monetary Board on monetary policy issues is scheduled on 16 June 2011.

- Unfavorable shifts in the public's inflation expectations remain a major policy consideration. The MB noted that recent surveys showed elevated inflation forecasts for 2011 and higher expected inflation for 2012. Sustained price pressures and higher inflationary expectations could influence future wage and price outcomes. With these considerations, the Board deemed it prudent to rein in inflation expectations further and contain second-round effects with a follow-through policy action.

- At the same time, the MB considered early indicators of economic activity which continue to suggest that economic prospects remain solid, with growth expected to be above trend. However, the MB also recognized the downside risks to the outlook for real activity, mainly due to inflation concerns which could dampen the public's purchasing power. Nevertheless, the MB reiterated that it remains prepared to take appropriate actions necessary to ensure the achievement of the BSP's price stability objective.

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 was higher in April at 4.5 percent from 4.3 percent in the previous month. This was due mainly to the increase in inflation for transportation and communication services and fuel as prices of petroleum products continued to increase during the month. Meat inflation also went up, possibly reflecting post-Lent demand. Likewise, electricity rates went up due to higher transacted prices at the Wholesale Electricity Spot Market (WESM). Meanwhile, inflation for fruits and vegetables went down and tempered headline inflation in April as supply amply met market requirements.

- Core inflation, which excludes certain food and energy items to measure generalized price pressures, was also higher in April at 3.8 percent compared with 3.5 percent (revised) in March. Likewise, month-on-month headline inflation went up to 0.8 percent from 0.3 percent in the previous month.

B. Inflation expectations

- Private analysts polled by the BSP and the AP consensus surveys continued to show elevated, although still within-target, mean inflation forecasts for 2011 and 2012. Results of the Consumer Expectations Survey for Q1 2011 also indicated that higher inflation is expected over the next 12 months relative to the previous survey.

C. Inflation outlook

- Latest baseline forecasts indicate that the 2011 average inflation could be slightly above the target range of 4.0 percent ± 1.0 percentage point while the 2012 inflation could settle within the same target range.

- The balance of risks to the inflation outlook remained skewed to the upside. The tightening of global oil and non-oil markets represents the principal upside risk to inflation. In April, Dubai crude oil traded above US$110 per barrel as the political unrest in Libya along with the UN-approved military intervention heightened concerns of global oil supply disruptions. Meanwhile, despite the slight dip in March, the Food and Agriculture Organization's (FAO) food index is still 37 percent above last year's level, indicating that it may be too early to conclude a reversal of the upward trend. Upside risks to the inflation outlook also include pending petitions for adjustments in electricity rates, higher-than-anticipated wage increases, and rising inflation sentiments. The downside pressures to inflation include the downside risk to global demand from elevated commodity prices and a sustained strengthening of the peso, which could help temper the impact of imported inflation.

- During the meeting, the MB discussed the new assumptions that were factored into the latest forecasts. In particular, they focused on the factors that contributed to the slightly higher inflation forecasts, notably the higher oil price assumption and the actual April inflation numbers.

D. Demand conditions

- The developments over the past month had not altered materially the outlook for the domestic economy, although there are both upside and downside risks. Information available continued to suggest that the economy would continue to grow above trend. Capacity utilization of the manufacturing sector remained consistently above 80 percent while vehicle sales continued to increase in the first quarter despite rising fuel costs. Measures of consumer confidence, however, were lower based on the first quarter survey, due largely to inflation concerns and increasing tensions in the Middle East.

- There is growing public clamor for wage hikes amid the continuing increase in oil prices. On 13 April 2011, the National Wages and Productivity Commission (NWPC) has confirmed the existence of supervening conditions in Metro Manila, allowing the Regional Tripartite Wages and Productivity Board (RTWPB) for the National Capital Region to start the wage deliberations process. The significant increases in the prices of petroleum products as well as higher transport fares were cited as supervening conditions. The RTWPB in Western Visayas has also confirmed the existence of a supervening condition in the region. Meanwhile, the RTWPBs in Northern Mindanao and Central Visayas have declared that there was no extraordinary increase in the prices of essential commodities in their areas.

E. Supply-side indicators

Developments in Agriculture

- In March, special rice prices eased while ordinary prices inched up nationwide, particularly in areas outside Metro Manila, reflecting consumers' preference for lower-priced ordinary rice. Meanwhile, the country's rice inventory level remains sufficient to last for 81 days based on the average daily rice requirement of 31 thousand metric tons.

- Meanwhile, the FAO revised upwards its estimate for the 2010/11 global cereal production. The slight upward revision reflected mostly higher estimates for production in Argentina, China and Ethiopia. Early prospects for winter crops in the northern hemisphere are also generally favorable and FAO's preliminary forecast for global wheat production in 2011/2012 points to an increase, with expectations of a recovery in major wheat-producing countries.

- However, the latest estimate still indicates a tightening of the global cereal supply and demand balance in 2010/11. The forecast for world cereal utilization in 2010/11 has been revised up, reflecting mainly the larger use of corn for ethanol production. Consequently, the world cereal stocks for crop seasons ending in 2011 are forecast to fall sharply because of a decline in inventories of wheat and coarse grains.

Oil Price Developments

- Dubai crude oil continued to trade above $110 per barrel as the political unrest in Libya along with the UN-approved military intervention heightened concerns of global oil supply disruptions. Oil prices in the futures market also increased. Tracking the movement of oil prices in the international market, domestic prices of petroleum products increased by almost ₱2 per liter for unleaded gasoline and ₱1 per liter for diesel and kerosene.

- On 1 April 2011, Executive Order (EO) No. 32 was released, establishing the Public Transport Assistance Program (PTAP) to cushion the impact of high fuel prices. The PTAP provides subsidy to identified public transport groups (i.e., jeepney and tricycle).

- With regard to transport fare adjustments, fares of Metro Manila buses were increased provisionally by ₱1 effective 29 March. However, there is a pending petition for additional ₱5.00 and ₱6.00 increases in the minimum fares for ordinary and air-conditioned buses, respectively, in Metro Manila.

- Toll increases also took effect as the Toll Regulatory Board (TRB) approved the imposition of higher toll rates at the Metro Manila Skyway effective 26 April 2011. The TRB also approved new toll rates for the extension of the Manila-Cavite Expressway Project, commonly known as the Coastal Road, effective 1 May 2011. These increases are in line with the completion of the Skyway Stage 2 and the extension of the Manila-Cavite Expressway Project.

<u>Developments in the Utilities Sector</u>

- Electricity rates were higher in April due to the increase in generation charges. According to Meralco, the WESM made some billing adjustments to reflect the costs incurred by must-run units in May 2010. Must-run units will have to operate and charge according to prevailing spot market prices. Should these prices prove to be lower than the actual cost of operating the facility at that time, the power generation firm can recover these costs later on.

- Meanwhile, a sustained increase in the price of petroleum oil poses a risk to electricity tariffs in the near term. The cost of electricity from coal-fired generation plants could increase due to the higher cost of shipping coal while the computation of the prices of natural gas incorporates the average price of petroleum in the past six months.

F. Financial market developments

Government Securities Market

- During the 18 April 2011 auction, interest rates for the 91-day, 182-day and 364-day Treasury bills (T-bills) decreased relative to the levels during the last auction. T-bill rates were lower due to the large volume of liquidity in the market, given maturing T-bills and T-bonds. The downward trend of GS rates was likewise influenced by the lower NG budget deficit in the first quarter. The auction was oversubscribed, with total tenders reaching ₱30.9 billion or around 3.4 times the original offered amount of ₱9.0 billion.

- Similarly, on 26 April, the 10-year T-bonds fetched an average interest rate of 6.4 percent, 92.2 basis points lower than the average rate fetched during the last auction for the same tenor on 15 March 2011. Demand for the papers was high as tenders amounted to ₱32.3 billion, more than three times the government's ₱9.0 billion offering. Much of the demand came from foreign investors who have been scouring the country's bond and stock markets for better returns.

- Tracking the primary market trend, secondary market yields and term spreads declined across all tenors on 26 April 2011, relative to the 31 March 2011 and 26 April 2010 levels. Debt paper yields declined on the back of massive liquidity in the financial system and lower NG budget deficit for the first quarter of the year.

Stock Market

- In April, the local bourse continued to rally after nearly a quarter-long decline. For the first time since the first week of January 2011, the PSEi breached the 4,200 level in April. Better fiscal performance locally may have fueled the market's growing confidence. However, sentimet was dampened partly by profit-taking, the continued surge in oil prices due to the political troubles in the Middle East and North Africa (MENA) region, ongoing problems in Japan's nuclear power plants, and resurfacing concerns over the European sovereign debt amid tightening monetary policy. The recent cut by Standard and Poor's (S&P) of the US' long-term sovereign credit outlook to negative, fueling concern that global recovery may slow down, also dampened investor risk appetite.

- In the near term, markets will face headwinds in terms of further monetary tightening. The market could move higher, however, should first quarter earnings prove robust.

Foreign Exchange

- For the first three weeks of April, the peso continued to strengthen. The sustained inflows of OF remittances, portfolio investments (reflecting investors' revived appetite for riskier emerging assets), and FDI remained the key drivers of the peso's strength. However, the re-emergence of concerns about the strength of the global economy's growth due to China's monetary tightening and weak US jobs data also tempered the peso's further appreciation. Likewise, the downgrade of the US credit outlook to negative also caused a momentary weakening of the peso. On a year-to-date basis, the peso appreciated against the US dollar by 1.5 percent on 25 April 2011, moving along with other Asian currencies except the Japanese yen, which depreciated vis-à-vis the US dollar.

Global Bond and Credit Default Swap Spreads

- In the first week of April, spreads continued its narrowing trend on the back of upbeat expectations on corporate earnings reports. However, widening pressures were observed in the third week as investors turned risk-averse following fears that Greece will have to restructure its debt alongside S&P's downgrade of the US credit outlook from "stable" to "negative." China's tightening of monetary policy likewise contributed to investors' cautiousness in holding emerging market assets. This caused EMBI+Global spread to widen at 265 bps on 22 April from the end-March level of 261 bps. Similarly, EMBI+Philippines spread swelled to 185 bps from the previous month's level of 171 bps. Meanwhile, the price of the country's CDS tied to government debt remained stable during the review period at 134 bps (just one basis point wider than previous month's 133 bps).

G. Domestic liquidity and credit conditions

- Domestic liquidity or M3 expanded at a slightly faster pace of 9.8 percent in February 2011 from 9.6 percent in January 2011 to reach ₱4.2 trillion. The larger increase in net foreign assets (NFA) of 19.3 percent in February from 17.8 percent in the previous month fueled the expansion in domestic liquidity. The BSP's NFA position grew by 32.9 percent, due in part to steady foreign exchange inflows from overseas remittances as well as portfolio and direct investments. Net domestic assets (NDA), meanwhile, decreased further by 5.1 percent in February following the decline of 4.2 percent in January.

- Bank lending growth, net of banks' reverse repurchase (RRP) placements with the BSP, accelerated in February to 12.3 percent year-on-year from an expansion of 11.0 percent in the previous month. Likewise, outstanding loans of commercial banks inclusive of RRPs expanded at a faster pace of 13.6 percent in February from 12.4 percent in January. Loans for production activities—which comprised more than four-fifths of commercial banks' total loan portfolio—expanded at a brisker rate of 13.9 percent in February from 12.4 percent a month earlier. The growth in consumer loans also accelerated to 10.0 percent from 8.7 percent in the previous month.

- Preliminary results of the Q1 2011 Senior Bank Loan Officers' Survey showed that most banks had generally unchanged credit standards for the eighth consecutive quarter starting Q2 2009, based on the proportion of banks indicating whether they tightened, loosened, or maintained credit standards. However, using the diffusion index approach, the survey results showed that, for loans to enterprises, all banks reported unchanged credit standards for all firm sizes in Q1 2011 relative to Q4 2010. Meanwhile, the survey indicated an overall net tightening of credit standards for loans to households.

- The Philippine equity capital market raised ₱33.4 billion in the first quarter, higher by 5 percent compared to last year's level. Bond issuances also increased, reaching ₱63.1 billion in the first quarter alone.

H. Fiscal developments

- The fiscal deficit for Q1 2011 was ₱26.2 billion, 80.5 percent lower than the deficit incurred during the same period last year. This represents 23.4 percent of the ₱112.0 billion programmed deficit for Q1 2011. Revenue collections increased by 21.5 percent while expenditures were 12.7 percent lower than the levels in the same period in 2010.

I. External developments

- The global economic recovery is seen to continue but vulnerabilities remain. The IMF, in its April 2011 World Economic Outlook (WEO), forecasts global output to expand by 4.4 percent in 2011 and by 4.5 percent in 2012. These estimates were unchanged from the IMF's January 2011 WEO Update. Nevertheless, the Fund noted that downside risks to growth persist. The principal risk to growth relates to the likelihood of further oil price hikes. In particular, a further deterioration of the crisis in the MENA region would automatically affect global oil prices which, in turn, could hurt global economic prospects.

- Economic activity in the Asian region is expected to remain buoyant. Strong private consumption and exports alongside the resurgence in capital inflows are fueling economic activity in the region. Nonetheless, there are risks to the economic outlook for Asia. Weaknesses in the external environment are still likely to be felt within the region since two-thirds of final demand for Asian exports comes from outside the region. Moreover, higher oil and commodity prices could trigger an inflation spiral. Overheating in a number of Asian economies is also a source of concern.