BANGKO SENTRAL NG PILIPINAS

HIGHLIGHTS OF THE MEETING OF THE MONETARY BOARD ON MONETARY POLICY ISSUES HELD ON 24 JANUARY 2013[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 and RPs;

c) Maintain the current reserve requirement ratios; and

d) Set the pricing of the Special Deposit Account (SDA) at 3.00 percent regardless of tenor, effective immediately, consistent with the BSP's continuing efforts to fine-tune the operation of its monetary policy tools.

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 the inflation environment remained manageable. Latest baseline forecasts continue to track the lower half of the 3-5 percent target range for 2013 and 2014, while inflation expectations also remain firmly anchored.

- Moreover, the MB considered the risks to the inflation outlook to be evenly balanced around the baseline forecast path. In particular, although global economic activity has stabilized in recent months, uncertainty surrounding the ongoing fiscal consolidation and lingering financial market stresses in advanced economies continue to weigh down on global growth prospects, thus mitigating upward pressures on commodity prices. However, pending domestic power rate adjustments and the strong inflow of capital continue to pose upside risks to the inflation outlook.

- The MB likewise noted the solid growth of the economy which is expected to continue based on most recent available indicators. Nevertheless, improving productive capacity on the back of continued growth in the aggregate capital stock appears to have produced a convergence between strong growth and low inflation. This view is supported by the various measures of core inflation which continue to indicate a benign trend for underlying inflation.

[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 24 January 2013 meeting were approved by the Monetary Board during its regular meeting held on 14 February 2013. The next meeting of the Monetary Board on monetary policy issues is scheduled on 14 March 2013.

- At the same time, the MB decided to set the interest rates on the SDA facility at 3.00 percent regardless of tenor, effective immediately, consistent with the BSP's continuing efforts to fine-tune the operation of its monetary policy tools. Previously, the SDA rate was priced at a premium over the policy rate. The MB decided to rationalize the SDA facility as an intermediate step toward the medium-term objective of developing an interest rate corridor for the BSP's various monetary policy instruments. Amid manageable liquidity growth and a benign inflation outlook, the operational refinement in the SDA facility will help enhance the ability of the BSP to ensure that liquidity remains adequate to meet the requirements of the growing economy.

- Going forward, the MB recognized the need to continuously monitor emerging demand and price developments to ensure that monetary policy settings remain consistent with price stability while being supportive of economic growth. The MB also reiterated its readiness to deploy additional macroprudential measures to address any potential misalignment in asset prices.

III. Recent Developments and Inflation Outlook

The MB considered the following developments in coming up with its policy decision:

A. Domestic price conditions

- December inflation increased slightly, driven mainly by higher inflation for food. Likewise, seasonally-adjusted month-on-month headline inflation went up. Tight domestic supply conditions, triggered by the recent weather-related production disruptions, as well as the onset of holiday season demand led to higher retail prices of food, particularly rice, fish, fruits, vegetables, and meat. Meanwhile, non-food inflation went down as a result of lower charges for household electricity rates due to lower demand. On a year-to-date basis, the average headline inflation in 2012 was within the Government's target for the year.

- Meanwhile, underlying inflationary pressures are relatively subdued as year-on-year core inflation continued to decline in December and the three alternative measures of core inflation estimated by the BSP were steady.

B. Inflation expectations

- The benign inflation environment is supported by well-anchored inflation expectations. Inflation expectations based on forecast surveys by the BSP and by Asia Pacific (AP) Consensus remain within the lower half of the target band for 2013-2014. Results of the January 2013 AP Consensus survey yielded a lower mean inflation forecast for 2013. Likewise, results of the BSP private sector survey in December 2012 showed lower mean inflation forecasts for 2012-2014.

C. Inflation outlook

- The latest baseline inflation forecasts continue to be within the target range over the policy horizon. The decline in the forecasted inflation for 2013 is slightly lower compared to the forecasts during the previous policy meeting due to lower-than-forecasted actual inflation in December 2012 as well as the decline in oil prices. However, for 2014, the estimated impact of higher taxes on tobacco and alcohol products and the change in NFA rice price assumptions offset the impact of the lower actual CPI in December 2012 and the decline in oil prices, thereby resulting in an upward adjustment in the 2014 average inflation forecast. Nevertheless, latest baseline inflation forecasts remained close to the lower bound of the target over the policy horizon.

- The risks to future inflation are considered to be broadly balanced. Downside risks to inflation outlook continue to persist owing to uncertainty over the strength of the global economy. At the same time, continued appreciation of the peso could temper imported inflation. Meanwhile, the upside pressures could emanate from additional petitions for utility rate adjustments and strong surge in liquidity.

D. Demand conditions

- The most recent available indicators continue to depict solid growth in the economy. Vehicle and energy sales have been strong in Q4 with growth in overall electricity sales driven by the commercial and industrial sectors. Capacity utilization rate in the manufacturing sector remained above 80 percent while the latest Purchasing Managers' Index (PMI) readings continue to indicate expansion in the manufacturing, retail/wholesale, and services sectors. Strong consumer sentiment for the quarter-and year-ahead was also recorded in the Q4 Consumer Expectations Survey.

E. Supply-side indicators

<u>Developments in Agriculture</u>

- The agriculture sector expanded by 2.9 percent in 2012 from a growth of 2.6 percent in 2011 due to increased output in the crops, livestock and poultry subsectors. Crop production, which accounted for about 52 percent of total agricultural output, increased by 4.1 percent during the year on account mainly of rice (up 8.1 percent) and corn (up 6.3 percent).

- The monthly FAO food price index dipped in December due largely to lower international prices of cereals and oils/fats. Cereal prices declined due to favorable supply outlook while the oil prices fell as abundant production in Southeast Asia coincided with a protracted weakness of import demand. For 2012, the Index averaged 212 points, 7.0 percent lower than the 2011 level, with declines noted across all food categories.

Oil Price Developments

- Oil prices decreased in December after US crude stockpiles rose to an 11-year high and on concerns over how the US fiscal cliff will be resolved. Meanwhile, as of 23 January 2013, the month-to-date average price of oil increased following a rebound in China's export growth.

Developments in the Utilities Sector

- The generation charge of Meralco registered an uptick in January 2013 due to the higher cost of electricity from the National Power Corporation (NPC). The increase in NPC's power rates was partly offset by the reduction in wholesale electricity and spot market charges and independent power producers' rates. The net increase in electricity rates in January was incorporated in the baseline inflation forecasts.

F. Financial market developments

- The PSEi continued to rally for the fifth straight month in January, boosted by optimism about global economic recovery following reports of an expansion in US and China's manufacturing and the passing of a bill by the US Congress averting spending cuts and reinstating tax cuts. The PSEi surpassed the 6,100 mark and set a new record high on 21 January 2013, driven by positive investor sentiment about the country's robust growth and manageable inflation outlook.

- Similarly, for the period 1-22 January 2013 the peso further strengthened to average ₱40.72/US$1, buoyed by continued optimism that the Philippines would get investment grade rating within the year.

- Debt spreads also narrowed in the first half of January on global stabilization signs, prompting markets to continue buying emerging market bonds. However, spreads inched up by 3-5 bps beginning 11 January over concerns on US debt ceiling that is set to expire by late February. As of 14 January, the extra yield investors demand for emerging-market debt over US Treasuries (or the EMBI+Global spread) stood at 251 bps, wider than from previous month's end of 248 bps. The EMBI+ Philippine spread likewise expanded to 121 bps from end-December's 119 bps. However, the country's 5-year sovereign credit default swap (CDS) continued to trade below 100 bps at 98.83 bps on 14 January after closing in 2012 at 105.7 bps.

G. Domestic liquidity and credit conditions

- Domestic liquidity or M3 grew at a faster pace of 9.8 percent year-on-year in November from 8.6 percent in October. 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 bank lending. Meanwhile, net foreign assets (NFA) decreased in November, due mainly to the continued decline in banks' NFA as their foreign liabilities continued to increase due in part to higher placements and deposits made by foreign banks with their local branches, while their foreign assets contracted due to the decline in loan receivables from foreign banks.

- The growth of outstanding loans of commercial banks, net of banks' reverse repurchase (RRP) placements with the BSP, grew by 14.0 percent in November from the previous month's expansion of 15.8 percent. Commercial banks' loans have been growing steadily at double-digit growth rates since January 2011. Loans for production activities—which comprised more than four-fifths of banks' aggregate loan portfolio—grew by 14.6 percent in November from 16.4 percent a month earlier.

- Corporates continue to tap capital markets for financing. Corporate bond issuances for the period January-November 2012 reached ₱248.3 billion, 27.8 percent higher than the 2011 level of ₱194.3 billion. Likewise, the total equity raised in the Philippine Stock Exchange (PSE) during the same period amounted to ₱203.5 billion, higher by 87.3 percent compared to the previous year's level of ₱108.6 billion.

H. Fiscal developments

- Government spending continued to gain some momentum in the latter part of 2012. The fiscal deficit in the period January-November 2012 was ₱127.3 billion, ₱31.0 billion higher than the deficit incurred during the same period in 2011, albeit lower than the programmed deficit for the year. This represented 45.6 percent of the ₱279.1 billion programmed deficit for 2012. Revenue collections increased by 12.7 percent while expenditure was higher by 14.1 percent.

I. External developments

- The MB noted that global developments over the past month have turned slightly more favorable. The JP Morgan Global All-Industry Output Index rose to a nine-month high in December. There have been further signs that the pace of growth had stabilized in China while the US economy had continued to grow at a moderate pace, with the uncertainties posed by the 'fiscal cliff' somewhat reduced. Meanwhile, economic activity in the euro area remains weak, but indicators signal potential stabilization.