BANGKO SENTRAL NG PILIPINAS

HIGHLIGHTS OF THE MEETING OF THE MONETARY BOARD ON MONETARY POLICY ISSUES HELD ON 28 JULY 2011[1]

I. Monetary Policy Decision

The Monetary Board (MB) decided to:

a) Raise the regular reserve requirement by 1 percentage point effective 5 August 2011;

b) Maintain the BSP's policy interest rates at 4.50 percent for the overnight RRP (borrowing) rate and 6.50 percent for the overnight RP (lending) rate; and

c) Maintain the current interest rates on term RRPs, RPs and SDAs.

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

- The MB's decision to raise the reserve requirement anew is a forward-looking move to better manage liquidity. The MB is of the view that sustained foreign exchange inflows, driven by upbeat market sentiment over the prospects for the Philippine economy, could fuel a further acceleration of domestic liquidity growth which could pose risks to future inflation.

- At the same time, in deciding to maintain the BSP's policy rates, the MB took into account the latest outlook for inflation which shows a lower path consistent with the 3-5 percent inflation target range for 2011 and 2012. Inflation expectations have also remained well contained while price pressures from global commodity prices appear to have stabilized of late. As a result, the inflation impetus has moderated. The softening of the global growth momentum is likewise expected to dampen inflationary pressures.

- However, the MB noted that the risks around the inflation forecasts remain skewed to the upside, suggesting a need for caution in the monetary policy stance. Protracted geopolitical instability in the MENA region is likely to continue to push up the oil price fear premium. In addition, commodity prices continue to pose a risk to the inflation outlook given structurally strong

[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 28 July 2011 meeting were approved by the Monetary Board during its regular meeting held on 18 August 2011. The next meeting of the Monetary Board on monetary policy issues is scheduled on 8 September 2011.

demand from emerging economies and low global reserves. Upside risks to the domestic inflation outlook also include petitions for adjustments in electricity rates, possible uptick in global rice prices, and renewed clamor for transport fare adjustments.

III. Recent Developments and Inflation Outlook

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

A. Domestic price conditions

- Headline inflation increased year-on-year to 4.6 percent in June from the May level of 4.5 percent, using the 2000-based Consumer Price Index (CPI) series. Meanwhile, the new 2006-based CPI series showed a higher headline inflation rate for June at 5.2 percent from 5.0 percent in May. Year-on-year headline inflation edged higher in June on account of higher inflation for electricity, gas, and other fuels.

- Using the 2000-based CPI series, core inflation, which excludes some food and energy items to measure generalized price pressures, advanced to 4.0 percent in June 2011 from 3.7 percent in May 2011.

- The MB, however, noted that inflation momentum has moderated with both headline and core inflation slowing down on an annualized month-on-month deseasonalized basis. The year-to-date average at 4.3 percent using the 2000 basket and 4.7 percent using the 2006 basket remain within the Government's target range of 3-5 percent for 2011.

B. Inflation expectations

- Inflation expectations appear to be well contained and within the target band for 2011 and 2012. Results of the Asia Pacific consensus forecast in July 2011 showed lower and within-target inflation forecasts for 2011 and 2012. Similarly, results of the BSP’s survey of private sector economists showed lower inflation forecast for 2011 but slightly higher inflation forecast for 2012.

- Respondents to the BSP Survey cited Europe’s financial woes as well as the International Energy Agency’s (IEA) recent release of strategic oil reserves to prevent high oil prices from undermining the fragile global economic recovery as key factors that are likely to dampen inflation pressures.

C. Inflation outlook

- The latest baseline inflation projections are on a lower path relative to those from the previous policy meeting, with average headline inflation rates for

2011-2012 projected to settle within the 3-5 percent inflation target range. The downward adjustment in the forecast path could be attributed mainly to the lower-than-projected inflation outturn for June 2011, easing international oil prices and slower endogenously-determined liquidity growth. The slowdown in the forecasted liquidity growth reflects the impact of the 1.0 percentage point increase in the reserve requirement in June and the 50-basis point hike in the BSP's policy rates since March.

- The balance of risks to the inflation outlook remained skewed to the upside. Global commodity prices have moderated but have remained elevated and will continue to pose a risk to the inflation outlook. Additional petitions for adjustments in electricity rates, possible uptick in global rice prices, and renewed clamor for transport fare adjustments could also lead to higher inflation. Meanwhile, the downside risks to inflation could come from slower-than-expected global economic recovery and a sustained strengthening of the peso, which could help temper the impact of imported inflation.

D. Demand conditions

- New data on real sector activity continue to indicate that the underlying strength of the economy remains intact. However, it is worth noting that the risk on output conditions through the second half of the year is leaning marginally towards a slower pace of economic activity as indicated by the movements of the leading economic indicators of the BSP and the NSCB. Although capacity utilization continued to be above 80 percent, there are already some signs of a slowdown in manufacturing activity, with the volume of production index (VOPI) growth slowing down for the sixth consecutive month in May. However, the slowdown could be partly explained by base effects as last year's strong performance was largely due to global inventory restocking and election-related activities. Nevertheless, domestic manufacturing activity could run into headwinds in the second half of the year given possible weakening of the global inventory cycle, output effects of the twin disasters in Japan, and high oil prices. Domestic macroeconomic conditions are also likely to be challenging in the second half of the year as global economic growth is expected to enter a soft patch. The release of the Q2 national income accounts (NIA) data in August should provide additional evidence on the strength of domestic demand.

E. Supply-side indicators

<u>Developments in Agriculture</u>

- Domestic agriculture supply conditions are favorable. The agricultural sector recovered in Q1 2011 (owing to improve weather conditions for crop production) after contracting in Q1 2010 while rice and corn production are expected to be robust in Q2 and Q3 2011. As of the first week of June, the country's rice inventory level remained sufficient to last for 91 days based on the average daily rice requirement of 34 thousand metric tons.

- Meanwhile, the Food and Agriculture Organization (FAO) reported that it revised downward its cereal production outlook for 2011. The revision reflected a downward adjustment in the 2011 maize production forecast in the United States and a reduction in the forecasts for wheat and barley crops in the European Union. At the revised level, world cereal production would now be slightly below overall utilization, leading to a further decline in world stocks.

- Meanwhile, the FAO food price index (FPI) settled at 232 points in May 2011. This is lower by 1 percent from the previous month's level but is 37 percent higher than a year ago. The month-on-month decline in FPI was attributed to lower world prices of cereals and sugar.

Oil Price Developments

- After peaking in April, oil prices have eased since May owing to a number of factors. These include uncertainty over the US economic recovery and monetary tightening by China to curb its overheating economy. However, it may be too early to conclude if the risk from oil prices has dissipated. Strong demand from emerging economies against a backdrop of modest increases in non-OPEC production and resurgence in geopolitical risks imply that a large decline in oil prices is unlikely.

- Oil prices have also remained volatile. Oil prices were boosted in June by the weakening of the dollar following the announcement of Moody's Investors Service that it may place the US government's rating under review if there is no progress on increasing its debt limit. The Organization of the Petroleum Exporting Countries' (OPEC) failure to reach an agreement on production targets for the first time in at least 20 years also helped push oil prices higher. However, the increase was tempered by weaker US employment data as well as lower Purchasing Managers' Index (PMI) data in May for both the US and China, bolstering concerns that fuel demand may slow in the world's biggest oil-consuming countries.

Developments in the Utilities Sector

- On a month-on-month basis, the generation charges were higher in June as peak demand for power rose in May due to warmer temperatures. More electricity was needed during the daytime peak periods, when electricity from generators is more expensive. The higher cost of electricity from the independent power producers (IPPs) was driven by the higher cost of fuel.

- Meanwhile, the Power Sector Asset and Liabilities Management (PSALM) filed a new petition with the ERC to recover stranded debts and contract costs through an increase in the universal charge. The Electric Power Industry Reform Act (EPIRA) provides that a universal charge will be imposed on all electricity end-users for the payment of stranded debt and stranded contract costs of the National Power Corporation (NPC).

F. Financial market developments

Government Securities Market

- During the 11 July 2011 auction, interest rate for the 91-day T-bill fell by 37.9 basis points while the 182-day and 364-day T-bill rates rose by 31.5 basis points and 1.7 basis points relative to previous auction levels. The 91-day T-bill rate edged lower given high demand as investors opted to park their cash in shorter-term papers amid inflation concerns. Meanwhile, despite the increase, the 182-day and 364-day T-bill rates were below secondary market levels. The auction was oversubscribed, with total tenders reaching ₱23.3 billion against the total offered amount of ₱9.0 billion.

- On 19 July 2011, the Auction Committee awarded in full the original issuance of 4-year T-bonds at 4.875 percent, which is 35.5 basis points lower than the highest bid rate during the last auction for a similar tenor. The market was very liquid as indicated by the total tenders of ₱22.7 billion against the ₱9.0 billion offering.

- The yield curve has flattened as secondary market yields and term spreads on 11 July 2011 rose for short-term instruments, reflecting investors' preference for shorter-dated instruments, whereas yields and term spreads in the longer end were generally lower compared to the levels in end-May 2011. Meanwhile, yields in the longer end of the curve were lower due in part to the recent upgrade by Fitch Ratings of the country's long-term foreign currency bond rating and as market players participate in the bond swap program of the government, as well as the view that the BSP's recent policy moves have helped temper the medium-term inflation outlook.

Stock Market

- Notwithstanding the losses in Wall Street on weak US data and persistent European debt concerns, the local bourse continued to show strength. The Philippine Stock Exchange index (PSEi) edged higher since June on positive local economic developments, including: (1) the upgrade of the country's credit rating by Fitch and Moody's, (2) lower Philippine unemployment rate in the second quarter, and (3) improvement in the country's fiscal balance.

Foreign Exchange

- In June, the peso slightly weakened amid heightened risk aversion arising from concerns over a possible global economic slowdown and the mounting concerns over the debt crisis in Greece. However, the recent upgrade by Moody's and Fitch on the Philippine's credit rating tempered the peso's depreciation. In July, the peso regained strength on sustained strong inflows of net portfolio investments due to investor's renewed interest in PSE-listed securities and fixed income investments.

Global Bond and Credit Default Swap Spreads

- Debt spreads of most emerging market bonds widened in early June. However, spreads subsequently eased after Greece received a confidence vote facilitating the release of the first round of IMF and EU bailout funds. The upgrade of the Philippines' sovereign credit rating likewise tempered spreads from widening. As of end-June, the EMBI+ Philippine spread continued to tighten from the end-May level. Meanwhile, the 5-year sovereign CDS widened against end-May's level, reflecting expectations of further tightening from the BSP and concerns on the emerging inflation outlook.

  By mid-July, the EMBI+ Philippine spread widened slightly as risk aversion crept in amid continued worries on Euro debt crisis. Debt spreads widened further as the US faces a possible credit rating downgrade. Meanwhile, the 5-year sovereign CDS spread narrowed on account of positive investor views given the upgrade of the Philippines' credit rating by Fitch and Moody's, as well as lower fiscal deficit position of the NG from January-May 2011.

G. Domestic liquidity and credit conditions

- Domestic liquidity or M3 increased at a faster pace of 8.0 percent in May 2011 from 7.3 percent in April 2011. The steady expansion in net foreign assets (NFA)—recorded at 15.3 percent in May—continued to fuel the expansion of domestic liquidity. Net domestic assets (NDA), meanwhile, declined at a slower pace of 6.2 percent from 9.3 percent in the previous month given the slower expansion in the net other items account (which includes revaluation and capital and reserve accounts as well as SDA placements of trust entities) in May. By contrast, the growth in net domestic credits rose to 7.7 percent with credits extended to the private sector expanding at a faster pace of 13.4 percent from 11.9 percent in the previous month. This trend is in line with the faster growth of bank lending to the productive sectors of the economy. Meanwhile, credits extended to the public sector declined further given the continued increase in NG deposits with the BSP and other banks during the month.

- Bank lending growth, net of banks' reverse repurchase (RRP) placements with the BSP, accelerated in May to 18.8 percent from the previous month's expansion of 14.2 percent. The increase is the highest rate recorded since April 2009. Commercial banks' loans have been growing steadily at double-digit growth rates since January 2011. The growth in loans for production activities—which comprised more than four-fifths of commercial banks' total loan portfolio— expanded at a brisker pace of 20.5 percent in May from 15.7 percent a month earlier. This was driven largely by increased lending to electricity, gas and water (which grew by 52.7 percent); manufacturing (20.2 percent); and real estate, renting and business services (21.3 percent).

- Corporate issues also continue to tap the equity and bonds market. Capital raising activities in the Philippine Stock Exchange reached ₱63.4 billion for the period January-May 2011, almost double last year's level. Corporate bond issuances also increased to ₱119 billion, higher by 20 percent compared to the level a year ago.

H. Fiscal developments

- The January-May 2011 fiscal deficit was ₱9.5 billion, 94.1 percent lower than the ₱162.1 billion deficit incurred during the same period last year. Revenue collections increased by 16.3 percent during the period while expenditures were lower by 10.7 percent than the disbursements in the same period in 2010.

I. External developments

- The global economy continued to grow at a steady pace, driven mainly by faster growth in emerging market economies, but dragged by the financial uncertainty and concerns over the sustainability of the recovery clouded the prospects for developed economies. According to the IMF World Economic Outlook update released in June 2011, the most urgent downside risk facing the global economy is the possibility of a weaker-than-expected US economic activity and the resurgence of global financial market volatility from concerns about sovereign debt worries in the euro area. The IMF also noted that persistent fiscal and financial sector imbalances in many advanced economies and signs of overheating in many emerging and developing economies also pose downside risks to global economic growth.

- Meanwhile, risks to global output conditions through the second half of the year are leaning towards a slower pace of world economic activity. The JPMorgan Global Composite Purchasing Managers' Index (PMI) slowed in June at 52.2 from 52.7 in May, the second-lowest reading from a 21-month low of 51.8 in April. June PMI data pointed to market decelerations in output growth in both the manufacturing and service sectors. Signal indicators showed some loss of momentum in global trade, as the June index for global new export orders stood at 52.0 compared to the previous month's 53.0.