HIGHLIGHTS OF THE MEETING OF THE MONETARY BOARD ON MONETARY POLICY ISSUES HELD ON 16 JUNE 2011[1]

I. Monetary Policy Decision

The Monetary Board (MB) decided to:

a) Raise the regular reserve requirement by 1 percentage point effective 24 June 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 considered the increase in the reserve requirement on 24 June 2011 as a preemptive move to counter any additional inflationary pressures from excess liquidity. The MB believed that additional monetary measures are necessary given that expectations of continued strong capital inflows, driven by positive market sentiment over the favorable prospects for the Philippine economy, could fuel domestic liquidity growth and contribute to inflation risks.

- The MB is of the view that, due to its mandatory nature, the increase in the RR ratio could strengthen the transmission of monetary policy changes to the real economy.

- In deciding to maintain policy rates, the MB took into account the latest baseline forecasts, which showed a lower path relative to the forecast path of previous meeting on the monetary policy stance. Inflation expectations have also shown some signs of leveling off. These developments suggest that the two previous policy rate adjustments are starting to work their way through the system.

[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 16 June 2011 meeting were approved by the Monetary Board during its regular meeting held on 7 July 2011. The next meeting of the Monetary Board on monetary policy issues is scheduled on 28 July 2011.

- However, the MB noted that, despite the deceleration in future inflation readings, risks to the inflation outlook remain. In particular, the MB agreed that while the movements of global commodity prices have moderated, there is some uncertainty as to whether the easing of price pressures will be sustained given structural supply constraints and expectations of solid demand by emerging economies. As a result, inflation expectations could be susceptible to commodity price volatility. Further action, therefore, will be taken as needed in the subsequent reviews of the monetary policy stance given the continued risks to inflation expectations and prospects of second-round effects.

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 May at 4.5 percent from 4.3 percent (revised) in the previous month. Inflation pressures in May were due mainly to the increase in non-food inflation, particularly higher year-on-year inflation for light. Higher rice prices due to crop damages wrought by Typhoon Chedeng also contributed to the uptick in inflation. Meanwhile, lower prices of fruits and vegetables tempered headline inflation in May as domestic supply remained adequate. Lower global prices of oil and subsequent rollbacks in the prices of petroleum products were also reflected in the lower or steady inflation outturns for fuel and transport and communication services. This helped dampened inflation pressures as well.

- Likewise, core inflation, which excludes certain food and energy items to measure generalized price pressures, was also higher in May at 3.7 percent compared with 3.3 percent (revised) in April. All alternative measures of core inflation estimated by the BSP also posted increases in May.

B. Inflation expectations

- Inflation expectations for 2011 have remained elevated but appear to be leveling off and are within target. The latest surveys of private sector forecasts show expected inflation for 2011 reaching the upper limit of the target range. Nonetheless, the surveys show mean forecasts for 2012 to be either lower or unchanged relative to data as of the previous meeting.

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. However, compared to the future readings considered at the previous policy meeting, the projected inflation path is now lower due to updates reflecting the lower actual inflation in April and May, reduction in international and domestic oil prices, slower domestic GDP growth, and the lower-than-assumed nominal wage adjustments. The cumulative 50-basis point hike in the BSP's policy rate also contributed to the decline in the latest forecast path.

- The balance of risks to the inflation outlook remained skewed to the upside. Commodity prices have moderated but will continue to pose a risk to the inflation outlook as structurally strong demand from emerging economies could exacerbate supply constraints. Additional petitions for adjustments in electricity rates, and rising inflation sentiments 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-dollar exchange rate, which could help temper the impact of imported inflation.

D. Demand conditions

- The Philippine economy continued to expand at a solid pace relative to its long-run average. Notwithstanding the slowdown in external demand and the reduction in government spending, economic growth in the first quarter continued to be supported by solid expansion of private consumption, robust capital formation, and healthy contribution from industry, particularly from manufacturing. Reflecting the strong performance of the manufacturing sector, capacity utilization has remained consistently above 80 percent. Key indicators in the property sector likewise indicated a sustained pick-up in the first quarter.

- Measures of business and consumer confidence based on second quarter surveys, however, were less upbeat due largely to inflation concerns, ongoing political conflict in the MENA region, and the recent disasters in Japan. Leading economic indicators also suggest that growth could moderate in the second quarter. Nevertheless, not all lower readings were indicative of a potential weakness in aggregate demand. The fall in vehicle sales was the result of supply constraints following the earthquake in Japan while the decline in energy sales was mostly due to relatively cooler temperature this year compared to last year, which experienced the brunt of the El Niño weather phenomenon.

E. Supply-side indicators

Developments in Agriculture

- The agricultural sector recovered in Q1 2011 after contracting in the same period last year, owing to more favorable weather conditions. Bright prospects are seen for palay and corn production for the second and third quarters of 2011. As of the first week of May, 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) expects world cereal production to recover during the year given the return to normal weather conditions and increased planting in response to higher prices. Nonetheless, world cereal stocks are likely to drop by end-2011 to the lowest recorded level in 2008 owing to the anticipated decline in coarse grain inventories. The FAO cited higher feed utilization and increasing industrial usage as factors that could contribute to the depletion of coarse grain inventories.

Oil Price Developments

- Oil prices have eased recently owing to a number of factors. These include uncertainty over the US economic recovery and monetary tightening by China to curb its overheating economy. Tracking the movement of oil prices in the international market, domestic prices of petroleum products, except LPG, were also reduced twice (as of 15 May). However, despite signs of moderation in oil price trends, it may be too early to conclude if the risk from oil prices has dissipated as some structural factors would continue to weigh on oil price trends.

Developments in the Utilities Sector

- The Energy Regulatory Commission (ERC) has approved Meralco's petition to raise distribution, metering, and supply charges under the Performance-Based Regulation (PBR) mechanism in 2012. The proposed rate adjustment was intended to allow Meralco to implement its capital expenditure program and pay for its operating and maintenance requirements. The approved increase, however, was lower than the adjustment sought by Meralco.

F. Financial market developments

Government Securities Market

- During the 30 May 2011 auction, the interest rates for the 91-day and 182-day T-bills increased relative to the previous auction levels. The Auction Committee rejected all bids for the 364-day T-bills as bids were deemed to be unreasonably high (above the rates in the secondary market). Treasury bill rates edged higher on concerns over rising inflation. The auction was oversubscribed, with total tenders reaching ₱12.2 billion against the total offered amount of ₱9.0 billion.

- On 7 June 2011, the average interest on the re-issuance of the 7-year T-bonds (originally issued as 10-year T-bonds), with remaining life of 6 years and 7 months, was slightly higher than the average rate fetched during the last auction for the same tenor. Rates increased as market participants continued to expect policy interest rate hikes amid concerns over rising inflation. However, liquidity continued to be ample in the market as indicated by the ₱31.7 billion in total tenders against the ₱9.0 billion offering.

- Tracking the primary market trend, secondary market yields and term spreads on 6 June 2011 generally rose across tenors compared to the levels in end-April 2011, but were lower relative to the 4 June 2010 levels. Yields on government securities in the secondary market generally rose across tenors as investors expected more interest rate hikes amid concerns over rising inflation.

Stock Market

- In May, trading activity was mixed. The Philippine Stock Exchange index (PSEi) trended lower in the first week of May due to inflation concerns and the BSP's second policy rate hike in six weeks. However, the index was boosted by the large fiscal surplus recorded in April. Toward the end of the month, reports of a US slowdown and lower-than-expected Philippine economic performance for Q1 2011 dampened trading sentiments. In the first week of June, the PSEi continued to be dampened by disappointing news from the US.

Foreign Exchange

- In May 2011, the peso continued to appreciate due to the sustained bullish outlook for emerging Asian economies despite the heightened risk aversion stemming from the worsening debt crisis in Greece and the uncertainty in the strength of the US economic recovery. Concerns over a possible slowdown of China's economy also weighed down on the peso. Nevertheless, the sustained inflows of OF remittances, portfolio investments, and FDIs continued to support the peso's strength. On a year-to-date basis, the peso has appreciated in nominal terms against the US dollar by 1.4 percent as of 31 May 2011.

Global Bond and Credit Default Swap Spreads

- Debt spreads continued to widen in June. The higher premium in holding Philippine bonds, in particular, was due to market concerns over the country's slower growth and higher inflation expectations. On the external front, disappointing manufacturing and jobs data in the US further contributed to the widening of spreads. As of 10 June, the EMBI+ Global yield spread rose to 290 bps, the EMBI+ Philippines spread increased to 185 bps while the 5-year sovereign CDS remained steady at 135 bps.

G. Domestic liquidity and credit conditions

- Domestic liquidity or M3 reached ₱4.2 trillion in April 2011, higher by 7.3 percent relative to the level a year earlier. The steady expansion in net foreign assets (NFA)—at 20.2 percent in April—fueled the growth of domestic liquidity. Net domestic assets (NDA), meanwhile, decreased anew by 9.3 percent in April following a decline of 3.5 percent in March. This was due largely to the continued expansion of the net other items account (which includes revaluation and capital and reserve accounts as well as SDA placements of trust entities). By contrast, net domestic credits rose by 7.2 percent, due to a further increase in credits extended to the private sector at 11.9 percent. This trend is consistent with the broadly steady growth of bank lending to the productive sectors of the economy. Meanwhile, the growth in credits extended to the public sector declined due mainly to the contraction in credits extended to the National Government (NG), indicating ample NG cash balances as reflected in the increase in NG deposits with the BSP and other banks during the month.

- The deceleration in M3 growth in April 2011 was also partly attributed to base effects as domestic liquidity expanded by 12.4 percent in April 2010, reflecting higher transactions demand for money due to election-related spending.

- Bank lending growth continued to expand in April by 14.2 percent, broadly similar to the previous month's expansion of 14.1 percent. The growth in loans for production activities—which comprised more than four-fifths of commercial banks' total loan portfolio—was broadly steady at 15.7 percent in April from 15.6 percent a month earlier. Meanwhile, the growth in consumer loans (which include credit card receivables and auto loans) was unchanged at 12.9 percent.

- Equity issuances amounted to ₱44.8 billion for the period January-April 2011, higher by 37 percent compared to the year-ago. On the other hand, bond issuances reached ₱75 billion, lower by 21 percent compared to the level a year ago.

H. Fiscal developments

- The January-April 2011 fiscal position yielded a surplus of ₱61.0 million, a turnaround from the ₱131.8 billion deficit incurred during the same period in 2010. Revenue collections increased by 18.2 percent to ₱461.4 billion in the first four months compared to ₱390.3 billion in the same period last year.

Expenditures in January-April 2011 amounted to ₱461.4 billion, 11.6 percent lower than the disbursements in the same period in 2010.

I. External developments

- The global economic recovery proceeded at a slightly slower pace in Q1 2010. Output expansion was maintained in the US, euro zone, and emerging markets in Q1 2011. By contrast, widespread disruptions caused by the triple disasters in the Tohoku region pushed Japan into a recession. Leading indicators suggest that global growth might have slowed down in April 2011. Data also suggested a cooling of business activity growth in the US non-manufacturing sector and a steep contraction in Japanese manufacturing. The decline in the global all-industry new orders index also signaled a potential slowdown in new business, particularly in the services sector.

- Meanwhile, inflation pressures appear to have broadened globally, even for advanced economies (AEs). Inflation outturns have risen steadily in AEs in recent months while those for emerging economies have remained elevated.