BANGKO SENTRAL NG PILIPINAS

HIGHLIGHTS OF THE MEETING OF THE MONETARY BOARD ON MONETARY POLICY ISSUES HELD ON 6 FEBRUARY 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) Maintain the current reserve requirement ratios.

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

- The MB's decision was based on its assessment of a manageable inflation outlook. While inflation has risen slightly due mainly to the recent increase in food prices on account of adverse weather conditions, latest baseline forecasts continue to indicate that the future inflation path will stay within the target ranges of 4±1 percent for 2014 and 3±1 percent for 2015. At the same time, market expectations remain anchored to the inflation target over the policy horizon.

- The MB noted that the balance of risks to the inflation outlook remained slightly weighted toward the upside given the pending petitions for adjustments in utility rates and the possible uptick in food prices. The Board also noted that while the global economy has become more challenging because of heightened financial market uncertainty following monetary policy adjustments in the US and generalized concerns about the sustainability of growth in emerging economies, domestic economic activity is likely to stay firm. Sound fundamentals such as buoyant demand, strong fiscal and external positions as well as favorable consumer and business sentiment would support economic activity going forward.

- The BSP will continue to closely monitor and assess evolving growth and liquidity conditions and will consider policy adjustments, when needed, to ensure continued price and financial stability.

[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 6 February meeting were approved by the Monetary Board during its regular meeting held on 20 February 2014. The next meeting of the Monetary Board on monetary policy issues is scheduled on 27 March 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 slightly higher in January due largely to higher prices of food and selected non-food items. Other indicators also increased such as two out of three alternative measures of core inflation estimated by the BSP and the seasonally adjusted 3-month moving average annualized headline inflation. By contrast, the seasonally-adjusted month-on-month headline and core inflation declined, while the official core inflation and the seasonally adjusted 3-month moving average annualized core inflation were steady.

- The slightly higher January headline inflation rate was traced mainly to higher prices of food and selected non-food items. Food inflation increased as key food items particularly rice, meat, fish, milk, oils, vegetables, and sugar, posted higher prices due to some tightness in domestic supply conditions triggered by recent weather-related production disruptions. The recent upward trend in inflation therefore appears to stem mainly from supply shocks, the impact of which are expected to be transitory. Non-food inflation also rose as a result of higher prices of clothing and footwear, furnishing and household equipment, and health-related products.

B. Inflation expectations

- Inflation expectations—reflected in forecast surveys of private sector economists by the BSP and by Consensus Economics—continue to support the within-target inflation outlook. For January 2014, results of the BSP's survey of private economists showed higher but within-target mean inflation forecasts for 2014 and 2015 at 4.0 percent (from 3.9 percent in December 2013) and 3.9 percent (from 3.6 percent), respectively. Similarly, results of the Consensus Economics survey in January 2014 showed a slightly higher mean inflation forecast for 2014 of 4.0 percent (from 3.9 percent in December 2013, while respondents expect inflation in 2015 to average at 3.9 percent).

C. Inflation outlook

- The latest baseline forecasts continue to indicate within-target inflation for 2014 – 2015. The average annual inflation forecasts for 2014-2015 are projected to settle close to the mid-point of the target range of 3-5 percent for 2014 and slightly above the mid-point of the target range of 2-4 percent for 2015. Compared to the previous forecast round, the latest baseline inflation forecast for 2014 is lower due mainly to the decline in oil prices and the effect of the temporary restraining order imposed on Meralco's rate adjustment. Meanwhile, the latest average baseline inflation forecast for 2015 is higher due to the change in the assumed dates of implementation of price adjustments in electricity rates, transport fares and NFA rice prices.

- The inflation uptick in Q4 2013 was due mainly to adverse supply-side price pressures brought about by typhoon Yolanda and higher power generation costs. These are seen to be generally transitory with a limited impact on the inflation path going forward.

- The risks to future inflation are skewed to the upside. Potential higher-than-expected increases in utility rates could result in higher inflation than current forecasts indicate. Additional sources of potential price pressures not covered in the baseline scenario would include movements in international oil prices as well as volatility in the exchange rate.

D. Demand conditions

- Newly available data suggest that the growth of the domestic economy is likely to continue at an above-trend pace, although capital flow volatility can create some challenges to financial markets in the near term. The Philippine economy continued to expand at an above-trend rate in Q4 2013, driven by strong household spending, exports, and capital formation (particularly durable equipment) on the expenditure side, and by solid gains in the services sector on the production side. Philippine GDP expanded by 6.5 percent in Q4 2013, bringing the 2013 GDP growth to 7.2 percent, above the Government's growth target of 6.0–7.0 percent for the year.

- The positive outlook for economic activity is expected to continue on the strength of consumer spending, as evidenced by the trend of various demand indicators. Labor market conditions likewise improved, with the unemployment rate at 6.5 percent based on the results of the October 2013 Labor Force Survey from 7.3 percent in the previous quarter. Meanwhile, manufacturing activity and exports have likewise been improving with the normalization of global trade. The latest WEO update sees global activity improving further in 2014-2015, and the recovery in advanced economies should spur export demand. Consistent with these developments, results of the latest Senior Loan Officers' Survey for Q4 2013 point to a sustained net increase in demand for loans from both enterprises and households. The outlook for domestic demand conditions is also likely to benefit from typhoon-related reconstruction and rehabilitation spending in 2014.

- However, EMEs, including the Philippines, could face volatile external conditions resulting from the withdrawal of accommodative monetary policy in the US. While financial market reactions have been relatively muted since the US Fed tapering announcement on 18 December, financial market and capital flow volatility could remain a concern.

E. Supply-side indicators

<u>Developments in Agriculture</u>

- The Agriculture sector posted a growth of 1.1 percent in Q4 2013 from an expansion of 4.8 percent in Q4 2012, driven by output gains in the crops, livestock and poultry subsectors. The crops subsector recovered in Q4 2013, growing by 2.2 percent from the previous quarter's contraction of 1.9 percent, due largely to the 8.2-percent growth in palay production. Corn output, on the other hand, declined by 3.6 percent in Q4 2013.

- The Bureau of Agriculture Statistics (BAS) expects *palay* output to expand by 3.8 percent in Q1 2014. However, near-term outlook on rice prices will depend largely on how the NFA will increase domestic supply, e.g., through additional imports. The NFA Council set to review the country's import requirement this Q1 2014.

- The FAO Food Price Index (FPI) was broadly steady in December 2013 compared to the previous month's level as higher dairy and meat prices were offset by lower prices of sugar, cereal and oil. Sugar prices went down amid increased production in Brazil and Thailand while oil prices declined due to a combination of weak demand and favorable supply prospects. Meanwhile, dairy and meat prices rose due to strong demand. For full-year 2013, the Index declined to 209.9 points from 213.4 points in the previous year due largely to lower prices of cereals, oils and sugar.

<u>Oil Price Developments</u>

- Oil prices were higher in December amid increasing signs of economic improvement in the US. However, for the period 1-28 January, oil prices were lower as US crude oil production rose to its highest level in more than two decades.

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

- On 9 December 2013, the Energy Regulatory Commission approved Meralco's three-phase collection of the ₱3.44 per kilowatt hour (kWh) increase in generation charge. Tight supply conditions resulting from the maintenance shutdown of Malampaya together with the scheduled and unscheduled maintenance shutdown of several power plants compelled Meralco to source its power supply requirements from the Wholesale Electricity Spot Market (WESM). Other bill components such as transmission, system loss, lifeline rate subsidy charges also increased.

- However on 23 December 2013, the Supreme Court (SC) issued a Temporary Restraining Order suspending the implementation of the upward adjustment in power rates for 60 days. Meralco has already advised its customers that upward or downward adjustments in their December billing statements shall be applied once the SC issues its final decision. The SC hearing for oral arguments is set on 4 and 11 February 2014.

- The MB noted that scheduled/unscheduled maintenance shutdowns of power plants or delays in the commissioning of committed power projects could affect prices amid thin reserve margins. New capacities will also be needed to meet the demand for power based on projections of the Department of Energy.

F. Financial market developments

- In January, the local bourse traded within a narrow band given the lack of any fresh leads. The PSEi followed the lead from markets abroad in the absence of positive economic news to drive a rally. The peso weakened further in January as recent positive data suggesting the strong recovery of the US economy and hawkish comments by some US Fed officials heightened uncertainty on the pace and duration of the US Fed tapering. Further, concerns that the damage caused by natural disasters will hurt the economy through fueling food shortages and inflation also weighed down on the peso. However, sustained foreign exchange inflows from OF remittances, BPO receipts, and portfolio and direct investments helped temper the depreciation of the peso.

- Debt spreads climbed in January on reports of weakening Chinese economy and lingering expectations that the US Fed will continue to cut back stimulus, denting appetite for riskier assets. China's slowing factory activity in December reinforced views that growth in the world's second largest economy moderated in the final quarter of 2013. Meanwhile, as the Fed prepared to unwind more of its asset buying program, the market has been demanding higher returns on emerging market assets. Moreover, anti-government protests in Ukraine, Thailand and Turkey likewise deteriorated sentiment, contributing further to the widening of debt spreads.

G. Domestic liquidity and credit conditions

- Domestic liquidity or M3 eased to 32.7 percent year-on-year (y-o-y) in December 2013 from 36.5 percent in the previous month. On a month-on-month basis, seasonally-adjusted M3 decreased by 1.5 percent, reversing the 4.4-percent growth (revised) in the previous month. The slower pace of increase in money supply is consistent with the expected normalization of M3 growth over the coming months following the completion of the operational adjustments in the BSP's Special Deposit Account (SDA) facility in November 2013.[2]

- The growth in money supply was driven largely by the sustained expansion in domestic claims, or credits to the domestic economy. Domestic claims rose by 11.6 percent in December from 12.3 percent in November, buoyed by the continued increase in claims on the private sector (by 17.3 percent) due to the steady growth in bank lending. Meanwhile, the level of net claims on the central government was broadly steady relative to its level a year ago.

- The outstanding loans of commercial banks, net of reverse repurchase (RRP) placements with the BSP, expanded by 16.4 percent in December from the previous month's growth of 14.8 percent. Similarly, bank lending inclusive of RRPs grew at a faster pace of 16.3 percent from 13.8 percent in the previous month. On a month-on-month seasonally-adjusted basis, commercial bank lending increased by 2.8 percent for loans net of RRPs and by 3.4 percent for loans inclusive of RRPs.

H. Fiscal developments

- The fiscal deficit in the period January-October 2013 was ₱112.5 billion, lower than the ₱115.6 billion deficit incurred during the same period in 2012. This represented 47.3 percent of the ₱238.0 billion programmed deficit for Q1-Q4 2013. Revenue collections increased by 11.8 percent while expenditures were higher by 10.5 percent.

I. External developments

- The MB noted that prospects for global economic growth have broadly strengthened. The outlook for the US economy has continued to improve on robust domestic demand, while economic activity in the euro area and Japan stabilizes further. However, the pace of growth in major emerging markets, particularly in China and India, has remained tepid.

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2 It will be recalled that the BSP has required trust entities to reduce by November 2013 their SDA placements that are inconsistent with the BSP's revised SDA guidelines as contained in Memorandum No. M-2013-021 dated 17 May 2013.