BANGKO SENTRAL NG PILIPINAS

HIGHLIGHTS OF THE MEETING OF THE MONETARY BOARD ON MONETARY POLICY ISSUES HELD ON 13 JUNE 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, 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 to maintain the BSP's policy interest rates was based on its assessment of a manageable inflation environment over the policy horizon amid robust domestic growth. The latest baseline forecasts indicate that inflation will remain within target for 2013-2015, while inflation expectations remain firmly anchored. The MB noted that domestic economic growth remains firm, driven by strong internal demand, while leading indicators suggest continued growth momentum. The MB was of the view that ample liquidity and strong bank lending should also continue to support economic activity in the months ahead.

- The MB considered the prevailing risks to the inflation outlook to be evenly balanced. Uncertainty over the strength of the global economy and the relative firmness of the peso are the key downside risks to the broad outlook for prices. Meanwhile, upside pressures could emanate from power rate adjustments and the possibility of a sustained surge in liquidity owing to strong capital inflows.

- The MB agreed that, on balance, a change in monetary settings does not appear necessary at present based on recently accumulated information on inflation and demand conditions. Recent global financial market developments also support an unchanged policy stance. At the same time, keeping policy settings steady allows time to assess the impact of recent fine-tuning in monetary operations.

- Going forward, the MB recognized the need to continuously monitor emerging demand and price developments as well as asset market developments to ensure that monetary

[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 13 June 2013 meeting were approved by the Monetary Board during its regular meeting held on 4 July 2013. The next meeting of the Monetary Board on monetary policy issues is scheduled on 25 July 2013.

policy settings remain consistent with safeguarding price and financial stability while being supportive of sustained and balanced economic growth.

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 unchanged in May as slightly higher food inflation was offset by lower prices for electricity and petroleum products. Food inflation increased slightly as some food commodities, particularly fruits, vegetables, and meat, posted higher prices due partly to tight supply conditions following higher spoilage of supplies during the summer season. Meanwhile, lower charges in electricity rates as a result of lower transmission and system loss charges, as well as price reductions in gasoline, diesel, LPG, and kerosene which reflected lower international prices of oil, offset the rise in food inflation.

- Meanwhile, core inflation, as well as two alternative measures of core inflation estimated by the BSP continued to decelerate in May. Other indicators show broad-based softness in price pressures as the number and weight of above-threshold items decreased further in May.

B. Inflation expectations

- The benign inflation outlook is supported by well-anchored inflation expectations. Inflation expectations based on forecast surveys of private sector economists by the BSP and by Asia Pacific (AP) Consensus remain within the target band for 2013-2014. Results of the May 2013 BSP survey showed lower mean inflation forecasts for 2013-2015. Likewise, results of the May 2013 AP Consensus survey yielded lower mean inflation forecast for 2013 and a steady mean inflation forecast for 2014.

C. Inflation outlook

- Headline inflation is projected to remain within the 4±1 target range for 2013-2014. Compared to the previous policy meeting, the baseline inflation forecast for 2013 has been revised downward due primarily to lower assumptions for oil and non-oil import prices which have offset the impact of stronger GDP growth. In contrast, the forecast for 2014 has increased slightly in the current forecasting round owing mainly to higher M3 forecasts for 2014 given the cumulative 150 bps cut in the SDA rate and the prohibition of funds originating from non-trust accounts in the SDA facility. Meanwhile, the initial inflation forecast for 2015 shows average headline inflation settling within the 3±1 percentage point target range.

- The risks to the inflation outlook remain broadly balanced. Downside risks to the inflation outlook continue to persist owing to uncertainty over the strength of the global economy. At the same time, the outlook of a stronger peso given continued foreign exchange inflows is seen to temper imported inflation. Meanwhile, upside pressures on prices could emanate from power rate adjustments and the possibility of a continued strong surge in liquidity due to sustained capital inflows.

D. Demand conditions

- GDP growth was higher-than-expected at 7.8 percent in the first quarter, supported by household spending, capital formation, and public spending on the expenditure side. These drivers of growth offset the negative contribution from exports. On the production side, all three major sectors grew in the first quarter, led by the industry sector.

- Meanwhile, the most recent available indicators continue to depict solid growth in the economy. Vehicle and energy sales have been strong in March and April, respectively, with growth in overall electricity sales driven by the residential and commercial 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. Bullish business sentiment for the current quarter was also recorded in the Q2 2013 Business Expectations Survey.

E. Supply-side indicators

<u>Developments in Agriculture</u>

- The agriculture, hunting, forestry and fishery (AHFF) sector grew by 3.3 percent in Q1 2013 due to improved agricultural production. Palay and corn increased by 4.5 percent and 11.4 percent, respectively, due to expansion of harvest areas, yield improvement, and sufficient use of irrigation and fertilizers.

- However, due to the movement of cropping to Q1 2013, the Bureau of Agricultural Statistics (BAS) forecasts palay production to fall in Q2 2013 but recover in Q3 2013. The projected output declines could also be attributed to decreases in planting due to insufficient water supply; shifting to other crops; and incidences of infestations. Similarly, corn output is projected to contract in Q2 2013 due to the movement of cropping from Q2 to Q1 in almost all regions as farmers attempted to avoid the effects of the earlier expected dry weather conditions.

<u>Oil Price Developments</u>

- Oil prices declined in May on rising US crude oil inventories and weak economic data in China. The subdued economic outlook for China as well as steady OPEC production amid rising supplies in the US and non-OPEC producers is expected to put downward pressure on prices amid modest demand growth.

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

- Electricity rates are lower in May 2013 due to the reduction in transmission charge from the National Grid Corporation of the Philippines and other bill components such as system loss charge and lifeline rate subsidy. Power rates of Independent Power Producers (IPPs) and the National Power Corporation (NPC) were also lower.

F. Financial market developments

- The Philippine Stock Exchange Index (PSEi) traded over the 7,100 mark for most of the month of May on account of better-than-expected Q1 domestic corporate earnings and the second upgrade to investment grade status received by the Philippines in 2013 although this rally was followed by some stock market correction due to investors cashing in on gains from previous highs and lingering overseas concerns. In particular, US Fed Chairman Ben Bernanke's statement that quantitative easing will end at some point, indicating a possible scaled-down bond-buying program by the US Fed, and the unexpected decline in China's manufacturing output in May added to concerns that global economic growth will be losing steam.

- Meanwhile, the peso weakened in May as the recent surge in US bond yields eroded the appeal of riskier, high-yielding assets including the Philippine bonds. The peso traded weaker thereafter, revisiting the ₱41-42/US$ levels on broad dollar strength amid signs of improving US economy.

- In May, debt spreads showed mixed trends. Debt spreads exhibited a narrowing trend with spreads tightening to record lows by mid-May. Reports on the US showing continued signs of economic recovery lifted sentiments, causing debt spreads in emerging markets to tighten considerably. In the Philippines, the second credit rating upgrade received from S&P boosted prices of its sovereign bonds in the market. As a result, the yields of Philippine bonds, which are already among the lowest for sub-investment grade sovereign in the world, dropped further, narrowing the gap between high-yielding EM bonds with US investment grade bonds. However, the narrowing trend was not sustained as debt spreads widened towards the end of the month. Renewed speculation that the Fed could start tapering its bond-buying program over the next few months translated to a sell-off in US Treasuries, which caused yields to rise in both the investment-grade and high-yielding emerging market bonds while debt spreads subsequently widened.

G. Domestic liquidity and credit conditions

- Domestic liquidity or M3 grew by 13.2 percent year-on-year in April 2013, broadly unchanged relative to the 13.3 percent in March 2013. Money supply growth was driven by the expansion of net domestic assets (NDA) following the sustained increase in credits to the private sector consistent with the robust lending activity of commercial banks. Similarly, net foreign assets (NFA) increased further in April owing to the increase in the BSP's NFA position, which, in turn, could be attributed to steady foreign exchange inflows from overseas Filipinos' remittances, portfolio investments, and BPO receipts. However, the NFA of banks declined further as banks' foreign liabilities continued to increase due in part to higher placements and deposits made by foreign banks with their local branches and other banks, while their foreign assets continued to decrease due to the decline in their loan receivables.

- The growth of outstanding loans of commercial banks, net of banks' reverse repurchase (RRP) placements with the BSP, grew by 12.0 percent in April from the previous month's expansion of 14.2 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 12.0 percent in April from 14.2 percent a month earlier.

H. Fiscal developments

- The fiscal deficit in the period January-April 2013 was ₱29.7 billion, significantly higher than the ₱2.9 billion deficit incurred during the same period last year. This represented 35.1 percent of the ₱84.7 billion programmed deficit for Q1-Q2 2013. Revenue collections increased by 7.8 percent while expenditure was higher by 12.9 percent.

I. External developments

- On the external front, global economic recovery continues to proceed at an uneven pace. Economic growth in the US remains modest on improved market sentiment, while activity in Japan continues to gain traction. However, the downturn in the euro area persists on financial sector weaknesses and ongoing fiscal constraints. Meanwhile, the pace of growth in many emerging markets remains fairly robust on stable domestic demand, although recent indicators also point to a softening of economic activity particularly in China.