BANGKO SENTRAL NG PILIPINAS

HIGHLIGHTS OF THE MEETING OF THE MONETARY BOARD ON MONETARY POLICY ISSUES HELD ON 12 DECEMBER 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 was based on its assessment of a manageable inflation environment. While the inflation forecast for 2014 has slightly risen due to the recent increase in global oil prices, utility rate adjustments, and the impact of the recent typhoons, the future inflation path is expected to be within the target over the policy horizon since the uptick is seen to be largely transitory. Meanwhile, market expectations of inflation remain consistent with the target range.

- The balance of risks to the inflation outlook remains tilted toward the upside due to the potential increases in food prices as well as the pending petitions for further adjustments in utility rates.

- The BSP continues to pay close attention to the evolving economic growth and liquidity dynamics and their implications on price and financial stability. While global economic conditions could be challenging, prospects for domestic activity are expected to stay firm, supported by buoyant domestic demand as well as favorable consumer and business sentiment. Moreover, as credit expands in lock-step with output growth, the economy's improved absorptive capacity will likewise be sustained, thus mitigating inflation pressures.

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 rose in November due largely to higher prices for food, electricity, and domestic petroleum products. Likewise, other price indicators increased such

[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 12 December 2013 meeting were approved by the Monetary Board during its regular meeting held on 3 January 2014. The next meeting of the Monetary Board on monetary policy issues is scheduled on 3 February 2014.

as the official core inflation, two out of three alternative measures of core inflation estimated by the BSP, seasonally-adjusted month-on-month headline and core inflation, seasonally adjusted 3-month moving average annualized headline and core inflation, and number and weight of above-threshold items.

- Some tightness in domestic supply conditions—triggered by recent weather-related production disruptions—led to higher prices of some food items, particularly rice, fish, and vegetables. Similarly, upward adjustment in electricity rates due to the increase in generation, transmission, and system-loss charges, as well as higher gasoline and LPG prices contributed to the increase in non-food inflation for the month.

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 November 2013, results of the BSP's survey of private economists showed higher but within-target mean inflation forecasts for 2013, 2014 and 2015 at 3.1 percent (from 2.9 percent in October), 3.8 percent (from 3.5 percent), and 3.7 percent (from 3.5 percent), respectively. Meanwhile, results of the Consensus Economics survey in November showed a slightly higher mean inflation forecast for 2013 of 2.9 percent (from 2.8 percent in October) and steady mean inflation forecast for 2014 of 3.6 percent.

C. Inflation outlook

- The latest baseline forecasts continue to indicate within-target inflation for 2014 – 2015. The latest average baseline inflation forecasts are higher for 2014 and 2015 compared to the previous forecast round due mainly to the increase in oil prices and the estimated impact of higher power rates in the Meralco franchise area as well as the likely impact of typhoons Yolanda and Santi.

- Inflation is expected to see an uptick in the near term, but this is seen as transitory and not likely to cause a significant deviation from the target.

- The risks to future inflation remain slightly skewed to the upside. Potential increases in food prices and utility rates due to some supply-related concerns alongside the likelihood of stronger-than-anticipated liquidity growth could result in higher inflation than current forecasts suggest. The downside risk to inflation emanates from lingering uncertainties on global economic activity and their impact on commodity prices.

D. Demand conditions

- Recent demand indicators affirm the earlier assessment that domestic demand conditions will remain relatively firm. Based on the latest national income accounts, the economy grew by 7.0 percent in the third quarter, slower than the quarter- and year-ago growth rates of 7.6 percent and 7.3 percent, respectively. The third quarter growth rate remains well above the long-run average growth rate of GDP of 4.8 percent for the period 1999 to 2013. The third quarter year-on-year performance was supported by household consumption, capital formation, and exports. The economy's growth rate for the first three quarters of 2013 was 7.4 percent, higher than the target of 6-7 percent for the entire year.

E. Supply-side indicators

Developments in Agriculture

- Palay production fell in Q3 2013 relative to Q3 2012 due to reduced harvest area, particularly in Cagayan Valley, Western Visayas, Bicol Region, ARMM, Davao Region and Ilocos Region. The output reduction also reflects the impact of several weather disturbances including Typhoons Labuyo, Maring, Nando and Odette.

- Based on the October 2013 round of the Palay and Corn Production Survey, palay output is expected to grow in Q4 2013 by 10.3 percent while corn output is forecast to decline by 3.8 percent. However, these projections have not taken into account the impact of Typhoon Yolanda.

- Favorable supply conditions have kept prices of meat, fish, fruits and refined sugar generally stable in October 2013 compared to their month-ago levels. Meanwhile, prices of some monitored vegetables rose in October following weather-related supply disturbances in producing provinces in Central and Northern Luzon.

- In November, retail prices of rice rose slightly reflecting the impact of recent typhoons.

- After five consecutive months of decline, the FAO Food Price Index (FPI) rose slightly by about 2.7 points (1.3 percent) to 205.8 points in October 2013 from the September 2013 level of 203.1 points. The slight increase was driven largely by higher sugar prices after unfavorable weather conditions delayed harvest in Brazil, the world's top sugar exporter.

Oil Price Developments

- Oil prices were lower in November amid surging US crude stockpiles. Meanwhile, on 26 November, the domestic prices of petroleum products, except kerosene and LPG, were increased.

Developments in the Utilities Sector

- Overall cost of electricity was higher in November 2013 due to the increase in generation charge and other electric bill components. Meralco reported that the generation charge rose due to the increase in the cost of electricity purchased from the Wholesale Electricity Spot Market (WESM). Tight supply conditions resulting from maintenance shutdown of several power plants compelled Meralco to source its power supply requirements from the WESM. Power rates of the Power Supply Agreements (PSAs) also increased but partly offset by the reduction in the average cost of power charged by Independent Power Producers (IPPs). Transmission charge and other bill components also increased.

- On 9 December 2013, the Energy Regulatory Commission also approved Meralco's three-phase collection of the ₱3.44 per kilowatt hour (kWh) increase in generation charge.

F. Financial market developments

- The Philippine Stock Exchange Index (PSEI) slid in November as market pessimism persisted over the impact of supertyphoon Yolanda. After sustaining a rally in September and October, the PSEi retreated in November as investor sentiment continued to be dampened by the anxiety over the possible tapering of the US Fed's quantitative easing (QE) program and the damage by Typhoon Yolanda. The PSEi continued to retreat in early December as investors stayed in the sidelines after the series of upbeat economic data in the US fueled speculation of an earlier winding-down of the US$85 billion monthly bond-buying program of the Fed. Market pessimism over the impact of Typhoon Yolanda on economic growth and corporate earnings and the spike in November inflation to 3.3 percent similarly tempered trading in the local bourse. On 6 December, the market closed at 6,014.94 index points, a 3.1-percent decline from the end-November level.

- In November, the peso depreciated to average ₱43.58/US$1 relative to ₱43.17/US$1 average in October on speculation that the US will start tapering by early next year. For the period 1-6 December, the peso further weakened to average ₱43.80/US$1 after the ERC allowed the country's largest power supplier (Manila Electric Co.) to increase electricity prices.

- Following a relative period of calm in October, bond spreads widened in November on concerns over the possible tapering of the US Fed's QE program. Asian markets saw renewed volatility as uncertainty persisted that the US Fed will start reducing its asset purchases soon following favorable employment data that showed signs of continued recovery. The devastation left by Typhoon Yolanda also dampened investor sentiment across all financial markets in the Philippines, including debt papers, as it is foreseen to drag economic growth and generate inflation pressures in the short to medium term. For the period 1-10 December, debt spreads eased on stronger US payroll data and robust Q3 Philippine GDP growth. Stronger trade data from China, Japan, and Germany likewise led to declines in premiums on holding emerging market bonds, tightening spreads during the period. As of 9 December, the extra yield investors demand to own Philippine debt over US Treasuries (or the EMBI+Philippine spread) stood at 145 bps, tightening by 6 bps from end-November's 151 bps. However, the country's 5-year sovereign credit default swap (CDS) stood at 110.5 bps, wider than the previous month's end of 105.4 bps. Against other neighboring economies, the Philippine CDS traded narrower than Thailand's 127 bps and Indonesia's 225 bps, but slightly wider than Malaysia's 102 bps.

G. Domestic liquidity and credit conditions

- Domestic liquidity or M3 grew by 32.5 percent in end October to reach ₱6.3 trillion. This growth was slightly faster than the 31.3-percent expansion (revised) recorded in September. On a month-on-month basis, seasonally-adjusted M3 increased by 2.0 percent, similar to the expansion recorded in the previous month (based on revised numbers).

- The growth in money supply was driven mainly by the continued expansion in domestic claims or credits to the domestic economy, reflecting in large part the sustained growth in bank lending to the private sector. Credits to the public sector likewise rose with increased investments in National Government securities, indicating strong market demand for Philippine government debt following the country's credit rating upgrade to investment grade.[2] Meanwhile, steady foreign exchange inflows from overseas Filipino workers' remittances, business process outsourcing (BPO) receipts, and portfolio investments have also continued to boost domestic liquidity growth.

- As in recent months, the strong growth in M3 was also due in part to the operational adjustments in the BSP's Special Deposit Account (SDA) facility. These adjustments are aimed

[2] Moody's Investors Service upgraded the Philippines' credit rating to investment grade status on 3 October 2013. This follows the similar move in 2013 by Standard & Poor's in May and Fitch Ratings in March.

at encouraging financial institutions to deploy loanable funds in support of domestic economic activity. The pace of liquidity growth is seen to normalize over the coming months after these adjustments are completed.[3] We expect the growth in monetary aggregates to start decelerating by early 2014.

- Furthermore, the temporary period of strong M3 growth is not seen to lead to significant inflationary pressures. Indeed, the inflation environment is expected to remain benign, as the BSP's latest baseline forecasts indicate that average inflation will continue to track the lower bound of the target range of 4.0±1.0 percent in 2013. Inflation is also projected to remain within target in 2014 and 2015, as inflation expectations remain firmly anchored.

- The outstanding loans of commercial banks, net of reverse repurchase (RRP) placements with the BSP, grew by 13.6 percent in October from the previous month's expansion of 16.2 percent. Similarly, the growth of bank lending inclusive of RRPs expanded at a slightly slower pace of 13.5 percent from 14.9 percent in the previous month. On a month-on-month seasonally-adjusted basis, commercial bank lending increased by 0.1 percent for loans net of RRPs and by 0.6 percent for loans inclusive of RRPs.

H. Fiscal developments

- The fiscal deficit in the period January-September 2013 was ₱101.2 billion, lower than the ₱103.9 billion deficit incurred during the same period in 2012. This represented 70.1 percent of the ₱144.5 billion programmed deficit for Q1-Q3 2013. Revenue collections increased by 13.2 percent while expenditures were higher by 11.8 percent.

I. External developments

- Recent developments suggest ongoing recovery in the global economy while volatility in global financial markets has somewhat abated. The US economy appeared to have been growing at a moderate pace although the government shutdown is expected to reduce growth slightly in the fourth quarter. Economic activity in the euro area continued to recover, albeit at a moderate pace. The Japanese economy continued to grow moderately with exports picking up. Meanwhile, the pace of growth in China has improved in Q3 2013.

- Meanwhile, the last-minute legislative measure to fund spending and suspend the debt ceiling along with the guidance about the path of US monetary policy have helped ease pressures in financial markets. However, the release of the FOMC minutes on 20 November added to expectations that the Fed may taper its asset purchases sooner than previously anticipated although the FOMC minutes were also seen to signal that interest rates are likely to remain at record lows even after the end of its asset purchase program.

[3] As contained in BSP memorandum to all banks and trust entities (Memorandum No. M-2013-021) issued on 17 May 2013, the BSP required trust entities to phase out their SDA placements that are inconsistent with the revised BSP SDA guidelines by November 2013.