HIGHLIGHTS OF THE MEETING OF THE MONETARY BOARD ON MONETARY POLICY ISSUES HELD ON 14 MARCH 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) Set the interest rate on RRPs at 3.5 percent for all tenors;

c) Set the Special Deposit Account (SDA) rate at 2.5 percent across all tenors; and

d) 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 rate settings was based on its assessment that the inflation environment remained manageable. Latest baseline forecasts continue to track the lower half of the 3-5 percent target range for 2013 and 2014, while inflation expectations also remain firmly anchored.

- Moreover, the MB deemed the risks to the inflation outlook to be evenly balanced along the baseline forecast path. Although global economic activity has gained further traction, lingering fiscal and financial market stresses in advanced economies also continued to dampen the broad outlook, thereby mitigating upward pressures on commodity prices. Meanwhile, pending domestic power rate adjustments, together with potentially stronger domestic liquidity expansion owing to further capital inflows, pose upside risks to the inflation outlook. The MB is also of the view that domestic demand conditions remain firm and continue to underpin the economy's growth momentum.

- Following its move to rationalize the SDA facility in January, the MB also decided to reduce the interest rates on the SDA facility by 50 basis points to 2.50 percent, applicable to all tenors. Furthermore, the MB decided to set the interest rate on RRPs at 3.5 percent for all tenors.

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

- The reduction in the SDA rate and the removal of the RRP term premium are consistent with the BSP's continuing efforts to fine-tune the operation of its monetary policy tools. The MB noted that the benign inflation outlook and improving growth prospects provide room for the reduction in the SDA rate.

- Going forward, the MB recognized the need to continuously monitor emerging demand and price developments to ensure that monetary policy settings remain consistent with price stability while being supportive of economic growth. The MB also reiterated its readiness to employ macroprudential measures as necessary to pre-emptively address any potential misalignment in asset prices.

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 accelerated in February, driven mainly by higher inflation for food, alcoholic beverages and tobacco, and transport. Likewise, other indicators such as the core inflation, seasonally adjusted 3-month moving average annualized headline and core inflation, and the number and weight of above-threshold items went up. Meanwhile, the alternative measures of core inflation estimated by the BSP showed mixed trends.

- Food inflation went up as most food commodities, particularly meat, rice, corn, and fish posted higher prices. Likewise, alcoholic beverages and tobacco inflation rose as a result of the implementation of the Sin Tax Reform Act of 2012. At the same time, transport inflation also accelerated due to the adjustments in gasoline and diesel prices, largely influenced by the higher international price of crude oil. The increase in the prices of domestic petroleum products more than offset the lower electricity rates in February.

B. Inflation expectations

- The benign inflation environment is supported by well-anchored inflation expectations. Inflation expectations based on forecast surveys by the BSP and by Asia Pacific (AP) Consensus remain within the target band for 2013-2014. For February 2013, results of the AP Consensus yielded unchanged mean inflation forecasts for 2013-2014. Meanwhile, results of the BSP survey of private sector economists showed slightly higher but still within-target mean inflation forecasts for 2013-2015.

C. Inflation outlook

- Baseline inflation forecasts have been revised slightly higher than in the previous meeting but continue to be within the target range for 2013-2014. The inflation forecasts are 3.29 percent (from 3.03 percent) for 2013 and 3.27 percent (from 3.17 percent) for 2014. The upward adjustment in the forecasted inflation path for 2013 – 2014 compared to the previous run could be attributed mainly to the slightly higher (than earlier forecasted) actual inflation outturn in January, increase in oil prices, and higher GDP growth rate. The latest baseline inflation forecasts also now incorporate the estimated impact of election spending and newly-approved power rate adjustments.

- The risks to future inflation appear to be 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 continued appreciation of the peso could temper imported inflation. Meanwhile, upside price pressures could emanate from additional petitions for utility rate adjustments and the surge in foreign exchange inflows which could lead to a build-up in liquidity.

D. Demand conditions

- Recent indicators of activity since the policy meeting in January suggest that domestic drivers of growth remain firm. Vehicle and energy sales have been strong at the start of Q1, while the latest Purchasing Managers' Index (PMI) readings continue to indicate broadly favorable conditions in the manufacturing, retail/wholesale and services sectors. Strong domestic demand is also consistent with the latest survey results of the Q4 2012 Senior Loan Officers' Survey (SLOS) which point to an increase in overall demand for loans, as reflected in the sustained expansion in private credit. Business expectations survey results for Q1 2013 suggest buoyant sentiment for the current and next quarters. Growth is also likely to be supported by election-related spending and the government's accelerated spending program.

E. Supply-side indicators

<u>Developments in Agriculture</u>

- The Bureau of Agricultural Statistics (BAS) expects palay and corn production to expand in Q1 2013 on account of increased yields and harvest area but could decline in Q2 2013 as some farmers were reluctant to plant amid expectations of dry weather conditions given pronouncements of a possible occurrence of El Niño during the year.

- Meanwhile, the MB noted that domestic rice prices have remained well behaved amid recovery of domestic production and stable global rice prices. NFA's inventory level also remained above target. Indicators also point to stable global rice prices. Nevertheless, rice importation level for 2013 should be carefully reviewed to ensure sufficient supply.

<u>Oil Price Developments</u>

- Oil prices advanced month-on-month in February after the US Fed maintained its asset-purchase program to boost the US economy. Oil prices were also higher following reports showing better-than-expected trade data in China and the US, leading to expectations of improved global economic growth and higher demand for oil.

Developments in the Utilities Sector

- The generation charge for the Meralco franchise areas declined in February 2013 due to lower rates contracted under the new Power Supply Agreements (PSAs), offsetting the increase in the rates charged by independent power producers (IPPs).

F. Financial market developments

- The PSEi pushed past the 6,400 level during the first trading days of February on the back of investor optimism over the Philippine economy, expectations of a credit rating upgrade and positive economic data from the US (with jobs and ISM factory index growing). The PSEi also rallied amid upbeat corporate earnings releases and ample market liquidity. Moreover, Asian markets were buoyant on expectations of more aggressive monetary easing led by Japan. The PSEi closed the month at another all-time high at 6,721.45 index points, 15.6 percent higher year-to-date.

- Similarly, in February 2013 the peso further strengthened to average ₱40.67/US$1, buoyed up by optimism on the country's strong growth prospects. Robust foreign exchange inflows from OF remittances, export receipts and foreign direct investments also supported the peso's strength. Nonetheless, the peso's strength was tempered by renewed concerns over the political stability in Europe.

- Meanwhile, debt spreads widened in February from the previous month's levels on worries of hot money flows towards the Asian region. The expansion in debt spreads was also caused by the lukewarm demand for fixed-income securities with investors preferring the equities market, and concerns over the electoral impasse in Italy, consequently driving bond yields up and widening spreads. In early March, the widening pressures eased on the back of strong US non-farm payrolls in February and the subsequent decline in the US unemployment rate. The improving US macroeconomic environment led to an increase in US Treasury yields, with US 10-year bonds breaching the two percent level. This boosted a "risk-on" trading of bonds like the ROPs, which, in turn, led to a decline in the country's bond yields and some tightening in debt spreads.

G. Domestic liquidity and credit conditions

- Domestic liquidity or M3 grew at a faster pace of 10.8 percent year-on-year in January 2013 from 10.6 percent in December 2012. 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. Meanwhile, net foreign assets (NFA) decreased in January, due mainly to the continued decline in banks' NFA as their foreign liabilities continued to increase due in part to higher placements and deposits made by foreign banks with their local branches, while their foreign assets contracted due to the decline in loan receivables from foreign banks.

- The growth of outstanding loans of commercial banks, net of banks' reverse repurchase (RRP) placements with the BSP, grew by 15.4 percent in January from the previous month's expansion of 16.2 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 15.6 percent in January from 16.6 percent a month earlier.

- Corporates continue to tap capital markets for financing. Corporate bond issuances for the month of January 2013 amounted to ₱84.0 million, while total equity raised in the Philippine Stock Exchange (PSE) during the same month amounted to ₱204.6 million.

H. Fiscal developments

- The fiscal deficit in 2012 was ₱242.8 billion, 22.8 percent higher than the deficit incurred in 2011. This represented 87.0 percent of the ₱279.1 billion programmed deficit for 2012. Revenue collections increased by 12.9 percent while expenditure was higher by 14.1 percent.

I. External developments

- Global economic activity has improved modestly in recent months. Recent developments suggest that the global economy, on balance, continues to stabilize. The global all-industry PMI continues to signal an expansion in economic output, underpinned by increased new businesses and improved international trade flows. Emerging markets continue to drive global economic growth. The US economy also continues to grow at a modest pace. However, market sentiment remains generally cautious amid the need for further fiscal adjustments on the horizon. Meanwhile, economic conditions in the euro area have broadly stabilized, although the broad outlook for the region remains on the downside due in part to lingering financial market uncertainty. Prospects also remain weak in Japan, prompting the Bank of Japan to pursue more aggressive monetary easing. Moving forward, global economic growth would likely remain subdued, but recent monetary policy actions by central banks in advanced economies are expected to provide ample support to economic activity.