Bangko Sentral ng Pilipinas

HIGHLIGHTS OF THE MEETING OF THE MONETARY BOARD ON MONETARY POLICY ISSUES HELD ON 1 OCTOBER 2009[1]

I. Monetary Policy Decision

The Monetary Board decided to:

a) Maintain the BSP's policy rates at 4.00 percent for the overnight RRP (borrowing) rate and 6.00 percent for the overnight RP (lending) rate;

b) Maintain the current interest rates on term RRPs, RPs, and SDAs; and

c) Maintain the current reserve requirement ratios.

The Monetary Board's decision took into consideration the BSP's latest assessment that the prevailing monetary settings remain appropriate given the continued favorable and within-target inflation outlook amidst increasing signs of economic recovery.

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

- On balance, the Monetary Board agreed that there was no compelling reason to modify the prevailing monetary settings. The inflation outlook continued to be within the target range, while both BSP and private sector surveys showed that inflation expectations remained anchored toward the target range over the policy horizon. At the same time, there were increasing signs of recovery, with real sector activity gradually normalizing, supported by household and government spending.

- The presence of continued soft spots in the macroeconomy supported the need to preserve the stimulus to economic activity. The continued

[1] The discussions presented herein 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 Advisory Committee 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 Managing Director of the Treasury Department. The highlights of the discussions on the 1 October 2009 meeting were approved by the Monetary Board during its regular meeting held on 15 October 2009. The next meeting of the Monetary Board on monetary policy issues is scheduled on 5 November 2009.

contraction in gross capital formation and manufacturing output along with the modest expansion in credit activity, suggested that the current monetary policy stance must continue to provide adequate stimulus to the real sector. Moreover, the volatility of economic indicators in advance economies highlighted the need to exercise caution in assessing the evolving global economic and financial developments.

- This need to be more circumspect with respect to any adjustment in the monetary policy stance was also prompted by the additional upside risks to the inflation outlook. Increasing signs of recovery in real sector activity indicate potential demand-driven pressures on consumer prices in the near term. Upward inflationary pressures could also stem from the extensive macroeconomic stimulus at play in advanced economies, the prevailing El Niño conditions in the Pacific area, and pending petitions to increase power rates. On the downside, inflationary pressures are expected to be dampened by the likelihood of a slow recovery in global economic activity.

III. Recent Developments in Economic Indicators

The Monetary Board's decision took into account recent developments in various economic indicators:

A. Domestic price conditions

- Headline inflation continued to fall in August, dropping to 0.1 percent year-on-year from 0.2 percent in July, the lowest in more than 22 years. This brought the year-to-date average down to 3.7 percent, well within the target range for 2009. Most major commodity groups registered lower or negative inflation rates in August.

- On a month-on-month seasonally-adjusted basis, headline inflation was 0.1 percent in August from -0.1 percent (revised) in July.

- Core inflation, which excludes specific food and energy items to measure generalized price pressures, was lower at 2.9 percent year-on-year in August from 3.6 percent in July. Likewise, all alternative core inflation measures estimated by the BSP declined. Year-on-year, the trimmed mean dropped to 1.7 percent from 1.9 percent, the weighted median to 2.2 percent from 2.9 percent, and the net of volatile items measure to 0.8 percent from 1.3 percent. Seasonally-adjusted month-on-month core inflation in August fell to 0.0 percent from 0.1 percent in the previous month.

B. Inflation Expectations

- Recent surveys showed that inflation expectations remained generally well-anchored. Relative to previous surveys, the Asia

Pacific consensus forecast for September and the BSP's survey of private sector economists for August showed lower and within-target average inflation forecasts for 2009.

- In the same direction, results of the Q3 2009 Consumer Expectations Survey (CES) reflected a marginally lower inflation expectation for the next 12 months, while the Q3 2009 Business Expectations Survey (BES) indicated a sharp decrease in the number of respondents expecting inflation to increase in the current quarter.

C. Inflation Outlook

- Emerging baseline inflation forecasts indicate that inflation would settle within the 3.5 percent $\pm$ 1.0 percentage point target range for 2009 and slightly below the low-end of the 4.5 percent $\pm$ 1.0 percentage point target range for 2010.

- While the inflation outlook continues to be within targe range, additonal upside risks have emerged: increasing signs of recovery in real sector activity, extensive macroeconomic stimulus in advanced economies, pending petitions to increase power rates, and prevailing El Niño conditions. Meanwhile, surges in world commodity prices over the policy horizon appear less likely as global economic recovery is likely to be sluggish, with the balance of risks remaining tilted to the downside.

D. Demand conditions

- Latest information shows increasing signs of stabilization in economic activity. The second quarter GDP growth came out better than expected at 1.5 percent. Various leading indicators also show that economic conditions have started to improve: capacity utilization in the manufacturing sector sustained its upward trend, energy sales continued to grow, business and consumer confidence indices had improved, and the PMI index for August suggested that economic expansion would continue.

E. Supply-side indicators

Developments in Agriculture

- Growth in the agriculture, fishery and forestry (AFF) sector slowed down to 0.3 percent in Q2 2009 from 4.9 percent in the same period a year ago. The modest growth in AFF during the period, which accounted for 16.5 percent of total GDP, was driven by fishery, banana, poultry, livestock, *palay,* and coconut including copra. Contraction in the sugarcane, forestry, corn, and other crops subsectors pulled down agricultural growth during Q2 2009.

- As of 29 September 2009, the Department of Agriculture estimates the damage to agricultural production brought by typhoon Ondoy to be about ₱3.2 billion, around 98 percent of which is accounted for by rice. In particular, initial estimated rice production loss is at 180.2 thousand metric tons, which is equivalent to about 2.8 percent of the projected rice production for Q4 2009.

- As of 25 September 2009, the country's total rice inventory stood at 2.4 million metric tons, lower than the previous month's level of 2.7 MMT but higher than the year-ago level of 1.9 MMT. The latest inventory level is sufficient to last for 67 days. Meanwhile, the contracted volume of imports for the whole year of 2009 (1.5 MMT) had arrived as of 20 August 2009. The NFA contracted an additional 75 thousand MT on 22 July 2009, 69.975 thousand MT (or 93.3 percent) of which had already arrived as of 25 September 2009 and had been included in the current national rice inventory.

- El Niño conditions are now prevailing across the equatorial Pacific Ocean. The persistence of these conditions will affect rainfall patterns in the country in the coming months and may adversely affect domestic water supply, agriculture, and day-to-day weather conditions.

Oil Price Developments

- Dubai crude oil prices were higher in August due to falling US inventories, gains in the commodities market, and tensions in Nigeria. However, oil prices decreased in September on unexpected increase in oil inventories in the US and uncertainties on the pace of its economic recovery. Prices in the futures market also decreased.

- In the domestic market, oil companies reduced the prices of gasoline and diesel by ₱1.00 per liter each on 29 September. This was the third price reduction for gasoline and the fourth for diesel during the month. This brought the year-to-date net decrease in the price of diesel to ₱0.68/liter. Unleaded gasoline, however, still posted a year-to-date net increase of ₱10.27/liter.

Developments in the Utilities Sector

- Retail electricity rates declined in August and September. Meralco reported that power rates were lower because of the start of the wet season and the relatively stable prices at the WESM.

- The ERC is set to approve the rules for the automatic recovery of monthly fuel and purchased power costs and foreign-exchange related costs of the NPC. Once the resolution becomes final, the NPC will be allowed to automatically reflect the increases or decreases in its costs of producing electricity.

F. Financial Market Developments

Government Securities Market

- Relative to their 28 August levels, the yields and term spreads (secondary market yields of GS net of overnight reverse repurchase or RRP rates) broadly increased across most tenors on 29 September. Yields increased with the decrease in bond prices, due to lingering concerns about the country's budget deficit.

Interest Rate and Interest Rate Differentials

- The differential between the BSP policy rate and the US federal funds rate remained steady in August. With the increase in the risk premium, the risk-adjusted differential narrowed in August, potentially discouraging capital inflows. However, the risk-adjusted differential subsequently widened to 117 basis points as of 15 September 2009 as the risk premium declined.

- The cumulative 200-basis-point policy rate cut of the BSP appeared to have been passed on by banks to their borrowers. Actual bank lending rates declined by 151.3 basis points during the period 8-11 September 2009 to reach 7.789 percent relative to 9.302 percent for the period 8-12 December 2008. This implies a 76 percent pass-through by banks.

Stock Market

- While the stock market index closed the month of August on a high note, the index trekked a general downtrend in September. During the first two weeks of September, trading was mixed as the index seesawed between such negative news as the rise in job cuts in the US private sector in August, the fall in the Shanghai Composite Index due to the perception that China will not meet growth expectations, and the lack of fresh news to stir local equities versus the positive developments in the local front, including the continued easing of inflation and the upward revision in the country's GDP growth targets. On the third to the fourth week of September, the PSEi was bearish as market sentiments were generally sluggish, with the PSEi moving within a tight consolidation range; while typhoon Ondoy was an added market dampener.

Foreign Exchange

- The peso weakened in early September as it reached a five-month daily low of ₱49.01/US$1 on 2 September 2009 as risk aversion continued amid heightened market concern on the health of US financial institutions.[2] Nevertheless, the peso firmed up against the US dollar by mid-September on improved risk appetite for high-yielding assets as reflected in the rally in regional stock markets. Furthermore, strong dollar inflows from OFs' remittances helped buoy the peso. On a year-to-date basis, however, the peso still depreciated by 0.1 percent against the US dollar as it closed at ₱47.52/US$1 on 29 September 2009.

Global Bond and Credit Default Swap Spreads

- Debt spreads generally tightened in September from the end-August level as growing signs of global economic recovery once again attracted investors to higher-yielding emerging market assets. The G-20's stance on maintaining economic stimulus policies and other measures in curbing bank leverage and raising the amount and quality of bank assets fueled market optimism that the worst of the financial crisis is over. The IMF's estimate that developing economies shall lead the global economy's recovery from its worst recession likewise supported the demand for emerging assets.

G. Domestic Liquidity and Credit Conditions

- Domestic liquidity or M3 continued to grow in July at a slightly faster pace of 12.9 percent year-on-year, relative to the 12.6 percent growth recorded in the previous month. On a monthly basis, seasonally-adjusted M3 growth accelerated to 1.1 percent from 0.3 percent in June. The expansion in liquidity continued to be fueled by the rise in net foreign assets (NFA) at 21.7 percent in July from 17.6 in June. This can be traced to the sustained growth in the NFA position of the BSP and of the banks at 18.1 percent and 42.8 percent, respectively. The NFA expanded as the BSP continued to build up its international reserves, supported by steady remittances from abroad, while banks repaid their foreign liabilities. On the other hand, the growth in net domestic assets (NDA) slowed down to 1.5 percent year-on-year from 3.2 percent in the previous month, due mainly to the larger decline (from -47.4 percent to -48.6 percent) in the net other items (NOI) account against the broadly steady growth (at 15.0 percent) in net domestic credit.

- Bank lending net of banks' reverse repurchase (RRP) placements with the BSP grew by 8.7 percent in July, albeit slower compared to the 14.3 percent expansion in the previous month. Outstanding loans of commercial banks, including RRPs, also grew by 2.9 percent from 11.1 percent in the previous month, to reach ₱2.1 trillion at end-July

[2] The peso last traded with a daily low of ₱49.27/US1 on 3 March 2009.

2009. On a month-on-month seasonally-adjusted basis, commercial banks' lending declined by 5.5 percent (for loans inclusive of RRPs) and by 3.1 percent (net of RRPs) in July.

- Total capital raised in the PSE for the period January-August 2009 remained significantly lower compared to the same period in 2008. Meanwhile, corporate bond issuance during the first eight months of 2009 was more than twice the level recorded in the comparable period in 2008.

H. Fiscal developments

- The January-August 2009 fiscal deficit reached ₱210.0 billion, more than six times higher than the ₱31.7 billion deficit in the comparable period last year. This represents 96.5 percent of the ₱217.6 billion programmed deficit for the first three quarters. Revenue collections declined by 6.5 percent to ₱739.1 billion in January-August 2009 compared to ₱790.3 billion for the same period last year while the cumulative expenditures for the first eight months of 2009 amounted to ₱949.1 billion, 15.5 percent higher than the disbursements in the comparable period in 2008. Excluding interest payments, total disbursements increased by 21 percent to ₱745.7 billion. Interest payments declined by 1 percent to reach ₱203.4 billion.

I. External developments

- Favorable developments, particularly the gains in manufacturing, suggest that global recovery has begun and could accelerate earlier than previously expected. Overall global economic growth, however, remains largely policy-driven.

- The rebound of the global manufacturing sector continued to accelerate in August as the JP Morgan’s Global Manufacturing purchasing managers’ index (PMI) registered an index level of 53.1, up from 50.0 in July. This is the highest reading so far in twenty-six months. Likewise, the US, China, and Japan registered further gains in manufacturing in August; and India, Hong Kong, and Taiwan also posted expansions in factory production in the same period.

- Despite the still-high degree of uncertainty, the current recession appears to be bottoming out, supported by the strong stimulus measures and improving financial conditions globally. Meanwhile, the negative base effects from last year’s price surge and the prevailing weakness in global economies continue to dampen prices. Nevertheless, current high fiscal deficits, record-low interest rates, large-scale monetary easing, and other government interventions are not sustainable: an expansion of private demand is necessary to drive the global recovery beyond the impact of the various stimuli.