Bangko Sentral ng Pilipinas

HIGHLIGHTS OF THE MEETING OF THE MONETARY BOARD ON MONETARY POLICY ISSUES HELD ON 18 NOVEMBER 2010[1]

I. Monetary Policy Decision

The Monetary Board (MB) decided to:

a) Maintain the BSP's policy rates at 4 percent for the overnight RRP (borrowing) rate and 6 percent for the overnight RP (lending) rate;

b) Maintain the current interest rates on term RRPs, RPs, and special deposit accounts (SDAs); and

c) Maintain the current reserve requirement ratios.

The MB's decision was based on its assessment that the current monetary policy settings represent a sound policy balance that is supportive of both inflation control and economic expansion.

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

- The MB's decision was based on its evaluation that inflation remained manageable, with headline inflation expected to remain at levels broadly consistent with the targets for 2010-2012. The slowdown in core inflation and inflation expectations also reflected more benign inflation readings over the policy horizon.

- Nonetheless, the MB considered the risks to the inflation outlook to be finely balanced between potential upside and downside pressures. The MB noted that the volatility of global commodity prices as well as the existing stimulus measures and quantitative easing programs in advanced economies could potentially generate inflationary pressures over the medium term.

[1] The discussions presented 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 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 18 November 2010 meeting were approved by the Monetary Board during its regular meeting held on 2 December 2010. The next meeting of the Monetary Board on monetary policy issues is scheduled on 30 December 2010.

- The favorable inflation outlook against a positive economic background suggests that current monetary policy settings remain appropriate. Economic growth is proceeding at a robust pace, underpinned by strong domestic demand. At the same time, domestic liquidity remains adequate to support economic activity given the steady uptrend in bank lending and continued improvements in domestic financial markets.

- The MB also noted that the global context seems to be more challenging as the second round of quantitative easing in the US is expected to lead to increased capital inflows into Asian markets given the still-fragile recovery in advanced economies and robust growth prospects in emerging economies. The BSP's approach to dealing with strong capital inflows appears to be on the right track thus far. It has allowed the peso to move accordingly, taking the opportunity to build up reserves, exercise moral suasion in getting the National Government and the private sector to prepay their external debt obligations, and amended its regulations on foreign exchange transactions. The recent run-up in asset prices, driven in part by strong foreign capital inflows, does not appear to pose an immediate threat to financial stability as there is limited evidence of stretched market valuations when compared to long-run averages while growth in credit and liquidity is broadly at pace with the expansion in economic activity. Nevertheless, asset price movements continue to warrant careful attention.

III. Recent Developments and Inflation Outlook

The MB considered the following developments:

A. Domestic price conditions

- Year-on-year headline inflation dropped further to 2.8 percent in October from 3.5 percent in September as most commodity groups posted lower readings. Food inflation went down due mainly to adequate supply of meat, fruits, and vegetables, despite damages caused by Typhoon Juan in a few localities. Inflation for light also went down due to improved power plant capacity, the appreciation of the peso, and seasonally low demand given cooler weather.

  Meanwhile, the impact of higher global crude oil prices on domestic pump prices of petroleum products led to higher inflation for transportation and communication services.

- The official measure of core inflation was also lower in October at 3.3 percent from 3.8 percent in September. Similarly, two of the three alternative core inflation measures estimated by the BSP declined.

B. Inflation expectations

- Various surveys continued to indicate well-contained inflation expectations over the policy horizon. The Asia Pacific consensus forecasts and the BSP's survey of private sector economists showed lower and within-target inflation forecasts for 2010 and 2011. Meanwhile, results of the Q3 2010 Consumer Expectations Survey (CES) indicated that significantly lower inflation is expected over the next 12 months. Results of the Q4 2010 Business Expectations Survey (BES) likewise indicated that the number of respondents expecting higher inflation had decreased.

C. Inflation outlook

- Average headline inflation is expected to settle within the 4.5 ± 1.0 percent target range for 2010. Forecasts for 2011 and 2012 suggest that inflation could settle below the target range of 4.0 percent ± 1.0 percentage point.

- Relative to the previous estimates, the average baseline inflation forecasts for 2010-2012 inched down. Lower actual inflation for October compared to the baseline forecast for the month contributed to the reduction in the inflation forecasts. In addition, the appreciating trend of the peso and the expected slight deceleration in liquidity growth also resulted in the downward revision in the forecasted CPI path.

- The upside risks to future inflation include a potential rebound in global food and oil prices, possible upticks in rice prices, the impact of adverse weather conditions on agriculture, petitions for electricity rate adjustments, and stronger-than-expected domestic demand that could be mitigated by improved productive capacity. The downside risks to inflation relate to the slow recovery of global growth and a sustained strengthening of the peso-dollar exchange rate which could help temper the impact of imported inflation.

D. Demand conditions

- Economic growth is expected to remain firm. Output expansion is expected to be sustained over the coming quarters with higher-frequency indicators of demand (vehicle sales, importation of consumer durables and investment goods, and volume of manufacturing output) still growing at double-digit rates while exports have continued to grow solidly in Q3. However, these demand indicators have also eased slightly from the rapid pace recorded in the early part of the year. This is consistent with the previous assessment that growth could moderate in the coming quarters, though remaining relatively strong.

E. Supply-side indicators

Developments in Agriculture

- The agriculture sector contracted in the first semester of 2010 due to the adverse effects of El Niño, particularly on the production of corn, *palay*, and sugarcane. Agricultural production is expected to register a year-on-year decline for the entire year due to the impact of weather disturbances. Typhoon Juan exacerbated the expected decline in the production of both rice and corn in 2010. Latest domestic climate reports point to the onset of a weak-to-moderate La Niña episode, which is expected to last until early 2011.

- In the international market, the projection of the Food and Agriculture Organization (FAO) for world cereal production this year was revised upward slightly from the previous update. World cereal production in 2010 is expected to be 1 percent below the 2009 level but still the third largest on record. A sharp decline in wheat and barley production due to adverse weather conditions in a number of major cereal-producing countries accounted for most of the anticipated reduction. Meanwhile, international prices of rice and corn continued to rise in September and October while prices of wheat fell in October after their rally in recent months.

Oil Price Developments

- The uptrend in Dubai crude oil's price continued in October up to early November. The surge in oil prices is linked to, among other things, the US Fed's second round of quantitative easing. Oil prices in the futures market also increased.

- Reflecting the increase in oil prices in the international market, domestic prices of unleaded gasoline, kerosene, and diesel were raised twice in November.

- Meanwhile, oil demand forecasts for 2010 were revised upward by global energy authorities on the back of a stronger-than-expected global economic growth in the first half of the year. China and other emerging market economies are expected to continue to drive demand growth. Meanwhile, the forecast growth in oil consumption for 2011 was broadly unchanged from the previous assessment.

Developments in the Utilities Sector

- Retail electricity rates were lower in October as Meralco passed on lower generation costs to consumers. The decline was due to improved power plant capacity, the appreciation of the peso, and seasonally low demand due to cooler weather. However, rates could be higher in November due to the higher settlement price at the Wholesale Electricity Spot Market (WESM) and higher rates of the National Power Corporation (NPC).

F. Financial market developments

Government Securities Market

- On 15 November 2010, T-bill rates fell significantly compared to previous auction levels. The drop in T-bill rates reflected mainly the strong market demand for government securities (GS) amid low inflation and ample liquidity in the financial system, coupled with the entry of foreign investors searching for higher yields.

- Secondary market yields were also lower across most tenors on 5 November 2010 relative to their 5 November 2009 and 30 September 2010 levels. The yields on GS in the secondary market fell across tenors given the benign inflation environment and ample market liquidity.

Stock Market

- Trading at the Philippine Stock Exchange (PSE) remained bullish, supported by the positive outlook on the economy. Investor optimism, combined with ample liquidity in the global market and investors' search for yields have led to robust trading at the Philippine stock market. In October, the market moved sideways, but with a slight upward bias, as investors were anticipating the release of more corporate earnings results in early November. The PSEi took the lead in Asian equities in October, with the index increasing at a daily average rate of 0.20 percent.

Foreign Exchange

- The peso strengthened on sustained investor risk appetite and positive domestic economic prospects. Sustained inflow of overseas remittances, along with the strong inflow of portfolio investments remained the key drivers of the peso's strength. The general weakening of the US dollar caused by the Fed's additional quantitative easing also supported the peso's appreciation. On a year-to-date basis, the peso appreciated against the US dollar by 5.7 percent as of 15 November 2010, along with other Asian currencies.

Global Bond and Credit Default Swap Spreads

- RP sovereign debt spreads remained tight compared to year-ago levels, underscoring investors' continued positive outlook on Asia's economic fundamentals. Capping the narrowing trend, however, are concerns of more capital flows in Asia given the US Fed's quantitative easing moves and the lingering uncertainty about sovereign debt issues in some euro area countries.

G. Domestic liquidity and credit conditions

- Domestic liquidity grew at a faster pace of 10.5 percent year-on-year in September from 8.6 percent in August. The faster expansion of domestic liquidity during the month can be traced mainly to continued foreign inflows and the steady uptrend in bank lending activities. Growth of net foreign assets (NFA) accelerated to 12.8 percent from 12.1 percent in August. Likewise, net domestic assets (NDA) grew at a faster pace of 5.1 percent in September relative to 4.4 percent in August due to the increase in private sector credits.

- Outstanding loans of commercial banks, net of banks' RRP placements with the BSP, continued to grow by 9.8 percent in September 2010, albeit slower than the previous month's expansion of 12.5 percent. The slower growth in bank lending, net of banks' RRP placements, can be traced to the deceleration in lending to both productive and household sectors. Loans for production activities—which comprised 81.5 percent of banks' total loan portfolio—expanded by 10.8 percent in September from 12.7 percent a month earlier. Likewise, the growth of consumer loans (which include credit card receivables and auto loans) decelerated to 8.0 percent from 15.4 percent previously.

- With the run-up in equity prices, capital-raising activity at the PSE increased significantly for the period January to October 2010. Net intercompany borrowings by local subsidiaries with parent companies were likewise higher during the first eight months of 2010 compared to the same period in 2009. Meanwhile, corporate bond issuances for the first ten months of 2010 were lower by 30.5 percent relative to the level reached in the previous year as companies turned more to the equity market to raise capital.

H. Fiscal developments

- The fiscal deficit in January-September 2010 at ₱259.8 billion represented 94.9 percent of the ₱273.7 billion programmed deficit for the first three quarters of 2010. Revenue collections accounted for 95.7 percent of the program for the first three quarters while expenditures were equivalent to 95.5 percent of the program for the same period.

I. External developments

- The global economy performed strongly in the first half of 2010 but latest indicators suggest that the pace of recovery is slowing down. Economic expansion in the US quickened in Q3 2010 but experts, including the US Fed, remained concerned about the sustainability of the recovery given tepid employment conditions. To promote a stronger pace of economic recovery and help ensure that inflation over time remained consistent with its price stability mandate, the US Fed committed to expand further its holdings of securities on 3 November 2010. Meanwhile, economic activity in the euro area grew strongly in the second quarter of 2010 but latest survey-based indicators point to a possible moderation in the third quarter. The Japanese economy also showed signs of moderate growth but the pace of recovery is slowing down. On the other hand, Asian economies continued to exhibit strong growth momentum.