HIGHLIGHTS OF THE MEETING OF THE MONETARY BOARD ON MONETARY POLICY ISSUES HELD ON 22 APRIL 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 SDAs; and

c) Maintain the current reserve requirement ratios.

The MB was of the view that current monetary policy settings remain appropriate, with inflation expected to settle within the target ranges over the policy horizon and inflation dynamics broadly unchanged.

In addition, the MB approved the reduction of the peso rediscounting budget from ₱40 billion to ₱20 billion, effective 3 May 2010.

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

- The MB's decision was based on the latest BSP baseline projections, which show that while inflation forecasts have risen somewhat, the inflation path remains within the target ranges for 2010 and 2011.

- The MB noted that current policy settings remain appropriate as the second-round effects of supply-side pressures, notably from higher energy prices, are manageable at the moment while inflation expectations are well-contained. In addition, while the global recovery

[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 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 22 April 2010 meeting were approved by the Monetary Board during its regular meeting held on 6 May 2010. The next meeting of the Monetary Board on monetary policy issues is scheduled on 3 June 2010.

is proceeding faster than expected, world economic activity remains dependent on macroeconomic stimulus policies, and therefore the self-sustaining nature of the global expansion remains to be seen.

- At the same time, the MB observed that the balance of risks to future inflation is tilted to the upside because of supply-side factors. With growth expected to improve over the policy horizon and inflows from abroad anticipated to strengthen, the Board maintained its resolve to remain vigilant against inflation pressures, ready to undertake timely and preemptive monetary policy actions to safeguard price stability.

- The MB also decided that the BSP's disengagement from crisis intervention measures should continue as economic conditions have steadily shown signs of improvement and as financial markets have remained stable.

III. Recent Developments

The MB considered the following developments:

A. Domestic price conditions

- Year-on-year headline inflation increased to 4.4 percent in March from 4.2 percent in February. Higher increases in the prices of non-food items, particularly light and transportation and communication services, accounted for the rise of inflation in March. The inflation rate of light increased with higher power rates as the ongoing El Niño phenomenon led to higher generation costs. Price hikes were also observed in transportation and communication services as increased oil prices in the international market drove up the pump prices of petroleum products in March.

- Food inflation decelerated to 3.1 percent in March from 3.8 percent in February, as the inflation rates of rice, dairy products, fish, and other food products slowed down, while corn prices contracted amid ample supply.

- Core inflation, which excludes some food and energy items to measure generalized price pressures, was also higher in March at 3.9 percent from 3.6 percent in February due mainly to increased power rates. This is indicative of the limited impact of supply-side pressures that could generate second-round effects.

B. Inflation Expectations

- Surveys continued to indicate well-contained inflation expectations for 2010 and 2011. The Asia Pacific consensus forecasts for April and the BSP's survey of private sector economists for March showed within-target inflation forecasts for 2010 and 2011.

- However, results of the Consumer Expectations Survey (CES) for Q1 2010 suggested a bigger number of respondents that expects increases in the prices of goods and services over the next 12 months. Consequently, a higher inflation number is expected by consumers over the next 12 months relative to the previous survey.

C. Inflation Outlook

- Average headline inflation is expected to settle above the middle of the 4.5 percent $\pm$ 1.0 percentage point target range for 2010 and at the lower half of the 4.0 percent $\pm$ 1.0 percentage point target range for 2011. Relative to the previous policy meeting, the latest baseline forecasts trace a higher inflation path for 2010 and 2011. The increase in the inflation forecasts was driven mainly by the effect of the March actual inflation data, higher projections for oil prices, the potential hike in jeepney fares, and the assumed 2010 wage hike implementation.

- The balance of risks to the inflation outlook is tilted to the upside due to potential inflationary pressures from supply-side factors. The impact of the El Niño phenomenon on food and electricity prices constitutes the main source of upside risks over the policy horizon. Higher-than-assumed increase in transport fares and wages, low power reserves and a possible surge in global commodity prices as recovery creates supply bottlenecks, also pose additional upside risks to the inflation outlook. Moreover, there could also be commodity price pressures from continued strong investor interest in commodity assets because of the weak dollar, and persistence of production constraints in the oil and agricultural sectors. Downside risks to the inflation outlook include the sustained appreciation of the peso which could offset the impact of imported inflation.

D. Demand conditions

- Latest demand indicators confirmed the previous assessment that demand activity is picking up: exports continued to grow since November 2009, capacity utilization in the manufacturing sector remained at historic highs, and vehicle and energy sales continued to post double-digit expansion. Furthermore, results of the first quarter CES showed improved confidence for the next 12 months.

- Meanwhile, three additional wage petitions were filed in the regional wage boards, bringing the total number of petitions to ten as of 22 April 2010.

E. Supply-side indicators

Developments in Agriculture

- As of 8 April 2010, the country's total rice inventory stood at 2.8 million metric tons (MMT), higher than the month- and year-ago levels of 2.7 MMT and 2.3 MMT, respectively. The latest inventory level is sufficient to last for 76 days. Meanwhile, about 1.3 MMT or 57.0 percent of the total NFA Council-approved volume of importation for 2010 (2.3 MMT) have arrived as of 7 April 2010.

- Rice prices were steady in Metro Manila (MM) but increased in areas outside Metro Manila (AOMM) in March. Rice prices in MM have been steady since March 2009 with continued adequacy of supply in the area, due partly to NFA intervention. The increase in rice prices in AOMM was due to higher *palay* cost with the decline in harvest due to the persistence of the El Niño weather condition.

- The El Niño episode remained moderate in strength but is still expected to last until June 2010. Water levels in major dams continued to decline, affecting the water resource for power and irrigation supply in some parts of Luzon. As of 14 April 2010, dam levels remained below the rule curve for Angat, Ambuklao, Binga, Pantabangan, Magat, and San Roque.

- In the global market, the February 2010 Crop Prospects and Food Situation Outlook of the Food and Agriculture Organization (FAO) indicated further improvement in the global cereal supply situation. Above-average production is expected to exceed consumption by a significant margin, bringing the total cereal inventory by the close of the season ending in 2010 to an 8-year high. Meanwhile, early prospects for the 2010/2011 season point to a reduction in global wheat output, reflecting smaller plantings due to lower prices and adverse weather conditions in some areas.

Oil Price Developments

- Dubai crude oil prices rose in March and in the first week of April amid optimism that fuel demand will increase with improved prospects for an economic recovery in the US, the world's biggest energy consumer. The announcement of the Organization of the Petroleum Exporting Countries (OPEC) that it will not increase oil production also contributed to the increase in oil prices. Oil prices in the futures market were also higher. The price of Brent crude oil for May 2010 deliveries increased to US$84.83 per barrel on 9 April 2010, higher by US$4.69 per barrel or 5.9 percent relative to its month-ago level of US$80.14 per barrel.

- As of 13 April, domestic retail prices of unleaded gasoline, diesel, and kerosene posted a net increase of ₱4.63 per liter, ₱3.49 per liter, and ₱2.74 per liter, respectively. Meanwhile, the price of LPG declined by ₱ 0.31 per liter during the same period.

- In the transport sector, petitions for minimum taxi and jeepney fare increases remained pending with the Land Transportation and Franchising Regulatory Board (LTFRB). The petition filed by the Philippine National Taxi Operators Association (PNTOA) on 26 January 2010 requested an increase in the flag-down rate and charge for succeeding meters and waiting time by ₱10.00 and ₱1.50, respectively. Meanwhile, some jeepney operators are requesting a minimum jeepney fare increase of ₱1.50 to be added to the existing ₱7.00.

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

- Mindanao power supply remained unstable as water supplies in major lakes and rivers throughout the island continued to suffer from El Niño. The National Grid Corporation of the Philippines noted that Mindanao, which depends on hydro power for more than 50 percent of its electricity requirement, sustained power outages due to the supply deficit. In the Visayas, power supply remained tight due to structural problems such as aging power plants that run on limited capacity and the lack of investment in new power plants. Meanwhile, the power supply situation in Luzon has normalized, due in part to the completion of the repairs of the Sual power plant.

- Electricity rates in Metro Manila went up in April due to higher generation, distribution, supply, and metering charges. The increase in generation charge was due to the shortage in electricity supply as several power plants were either generating below capacity due to the El Nino weather condition or under preventive or emergency maintenance shutdown. The increase in distribution, supply and metering charges was due to the ERC order, which allowed Meralco to adjust its charge based on the performance-based rate setting scheme. Subsequently, it is expected that the electricity bill of a Meralco residential customer that consumes 200 kwh will increase by about 18 percent month-on-month in April.

- Water rates were slightly lower in the second quarter due to the appreciation of the peso. The Metropolitan Waterworks and Sewerage System-Regulatory Office (MWSS-RO) approved the reduction in water rates through the foreign currency differential adjustments

(FCDA) for Q2 2010 by ₱0.10/m^3 and ₱0.01/m^3 for Manila Water and Maynilad, respectively.

F. Financial Market Developments

Government Securities Market

- Relative to their 8 March 2010 levels, the yields and term spreads (secondary market yields of government securities, net of overnight reverse repurchase or RRP rates) declined marginally across most tenors on 7 April 2010. The slight decline in yields was driven by the increased demand for government securities as traders sought investment avenues with the National Government's announcement that it will issue multi-currency Retail Treasury Bonds (RTBs).

Interest Rates and Interest Rate Differentials

- The positive differential between the BSP's policy interest rate and the US federal funds target rate was unchanged at 375 basis points in March 2010 as policy settings for both central banks were kept steady. Meanwhile, the risk-adjusted policy interest rate differential widened to 212 basis points as of end-March 2010 from 179 basis points in February 2010 as the risk premium tightened, thereby encouraging capital inflows.

- The real policy interest rate of the Philippines at negative 0.4 percent (preliminary as of March 2010) remained slightly above the average policy rate (adjusted for inflation) of -0.5 percent in a sample of 16 central banks.

- Actual bank lending rates declined by 224 basis points during the period 29 March-2 April 2010 to reach 7.032 percent relative to the 9.272 percent posted for the period 8-12 December 2008.

- Reflecting improved funding conditions, the spread of Philippine banks' quoted average lending rate over the 91-day RP T-bill rate in March decreased to 370 basis points, following the decline in banks' average quoted lending rate. The Philippines has the fourth lowest bank lending spread in a sample of 10 Asian countries.

Stock Market

- The Philippine stock exchange index (PSEi) peaked anew at 3,299.99 index points on 13 April 2010. The local index was supported mainly by the positive corporate earnings outlook after the BSP hinted that it may keep interest rates at record low in the first half of 2010. Expectations of higher-than-projected first quarter GDP growth on account of higher remittance inflows, consumer spending and exports growth as well as expectations of a lower budget deficit, also contributed to the surge in the PSEi. The local equity market was also buoyed by positive global developments such as the Fed's decision to hold interest rates steady along with its pledge to keep them near zero for an extended period and optimism on the European Union and the IMF's planned aid package for Greece.

Foreign Exchange

- In March 2010, the peso averaged stronger at ₱45.74/US$1 from ₱46.31/US$ in the previous month. In the first two weeks of April, the peso continued to strengthen, driven mainly by the sustained inflow of dollar remittances and the bearish US dollar. The peso's appreciating momentum also gained speed after it broke the psychological support level of ₱45.00/US$1. The rally in Wall Street following improvements in various global economic indicators also continued to spur positive investor sentiment and improved risk appetite for emerging markets' assets. The markets were also boosted by views that interest rates in the US will remain at exceptionally low levels.

Global Bond and Credit Default Swap Spreads

- In March, sovereign debt spreads tightened as the Philippine's budget deficit data for the first two months of 2010 fell in line with market expectations, calming earlier concerns that the government would overshoot deficit targets and will thus have to issue more bonds. Bond spreads tightened further after the BSP indicated that interest rates were likely to stay at current levels until the first half of 2010 along with the US Federal Reserve's accommodative monetary policy. However, the tightening of debt spreads were capped by renewed fears over Greece' ability to pay its debts. The sharp rise in China's inflation coupled with Malaysia's policy rate hikes likewise stoked fresh worries of more policy tightening in the near term that could weigh down on global growth.

- Towards the first half of April, overall sentiment remained upbeat as positive developments reined in market worries. Preliminary estimates indicated improvement in the government's tax collections for the first three months of 2010, giving investors confidence that the year ahead will extend the spread-tightening rally. However, spreads widened slightly beginning 16 April as the market reacted to reports of fraud allegations against Goldman Sachs which prompted a broad sell-off in the region's financial markets.

G. Domestic Liquidity and Credit Conditions

- Domestic liquidity or M3 growth rose to 9.9 percent year-on-year in February from 8.1 percent in January. On a monthly basis, seasonally-adjusted M3 expanded by 0.8 percent in February from a 0.2 percent decline posted in the previous month. The expansion in domestic liquidity continued to be driven by the growth in both net foreign assets (NFA) and net domestic assets (NDA). However, NFA growth decelerated to 14.0 percent from 23.2 percent in the previous month as the expansion in the NFA of the BSP moderated due to the slowdown in the growth of its foreign assets and the continued decline in its foreign liabilities. Similarly, there was a deceleration in the pace of growth in the NFA of banks as the growth in foreign assets moderated while that of foreign liabilities reversed to positive territory.

- Meanwhile, NDA growth increased by 5.9 percent, reversing the 2.9 percent decline in January. This developed following the double-digit growth in credit extended to the public sector on the back of increased lending to the National Government, which mostly took the form of investments in government securities. Credit to the private sector also continued to increase, consistent with the continued growth of bank lending.

- In particular, bank lending, net of banks' reverse repurchase (RRP) placements with the BSP, grew at a faster pace of 6.1 percent in February from the growth of 5.0 percent registered a month earlier. Outstanding loans of commercial banks including RRPs also continued to grow, albeit at a slower pace of 5.9 percent relative to the month-ago expansion of 6.9 percent. On a month-on-month seasonally-adjusted basis, commercial banks' lending in February grew by 1.2 percent for loans inclusive of RRPs, and by 1.1 percent for loans net of RRPs.

- Loans for production activities—which comprise around 80 percent of banks' total loan portfolio—grew by 5.8 percent in February from 4.4 percent a month ago. Loans to the manufacturing sector, which accounts for about 14 percent of total loans outstanding, contracted at a slower rate of 6.4 percent from 15.5 percent in the previous month.

- Meanwhile, loans for household consumption grew at a broadly steady pace of 12.0 percent at end-February from 12.5 percent in the previous month. This reflected the relative stability in the expansion of credit card and auto loans.

- Total equity raised in the PSE for the period January-March 2010 reached ₱16.9 billion, a marked improvement compared to the same period in 2009 when capital raising activity reached only ₱541 million.

- The corporate bond market remained a viable alternative source of funding. Corporate bond issuances amounted to ₱50.9 billion for the period January-March 2010, higher by 61.5 percent from the previous year's level of ₱31.5 billion. The increase was accounted for by the bond issuances of both the financial corporations (134.3 percent) and the non-financial corporations (20.8 percent).

H. Fiscal developments

- The January-February 2010 fiscal deficit reached ₱70.3 billion, higher than the ₱67.0 billion deficit incurred in the same period in 2009. This represents 63.4 percent of the ₱110.9 billion programmed deficit for the first quarter of 2010. Revenue collections increased by 6.0 percent to ₱169.0 billion in January-February 2010 compared to the ₱159.4 billion in the same period last year. It also represents 63.5 percent of the first quarter program of ₱266.3 billion. Meanwhile, the cumulative expenditures for the first two months of 2010 amounted to ₱239.3 billion, 5.7 percent higher than the disbursements in the comparable period in 2009, but lower than the first quarter program of ₱377.2 billion.

I. External developments

- The signs of a global economic recovery have become more evident: global manufacturing activity has recovered; global financial market conditions have improved steadily, and GDP growth has turned positive in a number of major economies. Nevertheless, uncertainties remain and global recovery appears fragile and uneven given high unemployment, continued deleveraging by households, and weak public finances in major economies worldwide. In addition, it remains to be seen whether recovery could be sustained beyond the fiscal and monetary stimulus measures and the inventory restocking cycle. While a high degree of uncertainty persists regarding the sustainability of future growth, risks to the global economic outlook are viewed to be broadly balanced.