Bangko Sentral ng Pilipinas

HIGHLIGHTS OF THE MEETING OF THE MONETARY BOARD ON MONETARY POLICY ISSUES HELD ON 7 OCTOBER 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's decision was based on its assessment that the economy continues to be in a situation where the goal of safeguarding inflation is compatible with helping support economic activity, as inflation remains low even as demand has strengthened.

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

- The Monetary Board's decision was based on its evaluation that current monetary policy settings continued to be appropriate as the outlook for inflation remained manageable and in line with the target ranges over the policy horizon. The latest BSP projections indicated inflation averaging within the target ranges of 4.5 ± 1 percent for 2010 and 4 ± 1 percent for 2011 and 2012. The relatively benign core inflation readings and within-target inflation expectations over the policy horizon also indicated a broadly stable trend for consumer prices going forward.

[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 7 October 2010 meeting were approved by the Monetary Board during its regular meeting held on 4 November 2010. The next meeting of the Monetary Board on monetary policy issues is scheduled on 18 November 2010.

- At the same time, the MB noted that, while incoming data have been robust and uniformly strong, it still remains to be seen whether the recent pick-up in domestic demand will lead to stronger inflation pressures for an extended period. Despite the strong output growth in the first half of 2010, inflation pressures have remained subdued. This can be traced to a number of factors, including the recent build-up of capital, which should add to the economy's productive capacity, thus tempering demand-induced price pressures. Inflation expectations also continued to be well anchored, thus moderating any upward pull on prices. In addition, global economic conditions pointed to a tepid demand recovery, keeping a lid on imported price pressures. Sustained foreign exchange inflows, which in part reflect a broader trend in capital flows in favor of emerging market economies like the Philippines, also provided a cushion to the domestic economy from imported inflation.

- Nevertheless, there are risks around the central projection coming from both supply and demand sides. These risks necessitate careful monitoring going forward to ensure that monetary policy settings continue to be appropriate.

III. Recent Developments

The MB considered the following developments:

A. Domestic price conditions

- Year-on-year headline inflation dropped to 3.5 percent in September from 4.0 percent in August as most commodity groups posted lower readings. Inflation for light went down with the reduced cost of power from the Wholesale Electricity Spot Market (WESM) while inflation for fuel declined due to lower prices of liquefied petroleum gas (LPG). Food inflation also declined in September, due mainly to lower prices of vegetables as well as chicken and pork.

- The official measure of core inflation was also lower in September at 3.8 percent from 4.2 percent in August. Similarly, all 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 Q3 2010 Business Expectations

Survey (BES) likewise indicated that the majority 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 and at about the low end of the 4.0 percent ± 1.0 percentage point target range for 2011. Forecasts for 2012 suggest that inflation could settle at the low end of the medium-term 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 slightly due largely to the inertial impact of the lower actual inflation for August and September.

- Risks to the central projection include a possible rebound in international oil prices given the continuing strong demand in emerging economies, the impact of adverse weather conditions on domestic food prices, petitions for electricity rate adjustments, and a stronger-than-expected domestic economic recovery that could induce demand-side price pressures. Meanwhile, the inflation path may be dampened by a slow recovery scenario for global growth and a possible sustained strengthening of the peso which will temper the impact of imported inflation.

D. Demand conditions

- Domestic demand conditions remained firm in the second half of 2010. Capacity utilization remained high while energy sales to the industrial sector and merchandise trade activity continued to grow robustly. Record-high consumer and business confidence also signal strong demand ahead. Meanwhile, labor demand showed initial signs of picking up, with unemployment falling in July.

E. Supply-side indicators

<u>Developments in Agriculture</u>

- 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. Through the second half of 2010, rice production is expected to increase but corn production would likely continue to contract. Agricultural production is expected to register a year-on-year decline for the entire year due to the impact of adverse weather conditions. Latest domestic climate reports point to developing La Niña conditions which are expected to strengthen in the coming months and persist until the early part of 2011.

- In the international market, projections for world cereal output in 2010 have been revised downwards by the Food and Agriculture Organization (FAO) due to adverse weather, although the level will remain the third highest on record and above the five-year average. Among the major cereals, wheat accounts for most of the cut in the latest forecast, reflecting mainly smaller harvests in the leading producers due to adverse weather conditions. Delayed planting in Thailand and flooding in Pakistan also threaten to reduce global rice supply.

Oil Price Developments

- The average price of Dubai crude oil increased further in September on expectations that the global economic recovery was strengthening following the rally in global equity markets and the release of encouraging manufacturing reports in the US and China in August.

- Oil prices in the futures market also increased. The price of Brent crude oil for November 2010 deliveries increased to US$83.75 per barrel on 1 October 2010, higher by US$7.03 or 9.2 percent relative to its month-ago level of US$76.72 per barrel.

- Reflecting the increase in oil prices in the international market, domestic prices of petroleum products, except LPG, were increased twice in September.

- Meanwhile, oil demand forecasts for 2010 and 2011 by global energy authorities were broadly unchanged from the previous assessments, with growth expected to come from countries outside of the Organization for Economic Cooperation and Development (OECD).

Developments in the Utilities Sector

- Power generation charges were lower in September, reversing the upward trend of the past three months. The decline was due to lower prices at the WESM and the lower cost of supply from independent power producers (IPPs) whose power plants were operating more efficiently.

- However, due to the adjustments in the foreign currency differential component, water rates are higher in Q4 2010. At the same time, the refund due to gains from the prepayments of dollar-denominated loans of Maynilad had already expired, raising rates further in Q4.

F. Financial market developments

Government Securities Market

- Treasury bill rates decreased during the 4 October 2010 auction compared to the levels in the 20 September 2010 auction, given the liquid market and the successful issuance by the Philippine government of the global peso notes. This development was also attributed to the benign inflation environment, steady BSP policy rates, and the market's perception of a manageable fiscal deficit by the National Government.

- Secondary market yields were also lower across most tenors on 29 September 2010 relative to their 31 August 2010 levels. Yields were markedly lower at the long end of the curve (4-10 year tenors) as market sentiment continued to be supported by the ample liquidity and the preference for longer-term maturities.

Stock Market

- Robust trading was sustained through September, with the index breaching the 4,000 mark on 16 September. The run-up in the local bourse was supported by positive economic data, including the stronger-than-expected GDP growth in the second quarter. For the period 1-28 September 2010, the PSEi was the best performing stock index in Asia, posting the highest average daily increase of 0.8 percent, followed by Jakarta (0.6 percent) and Thailand (0.3 percent).

Foreign Exchange

- The peso strengthened on sustained investor risk appetite and positive domestic economic prospects. The strong performance of Philippine sovereign bonds (driven by increased investor demand) likewise supported the peso. The peso's strength was also underpinned by the sustained inflow of remittances and strong export performance. On a year-to-date basis, the peso appreciated against the US dollar by 5.3 percent as of end-30 September 2010, moving in tandem with other Asian currencies.

Global Bond and Credit Default Swap Spreads

- Debt spreads continued to tighten in September as foreign buying in the bond market hit record levels, pushing ROP yields lower. Reports on the country's fiscal surplus in August and the robust investment inflows and remittances, which kept the Philippine balance of payments in surplus, also buoyed up market sentiment.

G. Domestic liquidity and credit conditions

- Domestic liquidity (M3) grew slower at 8.6 percent year-on-year in August from 10.2 percent in July. The slower expansion during the month was traced mainly to the lower growth of net foreign assets. Meanwhile, net domestic assets grew at a faster pace given the stronger expansion in private sector borrowing. Credits extended to the private sector rose by 10.9 percent, in line with the continued uptrend in bank lending activities which, in turn, was consistent with the strong pick-up in domestic demand.

- Nevertheless, bank lending growth, excluding banks' RRP placements with the BSP, accelerated slightly in August to 12.5 percent year-on-year from an expansion of 11.7 percent in the previous month. Loans for production activities—which comprise 84.9 percent of banks' total loan portfolio—expanded at a faster pace of 12.7 percent in August from 12.0 percent previously. Likewise, the growth of consumer loans accelerated to 15.4 percent from 12.5 percent a month earlier.

- With the run up in equity prices, capital-raising activity in the Philippine Stock Exchange increased significantly for the period January to August 2010. Net intercompany borrowings by local subsidiaries with parent companies were likewise higher during the first six months of 2010 compared to the same period in 2009. Meanwhile, corporate bond issuances for the first eight months of 2010 were lower by 33 percent relative to the level reached in the previous year.

H. Fiscal developments

- The fiscal deficit in January-August 2010 at ₱228.1 billion represented 96.1 percent of the ₱237.4 billion programmed deficit for the first three quarters of 2010. Revenue collections accounted for 84.6 percent of the program for the first three quarters while expenditures were equivalent to 86.9 percent of the program for the same period.

I. External developments

- Global economic recovery strengthened during the first half of 2010 but the strength of the upturn continued to be uneven. GDP growth in advanced economies was modest at 3.25 percent as low consumer confidence, sluggish incomes and reduced household wealth continued to hold consumption down.[2] In contrast, emerging market economies expanded by about 7.5 percent during the same period on resilient domestic demand and increased investment spending.[3]

- According to the October 2010 IMF World Economic Outlook (WEO), global economic activity is projected to grow by 4.7 percent in 2010 and 4.2 percent in 2011, broadly in line with estimates from the July 2010 WEO. Economic growth in advanced economies is expected to remain modest, with output projected to increase by 2.7 percent and 2.2 percent in 2010 and 2011, respectively. Meanwhile, growth in emerging economies is projected to be more robust at 7.0 percent in 2010 and 6.4 percent in 2011.

[2] October 2010 IMF WEO
[3] ibid