HIGHLIGHTS OF THE MEETING OF THE MONETARY BOARD ON MONETARY POLICY ISSUES HELD ON 26 AUGUST 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 current monetary policy settings continue to be appropriate given the favorable inflation profile as well as the existing balance between the economy's productive capacity and demand conditions.

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

- During its discussion, the MB considered the current monetary policy settings as appropriate, given the favorable inflation profile shown by current inflation trends, the inflation outlook, and the public's expectations about inflation. 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. Meanwhile, surveys of private forecasters showed that inflation expectations remained firmly anchored within the inflation target ranges over the policy horizon. In addition, core inflation measures suggested that underlying price pressures were not generalized.

[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 26 August 2010 meeting were approved by the Monetary Board during its regular meeting held on 16 September 2010. The next meeting of the Monetary Board on monetary policy issues is scheduled on 7 October 2010.

- At the same time, the MB took into account the higher-than-expected real GDP growth of 7.9 percent for the second quarter of 2010 and the revised first quarter 2010 real GDP growth of 7.8 percent. The MB observed that the recent strengthening of capital formation could have added to the economy's productive capacity, thus moderating additional price pressures.

- Based on these considerations, the MB noted that favorable inflation dynamics provide the flexibility to keep policy interest rates steady. The BSP's efforts to promote low and stable inflation therefore remained consistent with the maintenance of supportive conditions for domestic economic growth amid lingering uncertainty surrounding global economic growth prospects.

- The MB, however, noted that there were risks to the inflation outlook. These include the continued stronger-than-expected expansion in domestic demand and petitions for electricity rate adjustments. Meanwhile, a downside risk to inflation involves the prospect of a slower-than-expected growth in the global economy.

- Given the foregoing analysis, the MB decided to keep policy settings unchanged. The MB also noted that given the multi-speed growth dynamics, monetary policy stance needs to be tailor-fitted to individual country circumstances with careful contextualization of global and regional developments. Domestic activity had been expanding at a solid pace despite uncertainties about the global economic outlook. At the same time, the baseline or central inflation scenario remained favorable, traversing a consistent within-target path. This has allowed the BSP to keep rates steady since July 2009. In addition, the Board observed that the recent strengthening of capital formation could have added to the economy's productive capacity, thus moderating additional price pressures. Still, while the baseline inflation outlook appears benign, challenges also lie ahead, given the potential risks associated with the central projection. These necessitate careful monitoring over the months ahead to assess how the balance of these risks would evolve to ensure that monetary policy settings remain well calibrated.

III. Recent Developments

The MB considered the following developments:

A. Domestic price conditions

- Year-on-year headline inflation in July was unchanged at 3.9 percent from the previous month's inflation rate as lower non-food inflation was offset by marginally higher food inflation. The deceleration in fuel inflation brought down non-food inflation while food inflation inched up due to higher sugar prices. Rice prices also increased slightly, with the onset of the lean season.

- The official measure of core inflation was marginally higher in July at 3.9 percent from 3.8 percent (revised) in June while all the three alternative measures of core inflation estimated by the BSP declined. These suggested that underlying price pressures were not broad-based or generalized.

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 Business Expectations Survey (BES) indicated that a smaller majority of respondents expect inflation to increase. Results of the Q2 2010 Consumer Expectations Survey (CES) also indicated that a smaller majority of respondents expect increases in the prices of goods and services over the next twelve months.

C. Inflation outlook

- Average headline inflation is expected to settle within the 4.5 ± 1.0 percent target range for 2010 and the 4.0 ± 1.0 percent target range for 2011. The initial forecast for 2012 suggested that inflation could fall on the low end of the medium-term target range of 4.0 ± 1.0 percent.

- Compared with the projections in the previous policy meeting held last 15 July, the latest baseline inflation forecasts for 2010 and 2011 were slightly higher, due mainly to the estimated impact of potential cost-side shocks to inflation, particularly as a result of the prospective increase in transport fees and tollway charges. These cost-push factors are not expected to create permanent and appreciable shifts in the long-run inflation path through 2012.

- Risks to the inflation outlook include a stronger-than-expected recovery of the domestic economy and pending petitions for electricity rate adjustments. Meanwhile, the downside risks involve the possibility of slower-than-expected growth in the global economy which could dampen imported price pressures in the near term.

D. Demand conditions

- The latest available information suggested that domestic demand conditions remained solid. GDP growth in Q2 2010 accelerated to 7.9 percent, higher compared to the revised 7.8 percent growth in Q1

2010 and 1.2 percent in Q2 2009. Other leading economic indicators also pointed to the likelihood of sustained output growth. Capacity utilization remained high while energy sales to the industrial sector continued to grow robustly. Moreover, business confidence continued to rise while consumer sentiment remained positive over the period ahead. In the property sector, demand for commercial space continued to pick up, driving down vacancy rates and pushing up rental rates in the central business district. Meanwhile, five more regions were set to implement increases in minimum wages in August.

E. Supply-side indicators

Developments in Agriculture

- Latest data from the Bureau of Agricultural Statistics showed that the agriculture sector contracted in the first semester of 2010, part of the adverse effects of the El Niño episode. Through the second half of 2010, the forecast for agricultural production also remained unfavorable. Palay output for Q3 2010 was projected to decline as farmers' planting intentions were scaled down because of unfavorable weather conditions. For corn, the impact of the dry spell on farmers' planting intentions resulted in a decline of forecast production in the third quarter of 2010.

- In the international market, early indications pointed to near-record high world production of cereals for 2010-2011, a modest increase in world trade, and a fairly comfortable cereal supply and demand outlook. In fact, international cereal prices remained under downward pressure for most of the first half of 2010.

- However, global prices of corn and wheat rebounded in July. Adverse weather conditions in the top wheat-exporting countries curbed the outlook for harvests this year while corn prices rose on speculation that demand from livestock producers will increase due to rising wheat prices combined with the expected decline in global wheat production.

- Nevertheless, international rice prices remained on a downtrend. In the domestic market, rice prices in Metro Manila were steady due partly to NFA intervention while rice prices in areas outside Metro Manila reflected mixed trends with the onset of the lean season.

- Latest climate reports indicated early stages of La Niña. The episode will likely continue until early 2011.

Oil Price Developments

- Dubai crude oil prices averaged slightly higher in August relative to July due to some positive manufacturing reports in the US and euro zone. However, price movements remained generally sluggish as subsequent reports from the US and China showed signs of a slowing global economic recovery. Likewise, due to market concerns on the pace and strength of the global economic recovery, oil prices in the futures market also decreased. Reflecting the recent downward movement of prices in the international market, domestic prices of petroleum products were lower in August.

Developments in the Utilities Sector

- Contrary to expectations of lower power rates due to the onset of the rainy season, higher cost of purchases from the Wholesale Electricity Spot Market (WESM) led to higher electricity rates in August. In the months ahead, it is expected that, with the onset of the rainy season, power supplied by hydroelectric power plants will increase. This could help ease prices in the WESM which have remained high since February 2010.

- Meanwhile, there were several pending petitions for adjustments in power rates that could become potential sources of upside risks to inflation. These include Meralco's petition to increase its retail electricity charges in 2011, the Power Sector Assets and Liabilities Management's petition to recover stranded contract cost and debts of the National Power Corporation (NPC), and the NPC's petition to recover actual and incremental fuel, independent power producers, and foreign exchange rate fluctuation costs.

F. Financial market developments

Government Securities Market

- Treasury-bill rates increased generally in the primary market on concern over the National Government's growing fiscal deficit. Meanwhile, yields in the secondary market fell across most tenors, particularly at the longer end of the curve as market sentiment was supported by the favorable inflation outlook.

Interest Rates and Interest Rate Differentials

- The differential between the BSP policy rate and the US federal funds rate was unchanged in June 2010, but the risk-adjusted differential widened, reflecting a decline in risk aversion.

- In July, the real policy interest rate of the Philippines at 0.10 percent was above the average policy rate of -0.7 percent in a sample of 16 central banks.

Stock Market

- Market sentiment in July 2010 was generally mixed, with the Philippine Stock Exchange index (PSEi) moving upward within a narrow range. However, trading turned more robust in August on the back of renewed optimism over the country's growth prospects. Positive market sentiments over the region's strong growth performance also kept Asian stocks upbeat in August.

Foreign Exchange

- The peso strengthened on sustained investor risk appetite and positive domestic economic prospects. Year-to-date, the peso appreciated by 2.6 percent as of 20 August 2010.

Global Bond and Credit Default Swap Spreads

- Debt spreads generally eased in July and in the first three weeks of August. The affirmation by Fitch of the stable rating for Philippine foreign currency-denominated debt papers and the benign inflation environment supported the narrowing of the country's debt spreads.

G. Domestic liquidity and credit conditions

- Domestic liquidity grew by 10.3 percent year-on-year in June, broadly similar to the previous month's growth of 10.7 percent. On a monthly basis, seasonally-adjusted M3 growth decelerated to 0.3 percent in June from 2.2 percent (revised) in the previous month. The expansion in domestic liquidity continued to be driven by the sustained growth in net foreign assets (NFA).

- Consistent with improving aggregate demand conditions, banks' lending activities continued to expand. Bank lending, net of banks' reverse repurchase (RRP) placements with the BSP, grew at a faster pace of 9.6 percent in June from the growth of 8.1 percent a month earlier. The growth of loans for production activities—which comprise around four-fifths of commercial banks' total loan portfolio—accelerated to 9.3 percent in June from 7.9 percent a month earlier. Similarly, loans for household consumption (credit card, auto loans, and others) expanded at a faster pace of 13.0 percent from 10.3 percent in May.

- The results of the Q2 2010 Senior Bank Loan Officers' Survey indicated that banks had basically unchanged credit standards for the fifth consecutive quarter since Q1 2009. However, using the diffusion index, the survey results indicated less tightening in credit standards for loans to enterprises. For loans to households, there was a further net tightening, due mainly to a decline in banks' risk tolerance for all types of loans to consumers.

- As economic prospects improved, capital-raising activity in the Philippine Stock Exchange increased significantly for the period January to July 2010. Net intercompany borrowings by local subsidiaries with foreign/parent companies were likewise higher during the first five months of 2010 compared to the same period in 2009. Meanwhile, corporate bond issuances for the first seven months of 2010 were lower by 35.0 percent relative to the level reached in the previous year.

H. Fiscal developments

- The fiscal deficit in January-June 2010 was ₱196.7 billion, 28.2 percent higher than the ₱153.4 billion deficit incurred in the same period in 2009. This represents 135.5 percent of the ₱145.2 billion programmed deficit for the first semester of 2010. The major sources of overspending were the fast-tracking of infrastructure projects, implementation of activities to mitigate the effects of El Niño, release of election-related subsidy to LGUs, and frontloading of funds for the 2010 Census of Population and Housing. Subsidies to GOCCs also contributed to overspending during the period.

I. External developments

- The global economy continued to recover during the review period, but the strength of the upturn remained uneven across countries. While most emerging economies recorded vigorous economic growth, the momentum in most advanced economies remained subdued. The uneven growth pattern was also reflected in divergent inflationary pressures across regions, although global price pressures continued to be muted overall.