BANGKO SENTRAL NG PILIPINAS

HIGHLIGHTS OF THE MEETING OF THE MONETARY BOARD ON MONETARY POLICY ISSUES HELD ON 29 DECEMBER 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 current monetary policy settings remained appropriate as inflation forecasts continued to be within the target ranges for 2011-2012 while inflation expectations remained consistent with the medium-term inflation target.

The MB also agreed that communications with the public should emphasize the BSP's vigilance against any emerging upside risks to the inflation outlook and that appropriate policy adjustments will be carried out as and when needed to ensure that future inflation remains consistent with the medium-term target and supportive of sustainable economic growth.

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

- The MB's decision was based on its evaluation that the prevailing inflation outlook remained favorable as headline inflation is expected to track a target-consistent path over the policy horizon. Emerging baseline forecasts indicate that inflation would settle within the target ranges of 4.5 ± 1 percent for 2010 and 4 ± 1 percent for 2011 and 2012. In addition, inflationary pressures are expected to remain manageable, supported by well-contained inflation expectations.

- The MB likewise noted that foreign capital inflows do not currently appear to pose any significant short-term challenge to the economy while growth in credit and liquidity are broadly at pace with economic activity.

[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 29 December 2010 meeting were approved by the Monetary Board during its regular meeting held on 20 January 2011. The next meeting of the Monetary Board on monetary policy issues is scheduled on 10 February 2011.

- On balance, the favorable inflation outlook continues to provide space for keeping current policy settings unchanged for the time being. Nevertheless, the MB recognized that possible inflation pressures could still come from generally higher global food and oil prices as well as the approved increase in tollways fees and impending public transport fare hikes. In addition, while the rebound in investment is likely to add to productive capacity, leading to higher potential output over the medium term, a stronger momentum in demand growth may add to inflationary pressures in the short term.

III. Recent Developments and Inflation Outlook

The MB considered the following developments in coming up with its policy decision:

A. Domestic price conditions

- Headline inflation rose slightly in November, reflecting higher prices of electricity and petroleum products. Year-on-year headline inflation increased to 3.0 percent in November from 2.8 percent in October. Electricity prices went up in November with the higher cost of power from the National Power Corporation (NPC) and the Wholesale Electricity Spot Market (WESM). The impact of higher global crude oil prices on the domestic pump prices of petroleum products led to higher inflation for transportation and communication services.

  Meanwhile, food prices were generally stable, particularly for meat and rice.

- The official measure of core inflation was also slightly higher in November, driven mainly by the spike in electricity prices. Core inflation increased to 3.5 percent in November from 3.3 percent in October.

- With the year-to-date average inflation at 3.8 percent as of November 2010, average inflation is expected to be within target for 2010.

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 within-target inflation forecasts for 2010-2011. Results of the Q4 2010 Business Expectations Survey (BES) likewise indicated that the number of respondents expecting higher inflation had decreased. Meanwhile, results of the Q4 2010 Consumer Expectations Survey (CES) showed that higher inflation is expected over the next 12 months.

C. Inflation outlook

- Inflation is expected to settle within the 4.5 percent ± 1.0 percentage point target range for 2010. Latest baseline forecasts also indicate that the 2011 and 2012 inflation would be within the target range of 4.0 percent ± 1.0 percentage point.

- Relative to the previous estimates, the average baseline inflation forecasts for 2011-2012 are higher. The higher actual inflation for November compared to the baseline forecast for the month contributed to the increase in inflation forecasts. In addition, the forecasted stronger output growth and liquidity expansion, as well as higher oil prices, also contributed to the increase in the current forecast. The latest baseline forecasts also incorporated the 2-peso increase in the price of NFA rice.

- The upside risks to future inflation include a potential rebound in oil prices given the continuing strong demand by emerging economies, additional increase in rice prices, potential increase in the price of other non-oil commodities, the impact of adverse weather conditions on agriculture, petitions for electricity rate adjustments, and a stronger-than-expected domestic economic recovery that could induce demand-side price pressures. 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

- Despite the recent slowdown in industrial production and the drop in agricultural production, the underlying growth momentum continues to be robust. The deceleration is not surprising as the partly inventory-driven rebound in global trade in the first half of 2010 has been moderating. However, domestic demand momentum remains relatively strong. Leading indicators of demand (vehicle sales, energy consumption, and exports) continue to grow at double-digit rates. However, these demand indicators have also eased slightly from the rapid pace recorded in the early part of the year. Meanwhile, capacity utilization in manufacturing and measures of business and consumer confidence posted record highs in the fourth quarter.

E. Supply-side indicators

<u>Developments in Agriculture</u>

- Latest data showed a sustained contraction in agricultural production in the third quarter, reflecting the lingering impact of the El Niño, particularly on the production of *palay*, corn, and sugarcane. Consequently, the Bureau of Agricultural Statistics (BAS) revised downwards its forecast for *palay* production for 2010 and warned of a possible reduction in the fourth quarter output after Typhoon Juan hit Northern Luzon and damaged standing crops in October. Latest weather reports indicated that a moderate La Niña episode remains in effect across the tropical Pacific and is expected to persist until May 2011.

- In the international market, cereal prices, in general, continued to rise in November as global supplies tightened due to adverse weather conditions. In November, the projection of the Food and Agriculture Organization (FAO) for world paddy production for 2010 was revised downward but was still expected to be 2.0 percent above the 2009 harvest. Much of the revision reflected dimmer prospects in Asia, where a combination of droughts and floods has affected crops since the onset of the season.

<u>Oil Price Developments</u>

- The average price of Dubai crude oil increased further in November as the dollar weakened following the US Fed's second round of quantitative easing. Oil prices in the futures market also increased.

- 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.

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

- In the transport sector, the Toll Regulatory Board (TRB) is set to implement higher toll rates in January 2011.

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

- After increasing in November, retail electricity rates were lower in December due to the lower price of electricity in the WESM, which offset the slightly higher prices from other suppliers. Meanwhile, there were advance reports that the Energy Regulatory Commission (ERC) has directed the NPC to reduce its rates to reflect the impact of foreign exchange movements.

F. Financial market developments

<u>Government Securities Market</u>

- T-bill rates fell significantly during the last auction on 30 November 2010 compared to the 15 November 2010 auction levels as market investors hastened to park their excess funds in government securities. Ample market liquidity, favorable inflationary expectations, and renewed market risk aversion arising from Europe's debt woes likewise contributed to the drop in the interest rates.

- Secondary market yields and term spreads were generally lower across all tenors on 20 December 2010 relative to their 18 December 2009 and 30 November 2010 levels. The yields on GS in the secondary market fell across tenors given ample market liquidity, a benign inflation environment and positive sentiment following the results of the recent T-bill auction and the government's swap of shorter-dated peso bonds with bonds due in 10 and 25 years.

Stock Market

- Activity in the Philippine stock market turned bearish in November 2010, with the Philippine stock exchange index (PSEi) declining sharply month-on-month. The 30-stock composite index breached the 4,300-mark in early November over market positioning ahead of the release of third-quarter earnings results, the continued decline in inflation, and the positive outlook for the Philippine economy. However, towards the end of the month, the index was pulled down by the lower-than-expected third quarter GDP growth. Nevertheless, the index rallied in early December, with bargain hunting and strong gains in Wall Street boosting the index higher.

  In the near term, a positive bias is expected as investors position for the seasonal year-end window dressing. However, the market remains vulnerable to external developments. Uncertainty over Europe's lingering debt problems, remaining tensions between South Korea and North Korea, and the continued slow pace of the US economic recovery will continue to influence the market's performance in the coming months.

Foreign Exchange

- For the most part of December 2010, the peso depreciated as concerns on Europe's debt crisis lingered, fueled by the downgrade of Ireland's credit rating. Tensions in Korea likewise boosted demand for the dollar. On the local front, the slowdown in economic growth to 6.5 percent in the third quarter from 8.2 percent previously also weighed on the peso. However, the sustained inflow of OF remittances and foreign direct investments tempered the further weakening of the peso.

Global Bond and Credit Default Swap Spreads

- In November, RP sovereign debt spread movements were mixed due to the heightened risk of conflict in the Korean peninsula which affected the demand for emerging market's riskier assets, and led to a widening in debt spreads. In December, however, debt spreads started to ease on the back of improving employment data from the US, Japan, and Australia. Spreads narrowed further following President Obama's announcement to extend tax cuts to sustain the recovery in the US coupled with the Fed's decision to buy more securities to boost growth. The better-than-expected Chinese manufacturing and US housing data as well as the ECB's extended loan program also bolstered confidence on the global economic recovery. However, concerns over China's possible rate hike and Ireland's credit rate cut tempered investor risk appetite for emerging market assets.

G. Domestic liquidity and credit conditions

- Domestic liquidity grew at a slower pace of 7.7 percent year-on-year in October from 10.5 percent in September. The deceleration during the month can be traced to the slowdown in the growth of net foreign assets (NFA), driven mainly by the decline in banks' NFA position, which offset the growth of the BSP's NFA position. Similarly, the expansion in net domestic assets (NDA) decelerated in October as growth in credits extended to the public sector slowed down.

- Outstanding loans of commercial banks, net of banks' reverse repurchase (RRP) placements with the BSP, continued to expand in October, albeit at a slower pace of 8.4 percent from the 9.8 percent posted in the previous month. The slower growth in bank lending, net of banks' RRP placements, can be traced to the deceleration in lending to productive sectors. Loans for production activities—which comprised 81.9 percent of banks' total loan portfolio—expanded by a slower rate of 9.4 percent from 10.8 percent a month earlier. By contrast, the growth of consumer loans (which include credit card receivables and auto loans) rose to 8.9 percent from 8.0 percent previously.

- With the run-up in equity prices, capital-raising activity at the PSE increased significantly for the period January to November 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 eleven months of 2010 were lower by 23 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-November 2010 was ₱269.8 billion, 1.0 percent lower than the ₱272.5 billion deficit incurred in the same period in 2009. This represented 83.0 percent of the ₱325.0 billion programmed deficit for 2010. Revenue collections increased by 8.1 percent to ₱1,104.8 billion (or 85.4 percent of the 2010 program) in the first eleven months of 2010 compared to ₱1,021.7 billion in the same period last year. Expenditures for January-November 2010 amounted to ₱1,374.6 billion, 6.2 percent higher than the disbursements in the comparable period in 2009, and representing 84.9 percent of the 2010 program.

I. External developments

- The global economic recovery continued in Q3 2010. Both the US and Japan grew stronger than expected during the quarter. Likewise, the expansion remained robust in emerging economies, despite some moderation observed in recent months. Leading indicators suggest that the global economic recovery will hold steady in the near term amid still lukewarm employment conditions and slowing external demand. Meanwhile, inflationary pressures remained subdued in advanced economies but intensified somewhat in dynamic emerging markets, leading some central banks in these economies to raise policy rates.