Bangko Sentral ng Pilipinas

HIGHLIGHTS OF THE MEETING OF THE MONETARY BOARD ON MONETARY POLICY ISSUES HELD ON 17 DECEMBER 2009[1]

I. Monetary Policy Decision

The Monetary Board decided to:

a) Maintain the BSP's policy rates at 4.00 percent for the overnight RRP (borrowing) rate and 6.00 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 Monetary Board's decision was based on its view that current monetary policy settings remained appropriate as inflation forecasts continued to be within the target ranges over the policy horizon with underlying demand and supply pressures generally muted.

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

- The Monetary Board agreed that the current monetary policy settings remained appropriate given the prevailing assessment of future price and output conditions.

- Inflation forecasts continued to follow a target-consistent path over the policy horizon, with latest projections indicating that inflation would settle below the middle of the target ranges for 2010 and 2011. Inflation expectations also appeared to be well contained.

- Demand-based pressures, as evident from the relatively stable core inflation and soft labor market conditions, remained limited.

[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 17 December 2009 meeting were approved by the Monetary Board during its regular meeting held on 7 January 2010. The next meeting of the Monetary Board on monetary policy issues is scheduled on 28 January 2010.

- The Board also considered the latest assessment on the risks to the inflation outlook which points to increasing supply-side price pressures due to:

  - a possible resurgence in global commodity prices;
  - prevailing El Niño phenomenon which could add pressure to domestic food prices;
  - potential increase in international rice prices due to the expected higher demand from the Philippines and India; and
  - increases in domestic power costs in the offing due to pending NPC petitions for cost recovery.

- Upside risks to the inflation outlook could also come from the extensive macroeconomic stimulus and other policy measures undertaken by advanced economies.

- Meanwhile, recent demand and credit indicators affirmed the earlier assessment that growth in economic activity would be subdued, keeping price pressures in check over the near term. Macroeconomic conditions remained fragile as seen in the uneven performance of the aggregate demand components.

  - The expansion in aggregate consumption was driven largely by consumer and government spending, while private capital formation and exports contributed negatively to growth.

- Reflecting the relatively weak economic growth trajectory, bank lending, particularly in credit-intensive sectors such as manufacturing, expanded quite modestly despite the substantial easing of banks' lending rates.

- In addition, the appreciation of the peso resulting from foreign exchange inflows could temper the increase in domestic prices of imported commodities while the reduction in the system loss cap could temper electricity costs going forward.

- The Board reiterated its support for non-monetary government measures to promptly address supply-side price pressures. While the favorable inflation forecasts over the policy horizon and supply-side-driven risks to the inflation outlook do not warrant a monetary policy response, managing the risks to inflation expectations continue to be a key policy priority.

III. Recent Developments in Economic Indicators

The Monetary Board's decision took into account recent developments in various economic indicators:

A. Domestic price conditions

- Headline inflation rose to 2.8 percent year-on-year in November from 1.6 percent in October with the year-to-date average reaching 3.2 percent, well within the 2009 target range of 2.5-4.5 percent.

- The uptick in inflation was due mainly to the increase in the inflation rates of specific food items—notably fruits and vegetables, rice, and meat. Fuel inflation, which had been negative for almost a year, moved to positive territory during the month, while, the inflation rate of transportation and communication services remained negative.

- Core inflation was unchanged from the October level of 2.7 percent year-on-year.

B. Inflation Expectations

- Recent surveys showed that inflation expectations showed well-anchored average inflation forecasts for 2009 and 2010. Results of the BSP's survey of private sector economists as well as the Asia Pacific consensus survey for November 2009 yielded within-target inflation forecasts for 2009 and 2010.

- Meanwhile, results of the Q4 2009 Consumer Expectations Survey (CES) showed a smaller majority of respondents expects increases in the prices of goods and services over the next 12 months. However, the Q4 2009 Business Expectations Survey (BES) indicated that more respondents expect inflation to rise in the current quarter.

C. Inflation Outlook

- The latest baseline inflation forecasts indicated that inflation would settle below the middle of the 2009-2010 inflation target ranges.

- The widely-held assessment is for commodity prices to increase moderately in the future given the outlook of a gradual global economic recovery, sufficient commodity inventories, higher world oil production, and favorable production prospects for cereals as a whole. However, upside risks to commodity prices have heightened since the last policy meeting. These include: the possible resurgence in global commodity prices following some signs of global recovery, the sustained weakening of the US dollar, and the persistence of supply tightness in key agricultural sectors due to adverse weather conditions. Upside risks to the inflation outlook such as the prevailing El Niño weather conditions, and higher-than-anticipated adjustments in domestic oil prices, transport fares, and utility rates also remain.

- Meanwhile, downside risks to the inflation outlook include a stalled economic recovery and its likely downward pull on commodity prices, and a sustained strong inflow of foreign exchange.

D. Demand conditions

- The latest national income accounts (NIA) data indicate that, while the Philippine economy is on a growth trajectory, the recovery has been relatively moderate. Household consumption and stimulative spending of the government remained at the helm of economic expansion. Meanwhile, capital formation and exports continued to be weighed down by tepid global demand which was also reflected in the sustained drop in industrial output.

E. Supply-side indicators

Developments in Agriculture

- NIA data showed that the growth in agriculture, fishery and forestry (AFF) slowed down to 1.6 percent in Q3 2009 from 2.5 percent in the same period a year ago. The modest growth in AFF during the period was driven mainly by corn, *palay*, poultry, and coconut, including copra.

- P*alay* production for Q4 2009 is expected to decline by 11.3 percent due mainly to damages brought by typhoons “Pepeng,” “Ramil,” and “Santi.” However, *palay* production for Q1 2010 is expected to surpass Q1 2009’s, driven mainly by replanting of typhoon-damaged areas, availability of seeds, and the fertilizer subsidy.

- Corn production for Q4 2009 is forecast to grow by 5.2 due mainly to increased area harvested and improved yield. For Q1 2010, corn harvest is expected to be lower due to unfavorable weather conditions and lower profitability in corn farming.

- As of 28 November 2009, the country's total rice inventory stood at 2.37 MMT, lower than the month-ago and year-ago levels of 2.45 MMT and 2.94 MMT, respectively. The latest inventory level is sufficient to last for 66 days.

- While rice prices were steady in Metro Manila (MM), they increased in areas outside Metro Manila (AOMM) in November 2009, driving the national average up. The increase in rice prices in AOMM was mainly due to the lower supply from the ongoing harvest which was affected by the recent tropical storms.

- In international markets, the prices of rice from Vietnam, Pakistan and the US increased in October due to the recovery of Asian demand and the expected reduction of global export supply. In November, the Thai benchmark export price reached US$590 per ton, 10.3 percent higher than the October average.

- Conditions in the equatorial Pacific remain indicative of a weak-to-moderate El Niño. Latest observations suggest a slight strengthening of the phenomenon.

<u>Oil Price Developments</u>

- Dubai crude oil prices were higher in November on falling US oil inventory and better economic outlook. The spot price of Dubai crude oil was higher by US$4.57 per barrel in November at US$77.72 per barrel from US$73.15 per barrel in October.

- However, prices in the futures market decreased slightly following reports of larger-than-expected build-up in US crude and gasoline stocks for the week ending 2 December. The price of Brent crude oil for January 2010 deliveries decreased slightly to US$78.36 per barrel on 3 December 2009 from its month-ago level of US$78.94 per barrel.

- In the domestic market, oil companies reduced the prices of gasoline by ₱0.50 per liter and of kerosene and diesel by ₱1.00 per liter each on 15 December. Meanwhile, the price of LPG remained at its 24 November level when it rose by ₱0.94 per liter. This brought the year-to-date net increase in the price of unleaded gasoline, diesel, and kerosene to ₱13.27/liter, ₱4.43/liter, and ₱3.39/liter, respectively.

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

- After six consecutive months of rate reductions, retail electricity rates in Metro Manila increased month-on-month due to higher cost of power from suppliers and higher fuel cost. Nonetheless, retail electricity rates were still generally lower on a year-on-year basis for the seventh consecutive month in November.

- The system loss cap for distribution utilities (DUs) will be reduced effective January 2010 which could help lower electricity rates. The ERC has set the system loss cap for DUs at 8.5 percent from 9.5 percent.

F. Financial Market Developments

Government Securities Market

- Relative to their 30 October levels, the yields and term spreads (secondary market yields of GS net of overnight RRP rates) generally decreased across most tenors on 4 December. Yields decreased due to the strengthened market expectations that the BSP will keep its key policy rates steady well into 2010.

Interest Rate and Interest Rate Differentials

- The differential between the BSP policy rate and the US federal funds rate remained steady in November 2009. With the increase in the risk premium, the risk-adjusted differential narrowed in November 2009, discouraging potential capital inflows.

- The cumulative 200-basis-point policy rate cut of the BSP from 18 December 2008 to 9 July 2009 appeared to have been passed on by banks to their borrowers. Actual bank lending rates declined by 213.4 basis points during the period 23-27 November 2009 to reach 7.138 percent from 9.272 percent for the period 8-12 December 2008.

Stock Market

- Trading at local bourse exhibited mixed trends in December. The Philippine Stock Exchange Index (PSEi) breached the new resistance level of 3,100 on 2 December and settled at 3,120.0 index points. However, in the second week, the PSEi decreased marginally, due to the negative sentiment following the declaration of martial law in Maguindanao.

Foreign Exchange

- The peso strengthened in the first week of December 2009 due to the strong foreign exchange inflow from OF remittances ahead of the coming holiday season. On a year-to-date basis, the peso appreciated by 2.9 percent against the US dollar on 15 December 2009. The peso's appreciation is in line with the movements of other regional currencies which strengthened against the US dollar due to increased risk appetite for higher-yielding assets.

Global Bond and Credit Default Swap Spreads

- Debt spreads tightened in the first week of December as Dubai World began talks to restructure less than half of its debt. China's significant growth in its manufacturing sector likewise provided support for the market and the higher commodity prices added to optimism that a recovery in developing economies will be sustained.

G. Domestic Liquidity and Credit Conditions

- Demand for money strengthened in October as domestic liquidity or M3 growth accelerated to 12.5 percent year-on-year (y-o-y) from 11.6 percent in September. The steady rise in net foreign assets (NFA) which is associated with strong inflows from OF remittances continued to drive the expansion in domestic liquidity.

- Bank lending net of banks' reverse repurchase (RRP) placements with the BSP grew by 4.7 percent in October, slower compared to the 5.9 percent expansion in September. Outstanding loans of commercial banks, including RRPs, also grew by 2.6 percent compared to 6.1 percent in the previous month. The modest expansion in bank lending reflected moderate demand due to the still weak economic activity.

- Total equity raised in the PSE reached ₱7.5 billion for the period January-October 2009, around one-third of the level reached in the same period last year. Equity raised by both financial and non-financial corporations decreased significantly by 51.8 percent and 87.6 percent, respectively.

- Corporate bond issuances amounted to ₱262.0 billion for the first ten months of 2009, more than double the previous year's level at ₱104.3 billion. Non-financial corporations accounted for the bulk of the bond issues at ₱190.7 billion.

H. Fiscal developments

- The January-October 2009 fiscal deficit reached ₱266.1 billion, already exceeding the ₱250 billion programmed deficit for full year 2009. Revenue collections declined by 4.8 percent to ₱925.4 billion in January-October 2009, while the cumulative expenditures at ₱1,191.5 billion was 15.1 percent higher than the disbursements in the comparable period in 2008. Fiscal authorities expect a "worst case" deficit scenario of ₱300 billion at the end of 2009 if revenue collections do not improve and the privatization of some state-owned assets does not push through as planned.

I. External developments

- Survey indicators as well as hard data have been reinforcing the view that the world economy is starting to grow again. Inflation rates generally remained negative, resulting mostly from base effects from the previous years' surge in commodity prices as well as due to the presence of spare capacity. Although there is still some uncertainty with respect to the global economic outlook, the consensus view is that the risks to the global economic outlook are now broadly balanced.