HIGHLIGHTS OF THE MEETING OF THE MONETARY BOARD ON MONETARY POLICY ISSUES HELD ON 10 FEBRUARY 2011[1]

I. Monetary Policy Decision

The Monetary Board (MB) decided to:

a) Maintain the BSP's policy interest 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 MB also agreed that communications with the public concerning the monetary policy stance should emphasize that the BSP remains vigilant against emerging upside risks to the inflation outlook and that appropriate policy adjustments will be carried out to ensure that future inflation and inflation expectations remain 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 assessment that there is sufficient latitude to keep monetary policy settings unchanged for the time being given the within-target inflation path, manageable inflation expectations and thus far limited evidence of second-round effects.

- The latest baseline inflation forecasts remain within the target range of 4.0 percent ± 1.0 percentage point for 2011-2012. However, compared with the projections in the previous policy meeting held on 29 December 2010, the most recent forecasts are higher for both 2011 and 2012. The upward adjustment in the forecast path for 2011 is due partly to higher-than-forecast inflation in December 2010 and January 2011, as well as to the sharp increase in oil prices.

[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 10 February 2011 meeting were approved by the Monetary Board during its regular meeting held on 24 February 2011. The next meeting of the Monetary Board on monetary policy issues is scheduled on 24 March 2011.

- Nevertheless, the MB noted that the inflation impetus thus far remains manageable, the evidence of second-round effects is limited, and credit and money growths remain moderate.

- However, the MB believed that the balance of risks to the inflation outlook has tilted further to the upside. Factors which could cause an upward shift in the inflation path include a sustained uptrend in oil prices, additional increases in rice prices, further increases in the global price of non-oil commodities, the impact of adverse weather conditions on agricultural output, and petitions for electricity rate increases. Meanwhile, a weaker global recovery could dampen external demand while a sustained strengthening of the peso could help temper the impact of imported inflation.

- The MB noted further that developments in global commodities suggest a continued uptrend in prices. In addition, the MB observed that conditions are ripe for rising inflationary pressures should the global economic recovery become more synchronized amid tight global supply response. The main challenge for the near term will be to contain the impact of continued cost-push pressures on wage- and price-setting behavior. Second-round effects from cost-push factors need to be monitored closely given the expected increases in the prices of certain basic goods.

III. Recent Developments and Inflation Outlook

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

A. Domestic price conditions

- Year-on-year headline inflation in January 2011 increased to 3.5 percent from the December 2010 level of 3.0 percent. Higher inflation in January was traced mainly to higher prices of food and energy items. These, in turn, were linked to increased prices in the international market in the case of petroleum products, and the impact of domestic weather conditions in the case of food items such as fish and fruits and vegetables. Higher energy distribution costs also contributed to the higher inflation rate for the month. These factors represent supply-side pressures on prices which, if sustained, could subsequently trigger second-round effects on demand.

- Core inflation, which excludes some food and energy items to measure generalized price pressures, decreased to 3.3 percent in January 2011 from 3.4 percent in December 2010. Meanwhile, other measures of core inflation such as the net of volatile items, the trimmed mean, and the weighted median increased to 4.2 percent, 2.6 percent, and 2.1 percent from 4.1 percent, 2.4 percent, and 1.8 percent, respectively.

- The full year average inflation for 2010 registered at 3.8 percent, well within the target range of 4.5 percent ± 1.0 percentage point for 2010.

B. Inflation expectations

- Results of the Asia Pacific consensus forecasts as well as preliminary results of the BSP's survey of private sector economists for January 2011 showed higher but within-target inflation forecasts for 2011-2012. Results of the Business Expectations Survey (BES) for Q4 2010 indicated that the majority of respondents that anticipate inflation to move up in the survey quarter decreased. Meanwhile, results of the Consumer Expectations Survey (CES) for Q4 2010 indicated that higher inflation is expected over the next 12 months.

C. Inflation outlook

- The latest baseline forecasts indicate that 2011 and 2012 inflation will fall within the target range of 4.0 percent ± 1.0 percentage point.

- Compared to the previous forecast round, the baseline inflation forecasts are higher for both 2011 and 2012. The upward adjustment could be attributed to the higher-than-forecast inflation in December 2010 and January 2011 and the increase in oil prices. Moreover, the latest forecasts incorporate the estimated impact of the proposed hike in bus fares, the wage increase for government employees, further increase in NFA rice prices, pending water rate increases as well as the potential impact on domestic inflation of higher international prices of wheat and sugar.

- The balance of risks to the inflation outlook has tilted further to the upside. Factors which may cause an upward shift in the inflation path include a sustained uptrend in oil prices, additional increases in rice prices, further increases in the global price of non-oil commodities, the impact of adverse weather conditions on agricultural output, and petitions for electricity rate increases. Meanwhile, a weaker global recovery could dampen external demand while a sustained strengthening of the peso should help temper the impact of imported inflation.

  Apart from the upside risks, the successive cost-side pressures stemming from the increases in administered prices (such as utility and transport charges), domestic pump prices, and the cost of other basic food items (e.g., bread and sugar), while already part of the central forecast scenario, nevertheless, still pose a risk to the inflation outlook as they could raise inflation expectations.

D. Demand conditions

- The economy continued to expand in Q4 2010. GDP grew by 7.1 percent year-on-year, bringing the annual growth to 7.3 percent for 2010. The national accounts data confirm the solid performance of domestic marketoriented sectors such as construction and services. Investments also provided strong support to growth. Meanwhile, consistent with the strong pick-up in domestic demand and the normalization of global trade, industry outpaced the performance of services and agriculture. These indicate that domestic demand conditions are firm, supported by more optimistic business confidence readings in the first quarter of 2011.

E. Supply-side indicators

Developments in Agriculture

- The agricultural sector recovered in Q4 2010, but not enough to offset the contractions in the previous quarters. Relative to the previous year, agricultural output declined in 2010, reflecting largely the adverse impact of El Niño. In the first semester of 2011, palay and corn output are expected to expand with improvements in harvest area and yields. Looking ahead, agricultural production is expected to be sustained by increased public spending on research and extension work and the adoption of strategies to counter the impact of weather-related disturbances. Latest weather reports indicated that a moderate-strength La Niña episode is still expected to persist until at least the March-May 2011 season across the tropical Pacific.

- In the international market, the Food Agriculture Organization's (FAO's) latest estimate of world cereal production in 2010 stands slightly more than the previous forecast in November but is still below the 2009 estimate. The revision mostly reflected higher estimates for production in Australia, Canada, Mexico, and Nigeria that have more than compensated for the reduced estimates for India and Kazakhstan. Despite the upward revision in the 2010 cereal production, the world supply and demand balance for cereals is still expected to tighten considerably. The tightening of the cereal market anticipated in the 2010/11 marketing year has already resulted in sharp increases in world prices of all major cereals in recent months.

Oil Price Developments

- The average price of Dubai crude oil increased further in December following the release of upbeat economic news in the US and Asia, supporting market expectations that global economic recovery will be sustained in 2011. The oil price uptrend was sustained in January with positive manufacturing reports in the US and the euro zone. Oil prices in the futures market also increased.

- Tracking the movement of oil prices in the international market, the domestic prices of petroleum products, except LPG, increased in January.

- In the transport sector, the Land Transportation and Franchising Regulatory Board (LTFRB) approved effective 20 January 2011 the increase of ₱10.00 and ₱1.00 in the flag-down rate and charge for succeeding meters and waiting time for taxis, respectively.

Developments in the Utilities Sector

- Retail electricity rates were lower in January due to the reduced price of electricity in the Wholesale Electricity Spot Market (WESM) as well as lower prices from independent power producers (IPPs) and the National Power Corporation (NPC). Likewise, transmission costs went down in January as Meralco completed the collection of transmission cost under-recoveries. The lower generation and transmission costs offset the increase in the distribution charges for 2011.

F. Financial market developments

Government Securities Market

- During the 7 February 2011 auction, the interest rates for the 182-day and 364-day Treasury bills (T-bills) increased relative to their last auction levels. Meanwhile, the Auction Committee rejected all bids for the ₱1.0 billion offering of the 91-day T-bill. The rise in the rates of the 182-day and 364-day T-bills were due to inflation concerns following the higher inflation rate in January 2011 relative to December 2010, which prompted investors to bid high rates as they wanted to stay on the defensive side in anticipation of a possible upward adjustment in the BSP's policy interest rates.

- Secondary market yields and term spreads were higher across all tenors on 4 February 2011 relative to the 30 December 2010 level. The yields on GS in the secondary market are expected to continue their uptrend given market correction from the sharp decline in mid-November 2010 and as market players speculate on the recent comments made by the BSP, in particular, that it is ready to rein in inflation if needed. Selling continued in the secondary government securities market on concerns that rising fuel prices will contribute to inflationary pressures.

Stock Market

- Stock trading remained uneven in early-February 2011. The PSEi slid lower in the first trading day of the month as investors continued to ignore reports of a robust growth for the Philippine economy for the whole of 2010. However, the index rebounded on 2 February, boosted by positive developments in the civil strife in Egypt that also lifted the US markets.

- The index is expected to continue to move sideways or lower in the coming weeks as investors search for drivers of growth for the local economy and corporate earnings. However, analysts are of the view that market activity will be more robust in 2011. Hence, the first quarter is essentially an opportunity for investors to accumulate attractive stocks. The promising industries are power, gaming, tourism, and mining.

Foreign Exchange

- In January 2011, the peso depreciated further due to investors' move to cover for dollar-short positions ahead of US non-farm payroll data. For the period 1-2 February, however, the peso strengthened on stronger-than-expected Philippine economic growth. On a year-to-date basis, the peso depreciated against the US dollar by 0.3 percent on 2 February 2011 as it closed at ₱43.97/US$1, moving in tandem with the Thailand baht, Indian rupee, Japanese yen, and the Indonesian rupiah.

Global Bond and Credit Default Swap Spreads

- In January, debt spread movements were mixed. In early February, spreads started to ease from the end-January level, following the country's better-than-expected GDP growth alongside reports of expansion in China's manufacturing data. As of 2 February, the EMBI+Philippine spread traded narrower than the EMBI+ Global spread during the same period. Similarly, the price of the country's Credit Default Swaps (CDS) tied to government debt declined in early February from the end-January level. Against neighboring economies, the Philippine CDS spread traded lower than Indonesia's but wider than Malaysia's and Thailand's.

G. Domestic liquidity and credit conditions

- Domestic liquidity or M3 rose at a faster pace of 10.6 percent year-on-year in December from 7.5 percent in November. This brought the full-year (2010) average M3 growth rate to 9.7 percent. The faster growth in net foreign assets (NFA) of 17.7 percent in December from 14.9 percent in the previous month continued to drive the expansion in domestic liquidity. Similarly, net domestic assets (NDA) rose slightly by 0.4 percent in December from a contraction of 1.2 percent in the previous month as net domestic credits continued to expand.

- Total outstanding loans of commercial banks, net of banks' reverse repurchase (RRP) placements with the BSP, continued to expand in December by 8.9 percent, broadly similar to the previous month's expansion of 9.0 percent. Bank lending inclusive of RRPs grew at a slower rate of 8.9 percent from an expansion of 10.3 percent in November. The growth of loans for production activities—which comprised more than four-fifths of commercial banks' total loan portfolio—accelerated to 10.1 percent in December from 9.9 percent a month earlier. Meanwhile, the growth in consumer loans (which include credit card receivables and auto loans) slowed to 8.9 percent from 12.0 percent previously.

- Capital raising activities of listed companies in the PSE was significantly higher compared to 2009. However, total corporate bond issuances were lower in 2010 as companies returned to the equity market to raise capital. Meanwhile, for the period January to October 2010, local subsidiaries' net loan availments reached US$413 million whereas there were net repayments for the same period in 2009.

H. Fiscal developments

- The fiscal deficit in January-November 2010 was ₱269.8, 1.0 percent lower than the ₱272.5 billion deficit incurred in the same period in 2009. This represents 83.0 percent of the ₱325.0 billion programmed deficit for 2010. Revenue collections increased by 8.1 percent in the first eleven months of 2010 and accounted for 85.4 percent of the program amounting to ₱1.3 trillion for the year. Meanwhile, expenditures for January-November 2010 was 6.2 percent higher than the disbursements in the comparable period in 2009, and represents 84.9 percent of the program of ₱1.6 trillion.

I. External developments

- The global economic recovery proceeded in Q4 2010, and estimates by the IMF showed that world GDP grew by 4.7 percent during this period. Latest projections from the IMF also show stronger global growth prospects for 2011 but the multi-speed nature of the recovery is likely to continue. In addition, the latest World Economic Outlook (WEO) Update (January 2011) projects global economic activity to grow by 4.4 percent in 2011 and 4.5 percent in 2012, an upward revision of 0.2 percentage point (ppt) for 2011 relative to the October 2010 WEO. The report also cited that economic growth in advanced economies is gaining some traction, with output projected to increase by 2.5 percent in 2011 and 2012. Meanwhile, the growth estimate in 2011 for emerging and developing economies was revised upward to 6.5 percent in 2011 and 2012.