HIGHLIGHTS OF THE MEETING OF THE MONETARY BOARD ON MONETARY POLICY ISSUES HELD ON 11 MARCH 2010[1]

I. Monetary Policy Decision

The Monetary Board 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 Monetary Board's decision was based on its view that current monetary policy settings remain appropriate with inflation expected to settle within the target ranges over the policy horizon.

In addition, the Board approved the gradual disengagement from crisis intervention measures in line with the continued improvement in financial market conditions. Thus, the Board also decided, effective 15 March 2010, to:

d) Reduce the peso rediscounting budget from ₱60 billion to ₱40 billion;

e) Restore the loan value of all eligible rediscounting papers to 80 percent from 90 percent of the borrowing bank's credit instrument; and

f) Revert to the pre-crisis NPL ratio requirement of two percentage points above the latest available industry average.

[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 11 March 2010 meeting were approved by the Monetary Board during its regular meeting held on 25 March 2010. The next meeting of the Monetary Board on monetary policy issues is scheduled on 22 April 2010.

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

- The Monetary Board noted that inflation is expected to continue to track a target-consistent path over the policy horizon, supporting the maintenance of current policy settings. At the same time, the Board noted that while the recent pick-up in inflation has emanated largely from the supply side, upside risks to the inflation outlook need to be closely watched as these could lead to a build-up in inflationary pressures and could influence inflation expectations. Upside risks include the impact of the El Niño weather phenomenon on food supply, power supply concerns, demands for wage and utility rate adjustments, and global commodity price increases.

- Domestic output growth for 2010 is expected to be modest and is likely to be sub-par compared to the pre-crisis period. Nonetheless, the Board recognized that there are firmer signs of recovery with a broad range of indicators pointing to an increasing momentum in domestic economic activity. Latest export numbers have been quite strong, and export growth is likely to gain more traction as the global economic outlook improves. Business confidence was also more upbeat in the first quarter, providing additional support to the domestic economy.

- In line with the exit framework which calls for the withdrawal of crisis intervention measures when financial market conditions stabilize, the Board also decided to phase out liquidity-enhancing crisis response measures, effective 15 March 2010. The Board concurred that the gradual disengagement from crisis intervention measures will encourage depository institutions to seek funding outside the BSP, thus promoting a more efficient distribution of funds in the financial system.

III. Recent Developments

The Monetary Board considered the following developments:

A. Domestic price conditions

- Year-on-year headline inflation dropped to 4.2 percent in February from 4.3 percent in January. Slower increases in the prices of food items, particularly rice and fruits and vegetables, more than offset the higher inflation of non-food items, specifically electricity. The decline in food price inflation could be attributed to the waning impact of typhoon-related disturbances on food production.

- However, core inflation, which excludes some food and energy items to measure generalized price pressures, was higher in February at 3.6 percent from 3.0 percent in January. The increase in core inflation was not broad-based and was due mainly to higher light and miscellaneous food (particularly sugar) inflation.

- Seasonally-adjusted month-on-month headline and core inflation in February 2010 were higher compared to the previous month's levels, also mainly due to higher electricity rates and sugar prices.

B. Inflation Expectations

- Surveys continued to indicate well-contained inflation expectations for 2010 and 2011.

  - Results of the Business Expectations Survey (BES) for Q1 2010 indicated that the proportion of respondents that anticipate inflation to move up in Q1 2010 decreased. Relative to the previous survey, a smaller majority of respondents expects inflation to move up in Q1 2010 (from a diffusion index of 28.2 percent to 23.3 percent) as well as in the next quarter (from 25.1 percent to 22.6 percent).

  - Results of the BSP's survey of private sector economists for January 2010 yielded a slightly lower inflation forecast for 2010 from 4.8 percent in the previous month to 4.7 percent. For 2011, the mean inflation forecast was also slightly lower at 4.6 percent from 4.7 percent. For 2012, however, the survey showed a higher inflation forecast of 4.9 percent from 4.7 percent.

  - Results of the Asia Pacific consensus survey in February also showed within-target, albeit slightly higher, inflation forecasts for 2010 and 2011. Respondents expect inflation for 2010 at 4.9 percent, up from 4.8 percent in January 2010. For 2011, respondents to the survey expect inflation at 4.8 percent, up from 4.7 percent in the previous month.

C. Inflation Outlook

- The latest baseline forecasts indicate that inflation would settle within the 4.5 percent $\pm$ 1.0 percentage point target range for 2010 and the 4.0 percent $\pm$ 1.0 percentage point target range for 2011.

- The risks around the central projection for inflation lie mainly on the upside, which include: the effects of El Nino on agricultural production; utility rate hikes due to tight power reserves and pending petitions; possible wage increases, sustained strong investments in commodity assets; fundamental constraints in global oil production; a stronger-than-expected rebound in world economic activity; and delayed implementation of exit strategies especially in advanced economies.

- Downside risks to the inflation outlook include a delayed global economic recovery and its potential downward pull on world commodity prices and sustained appreciation of the peso.

D. Demand conditions

- Latest indicators signaled a sustained pick-up in domestic demand activity. Exports in January posted the highest growth in 15 years at 42.5 percent. Other leading indicators mirrored this trend: capacity utilization in the manufacturing sector in December 2009 posted the highest level recorded in the 2000-based MISSI series. Energy sales also expanded at a faster pace in December as all major sectors reflected higher growth rates, particularly the industrial sector which recorded double-digit growth rates.

- Meanwhile, total vehicle sales continued to increase as consumers continued to replace flood-damaged units. Vehicle sales were also supported by strong remittances from overseas Filipinos and attractive financing packages offered by banks.

- Results of the Q1 2010 Business Expectations Survey showed a notable improvement in business sentiment as the current and next quarter outlook approximated the level of optimism in 2007.

- Meanwhile, there were additional petitions for an across-the-board wage increase, bringing the total number of petitions to seven (7) as of 11 March 2010.

E. Supply-side indicators

Developments in Agriculture

- The El Niño episode sustained its moderate strength as of March 2010, and was assessed to have reached the mature stage. It is likely to last until June 2010.

- Latest reports from the Department of Agriculture (DA) showed that the damage to agriculture as of 3 March 2010 was at ₱11.195 billion. Of this amount, ₱5.08 billion (298,852 metric tons or MT) was accounted for by palay, ₱6 billion by corn (460,848 MT), ₱115 million by high value crops or HVCC (25,692 MT) and ₱0.94 million by fisheries (34 MT).

- As a caution against a severe El Nino scenario, the NFA was authorized on 11 February 2010 to raise the import limit for 2010 from 2.4 million metric tons (MMT) to more than 3 MMT.

- As of 26 February 2010, total rice inventory stood at 2.7 million metric ton (MMT), higher than the month-ago and year-ago levels of 2.6 MMT and 2.3 MMT, respectively. The latest inventory level is sufficient to last for 75 days based on the average daily rice requirement of 36.3 thousand MT.

- In the global market, the Food and Agriculture Organization (FAO) reported that latest information confirms a further improvement in the global cereal supply situation, with output exceeding consumption significantly and inventories climbing to an 8-year high. For rice, however, the FAO anticipates a 1.3 percent decline in global stocks to 123 million tons from its opening level of 125 million tons. The contraction in rice inventories among the five major exporting countries (Thailand, Vietnam, India, Pakistan and the US) would be much sharper at 24.3 percent from 32 million tons to about 25 million tons.

Oil Price Developments

- Dubai crude oil prices were higher in January 2010 with increased demand in winter but averaged lower in February as the weak US economy dampened demand growth. Spot price of Dubai crude oil dropped by US$3.21 per barrel in February 2010 to average US$73.48 per barrel from US$76.69 per barrel in January 2010.

- However, oil prices in the futures market increased. The price of Brent crude oil for April 2010 deliveries rose to US$77.25 per barrel on 23 February 2010, higher by US$1.57 per barrel relative to its month-ago level of US$75.68 per barrel. The futures price increased on supply concerns in Iran (the second largest crude producer in OPEC).

- As of 3 March, domestic retail prices of unleaded gasoline, diesel, and kerosene posted a net increase of ₱2.62 per liter, ₱1.75 per liter, and ₱0.99 per liter, respectively.

Developments in the Utilities Sector

- Tight power supply conditions are expected to hit the country in the first semester and could possibly result in higher electricity rates. El Niño conditions have brought down dam levels to critical levels and caused temperatures to be above normal, resulting in higher electricity consumption. Demand is also expected to recover as the economy is expected to grow faster this year, which would put upward pressure on electricity use.

- In the Visayas, concerns were raised that power supply conditions are hitting critical levels as existing power capacity could fall short of demand. The tightness of power supply in the Visayas was due to aging power plants that run on limited capacity and require more frequent maintenance. The combined impact of the capacity problem in the Visayas and the low power generation from hydro power plants in Luzon and Mindanao due to El Niño conditions indicates power supply tightness in the country as a whole.

F. Financial Market Developments

Government Securities Market

- Relative to their 29 January 2010 levels, secondary market yields of government securities generally decreased across all tenors except for the 5-year tenor on 8 March 2010. Yields declined for most tenors on increased demand for GS as traders sought investment avenues where they can place the proceeds of foreign exchange T-bonds which matured in February. Yields remained steady for longer term tenors, reflecting some uncertainty regarding the start of the BSP's tightening cycle which influenced investors' decisions about long-term investments.

Interest Rate Differentials

- The differential between the BSP policy rate and the US federal funds rate remained steady in February 2010 while the risk-adjusted policy interest rate differential widened as the risk premium declined compared to January 2010, thereby encouraging capital inflows.

Lending Rates

- The cumulative 200-basis-point policy rate cut of the BSP from 18 December 2008 to 9 July 2009 have been passed on by banks to their borrowers. Actual bank lending rates declined by 222.3 basis points during the period 15-19 February 2010 to reach 7.049 percent relative to the 9.272 percent posted for the period 8-12 December 2008.

Stock Market

- The Philippine stock exchange index (PSEi) was on a general downtrend in January 2010 but managed to recover towards the second half of February. The PSEi recovered for the most of February, on favorable news on Greece's debt-rescue plan, improvement in the Philippines' merchandise exports for December 2009, the better-than-expected manufacturing data in the US and the strong run up in the major bourses abroad, which kept the market upbeat.

Foreign Exchange

- In February 2010, the peso averaged slightly weaker at ₱46.29/US$1 from ₱46.01/US$1 in January 2010 as concerns over the January inflation data dragged down the peso in the first week of February. However, news of improved revenue collection by the Bureau of Internal Revenue (BIR) and the Bureau of Customs (BoC) and improved risk appetite for emerging market assets tempered the further weakening of the peso. As of 5 March 2010, the peso appreciated by 0.3 percent compared with the end-2009 level. Meanwhile, other regional currencies likewise strengthened against the US dollar as risk appetite for emerging market assets improved on expectations that the global economy has gained traction.

Global Bond and Credit Default Swap Spreads

- Debt spreads generally narrowed in February. Plans to bail-out Greece eased fears that the Euro zone's fiscal difficulties could stifle global economic recovery, resulting in a tightening of debt spreads and lower risk premiums. The lower-than-expected January inflation in the US and Fed's reaffirmation that borrowing costs would stay low for an extended period of time likewise calmed market worries. There was also ample liquidity in the market which prompted investors to put their surpluses in bonds, pushing bond yield spreads to tighten. For the first week of March, debt spreads continued their narrowing trend.

G. Domestic Liquidity and Credit Conditions

- Domestic liquidity or M3 growth decelerated slightly to 8.1 percent year-on-year in January 2010 from 8.3 percent in December 2009. On a monthly basis, seasonally-adjusted M3 continued to drop by 0.3 percent in January from 0.8 percent (updated) in the previous month. The combined net foreign assets (NFA) of the BSP and depository corporations continued to drive the trend of M3 growth. NFA expanded in December 2009, although at a slower pace of 23.2 percent year-on-year from 26.5 percent a month ago. Meanwhile, net domestic assets posted a further contraction of 2.9 percent year-on-year from the 4.5 percent decline in December. Credit extended to the private sector slowed down to 7.2 percent year-on-year from 8.1 percent in the previous month. Meanwhile, the expansion in public sector credit strengthened (13.5 percent from 5.8 percent) due mainly to the rise in credit extended to the National Government.

- Bank lending, net of banks' reverse repurchase (RRP) placements with the BSP, continued to grow in January, albeit at a slower pace of 5.0 percent from the previous month's expansion of 10.0 percent. Outstanding loans of commercial banks including RRPs also grew at a slower rate of 6.9 percent in the same period relative to 9.1 percent in December. On a month-on-month seasonally-adjusted basis, commercial banks' lending in January declined by 2.1 percent for loans inclusive of RRPs, and by 1.1 percent for loans net of RRPs.

- The deceleration of bank lending growth could be traced to the slowdown in the growth of loans for production activities at 4.4 percent in January from 9.9 percent a month ago. In particular, the slower growth in production loans was due mainly to the deceleration in the growth of loans to financial intermediation, and transportation, storage and communication. The decline in the outstanding loans to electricity, gas and water also contributed to the overall slowdown of lending growth. Meanwhile, manufacturing and construction loans contracted at a slower rate in January. Consumption loans, however, expanded at a faster rate in January, following the stronger growth in auto loans and credit card lending.

- Total equity raised in the PSE for January 2010 reached ₱4.8 billion, a marked improvement compared to January 2009 when there was no capital raising activity in the equities market. Meanwhile, there was no corporate bond issuance in January 2010.

H. Fiscal developments

- The 2009 full-year fiscal deficit reached ₱298.5 billion, more than four times higher than the ₱68.1 billion full-year deficit in 2008. This also exceeded the ₱250 billion programmed deficit for the full year by ₱48.5 billion and is equivalent to 3.9 percent of GDP. Revenue collections declined by 6.6 percent to ₱1,123.2 billion in 2009 compared to the ₱1,202.9 billion collection in 2008. Meanwhile, the cumulative expenditures in 2009 amounted to ₱1,421.7 billion, 11.9 percent higher than the disbursements in 2008, but still lower than the full-year program at ₱1,489.2 billion.

I. External developments

- The global economy continues to show stronger signs of a return to growth, while global inflation has also moved back to positive territory. While the near-term prospects for the global economy generally appear to be favorable, uncertainty still surrounds the strength of the upswing, particularly on the sustainability of future growth beyond the impact of the stimulus measures.