# HIGHLIGHTS OF THE MEETING OF THE MONETARY BOARD ON MONETARY POLICY ISSUES HELD ON 15 JULY 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 within-target inflation path as well as current conditions and prospects for output growth.

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

- During its discussion, the Board noted that there were arguments for the continuation of the BSP's exit from the monetary easing measures in response to the crisis. These arguments included the stronger-than-anticipated growth in domestic economic activity during the first quarter of 2010 and the strength shown in many leading economic indicators. These developments pointed to increased internal momentum and therefore to potential demand-side inflationary pressures in the period ahead.

- The Board also noted that upward risks to inflation were present, including pending petitions for power increases, possible agricultural

[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 Assistant Governor of the Treasury Department. The highlights of the discussions on the 15 July 2010 meeting were approved by the Monetary Board during its regular meeting held on 5 August 2010. The next meeting of the Monetary Board on monetary policy issues is scheduled on 26 August 2010.

supply bottlenecks due to adverse weather conditions, and recovery of private demand particularly in emerging Asia, which could boost commodity prices.

- The Board also took into account that real policy rates remained in negative territory in the past six months, indicating relatively accommodative monetary policy settings. This has provided support to domestic economic activity at a time when global economic conditions were subdued as many advanced economies were still pulling through the crisis.

- Nevertheless, the Board also took into consideration the favorable inflation outlook and well-cemented inflation expectations in deciding to maintain the current policy settings. The latest BSP projections showed inflation staying within the target ranges of 4.5 percent ± 1.0 percentage point for 2010 and 4.0 percent ± 1.0 percentage point for 2011. Meanwhile, surveys of private forecasters showed that inflation expectations remained firmly anchored within the inflation targets over the policy horizon. In addition, the continued easing of core inflation pointed to a broadly stable trend for consumer prices. The Board also considered that domestic liquidity conditions were just adequate.

- Compared with the projections in the previous policy meeting on 3 June 2010, the latest baseline inflation forecasts have been scaled down, due mainly to lower actual inflation in May and June. The downgrade in domestic oil price projections, owing mainly to the decline in international futures prices, contributed to the downward adjustments in the latest forecasts. The lower baseline forecasts also reflected the lower-than-expected wage adjustment in July 2010. The Board noted that, even with the downward shift in the forecast trajectory, which brought the average inflation projection close to the low-end of the target range for 2011, current policy settings were deemed appropriate.

- At the same time, the Board considered that while global recovery is expected to continue, uncertainty over the strength and pace of the global economic recovery amid financial market tensions particularly in the euro area and signs that economic recovery in the US is losing steam could pose a downside risk to the domestic economy, warranting the need to keep current monetary settings steady.

- Given the foregoing analysis, the Board decided to keep policy settings unchanged. The Board reiterated, however, that it will continue to be attentive to risks to the inflation outlook amid improving domestic demand conditions and carefully keep track of domestic liquidity conditions given the prospect of strong foreign exchange inflows.

## III. Recent Developments

The MB considered the following developments:

### A. Domestic price conditions

- Year-on-year headline inflation in June eased further to 3.9 percent from 4.3 percent in May as a result of the deceleration in non-food inflation, specifically for transportation and communication services and fuel. Meanwhile, food inflation remained steady in June.

- Official measure of core inflation was also slightly lower in June at 3.7 percent from 3.8 percent in May while two of the three alternative core inflation measures estimated by the BSP declined.

### B. Inflation expectations

- 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 for June showed within-target inflation forecasts for 2010 and 2011. Meanwhile, results of the Q2 2010 Consumer Expectations Survey (CES) indicated that a smaller majority of respondents expected increases in the prices of goods and services over the next twelve months. Results of the Business Expectations Survey (BES) for Q2 2010 also indicated that the number of respondents that anticipated inflation to move up in the survey quarter decreased.

### C. Inflation outlook

- Average headline inflation is expected to settle within the 4.5 percent ± 1.0 percentage point target range for 2010 and at around the low end of the 4.0 percent ± 1.0 percentage point target range for 2011. Relative to the previous estimates, the average baseline inflation forecasts for 2010 and 2011 are lower due mainly to the downward revision in the CPI path given lower actual inflation in May and June. The lower oil price projections, owing mainly to the decline in international futures prices of oil, also contributed to the reduction in the inflation forecasts. At the same time, the approved wage adjustment beginning July 2010 is below earlier assumption, leading to a lower wage assumption path for the latest run.

- The potential upside risks to inflation relate to both supply- and demand-side factors. Strong economic growth in the first quarter, if sustained, could generate demand-pull price pressures. Petitions for cost recovery could increase electricity rates in the near term while the probability of the La Niña phenomenon occurring in Q4 2010 could pose upside risks to domestic food prices as it could adversely impact on agricultural production. Furthermore, with the increasingly important role of emerging and developing economies in global commodity demand, the expected strong recovery of private demand in Asia could support global commodity prices going forward.

- On the downside, the key source of uncertainty about the inflation outlook is the strength of global economic activity and its effect on international commodity demand.

**D. Demand conditions**

- Latest demand indicators suggest that economic activity is picking up. The 7.3 percent economic expansion in the first quarter of the year implies that economic recovery is beginning to take hold while the latest results of the BSP's business cycle model indicate a sustained pick-up in domestic economic activity going forward. The strength of domestic demand is also reflected in other demand indicators such as capacity utilization and energy sales to the industrial sector. Results of the second quarter Consumer Expectations Survey also indicate improved consumer confidence through the rest of the year.

- However, based on the April 2010 Labor Force Survey, unemployment rate increased to 8.0 percent in April 2010 from 7.3 percent in January 2010. Meanwhile, the approved wage increase in the NCR was lower than expected.

**E. Supply-side indicators**

<u>Developments in Agriculture</u>

- *Palay* production is expected to be lower in Q2 2010 due largely to the adverse effects of the El Niño episode. *Palay* output for Q3 2010 is also projected to decline as farmers' planting intentions dropped because of unfavorable weather conditions. Corn production is also estimated to be lower in Q2 2010 due to insufficient water supply. The impact of the dry spell on farmers' planting intentions likewise resulted in a decline of forecast production for Q3 2010.

- As of 2 July 2010, the rice inventory level was sufficient to last for 95 days. Meanwhile, about 86.5 percent of the total NFA Council-approved volume of importation for 2010 had arrived.

- Rice prices were unchanged in Metro Manila (MM), but rose in areas outside MM (AOMM). Rice prices in MM have been steady since March 2009 due partly to NFA intervention. However, with the onset of the lean season, rice prices averaged higher in AOMM, bringing average rice prices higher on a national level.

- Early indications point to near-record 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.

- The El Niño episode that started in June 2009 has ended. However, latest climate reports indicate the possibility of a transition to La Niña conditions during the second semester of 2010.

Oil Price Developments

- Dubai crude oil prices remained on a downtrend in June and early July amid continuing concerns on the pace of the global economic recovery. Oil prices in the futures market also decreased. Reflecting the movement in the international market and the removal of the tariff on crude oil and petroleum products (per Executive Order No. 890), domestic prices of petroleum products (unleaded gasoline, diesel, and kerosene) were reduced twice in July.

Developments in the Utilities Sector

- Upward pressures on power generation costs are expected to be tempered by the onset of the rainy season as hydroelectric plants, which generate cheaper power, will begin operating at nearly full capacity.

- Water rates in Metro Manila were slightly lower starting July 2010 due to the appreciation of the peso. Water rates of Manila Water and Maynilad decreased quarter-on-quarter by 1.2 percent and 0.7 percent, respectively.

**F. Financial market developments**

Government Securities Market

- As of 6 July 2010, secondary market yields and term spreads generally fell across most tenors. Yields declined on the back of ample liquidity in the market, the government's upward revision of its growth target, and the relatively 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 narrowed as the risk premium increased, reflecting renewed risk aversion in the last two months.

- Bank lending rates declined by 224.0 basis points during the period 21-25 June 2010 to reach 7.07 percent relative to the 9.272 percent posted for the period 8-12 December 2008, bringing the pass-through rate to 110 percent.

Stock Market

- The market was generally upbeat in June due the following positive factors: higher-than-expected first quarter GDP growth, stable interest rates, strong local and foreign earnings reports, improved business and consumer confidence, and coordinated efforts to resolve the debt problem in the euro area. The index reached its highest level on 29 June at 3,372.7 index points.

- However, market sentiments were mixed during the first week of July, weighed down by reported sell-offs in major bourses overseas and the negative news of a possible downgrade of Spain's sovereign debt ratings. However, the market recovered on the back of the lower inflation outturn for June.

Foreign Exchange

- The peso depreciated in June and the early part of July on continued risk aversion as the global financial markets continued to be cautious due to the euro area's debt crisis. Year-to-date, the peso depreciated by 0.4 percent as of 6 July 2010.

- The peso's depreciation was tempered by the release of the April and May export data showing double-digit growth rates. The peso was also supported by the positive outlook on the Asian region's exports and China's announcement to allow some flexibility on the movement of the yuan.

Global Bond and Credit Default Swap Spreads

- Debt spread movements were mixed. In June, widening pressures continued as fears about the state of public finances in some European countries escalated. Debt spreads, however, started to narrow by mid-June following reports of improvements in market demand for European sovereign debt. However, the tightening trend was not sustained towards the end of June as signs of a weaker US economic recovery weighed on global sentiment. On the local front, reports that the Philippines' budget deficit in the first five months of 2010 exceeded the target for the first semester also increased risk aversion. Nonetheless, debt spreads started to ease in the first week of July on the back of the country's lower-than-expected inflation turnout in June.

## G. Domestic liquidity and credit conditions

- Domestic liquidity continued to post double-digit growth in May 2010, albeit at a moderate pace of 10.7 percent year-on-year compared to 12.4 percent in April. On a monthly basis, seasonally-adjusted M3 growth decelerated to 0.6 percent in May from 1.8 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 continue to expand. Outstanding loans of commercial banks, net of banks' reverse repurchase (RRP) placements with the BSP, grew at a faster pace of 8.1 percent in May compared to the previous month's expansion of 6.7 percent. The growth of bank lending, inclusive of RRPs, also accelerated by 7.7 percent from 6.2 percent in April. On a month-on-month seasonally-adjusted basis, commercial banks' lending in May rose by 1.5 percent for loans net of RRPs, and by 1.9 percent for loans inclusive of RRPs.

- As financial markets stabilized and economic prospects improved, capital raising activity in the Philippine Stock Exchange (PSE) rebounded strongly in the first semester of 2010. Total equity raised in the PSE reached ₱39 billion during the period January-June 2010, significantly higher compared to the same period in 2009 when capital raising activity only reached ₱6.1 billion. Meanwhile, corporate bond issuances in the first semester of 2010 were lower by 36.1 percent relative to the level reached in the previous year.

## H. Fiscal developments

- The fiscal deficit in January-May 2010 reached ₱162.1 billion, 31.6 percent higher than the ₱123.2 billion deficit incurred in the same period in 2009. This represents 111.6 percent of the programmed deficit for the first semester of 2010.

## I. External developments

- While the growth outlook is subject to significant downside risks from a further deterioration in financial conditions and possible contagion effects from the sovereign debt crisis in Europe, global economic growth was still strong in Q1 2010.

- In the latest World Economic Outlook as of July 2010, the IMF raised the 2010 growth forecast for world output, noting the modest but steady recovery in most advanced economies and the strong growth in many emerging and developing economies.

- Emerging Asia continues to be the engine of growth, with export performance exceeding market expectations. Together with strengthening domestic demand, buoyant export growth has led to a surge in regional output.

- However, while the global economy continues to emerge from the recession, risks related to the growth in public debt in advanced economies have become more pronounced.