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# HIGHLIGHTS OF THE MEETING OF THE MONETARY BOARD ON MONETARY POLICY ISSUES HELD ON 24 MARCH 2011[1]

## I. Monetary Policy Decision

The Monetary Board (MB) decided to:

a) Raise the BSP's policy interest rates by 25 basis points to 4.25 percent for the overnight RRP (borrowing) rate and 6.25 percent for the overnight RP (lending) rate;

b) Adjust accordingly 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 inflationary risks and possible second-round effects of commodity price pressures and that further policy adjustments will be carried out as necessary to safeguard price stability.

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

- The MB's decision was based on its assessment that there were signs of stronger and broadening inflation pressures as well as a further upward shift in the balance of inflation risks. International food and oil prices have continued to escalate due to the combination of sustained strong global demand and supply disruptions and constraints. Reflecting these, Philippine headline and core (or underlying) inflation have started to rise. The latest baseline inflation forecasts now indicated that the 3-5 percent inflation target range in 2011 could be at risk. Given these developments, the MB believed that a preemptive response will minimize the overall impact of rising inflation on domestic economic activity by helping to firmly anchor the public's inflation expectations. The MB noted that buoyant domestic demand conditions provide room for a policy interest rate hike without affecting the country's economic growth prospects.

[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 24 March 2011 meeting were approved by the Monetary Board during its regular meeting held on 7 April 2011. The next meeting of the Monetary Board on monetary policy issues is scheduled on 5 May 2011.

- The MB emphasized that the main priority is to guide and prevent unfavorable shifts in the public's inflation expectations especially given the possibility that higher commodity prices could persist over the near term. Well-anchored inflation expectations would safeguard price stability and, therefore, preserve the public's purchasing power.

- At the same time, the MB continues to closely watch the evolving global situation, focusing in particular on the macroeconomic risks of protracted political tensions in the Middle East and North African region and the growth and inflation implications of the recent disasters in Japan, where events continue to unfold.

## III. Recent Developments and Inflation Outlook

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

### A. Domestic price conditions

- In February, headline and core inflation posted the highest month-on-month increase since July 2008 on both a seasonally adjusted and unadjusted basis. Higher inflation in February was traced mainly to the increase in food inflation, particularly for fruits and vegetables due to crop damage from continuous heavy rains during the month, particularly in Mindanao. At the same time, inflation for services also accelerated due to increases in the domestic prices of petroleum products, largely influenced by rising imported crude oil prices, and the recent hikes in transport fares.

- Other indicators also reflected the uptrend: official and alternative core inflation measures increased in February, suggesting that broad-based inflationary pressures were building up.

### B. Inflation expectations

- Mean inflation forecasts of private analysts polled by the BSP and the Asia Pacific Consensus surveys showed higher but within-target inflation forecasts for 2011. In addition, results of the Q1 2011 Business Expectations Survey (BES) indicated a significantly higher majority of respondents expecting inflation to increase in the first and second quarter of 2011.

### C. Inflation outlook

- The latest baseline forecasts show that the target inflation for 2011 could be at risk. Inflation forecast for 2012, however, remained broadly unchanged.

- The balance of risks to the inflation outlook has tilted further to the upside. Upside risks to future inflation include higher global food and oil prices, a possible further increase in rice prices, the impact of adverse weather conditions on agriculture, higher-than-expected wage adjustments, and petitions for electricity rate hikes. On the other hand, the downside risks to inflation could continue to arise from the slow recovery of global growth and a sustained strengthening of the peso which could help temper the impact of imported inflation.

**D. Demand conditions**

- Growth will likely remain firm, supported by solid domestic demand conditions. The latest results of the BSP's business cycle model showed a sustained upturn in domestic economic activity with five out of eight BSP leading and coincident indicators pointing to a continued economic expansion. In addition, results of the Q1 2011 Business Expectations Survey showed that business optimism continued to be strong for the current quarter outlook. Business outlook for the next quarter was more bullish, rising to a new all-time high. This is validated by the latest Colliers report which shows a more upbeat property sector with demand for expansion space from business process outsourcing (BPO) companies driving rental values up and vacancy rates down.

**E. Supply-side indicators**

<u>Developments in Agriculture</u>

- In February, domestic rice prices continued to increase nationwide, particularly in areas outside Metro Manila, reflecting limited deliveries before the onset of the summer harvest season.[2] Nevertheless, the country's rice inventory levels remains sufficient to last for 96 days based on the average daily rice requirement of 31 thousand metric tons.

- Prices of other basic food items also increased in February due to adverse weather conditions. Prices of some monitored fish varieties increased in a number of trading centers as the cold weather affected the supply of marine species while prices of some monitored vegetables went up due to crop damage from continuous heavy rains during the month. On the other hand, prices of meat and fruits were generally stable in February relative to their previous month's levels. Meanwhile, the domestic price of sugar started to ease in some trading centers, reflecting improving supply conditions as the milling season has peaked. However, price of cooking oil rose on increasingly tight global supply.

[2] *Weekly Cereals and Fertilizer Price Monitoring* from the BAS

- In the international market, the Food and Agriculture Organization's (FAO) food price index rose for the eighth consecutive month in February 2011, settling at 236 points, the highest ever recorded since January 1990. With the exception of the sugar price index which was slightly below the previous month's level, the price indices for all food groups monitored by FAO increased in February. The uptick in the food price index was underpinned primarily by tight global supplies.[3] However, a slight pullback has been noted recently in the futures prices of agricultural commodities over concerns that rising political tensions could hamper the ongoing global recovery and dampen global demand.

Oil Price Developments

- The average price of Dubai crude oil increased further in February over the spreading political unrest in the Middle East and North Africa, prompting concerns of global disruptions in oil supply. Oil prices in the futures market also increased.

- The EIA expects oil prices to rise over the next two years with the continued tightening in oil markets. World oil consumption is expected to pick up while growth in non-OPEC production is likely to remain modest, leaving the global oil market to rely on OPEC production. At the same time, political uncertainty in oil-producing countries could push oil prices higher.

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

Developments in the Utilities Sector

- Retail electricity rates were higher in February due to higher generation rates from independent power producers (IPPs). Rates from IPPs went up due to lower economic dispatch following low power demand in January. The utilization level of the IPPs fell below 80 percent for the first time since April 2010, as Meralco's peak demand went down due to cooler temperatures. The higher power cost from IPPs was tempered by the lower prices from the Wholesale Electricity Spot Market (WESM) and the National Power Corporation (NPC).

**F. Financial market developments**

Government Securities Market

- During the 21 March 2011 auction, the interest rates for the 182-day and 364-day Treasury bills (T-bills) decreased by 3.8 basis points and 2.2 basis points, respectively, relative to their last auction levels. Meanwhile, the 91-

[3] FAO, *Global Food Price Monitor*, 3 March 2011, available online at http://www.fao.org

day T-bill rate increased by 8.4 basis points. There was a huge demand for the 91-day and 182-day T-bills, reflecting investors' preference for shorter-term instruments. However, bids for the 364-day T-bill were deemed high so the Committee decided to make a partial award for the one-year paper.

- Secondary market yields and term spreads were generally higher across most tenors on 21 March 2011 relative to the 30 December 2010 levels. The yield curve generally steepened with markedly higher yields at the medium to long end of the curve. The yield curve might continue to steepen as the short end is seen to align to the lower T-bill auction rates while the medium to longer tenors might continue to rise given inflation concerns.

Stock Market

- The index continued to trade below the 4,000 level amidst escalating tensions in the Middle East. More recently, concerns over the longer-term effects of the earthquake and subsequent tsunami in Japan weighed heavily on markets here and abroad. The index closed at 3,896.3 index points on 15 March, 3.4 percent higher than the closing index of February but lower by 7.3 percent year-to-date.

- Developments overseas, rather than local events, are expected to continue to guide movements in the local bourse in the near term. In particular, concerns over (a) the civil war in Libya and continued unrest in other Arab nations, (b) the lingering sovereign debt crisis in Europe, and (c) the effects of the earthquake and tsunami on Japan's economy, as well as of the possible meltdown of the nuclear power plants in Fukushima, will place a negative pressure on stock trading.

Foreign Exchange

- Despite the tensions in the Middle-East and North Africa, the sustained inflows from net portfolio investments and FDI remained the key drivers of the peso's strength. However, investors' move to cover dollar-short positions amid higher oil prices weighed down on the peso. Investors' move to cut positions in the riskier assets due to the earthquake in Japan also tempered the appreciation of the peso. On a year-to-date basis, the peso appreciated against the US dollar by 0.34 percent on 14 March 2011, moving along with other Asian currencies except for the Japanese yen, Thailand baht, Indian rupee, the Taiwan dollar, and the Korean won, which depreciated vis-à-vis the US dollar.

Global Bond and Credit Default Swap Spreads

- For the period February-March, debt spreads generally widened as the spreading unrest in the Middle East and North African (MENA) region exerted upward pressure on oil prices. At the same time, the downbeat impact to global recovery of Japan's calamities and nuclear problems has escalated market worries, causing debt spreads to widen to their peak levels for 2011. As of 16 March, the EMBI+Philippine spread was wider than end-February's level, although still trading narrower than the EMBI+ Global spread. However, the price of the country's CDS tied to government debt remained stable during the review period and remained tighter than end-February's level.

## G. Domestic liquidity and credit conditions

- Domestic liquidity or M3 grew by 9.6 percent in January 2011 from 10.6 percent in December 2010 to reach ₱4.2 trillion. The sustained growth in net foreign assets (NFA) of 17.8 percent in January from 17.7 percent in the previous month fueled the expansion in domestic liquidity. Net domestic assets (NDA), on the other hand, contracted by 4.2 percent in January from a growth of 0.4 percent in December 2010. This was due largely to the faster expansion of the net other items account (which includes revaluation and capital and reserve accounts as well as the SDA placements of trust entities), which pulled down domestic liquidity.

- Bank lending, exclusive of banks' reverse repurchase (RRP) placements with the BSP, grew at a brisker pace of 11.0 percent in January from 8.9 percent in the previous month. Likewise, outstanding loans of commercial banks, inclusive of RRPs, registered a stronger growth of 12.4 percent in January from 8.9 percent in December to reach ₱2.5 trillion. The growth of loans for production activities—which comprise more than four-fifths of commercial banks' total loan portfolio—accelerated to 12.4 percent in January from 10.1 percent a month earlier. Meanwhile, the growth of consumer loans (which include credit card receivables and auto loans) was broadly steady at 8.7 percent.

- The Philippine equity market raised ₱16.9 billion in fresh capital for the period January to February 2011, lower by 15 percent compared to the previous year's level. In contrast, bond issuances were up, reaching ₱43.5 billion in the first two months alone.

## H. Fiscal developments

- The fiscal deficit for the full year of 2010 was ₱314.5 billion, 5.3 percent higher than the ₱298.5 billion deficit incurred in 2009. This represents 96.8 percent of the ₱325.0 billion programmed deficit for 2010. Revenue collections increased by 7.5 percent and accounted for 93.3 percent of the 2010 program of ₱1.3 trillion. Meanwhile, expenditures in 2010 was 7.1 percent higher than the disbursements in 2009, reaching 94.0 percent of the 2010 program of ₱1.6 trillion. Excluding interest payments, total disbursements rose by 7.5 percent to ₱1,228.1 billion.

## I. External developments

- The global economic recovery is seen to be more self-sustaining. However, the pace of economic recovery is expected to remain geographically uneven. Strong domestic consumption, recovering exports, and large capital inflows are helping bring back output in emerging and developing economies to pre-crisis peaks. Meanwhile, it may be too early to fully assess the impact of the instability in the Middle East and North Africa (MENA) region on global economic activity. A further deterioration of the crisis in the said region would automatically affect global oil prices which, in turn, could hurt global economic prospects.

  At the same time, it may also be too early to determine the impact of the devastation in Japan on global economic activity. Initial analysis suggests that the Japan's recovery would likely follow a V-shaped growth pattern. A sharp dip could be expected with damages estimated at around 3 percent of the country's GDP. However, a sharp recovery is likely to follow as reconstruction efforts begin. The major downside risk to the Japanese economy is the potential for large nuclear contamination.