

**INFLATION
REPORT**
FOURTH Quarter
2010



BANGKO SENTRAL NG PILIPINAS

FOREWORD



The primary objective of monetary policy is to promote a low and stable rate of inflation conducive to a balanced and sustainable economic growth. The adoption in January 2002 of the inflation targeting framework for monetary policy was aimed at helping to fulfill this objective.

One of the key features of inflation targeting is greater transparency, which means greater disclosure and communication by the BSP of its policy actions and decisions. This Inflation Report is published by the BSP as part of its transparency mechanisms under inflation targeting. The objectives of this Inflation Report are: (i) to identify the risks to price stability and discuss their implications for monetary policy; and (ii) to document the rigorous economic analysis behind the conduct of monetary policy and convey to the public the overall thinking behind the BSP's decisions on monetary policy. The broad aim is to make monetary policy easier for the public to follow and understand and enable them to better monitor the BSP's commitment to the inflation target, thereby helping both in anchoring inflation expectations and encouraging informed debate on monetary policy issues.

The government's targets for annual headline inflation under the inflation targeting framework have been set at 4.5 percent and 4.0 percent for 2010 and 2011, both with a tolerance interval of ± 1.0 percentage point. The inflation target range for 2010 therefore is 3.5-5.5 percent and for 2011, 3.0-5.0 percent. For the medium term, the BSP shifted to a fixed inflation target of 4.0 ± 1.0 percent for 2012-2014.

The report is published on a quarterly basis, presenting a survey of the various factors affecting inflation. These include recent price and cost developments, prospects for aggregate demand and output, labor market conditions, monetary and financial market conditions, fiscal developments, and the international environment. A section is devoted to a discussion of monetary policy developments in the last quarter, as well as a comprehensive analysis of the BSP's view of the inflation outlook for the policy horizon. This is followed by a discussion of the implications of the assessment of inflation and economic conditions on the monetary policy settings of the BSP. This issue also features a box article on the shift of the BSP to a fixed medium-term inflation target to promote a long-term view on inflation and help better anchor inflation expectations.

The Monetary Board approved this Inflation Report at its meeting on 20 January 2011.


AMANDO M. TETANGCO, JR.
Governor

List of Acronyms, Abbreviations, and Symbols

AE	Advanced economy
AFF	Agriculture, Fishery, and Forestry
AP	Asia Pacific
AL	Auto Loans
BAS	Bureau of Agricultural Statistics
BES	Business Expectations Survey
BIR	Bureau of Internal Revenue
BIS	Bank for International Settlements
BOC	Bureau of Customs
BPO	Business Processing Outsourcing
BTr	Bureau of the Treasury
CAMPI	Chamber of Automotive Manufacturers of the Philippines, Inc.
CAR	Capital Adequacy Ratio
CBD	Central Business District
CCRs	Credit Card Receivables
CES	Consumer Expectations Survey
CDS	Credit Default Swaps
CI	Confidence Index
CPI	Consumer Price Index
DBCC	Development Budget Coordinating Committee
DOF	Department of Finance
EIA	Energy Information Administration
EM	Emerging economy
EMBI	Emerging Market Bond Index
ERC	Energy Regulatory Commission
EU	European Union
FAO	Food and Agriculture Organization
GDP	Gross Domestic Product
GNP	Gross National Product
GRAM	Generation Rate Adjustment Mechanism
ICERA	Incremental Currency Exchange Rate Adjustment
IEA	International Energy Agency
IMF	International Monetary Fund
IPP	Independent Power Producer
KBs	Commercial banks
LFS	Labor Force Survey
LPG	Liquefied Petroleum Gas
LTFRB	Land Transportation Franchising and Regulatory Board
MB	Monetary Board
MEM	Multi-Equation Model
Meralco	Manila Electric Company
MISSI	Monthly Integrated Survey of Selected Industries
MTP	Major Trading Partner

NCCP	National Council for Commuters Protection
NDA	Net Domestic Assets
NEDA	National Economic Development Authority
NFA	Net Foreign Assets, National Food Authority
NFIA	Net Factor Income from Abroad
NG	National Government
NPC	National Power Corporation
NPLs	Non-performing loans
NSO	National Statistics Office
OPEC	Organization of Petroleum Exporting Countries
PBR	Performance-based Rate
PCE	Personal Consumption Expenditure
PMI	Purchasing Managers' Index
PSEi	Philippine Stock Exchange Composite Index
PSIC	Philippine Standard Industrial Classification
RB	Rural Banks
REER	Real Effective Exchange Rate
ROP	Republic of the Philippines
RP	Repurchase
RREL	Residential and Real Estate Loans
RRP	Reverse Repurchase
SEM	Single-Equation Model
SMS	Short Message Service
SDA	Special Deposit Account
TCS	Transportation, Communications, and Storage
U/KBs	Universal/commercial banks
WEO	World Economic Outlook
WESM	Wholesale Electricity Spot Market



THE MONETARY POLICY OF THE BANGKO SENTRAL NG PILIPINAS

The BSP Mandate

The BSP's main responsibility is to formulate and implement policy in the areas of money, banking and credit, with the primary objective of maintaining stable prices conducive to a balanced and sustainable economic growth in the Philippines. The BSP also aims to promote and preserve monetary stability and the convertibility of the national currency.

Monetary Policy Instruments

The BSP uses various instruments to effect the desired monetary policy stance to achieve the inflation target. These include (a) raising/reducing the BSP's policy interest rates; (b) increasing/decreasing the reserve requirement; (c) encouraging/discouraging deposits in the special deposit account (SDA) facility by banks and trust entities of BSP-supervised financial institutions; (d) increasing/decreasing its rediscount rate on loans extended to banking institutions on a short-term basis against eligible collaterals of banks' borrowers; and (e) outright sales/purchases of the BSP's holdings of government securities. The BSP's primary monetary policy instruments are its overnight reverse repurchase (RRP) or its borrowing rate and overnight repurchase (RP) or its lending rate.

Policy Target

The BSP uses the Consumer Price Index (CPI) or headline inflation rate which is compiled and released to the public by the National Statistics Office (NSO) as its target for monetary policy. The policy target is set by the Development Budget Coordination Committee (DBCC)¹ in consultation with the BSP. For 2010, the headline inflation target has been set at 4.5 percent \pm 1.0 percentage point, while for 2011, the inflation target has been set at 4.0 \pm 1.0 percentage point. On 9 July 2010, the BSP announced its shift to a fixed inflation target for the medium term of 4.0 \pm 1.0 percent for 2012-2014.

BSP's Explanation Clauses

These refer to the predefined set of acceptable circumstances under which an inflation-targeting central bank may fail to achieve its inflation target. These clauses recognize the fact that there are limits to the effectiveness of monetary policy and that deviations from the inflation target may sometimes occur because of factors beyond the control of the central bank. Under the inflation targeting framework of the BSP, these exemptions include inflation pressures arising from: (a) volatility in the prices of agricultural products; (b) natural calamities or events that affect a major part of the economy; (c) volatility in the prices of oil products; and (d) significant government policy changes that directly affect prices such as changes in the tax structure, incentives, and subsidies.

¹ The DBCC, created under Executive Order (E.O.) No. 232 dated 14 May 1970, is an inter-agency committee tasked primarily to formulate the National Government's fiscal program. It is composed of the Department of Budget and Management (DBM), National Economic and Development Authority (NEDA), and the Department of Finance (DOF). The BSP sits as a resource agency.

The Monetary Board

The powers and functions of the BSP, such as the conduct of monetary policy and the supervision over the banking system, are exercised by its Monetary Board, which has seven members appointed by the President of the Philippines. Beginning in July 2006, the Monetary Board meets every six weeks to review and decide on the stance of monetary policy. Prior to July 2006, monetary policy meetings by the Monetary Board were held every four weeks.

Chairman	Amando M. Tetangco, Jr.
Members	Cesar V. Purisima Juanita D. Amatong Nelly F. Villafuerte Alfredo C. Antonio Ignacio R. Bunye Peter B. Favila

The Advisory Committee

The Advisory Committee was established as an integral part of the institutional setting for inflation targeting. It is tasked to deliberate, discuss and make recommendations on monetary policy to the Monetary Board. The Committee meets every six weeks (beginning July 2006) but may also meet in between the regular meetings, whenever it is deemed necessary. Prior to July 2006, the Committee met every four weeks.

Chairman	Amando M. Tetangco, Jr. Governor
Members²	Diwa C. Guinigundo Deputy Governor Monetary Stability Sector Nestor A. Espenilla, Jr. Deputy Governor Supervision and Examination Sector Ma. Cyd N. Tuaño-Amador Assistant Governor Monetary Policy Sub-Sector Ma. Ramona GDT Santiago Assistant Governor Treasury Department

² The Advisory Committee is supported by a Technical Secretariat composed of officers and staff from the Department of Economic Research, Center for Monetary and Financial Policy, and the Treasury Department.

2011 SCHEDULE OF MONETARY POLICY MEETINGS, INFLATION REPORT PRESS CONFERENCE AND PUBLICATION OF MB HIGHLIGHTS *					
Period	Advisory Committee (AC) Meeting	Monetary Board (MB) Meeting	MB Highlights Publication	Inflation Report (IR) Press Conference	
2011	Jan		27 (Thu) <i>(29 Dec 2010 MB meeting)</i>	28 (Fri) <i>(Q4 2010 IR)</i>	
	Feb	4 (Fri) <i>(AC Meeting No. 1)</i>	10 (Thu)		
	Mar	18 (Fri) <i>(AC Meeting No. 2)</i>	24 (Thu)	10 (Thu) <i>(10 Feb 2011 MB meeting)</i>	
	Apr	29 (Fri) <i>(AC Meeting No. 3)</i>		20 (Wed) ¹ <i>(24 Mar 2011 MB meeting)</i>	
	May		5 (Thu)		20 (Fri) <i>(Q1 2011 IR)</i>
	Jun	10 (Fri) <i>(AC Meeting No. 4)</i>	16 (Thu)	2 (Thu) <i>(5 May 2011 MB meeting)</i>	
	Jul	22 (Fri) <i>(AC Meeting No. 5)</i>	28 (Thu)	14 (Thu) <i>(16 June 2011 MB meeting)</i>	
	Aug			25 (Thu) <i>(28 Jul 2011 MB meeting)</i>	12 (Fri) <i>(Q2 2011 IR)</i>
	Sep	2 (Fri) <i>(AC Meeting No. 6)</i>	8 (Thu)		
	Oct	14 (Fri) <i>(AC Meeting No. 7)</i>	20 (Thu)	6 (Thu) <i>(8 Sep 2011 MB meeting)</i>	
	Nov	25 (Fri) <i>(AC Meeting No. 8)</i>		17 (Thu) <i>(20 Oct 2011 MB meeting)</i>	4 (Fri) <i>(Q3 2011 IR)</i>
	Dec		1 (Thu)	29 (Thu) <i>(1 Dec 2011 MB meeting)</i>	

* Note: AC meetings will be strictly every six weeks and are unadjusted for IMF/BIS meetings and Christmas holidays.

¹ MB highlights publication scheduled on 21 April 2011 (Thursday) will be moved to 20 April 2011 (Wednesday). 21 April 2011 (Maundy Thursday) is a regular holiday.

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OVERVIEW³

Inflation decelerates further in Q4 2010 and average inflation for 2010 falls within target. Headline inflation for 2010 averaged 3.8 percent, well within the Government's target range of 3.5-5.5 percent. In Q4 2010, headline inflation eased for the third consecutive quarter to 2.9 percent from 3.8 percent in Q3 2010 as a result of lower food and non-food inflation. Food inflation declined, with most major food groups posting lower inflation rates as supply conditions in the domestic market remained stable. Non-food inflation also went down, influenced mainly by lower light inflation due to the reduced cost of power supply from the National Power Corporation (NPC) and independent power producers (IPPs). Similarly, core inflation decreased to 3.4 percent from 4.0 percent in the previous quarter. The decline in core inflation could be traced largely to lower meat inflation and power rates.

Domestic demand momentum remains relatively strong. Output growth had slowed down in Q3 2010 but continued to be above trend, with the real gross domestic product (GDP) growing by 7.5 percent in the first three quarters of the year. On the production side, the steady growth in services and industry offset the contraction in agricultural output in Q3 2010, which was due largely to the impact of El Niño. On the expenditure side, growth was led by the sustained recovery in external trade, consumer spending, and investments. Other demand indicators likewise reflected the strength of the economy. Capacity utilization and production in the manufacturing sector remained high while energy consumption continued to increase. Business confidence and consumer sentiment for the current quarter set new record highs while sales of passenger cars and commercial vehicles continued to post solid growth.

Global economic recovery continues in Q3 2010 but the multi-speed nature of recovery will likely extend going forward. Survey-based indicators suggest that the global economic recovery will hold steady in the near term but the multi-speed recovery will likely continue, with dynamic emerging markets (EMs) fueling global economic growth. The subdued economic prospects in advanced economies (AEs) will continue to hold down employment conditions and private demand. Meanwhile, EMs are faced with the challenge of dealing with strong capital inflows and averting potential overheating in their economies. At the same time, the need for internal and external rebalancing remains a crucial element in sustaining global economic growth. Inflationary pressures have intensified somewhat in EMs, leading central banks in these economies to tighten further their monetary stance. The recent surge in capital inflows to Asia, encouraged largely by brighter growth prospects in the region along with the international yield differentials favoring EMs and improved risk appetite for EM assets, drove some EM central banks to introduce various forms of capital control. Meanwhile, the US Fed and the Bank of Japan (BOJ) implemented further quantitative easing to help promote a stronger pace of economic recovery in their economies.

Bullish market sentiments continue in Q4 2010, supported by ample liquidity in the system and continued favorable prospects for output growth. Strong economic data on the domestic and international fronts likewise contributed to the upbeat mood in the local bourse, the continued narrowing of sovereign debt spreads, and the appreciation trend of the peso during the quarter. Bank lending also continued to grow, indicating that ample funds are available to support the funding requirements of the economy. In addition, the sustained resiliency of the banking sector, reflective of

³ The analyses in this report are based on information as of 29 December 2010.

the continued fine-tuning of regulatory and supervisory mechanisms in recent years, bolstered investor sentiment. However, lingering uncertainties over the sovereign debt problem in Europe as well as asset price bubble and overheating concerns in fast-growing emerging markets dampened investor confidence.

The Monetary Board (MB) maintains policy rates in Q4 2010, noting that current monetary settings represent a sound policy balance that is supportive of both inflation control and economic expansion. The Board noted that inflation projections continued to indicate a manageable inflation environment, with inflation settling within the target ranges for 2010- 2012. The forecasts were also supported by well-contained inflation expectations based on the results of surveys of private economists while various measures of core inflation suggested that underlying price pressures are not generalized. The favorable inflation profile against a favorable economic background suggested that current monetary settings remain appropriate. At the same time, growth of credit and liquidity continued to be broadly consistent with the pace of economic expansion.

However, the BSP's assessment of current price trends and risks to future inflation suggests that the balance of risks to the inflation outlook is tilted slightly to the upside. The domestic demand momentum remains relatively strong, and is facilitating overall output expansion. Solid domestic demand conditions point to the likelihood of stronger inflationary pressures over the policy horizon. While the rebound in investment is likely to add to productive capacity, and lead to higher potential output over the medium term, a stronger momentum in demand growth could add to inflationary pressures in the short term. Moreover, potential supply-side pressures pose upside risks to the central inflation projection. These could come from higher global food prices, persistent increases in world oil prices, the potential impact of weather disturbances on agricultural production, and further adjustments in domestic rice prices and electricity charges. Nevertheless, the downside risks relating to the slower-than-expected recovery of the global economy and to the continued stability of the peso could also help temper the impact of imported inflation.

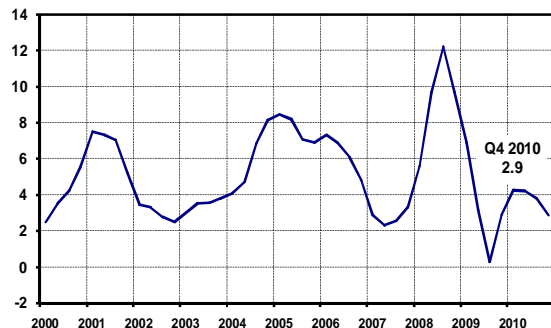
The BSP, therefore, remains vigilant against any emerging risks to the inflation outlook and is ready to adjust policy settings if and when needed to ensure that future inflation will remain consistent with the medium-term target and that domestic liquidity conditions will remain supportive of sustainable economic growth.

I. INFLATION AND REAL SECTOR DEVELOPMENTS

Prices

Inflation decelerates further in Q4 2010 and average inflation for 2010 falls within target.

Headline Inflation
Quarterly average in percent (2000=100)

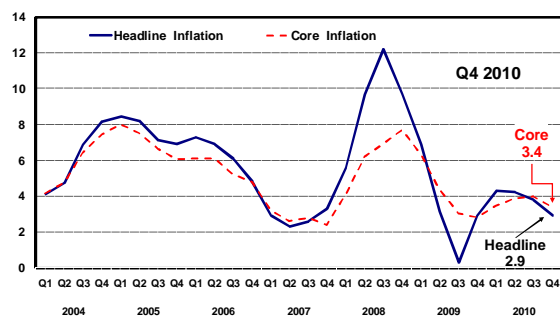


Headline inflation for 2010 averaged 3.8 percent, well within the Government's target range of 3.5-5.5 percent. In Q4 2010, inflation dropped further to 2.9 percent from 3.8 percent in Q3 2010 as both food and non-food inflation decelerated. Food inflation declined, with most major food groups posting lower inflation rates as supply conditions in the domestic market remained stable despite adverse weather conditions. Non-food inflation also went down, influenced mainly by lower light inflation.

Similarly, core inflation decreased to 3.4 percent from 4.0 percent in the previous quarter. The decline in core inflation was due largely to lower meat inflation and power rates.

Headline inflation eases on account of lower food and non-food inflation.

Headline and Core Inflation
Quarterly average in percent (2000=100)



Headline and Core Inflation

Headline inflation eased for the third consecutive quarter to 2.9 percent in Q4 2010 compared to 3.8 percent in Q3 2010 as a result of lower food and non-food inflation. Headline inflation was also 2.9 percent in the same quarter a year ago. Food inflation went down due to lower prices of fruits and vegetables, as supply remained ample despite damages wrought by typhoon Juan in a few localities; and as meat inflation fell given the adequate supply of chicken and pork. Meanwhile, the decline in non-food inflation could be traced largely to lower power rates due to the reduced cost of power supply. This, in turn, was driven by improved power plant capacity, the appreciation of the peso, and the seasonally low power demand with cooler weather.

Official core inflation drops due largely to lower meat inflation and electricity prices.

Core inflation, which excludes some food and energy items to measure generalized price pressures, also declined during the quarter. The official NSO core inflation measure decreased to 3.4 percent in Q4 2010 from 4.0 percent in the previous quarter due largely to lower inflation for meat, with adequate supply, and for light, as electricity prices went down due to lower cost of supply from the National Power Corporation (NPC)

Alternative Core Inflation Measures
Quarterly averages of year-on-year change

Quarter	Official Core Inflation	Trimmed Mean 1/	Weighted Median 2/	Net of Volatile Items 3/ *
2008	6.2	7.6	7.2	7.7
Q1	4.1	5.1	4.5	5.1
Q2	6.2	7.7	7.4	8.0
Q3	6.9	9.5	8.9	9.6
Q4	7.7	7.9	8.1	8.1
2009	4.1	3.6	3.6	2.9
Q1	6.3	5.8	5.6	5.2
Q2	4.4	3.9	3.9	2.6
Q3	3.0 ^r	1.8	2.2 ^r	1.1
Q4	2.8 ^r	3.0	2.9	2.6
2010	3.7	3.0	2.6	4.9
Q1	3.5	3.4	3.2	5.0 ^r
Q2	3.9 ^r	3.2	2.9	5.5
Q3	4.0	2.8	2.4	4.8
Q4	3.4	2.5	1.8	4.1

1/ The trimmed mean represents the average inflation rate of the (weighted) middle 70 percent in a lowest-to-highest ranking of year-on-year inflation rates for all CPI components.

2/ The weighted median represents the middle inflation rate (corresponding to a cumulative CPI weight of 50 percent) in a lowest-to-highest ranking of year-on-year inflation rates.

3/ The net of volatile items method excludes the following items: educational services, fruits and vegetables, personal services, rentals, recreational services, rice, and corn.

^r Revised.

* The series has been recomputed using a new methodology that is aligned with NSO's method of computing the official core inflation, which re-weights remaining items to comprise 100 percent of the core basket after excluding non-core items. The previous methodology retained the weights of volatile items in the CPI basket while keeping their indices constant at 100.0 from month to month.

Source: NSO, BSP estimates

Contribution to Quarterly Inflation
in percent

Item	Weight in Headline CPI	Percentage Contribution to Year-on-Year Headline Inflation		
		Q4 2010	Q3 2010	Q4 2009
Core Inflation	81.6	2.85	3.32	2.11
<i>Non-core Items</i>	<i>18.4</i>	<i>0.05</i>	<i>0.48</i>	<i>0.79</i>
Rice	9.4	0.09	0.08 ^r	0.25
Corn	0.9	-0.01	0.00	0.00
Fruits and Vegetables	5.3	-0.31	0.12	0.62
Gas, LPG	1.3	0.09	0.12	0.12
Kerosene	0.3	0.02	0.02	-0.03
Oil, Gasoline and Diesel	1.3	0.17	0.14	-0.17
Headline Inflation	100.00	2.9	3.8	2.9

Source of Basic Data: NSO, BSP

and independent power producers (IPPs). The reduction in IPP rates was due largely to higher plant capacity as power plants operated more efficiently, resulting in lower fixed cost per kilowatt-hour. Meanwhile, the Q4 2010 core inflation was higher compared to the 2.8 percent posted in the same quarter a year ago.

Similarly, all three alternative measures of core inflation estimated by the BSP reflected a downtrend in Q4 2010 relative to the levels registered in the previous quarter. The trimmed mean, weighted median, and net of volatile items measures dropped to 2.5 percent, 1.8 percent, and 4.1 percent from 2.8 percent, 2.4 percent, and 4.8 percent, respectively.

Core inflation contributed 2.9 percentage points to headline inflation in Q4 2010, lower than the 3.3 percentage-point contribution in the previous quarter but higher than the 2.1 percentage-point contribution recorded in Q4 2009. Non-core consumer price index (CPI) items contributed 0.1 percentage point to headline inflation during the period, lower than the previous quarter's 0.5 percentage-point contribution and the 0.8 percentage-point contribution in the same quarter a year ago.

The proportion of CPI components showing inflation rates above a given threshold provides an indication as to whether pressures on consumer prices are becoming generalized over time.

The number of items with inflation rates greater than the threshold of 5.5 percent (the upper end of the inflation target for 2010) decreased to 14 in Q4 2010 from 16 in the previous quarter. These items accounted for a lower proportion of the CPI basket at 10.5 percent compared to 13.6 percent in the previous quarter.

Dividing the CPI basket into food and non-food components showed less food items but more non-food items above the threshold. There were 6 food items with inflation rates above the threshold from 9 in the previous quarter. Meanwhile there were 8 non-food commodities with inflation rates higher than the threshold in Q4 2010 from 7 in the previous quarter.

Lower inflation for fruits and vegetables and meat drive down food inflation.

Inflation Rates for Selected Food Items

Quarterly averages in percent (2000=100)

Commodity	2010		2009	
	Q4	Q3	Q4	Q3
Food, Beverage and Tobacco	1.9	3.3	4.6	1.9
Food	2.0	3.4	4.7	1.8
Cereal & Cereal Products	1.4	1.4	2.6	-2.1
o/w Rice	1.0	0.9 ^r	2.7	-3.8
Corn	-0.6	0.1	0.5	-5.0
Dairy Products	1.5	1.5	3.4	5.0
Eggs	2.8	2.9	5.9	6.4
Fish	2.3	2.4	5.2	6.5
Fruits & Vegetables	-5.8	2.3	11.7	1.7
Meat	1.3	4.3	5.9	2.6
Misc. Food	7.3	7.2 ^r	3.2	2.7
Beverages	1.8	1.7	2.4	3.2
Tobacco	2.5	2.7	3.9	3.5

Source of Basic Data: NSO, BSP

Lower prices of electricity drive the decline in non-food inflation.

Inflation Rates for Selected Non-Food Items

Quarterly averages in percent (2000=100)

Commodity	2010		2009	
	Q4	Q3	Q4	Q3
Non-Food Items	3.9	4.3	1.2	-1.2
Clothing	1.8	1.9 ^r	2.1	2.2
Housing & Repairs	1.9	1.7 ^r	2.1	2.2
Fuel, Light & Water	10.6	13.9 ^r	0.8	-4.6 ^r
Fuel	6.4	7.6	4.3	-12.8
Light	15.2	20.9	-4.8	-1.5
Water	7.6	7.5	12.0	12.4
Services	3.7	3.5	0.3	-3.9
Transpo & Comm.	3.9	3.4	-2.8	-10.6
Miscellaneous	1.2	1.3	1.9	2.4 ^r

Source of Basic Data: NSO, BSP

Food Inflation

Food, beverage, and tobacco inflation decreased in Q4 2010 to 1.9 percent from 3.3 percent in the previous quarter and from 4.6 percent a year ago, with lower prices of agricultural commodities. Inflation for fruits and vegetables as well as meat decreased amid adequate supply.

The farmgate price of *palay* went down to ₱14.40 per kilo in December 2010 from ₱14.56 per kilo a year ago. However, the retail prices of ordinary and special rice increased in Q4 2010 to ₱30.55 per kilo and ₱34.11 per kilo from the Q4 2009 levels of ₱30.30 per kilo and ₱33.99 per kilo, respectively. Similarly, the retail price of yellow corn averaged higher in December 2010 at ₱19.19 per kilo from its year-ago level of ₱18.58.

Meanwhile, the prices of *palay* and milled rice declined generally compared to their end-Q3 2010 levels, reflecting the stability of supply with the onset of the main harvest season, which normally starts in October to December of each year. However, corn prices registered higher prices on a quarter-on-quarter basis.

Non-food inflation

Non-food inflation at 3.9 percent was lower relative to 4.3 percent posted a quarter ago but was higher relative to 1.2 percent a year ago. In particular, lower light inflation accounted for the lower non-food inflation in Q4 2010. From 20.9 percent in Q3 2010, light inflation declined to 15.2 percent during the quarter, reflecting lower prices of electricity.

Energy Prices

Average oil price increases with weaker dollar following the US Fed's decision to purchase more government debt papers and some easing of sovereign debt problems in Europe.

The international price of Dubai crude oil increased by 14.1 percent quarter-on-quarter to US\$84.31 per barrel in Q4 2010 from an average of US\$73.90 per barrel in Q3 2010, as the dollar weakened following the US Fed's announcement to increase further its holding of government securities on 3 November 2010 to help boost the US economy.⁴ Ireland's bailout agreement with the European Union and the International Monetary Fund (IMF) to save its banks, which eased sovereign-debt concerns in the region, also helped push oil prices higher. Furthermore, the release in December of reports indicating that the index of leading economic indicators in the US reached an eight-month high in November provided further optimism that economic recovery will strengthen next year and boost fuel demand. On a year-on-year basis, the international oil price was higher by 11.8 percent.

The Organization of Petroleum Exporting Countries (OPEC), Energy Information Agency (EIA), and International Energy Agency (IEA) forecast the 2011 global demand to increase by 1.2 million barrels per day (mmbd),⁵ 1.4 mmbd,⁶ and 1.3 mmbd,⁷ respectively. Non-OECD⁸ regions, especially China, the Middle East, and Brazil, represent most of the expected growth in the 2011 world oil consumption.

Local pump prices increase during the quarter.

In Q4 2010, the domestic prices of unleaded gasoline, LPG, kerosene, and diesel increased by ₱7.00 per liter, ₱7.51 per liter, ₱5.50 per liter, and ₱5.00 per liter, respectively, relative to end-Q3 2010 levels. During the review quarter, the prices of unleaded gasoline and kerosene were increased eight times and reduced twice; the price of diesel was increased seven times and reduced thrice; and the price of LPG was increased six times.

⁴ The US Fed committed to purchasing US\$600 billion worth of long-term US Treasury securities by the end of Q2 2011.

⁵ OPEC Monthly Oil Market Report, www.opec.org

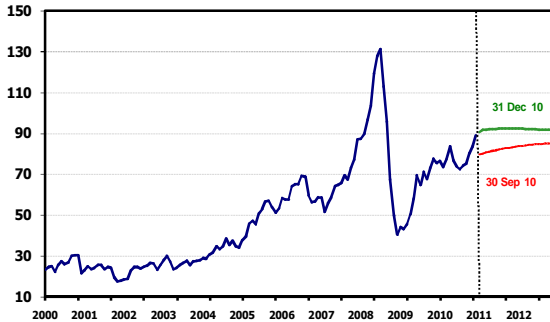
⁶ Energy Information Agency, Short-Term Energy Outlook, www.eia.doe.gov

⁷ IEA, Oil Market Report, www.iea.org

⁸ Organization for Economic Cooperation and Development

World oil prices are expected to track a higher path.

Spot and Estimated Future Prices of Dubai Crude Oil*
Price in US dollars per barrel



*Futures price derived using Brent crude futures data.

Compared to their end-Q4 2009 levels, pump prices of petroleum products were all higher at end-Q4 2010. In particular, the prices of unleaded gasoline, kerosene, diesel, and LPG increased by ₱7.38 per liter, ₱5.49 per liter, ₱6.24 per liter, and ₱5.94 per liter, respectively.

The estimated future prices of Dubai crude oil, based on movements in Brent crude oil futures, suggest a higher path for 2011 compared to the forecasts at end-Q3 2010. This could be attributed to expectations of sustained world economic recovery in 2011, led by emerging markets, after a stronger-than-anticipated oil consumption turnout in 2010.

Transportation

In the transport sector,⁹ there are pending petitions for minimum taxi fare and jeepney fare hikes with the Land Transportation and Franchising Regulatory Board (LTFRB). The petition filed by the Philippine National Taxi Operators Association (PNTOA) on 26 January 2010 requested an increase in the flag-down rate and charge for succeeding meters and waiting time by ₱10.00 and ₱1.50, respectively. Moreover, the petition by the Alliance of Concerned Transport Operators (ACTO) for a 50-centavo provisional increase in jeepney fares was already filed for resolution.

Meanwhile, the Toll Regulatory Board (TRB) is set to implement higher toll rates in the South Luzon Expressway (SLEX), North Luzon Expressway (NLEX), and Subic-Clark-Tarlac Expressway (SCTEX) starting January 2011. The TRB approved toll fee increases of P3.03 per kilometer from P0.76 per kilometer, P2.38 per kilometer from P2.13 per kilometer, and P2.67 per kilometer from P2.49 per kilometer for SLEX, NLEX, and SCTEX, respectively.

Water

Water rates were higher in Q4 2010. The Foreign Currency Differential Adjustment (FCDA) component for Manila Water increased to ₱0.10

Water rates are higher due to higher FCDA component.

⁹ Land transportation expense accounts for 3.5 percent of the total CPI basket.

per cubic meter (m^3) from zero in the previous quarter. This raised the total tariff rate of Manila Water by $\text{₱}0.13/m^3$ from $\text{₱}29.99/m^3$ in the previous quarter to $\text{₱}30.12/m^3$ in Q4. Meanwhile, the FCDA component for Maynilad was zero (from $-\text{₱}0.09/m^3$ in Q3). Likewise, the refund due to gains from the prepayments of dollar-denominated loans expired during the quarter. This brought the Maynilad rates to $\text{₱}37.40/m^3$ in Q4 from $\text{₱}33.08/m^3$ in the previous quarter, or an increase of $\text{₱}4.32/m^3$.

On a quarter-on-quarter basis, the water rates of Manila Water and Maynilad increased by 0.4 percent and 13.1 percent, respectively.

Power

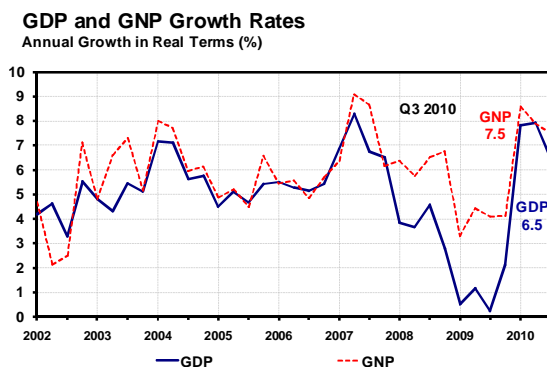
Power rates decline due to lower generation costs.

Power rates declined generally in Q4 2010 as Meralco passed on lower generation costs to consumers. The decline was due to lower costs of supply from the NPC and IPPs. In the beginning of the quarter, the reduction in IPP rates could be traced largely to higher capacity as power plants operated more efficiently, resulting in lower fixed cost per kilowatt-hour. At the same time, the stronger peso contributed to lowering the costs of power from the IPPs. Electricity costs also declined with the onset of the cooler weather and given seasonally low demand during the second semester.

However, there remain potential sources of upside pressures on electricity charges stemming from pending petitions with the Energy Regulatory Commission (ERC). These include: (1) Meralco's petition to increase its retail electricity charges in 2011-2015; (2) Power Sector Assets and Liabilities Management's (PSALM) petition to recover NPC's stranded contract cost and debts; (3) NPC's petition to recover actual and incremental fuel, IPP and foreign exchange rate fluctuation costs under the 13th-17th generation rate adjustment mechanism (GRAM) and the 12th-16th incremental currency exchange rate adjustment (ICERA); and (4) the National Grid Corporation's petition to recover the costs of repair on damages caused by the tropical storms in 2009 and the bombings in Lanao del Norte.

Aggregate Demand and Supply

Economic momentum remains strong.



The domestic economy expanded by 6.5 percent in Q3 2010, slower than the revised 8.2 percent growth in Q2 but significantly higher than the year-ago growth rate of 0.2 percent. The Q3 2010 GDP growth reflected the solid growth in net exports and private demand, as well as the accelerated growth in services. For the first three quarters of 2010, GDP increased by 7.5 percent.

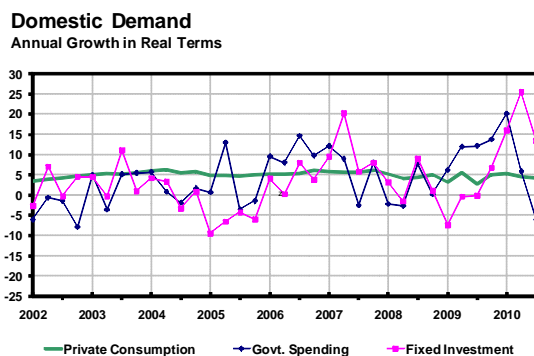
On the production side, agricultural output continued to contract while services and industry continued to grow. On the expenditure side, growth was led by sustained recovery in external trade, consumer spending, and investments.

Meanwhile, net factor income from abroad (NFIA) rose by 13.7 percent on the back of steady inflows of overseas Filipino (OF) remittances. This resulted in the 7.5 percent expansion in the Q3 2010 real GNP compared to the 4.1 percent growth recorded in the same quarter in 2009.

Seasonally-adjusted estimates, however, showed that GDP declined slightly by 0.5 percent in Q3 2010 from a growth of 1.4 percent (revised) in Q2 2010. The contraction was due mainly to the 4.4 percent decrease in industrial production, a reversal of the 3.0 percent seasonally-adjusted growth in the previous quarter.

Aggregate Demand

Expenditures by major economic sectors



Domestic demand momentum remained relatively strong. Personal consumption expenditure (PCE) continued to be the major driver of growth on the expenditure side. Improving consumer confidence coupled with benign inflation resulted in the 4.2 percent y-o-y growth in household spending, higher than the 2.6 percent growth in Q3 2009 but slightly lower than the 4.6 percent growth posted in Q2 2010. Broadly stable spending was seen in all major expenditure items, particularly in necessities such as food, utilities, and household operations.

Economic Performance

Growth rate (in percent)

Sector	2009	2010	
	Q3	Q2	Q3
<i>By expenditure item</i>			
Personal consumption	2.6	4.6	4.2
Government consumption	12.1	5.8	-6.1
Capital formation	-11.4	10.8	8.9
Fixed capital formation	-0.1	25.5	13.4
Exports	-12.9	29.1	29.9
Imports	-2.6	20.4	18.2

Source: NSCB

With the objective of containing the deficit within the program, the national government (NG) tightened spending in Q3 2010, leading to the 6.1 percent drop in government consumption. The improved fiscal performance can be traced to the decline in both the maintenance and other operating expenditures (MOOE) and in the net lending to government-owned and -controlled corporations (GOCCs).

Capital formation sustained its growth, expanding by 8.9 percent in Q3 2010 from an 11.4 percent contraction in the same period a year ago and a 10.8 percent growth in Q2 2010. The fourth consecutive quarter of capital formation growth was fuelled by higher investment in durable equipment and increased private construction activities. The double-digit growth of investment in durable equipment at 16.4 percent came from the upswing in spending on transport equipment (particularly road vehicles and water transport), specialized machinery, and miscellaneous equipment (e.g., office machinery and data processing equipment). The expansion in capital formation was likewise supported by the accelerated growth in private construction at 41.1 percent, offsetting the 24.0 percent decline in public construction. The increase in private construction was due to the commencement of commercial and residential building projects that were put on hold during the crisis. These included construction projects in the commercial segment which cater to the expanding business process outsourcing (BPO) sector, and the housing segment driven by post-disaster reconstruction and the expansion of residential projects for the middle-income group. Meanwhile, public construction spending dropped as funding for public works projects were frontloaded during the first half of the year.

Meanwhile, with the recovery of global trade, the country's external trade performance continued to improve as both exports and imports posted double-digit y-o-y growth rates for the third consecutive quarter in Q3 2010 at 29.9 percent and 18.2 percent, respectively.

Other Demand Indicators

Other demand indicators reflected the strength of the economy. Capacity utilization and production in the manufacturing sector remained high while energy consumption continued to increase. Business confidence and consumer sentiment for the current quarter set new record highs while sales of passenger cars and commercial vehicles continued to post solid growth. The property sector, meanwhile, was generally stable despite ongoing market correction.

Property Prices

Land values are lower in Q2 2010 due to on-going market correction.

The latest report from Colliers International indicated that, on a quarter-on-quarter basis, implied land values¹⁰ continued to decline in Q2 2010. On a y-o-y basis, implied land values for the Makati Central Business District (CBD) and Ortigas Center also showed a decline of 7.9 percent and 7.0 percent, respectively, in the second quarter of 2010. Implied land values in the Makati CBD and Ortigas Center were lower at ₱265,365/sq.m. and ₱120,000/sq.m., respectively, due to the continuing correction in the commercial property market. According to Colliers, while commercial values in general have bottomed out, land values in the Makati CBD are expected to remain stable towards the end of the year. Land values are presently at about 61-63 percent of their 1997 levels in nominal terms, but only about 30-32 percent of their 1997 levels in real terms.

Vacancy Rates

Makati CBD office vacancy rates decline marginally in Q2 2010...

According to Colliers International, the monthly office vacancy rate in the Makati CBD of 6.9 percent was lower in Q2 2010 compared to the quarter-ago level but higher than its year-ago level. Although the overall office vacancy rate in the Makati CBD declined marginally in Q2 2010, vacancy rates increased significantly in both the Premium and Grade A segments due to decentralization pressures as office buildings outside the Makati CBD experienced strong demand from the outsourcing and offshoring industry.

¹⁰ In the absence of reported closed transactions, implied land values based on trends are used by Colliers International to monitor prices.

... while residential vacancy rates are expected to rise further with the expected completion of more residential condominiums in the near term.

Meanwhile, the residential vacancy rate at 7.8 percent during the quarter was higher compared to the Q1 2010 level but lower than the year-ago level. There is an anticipated trend of rising vacancies in most locations in Metro Manila, particularly for studio and one-bedroom units aimed at young professionals and start-up families as new residential condominium units are scheduled to be completed in the near term. In contrast, there remains a shortage of expatriate-quality two-bedroom and three-bedroom units.

Rental Values¹¹

Office rental values increase slightly in Q3 2010.

Meanwhile, Jones Lang LaSalle estimated average office rentals in the Makati CBD at ₱7,498/sq.m. per annum in Q3 2010, higher by 0.5 percent compared to the previous quarter and by 1.8 percent compared to the same quarter in the previous year.¹² The report noted that the increase may be attributed to the continued recovery in the demand for Prime and Grade A office space, buoyed up by the off-shoring and outsourcing (O&O) sector as well as the improving outlook on the Philippine economy and resurging business confidence. Jones Lang LaSalle expects rental rates to rise over the next 12 months with demand for office space still mainly driven by the O&O sector.

Likewise, residential rental values trend higher.

Similarly, Jones Lang LaSalle's estimate of average rental for luxury residential developments in the Makati CBD rose to ₱6,252/sq.m. per annum in Q3 2010, higher by 0.6 percent and by 10.9 percent compared to the quarter- and year-ago levels. The rise in residential rental values was due to the moderate growth in investor demand for residential condominium units given the sustained growth in OF remittances and continued low interest rates. Jones Lang LaSalle projects rental values to trend upwards over the next 12 months on the back of optimistic

¹¹ Rentals comprise 15.8 percent of the CPI basket. Apartment and house rentals account for 11.7 percent while room rentals account for 4.0 percent. The NSO presently surveys rentals only ranging from around ₱300-₱10,000/month to compute rent inflation. However, the rental values discussed in this section pertain to high-end rented properties, which may be considered as indicators of wealth and demand.

¹² Jones Lang La Salle is one of the world's leading real estate services and money management firms, with approximately 160 offices worldwide. It has over 45 years of experience in Asia Pacific, with over 12,500 employees operating in more than 60 offices in 13 countries across the region.

economic outlook, sustained inflow of OF remittances, and expectations of continued low interest rates.

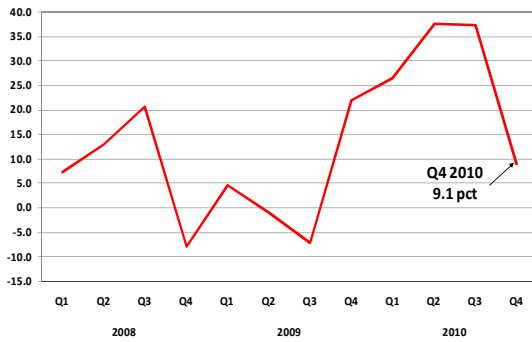
Vehicle Sales

Sales of passenger cars and commercial vehicles continue grow.

Passenger car sales continued to grow by 9.1 percent year-on-year in Q4 2010, albeit lower than the quarter- and year-ago growth rate of 37.3 percent and 22.0 percent, respectively. According to the Chamber of Automotive Manufacturers of the Philippines, Inc., the usually high sales growth associated with the holiday season was not seen as the fourth quarter sales growth was outpaced by the expansion of sales early in the year due to replacement of vehicles damaged by Typhoon Ondoy and election spending. On a quarter-on-quarter basis, passenger car sales declined by 11.7 percent in Q4, a reversal of the 6.4 percent growth posted in Q3 2010.

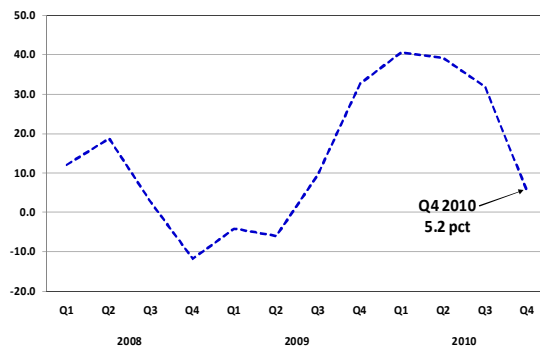
Quarterly Sales of Passenger Cars

Year-on-year change in percent



Quarterly Sales of Commercial Vehicles

Year-on-year change in percent



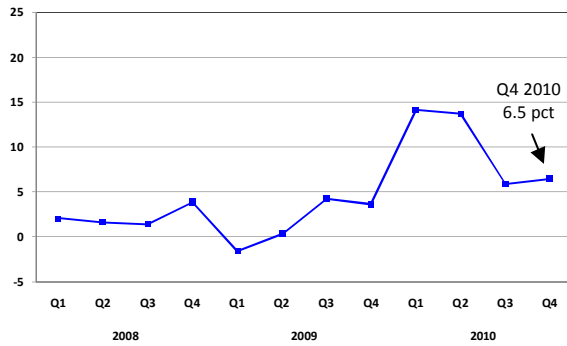
Likewise, year-on-year sales of commercial vehicles¹³ continued to grow by 5.2 percent in the fourth quarter of 2010, although lower than the quarter- and year-ago sales growth of 31.7 percent and 32.6 percent, respectively. Meanwhile, quarter-on-quarter sales of commercial vehicles declined in Q4 2010 by 4.4 percent after expanding by 1.2 percent in the previous quarter.

¹³ Commercial vehicles include Asian utility vehicles (AUVs), sports utility vehicles (SUVs), light commercial vehicles (LCVs), light trucks, heavy-duty trucks, and buses.

Energy Sales

Energy sales post solid growth.

Quarterly Power Meralco Sales
Year-on-year change in percent



Power sales of the Manila Electric Company (Meralco) grew by 6.5 percent year-on-year in the fourth quarter of 2010, higher than the quarter- and year-ago growth of 5.9 percent and 3.6 percent, respectively. According to Meralco, the growth in energy sales growth is due to the following factors: (1) high business and consumer confidence, (2) benign inflation environment; (3) robust OF remittances; and (4) sustained export growth. Another factor that contributed to the growth is the increase in customer count under the commercial sector. Meanwhile, on a quarter-on-quarter basis, energy sales continued to decline in Q4 2010 at 1.6 percent, albeit less negative than the 3.1 percent contraction in the previous quarter.

Manufacturing activity reaches new peak.

Monthly Average Capacity Utilization for Manufacturing
In percent

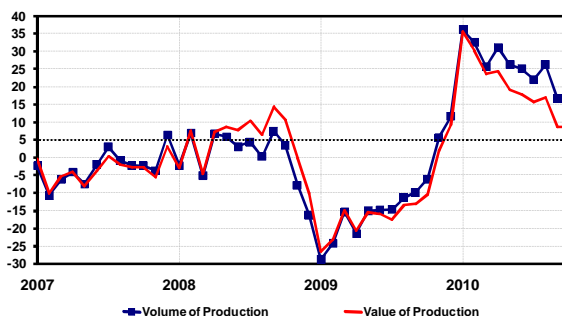


Capacity Utilization

The latest survey of capacity utilization, which captures the intensity with which companies use their employees and capital, showed a new peak of manufacturing activity. This indicated that the margin of spare capacity in the economy continued to narrow with improved demand. Based on the rates presented in the NSO's Monthly Integrated Survey of Selected Industries (MISSI), the average capacity utilization in manufacturing of 83.5 percent in October 2010 represented a new record and marked the twelfth consecutive month that the pre-crisis peak in 2008 had been surpassed.

Volume and value of production indices reflect robust expansion.

Volume and Value Indices of Manufacturing Production
year-on-year change in percent



Volume and Value of Production

Based on MISSI data, indicators for volume and value of production also reflected robust expansion. A double-digit y-o-y growth was reported for the volume of production index for the eleventh consecutive month in October. The value of production index likewise continued to show respectable growth since the reversion of the index's growth to positive territory in November 2009. Publishing and printing, paper and paper products, and textiles were among the major sectors that reported production increases.

Business confidence surges to new record high on expectations of sustained solid economic growth.

Business Expectations Survey

Index	2009		2010		
	Q4	Q1	Q2	Q3	Q4
Business Outlook Index					
Current Quarter	22.0	39.1	43.9	45.0	50.6
Next Quarter	34.0	52.6	46.3	59.2	51.0

Source: BSP

Business Expectations Survey (BES)

Business optimism surged further in Q4 2010 to set a new record high for the current quarter outlook. The overall confidence index (CI) rose to 50.6 percent from 45.0 percent in the previous quarter. Business confidence in the NCR was notably more upbeat compared to areas outside the NCR. Meanwhile, the next quarter outlook of 51.0 percent was lower than the last quarter's 59.2 percent, but was still considerably higher compared to the 34.0 percent seen in the same quarter a year ago.

The all-time high business outlook for the current quarter was driven by: (a) expectations of sustained improvements in the economy on the back of strong domestic demand fuelled in part by the steady stream of OF remittances and higher capital inflows; (b) the seasonal factor of stronger business sentiment during the Christmas and harvest seasons; and (c) continued strong confidence in the Aquino administration. The positive business sentiment likewise mirrored the improving business outlook in countries such as Canada, Hong Kong, India, Germany, Italy, and New Zealand. Businesses were less optimistic for the next quarter (Q1 2011), in view of the expected slowdown of business activity after the Christmas season.

Consumer Expectations Survey (CES)

Consumer sentiment on an uptrend due to expectations of better job opportunities and higher income.

Consumer Expectations Survey

Index	2009		2010		
	Q4	Q1	Q2	Q3	Q4
Current Quarter	-36.0	-27.6	-28.7	-14.0	-8.5
Next 3 months	-10.5	-4.8	-1.8	15.3	11.9
Next 12 months	-0.8	5.1	10.0	33.4	25.9

Source: BSP

Following the peak of -14.0 percent in the third quarter, the consumer confidence index (CI) in the fourth quarter climbed to a new record-high at -8.5 percent. The sustained rise in consumer confidence was supported by the better-than-expected GDP growth for the first three quarters of the year at 7.5 percent. According to respondents, their favorable outlook was due to expectations of better job opportunities, new investments, higher income, good governance, and a low rate of inflation. The buoyant current quarter outlook also reflected the rising optimism of consumers in advanced economies such as the United States, Canada, Germany, Italy, France, Brazil, Singapore, India, and South Korea.

For the next quarter and the year ahead, consumer sentiments were less upbeat as the CIs dropped to 11.9 percent and 25.9 percent, respectively, compared to their quarter-ago levels of 15.3 percent and 33.4 percent. Nonetheless, the next quarter- and next 12 month-CIs remained positive at double-digit levels for the second time in a row, suggesting that respondents expect sustained, although slower, economic growth in 2011. Their less upbeat expectations could be due to seasonally lower consumer demand in the first quarter of the year and the strong headwinds faced by advanced economies.

External Demand

Exports

Exports of goods grew by 41.3 percent in Q3 2010, higher than the 34.3 percent growth in the previous quarter. Merchandise exports declined by 22.0 percent in the same period in 2009. Manufactured goods, boosted by exports of semiconductors, expanded by 41.5 percent. This is consistent with the average book-to-bill ratio of 1.14 in Q3 2010. The increase in semiconductor exports can be traced to the strong demand for consumer and industrial electronic products, particularly new technology and energy-efficient products. This was followed by exports of coconut products as global demand and prices of coconut oil and products went up. Meanwhile, the growth of shipments of mineral products more than doubled at 45.5 percent in Q3 2010 relative to the previous quarter due to the higher demand for, and prices of, copper metal and concentrates.

Exports of Goods (BOP data)

Growth rate (in percent)

Commodity Group	2009	2010	
	Q3	Q2	Q3
Coconut products	-22.7	116.1	77.2
Sugar and Products	32.6	-54.5	-37.5
Fruits and Vegetables	-3.1	-29.9	3.4
Other Agro-based products	-8.9	38.1	18.6
Forest products	62.4	-10.0	-40.0
Mineral products	-57.9	21.8	45.5
Petroleum products	-88.4	-60.0	40.4
Manufactures	-15.9	36.0	41.5
Special transactions	-40.0	3.2	-18.6
Total Exports, as per NSO Foreign Trade Statistics	-21.5	33.3	39.9
Conceptual and coverage adjustments	-12.3	9.6	27.1
<i>Total Exports, BPM5</i>	-22.0	34.3	41.3

Source: BSP

Imports of Goods (BOP data)

Growth rate (in percent)

Commodity Group	2009		2010
	Q3	Q2	Q3
Capital Goods	-18.5	26.7	8.5
Raw Materials & Intermediate Goods	-19.4	25.3	39.1
Mineral Fuels & Lubricants	-49.0	34.9	8.4
Consumer Goods	-40.2	15.1	40.0
Special Transactions	-30.5	56.1	61.3
Total Imports ^{1/}	-28.5	26.1	29.4
Conceptual and coverage adjustments	-80.6	0.0	243.9
<i>Total Imports, BPM5</i>	-29.2	26.0	30.1

^{1/} Include valuation adjustments to NSO data

Source: BSP

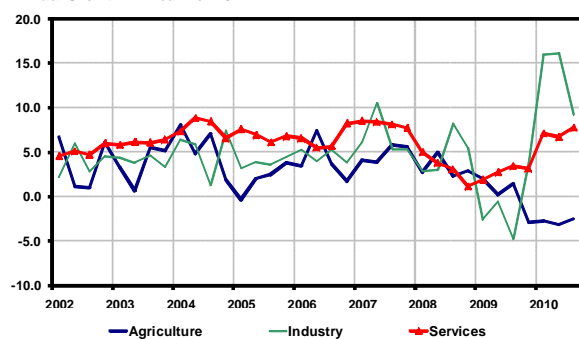
Imports

Likewise, imports of goods increased by 30.1 percent y-o-y in Q3 2010 from a 26.0 percent growth in the previous quarter. Merchandise imports contracted by 29.2 percent in the same quarter a year ago.¹ All major commodity groups posted year-on-year growth during the review quarter. The surge was due largely to the 39.1 percent rise in imports of raw materials and intermediate goods. In particular, materials/accessories for the manufacture of electrical equipment grew by 51.0 percent and contributed 16.3 percentage points to import growth. This was followed by imports of consumer goods, which expanded by 40.0 percent, as traders stocked up in preparation for higher domestic demand during the holiday season. Inward shipments of other commodity groups also expanded, including capital goods by 8.5 percent, and mineral fuels and lubricants by 8.4 percent.

Services drive economic expansion on the production side.

Agriculture, Industry and Services Sectors

Annual Growth in Real Terms



Aggregate Supply

On the production side, economic growth was led by the services sector which contributed 3.9 percentage points to GDP growth. Services, which accounted for 51.1 percent of total GDP, increased at a faster pace of 7.7 percent y-o-y in Q3 2010 compared to the quarter-ago growth of 6.7 percent and the year-ago growth of 3.4 percent. The expansion in the services sector was supported by trade, private services, and finance. Meanwhile, transportation, communications, and storage (TCS) and ownership of dwellings and real estate (ODRE) maintained a steady rate of growth in Q3 2010 relative to the previous quarter. The robust growth in the services sector pointed to more vibrant domestic economic activity backed by improved consumer sentiment, a favorable inflation environment, and sustained inflows of OF remittances.

¹ Merchandise imports in the quarterly BOP report are quoted in current US dollar prices, while those from the NIA are quoted in constant 1985 peso prices. Imports per BOP are based on the BPM5 concept (i.e., excluding from the NSO foreign trade figures those goods that did not involve change in ownership) and reflect, among others, the following things: a) upward adjustments on the valuation of consigned raw materials for electronics and garments exports; b) OF remittances in kind; and c) military imports.

Economic Performance

Growth rate (in percent)

Sector	2009	2010	
	Q3	Q2	Q3
By industrial origin			
Agriculture, Fishery & Forestry	1.4	-3.2	-2.5
Agriculture and Fishery	1.4	-2.9	-2.5
Forestry	-2.1	-37.9	-7.3
Industry	-4.8	16.1	9.2
Mining and quarrying	29.5	37.4	4.6
Manufacturing	-7.9	12.7	9.3
Construction	2.0	22.6	11.1
Electricity, gas and water	-6.3	8.6	8.1
Services	3.4	6.7	7.7
Transport., Comm., & Storage	-1.5	3.5	3.5
Trade	1.6	9.1	11.7
Finance	11.5	1.7	8.4
O. Dwellings & real estate	-2.3	9.0	9.1
Private services	6.7	7.1	7.2
Government services	8.9	7.9	-1.3

Source: NSCB

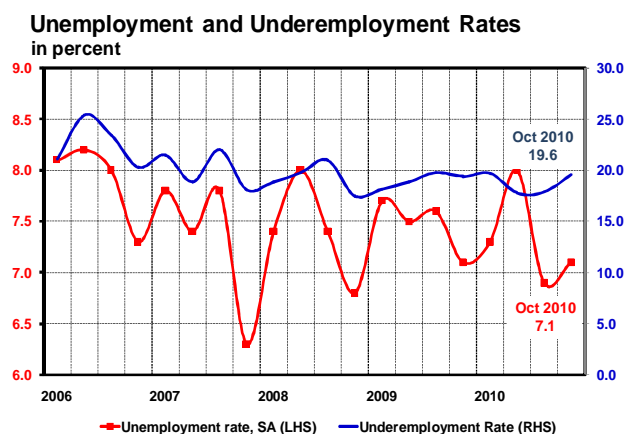
The industry sector, which comprised 33.2 percent of GDP, expanded at a respectable pace of 9.2 percent in Q3 2010, contributing 3.0 percentage points to GDP growth. Despite the slower growth compared to the previous quarter, the Q3 2010 performance was a significant improvement from the 4.8 percent contraction registered in the same period in 2009. The growth in industry was supported by the 9.3 percent expansion in the manufacturing sub-sector, bolstered by the rebound in global trade. Meanwhile, the output of utilities had been growing solidly since the first quarter, reflecting the pick-up in domestic economic activity.

On the other hand, the agriculture, fishery, and forestry (AFF) sector continued to contract in Q3 2010, pulling down overall GDP growth by 0.4 percentage point. AFF output declined for the fourth consecutive quarter as the El Niño weather condition in the first half of 2010 continued to adversely affect cropping patterns, resulting in lower production. In particular, *palay* and corn production dropped by 24.8 percent and 2.4 percent, respectively, as planting was delayed due to the late onset of rainfall and the shift of the harvest period to the fourth quarter.

Based on seasonally-adjusted estimates, the services and AFF sectors posted quarter-on-quarter growth rates of 1.9 percent and 0.3 percent, respectively, in Q3 2010. However, the said gains were offset by the 4.4 percent decline in the industry sector's output, yielding a 0.5 percent contraction in the seasonally-adjusted GDP.

Labor Market Conditions

October unemployment steady year-on-year.



Based on the results of the October 2010 Labor Force Survey (LFS), the unemployment rate in October 2010 was estimated at 7.1 percent, the same as in October 2009 but higher than the 6.9 percent recorded in July 2010. Meanwhile, the proportion of underemployed to total employed persons was higher at 19.6 percent in October 2010 from 19.4 percent in the same period last year and 17.9 percent in July 2010.

Employment increased by 2.8 percent y-o-y in October 2010, driven mainly by the employment growth in the services and industry sectors. The number of employed persons in October 2010 was recorded at 36.5 million, higher by about 1 million compared to the level registered in the same period a year ago. The services sector employed 51.7 percent of the total employed persons, while the AFF and industry sectors accounted for 33.6 percent and 14.7 percent, respectively.

In terms of major occupation groups, the year-on-year increase in the employment level was due mainly to the higher number of laborers and service workers. However, the decline in the employment of technicians and special workers pulled down employment growth in October 2010.

II. MONETARY AND FINANCIAL MARKET CONDITIONS

Domestic Liquidity and Credit Conditions

Liquidity conditions remained broadly consistent with the pace of economic expansion in the country as evidenced by the steady growth in both domestic liquidity and outstanding loans of commercial banks. Domestic liquidity or M3 continued to be driven by robust foreign exchange inflows from overseas remittances, export receipts, and outsourcing revenues, supported by continued improvements in domestic financial market conditions. Year-on-year M3 growth declined slightly to 7.5 percent in November 2010 from 10.5 percent in September.

Liquidity growth is broadly steady.

The slower expansion of domestic liquidity in November could be traced to the 1.2 percent contraction (from a 5.1 percent growth in September) in net domestic assets (NDA), due largely to the 23.9 percent expansion of the net other items account (which includes revaluation and capital and reserve accounts and SDA placements of trust entities), which pulled down domestic liquidity. Nonetheless, net domestic credits continued to rise, albeit at a slower pace of 8.0 percent from 9.4 percent in September, given the steady increase in credits extended to the private sector at 10.0 percent. Meanwhile, net foreign assets (NFA) increased at a faster pace of 14.9 percent from 12.8 percent in September, bolstered by the 29.1 percent growth in the BSP's NFA position, reflecting continued foreign exchange inflows from OF remittances, portfolio investments, and export receipts.

Bank lending continues to expand.

The sustained growth in bank lending was indicative of the strong domestic demand momentum. As of November 2010, bank lending, net of banks' reverse repurchase (RRP) placements with the BSP, continued to expand, albeit at a slightly slower pace of 9.0 percent from 9.8 percent in September 2010. The growth of bank lending was driven mainly by lending to the following productive sectors: manufacturing; agriculture, hunting and forestry; real estate, renting and business services; and electricity, gas and water. Meanwhile, consumer loans (which include credit card receivables and auto loans) expanded at a faster pace of 12.0 percent from 8.0 percent as of end-Q3 2010.

Meanwhile, overall credit standards remain generally unchanged in Q4 2010.

Results of the Q4 2010 Senior Bank Loan Officers' Survey¹⁴ showed that most banks had generally unchanged credit standards for the seventh consecutive quarter starting Q2 2009, based on the proportion of banks indicating whether they tightened, loosened, or maintained credit standards.¹⁵ However, using the diffusion index approach,¹⁶ the survey results indicated an overall net tightening in credit standards for loans extended to enterprises. Meanwhile, for loans to households, all of the respondents reported that, in general, credit standards were unchanged in Q4 2010 relative to Q3 2010.

Lending to Enterprises

With regard to firm size, banks reported a net tightening of general credit standards for large middle-market enterprises, consistent with the overall net tightening of credit standards. However, overall credit standards for top corporations and small and medium enterprises showed no net change¹⁷ while those for micro enterprises were unchanged¹⁸ for the second consecutive quarter.

Respondent banks' specific credit standards¹⁹ showed an overall net tightening in terms of collateral requirements, loan covenants, and loan maturities. However, respondents indicated a net narrowing of loan margins and a net increase in the size of credit lines overall as well as for top corporations.

General Credit Standards to Enterprises (Overall)								
	Q1 2009	Q2 2009	Q3 2009	Q4 2009	Q1 2010	Q2 2010	Q3 2010	Q4 2010
Tightened considerably	8.7	0.0	0.0	0.0	5.3	0.0	0.0	0.0
Tightened somewhat	56.5	22.2	29.4	14.3	10.5	4.5	9.5	15.0
Remained basically unchanged	34.8	77.8	64.7	85.7	84.2	95.5	90.5	80.0
Eased somewhat	0.0	0.0	5.9	0.0	0.0	0.0	0.0	5.0
Eased considerably	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Total	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0
Diffusion Index	65.2	22.2	23.5	14.3	15.8	4.5	9.5	10.0
Weighted Diffusion Index	37.0	11.1	11.8	7.1	10.5	2.3	4.8	5.0
Mean	2.3	2.8	2.8	2.9	2.8	3.0	2.9	2.9
Number of banks responding	23.0	18.0	17.0	21.0	19.0	22.0	21.0	20.0

Note: A positive diffusion index indicates that more banks have tightened their credit standards compared to those that eased ("net tightening"), whereas a negative diffusion index indicates that more banks have eased their credit standards compared to those that tightened ("net easing").

¹⁴Survey questions were sent to 35 commercial banks, with 21 banks responding, for a response rate of 60.0 percent. As of June 2010, commercial banks' loans accounted for around 86 percent of the banking system's total outstanding loans.

¹⁵Prior to the Q1 2010 survey, the BSP looked only at the mode of responses in interpreting the results of the survey, i.e., the number of banks that tightened, loosened, or maintained credit standards. Since Q1 2010, the BSP started analyzing the results of the survey by looking at the percentage difference ("diffusion index") between banks reporting that credit standards have been tightened and those reporting that they have been eased.

¹⁶A positive diffusion index indicates that more banks have tightened their credit standards compared to those that eased ("net tightening"), whereas a negative diffusion index indicates that more banks have eased their credit standards compared to those that tightened ("net easing").

¹⁷"No net change" means that the percentage of banks that tightened credit standards is the same as the percentage of banks that eased credit standards.

¹⁸"Unchanged credit standards" means that no bank has reported tightening or easing of credit standards.

¹⁹The survey questionnaire identified five specific credit standards: (1) loan margins (price-based); (2) collateral requirements; (3) loan covenants; (4) size of credit lines; and (5) length of loan maturities.

Looking at the external and bank-specific factors affecting banks' credit standards, the overall net tightening in credit standards was due to banks' less optimistic outlook on the economy, due largely to concerns on the effects of adverse weather conditions on the agricultural sector, and indications of weak global demand recovery. Banks likewise cited reduced tolerance for risk as a contributing factor in the net tightening of overall credit standards for enterprises.

Lending to Households

Banks had basically unchanged credit standards overall and across all types of household loans,²⁰ except housing loans (which reflected a net easing). Respondent banks reported no change in terms of collateral requirements, loan covenants, and loan maturities overall as well as for most types of household loans. The reported net easing of overall credit standards for housing loans can be traced to narrower loan margins, increased size of credit lines, and less strict collateral requirements. Stable access to market financing and competition from other banks as well as non-bank lenders contributed to the unchanged credit standards for household loans.

Loan demand

The survey results also pointed to a net increase in demand²¹ for loans from enterprises compared to the previous quarter. Demand increased across all firm sizes, except for micro enterprises, which was unchanged from the previous quarter. Among the more important reasons for the net increase in demand for loans by enterprises

General Credit Standards to Households (Overall)								
	Q1 2009	Q2 2009	Q3 2009	Q4 2009	Q1 2010	Q2 2010	Q3 2010	Q4 2010
Tightened considerably	6.7	7.1	8.3	0.0	11.1	0.0	0.0	0.0
Tightened somewhat	66.7	14.3	8.3	25.0	11.1	23.1	8.3	0.0
Remained basically unchanged	26.7	71.4	83.3	75.0	66.7	69.2	83.3	100.0
Eased somewhat	0.0	7.1	0.0	0.0	11.1	7.7	8.3	0.0
Eased considerably	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
<i>Total</i>	<i>100.0</i>	<i>100.0</i>	<i>100.0</i>	<i>100.0</i>	<i>100.0</i>	<i>100.0</i>	<i>100.0</i>	<i>100.0</i>
<i>Diffusion Index</i>	<i>73.3</i>	<i>14.3</i>	<i>16.7</i>	<i>25.0</i>	<i>11.1</i>	<i>15.4</i>	<i>0.0</i>	<i>0.0</i>
<i>Weighted Diffusion Index</i>	<i>40.0</i>	<i>10.7</i>	<i>12.5</i>	<i>12.5</i>	<i>11.1</i>	<i>7.7</i>	<i>0.0</i>	<i>0.0</i>
<i>Mean</i>	<i>2.2</i>	<i>2.8</i>	<i>2.8</i>	<i>2.8</i>	<i>2.8</i>	<i>2.8</i>	<i>3.0</i>	<i>3.0</i>
<i>Number of banks responding</i>	<i>15.0</i>	<i>14.0</i>	<i>12.0</i>	<i>12.0</i>	<i>9.0</i>	<i>13.0</i>	<i>12.0</i>	<i>10.0</i>

Note: A positive diffusion index indicates that more banks have tightened their credit standards compared to those that eased ("net tightening"), whereas a negative diffusion index indicates that more banks have eased their credit standards compared to those that tightened ("net easing").

²⁰Loans extended to households include: (1) housing loans; (2) credit card loans; (3) auto loans; and (4) personal/salary loans.

²¹"Net demand" refers to the percentage difference between banks reporting an increase in loan demand and banks reporting a decrease. Net demand will therefore be positive if more banks reported an increase in loan demand compared to those stating the opposite, whereas it will be negative if more banks reported a decrease in loan demand compared to those reporting an increase.

were the lower interest rates, higher cash flow requirements, and lack of access to other sources of financing.

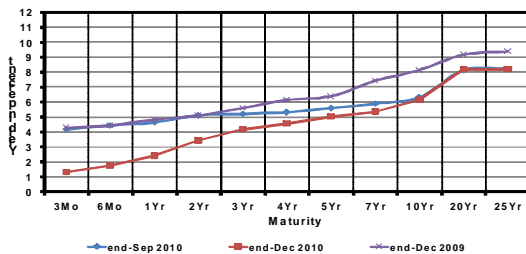
For loans to households, banks likewise indicated a net increase in demand for all types of loans. Moreover, the higher demand for auto loans was consistent with the solid growth of passenger car and commercial vehicle sales in Q4 2010.

The overall net increase in demand for household and corporate loans was consistent with the sustained growth in bank lending during the first two months of the quarter for which data are available.

Interest Rates

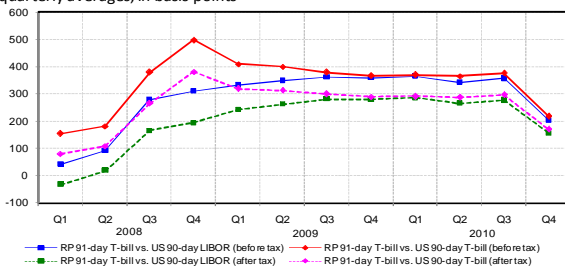
Yields in the secondary market decline significantly.

Yield of Government Securities in the Secondary Market
In percent



Interest rate differentials narrow.

INTEREST RATE DIFFERENTIALS
quarterly averages; in basis points



Yield Curve

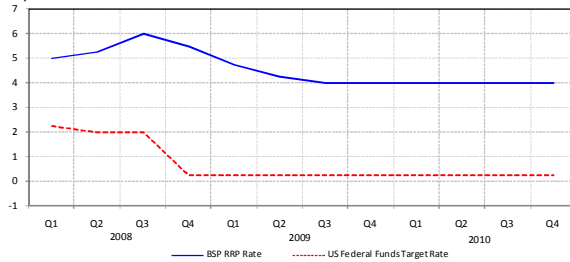
Secondary market yields fell, reflecting market participants' expectations on the future path of policy rates as well as their sentiment on the fiscal developments in the country. Yields were markedly lower as of end-December 2010 relative to end-September 2010 levels, except for the 10-to 25-year tenors. Lower secondary market yields were supported by benign inflation and ample liquidity in the financial system.

Interest Rate Differentials

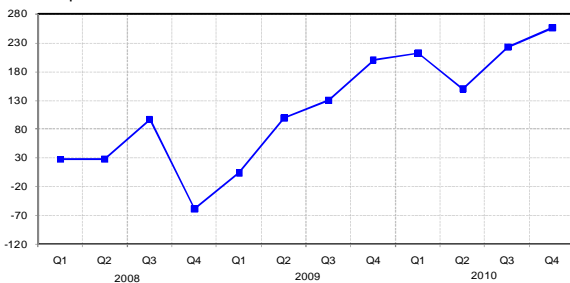
The average positive differentials between domestic and US interest rates, net of tax, narrowed in Q4 2010 compared to previous quarter due to the larger decline in the RP 91-day T-bill rate relative to the fall in both the US 90-day LIBOR and 90-day T-bill rate.

Meanwhile, the positive differential between the BSP's policy interest rate (overnight borrowing or RRP rate) and the US federal funds target rate remained at 375 basis points in Q4 2010, reflecting the unchanged monetary policy stance of both the BSP and the US Fed during the review quarter. Adjusted for the risk premium—which is measured as the

BSP RRP RATE AND US FEDERAL FUNDS TARGET RATE
in percent

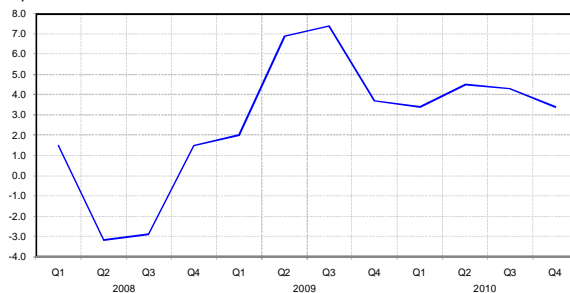


RISK-ADJUSTED DIFFERENTIALS
in basis points



Real lending rate declines.

PHILIPPINES' REAL LENDING RATE
in percent



Financial Market Conditions

Ample liquidity and favorable domestic growth prospects bolster investor confidence.

differential between the 10-year ROP note and the 10-year US Treasury note—the average spread between the BSP’s policy rate and the US federal funds target rate, however, continued to rise to 242 basis points from 211 basis points in Q3 2010. This development may be traced to the decrease in the risk premium, which fell by the same magnitude, given the bigger rise in the yield of the 10-year US note compared to the minimal decline in the yield of the 10-year ROP note during the review period.

The larger decline in nominal bank lending rates, amid the lower inflation rate in December 2010 resulted in the decrease in the real lending rate—measured as the difference between the average bank lending rate and inflation—at 3.4 percent in December 2010 from 4.3 percent in September 2010. Meanwhile, the real lending rate of the Philippines in December 2010 ranked third highest in a sample of 10 Asian countries, while Indonesia recorded the highest real lending rate at 5.4 percent during the quarter.

Bullish market sentiments continued in Q4 2010, supported by ample liquidity in the system and sustained favorable outlook on the country’s growth prospects, and the quantitative easing programs of AE central banks. Strong economic data on the domestic and international fronts likewise contributed to the upbeat mood in the local bourse, the continued narrowing of sovereign debt spreads, and the appreciation trend of the peso during the quarter. The generally stable bank lending growth also continued to suggest that ample funds are available to support the funding requirements of the economy. In addition, the sustained resiliency of the banking sector,

reflective of the continued fine-tuning of regulatory and supervisory mechanisms in recent years, bolstered investor sentiment. However, lingering uncertainties over the sovereign debt problem in Europe as well as asset price bubble and overheating concerns in fast-growing emerging markets dampened investor confidence.

Stock Market

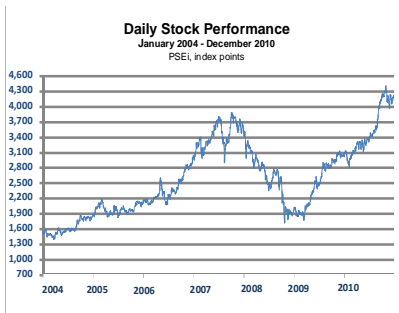
Local equities continued to rally in the last quarter of 2010, setting new historic highs six times during the period. The positive outlook for the Philippine economy and the decision of other central banks to implement stimulus measures helped boost the 30-stock composite index to its highest level at 4,397.3 index points on 4 November, which was about 44.0 percent higher year-to-date.

Starting mid-November, however, trading was dampened partly by investor concern over China’s monetary tightening, the US Fed’s investigation of insider trading in Wall Street, the international bailout for Ireland following a similar rescue for Greece last May, and escalating tension between North and South Korea. Reports of a lower-than-expected third quarter growth for the Philippine economy also encouraged investors to cash-in on gains following the previous months’ rallies.

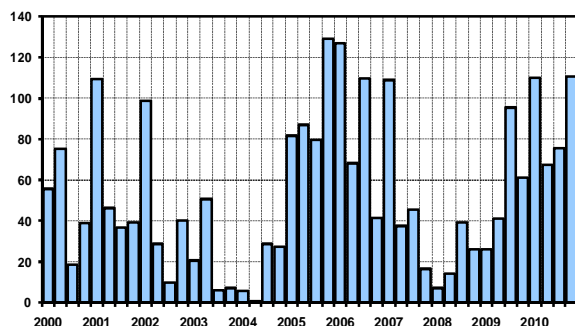
Towards the end of the quarter, year-end window dressing and strong gains in Wall Street helped lift the PSEi higher, although the uptick continued to be tempered by external developments. The PSEi closed the year at 4,201.1 index points, higher by 6.3 percent than the end-November index and by 37.6 percent relative to the closing index in 2009.

Overall, the PSEi rose to average 4,141.2 index points in the last three months of 2010, higher by 12.0 percent from the previous quarter’s average or by 37.9 percent relative to the year-ago level. Stock market capitalization also went up by 20.1 percent quarter-on-quarter or 47.1 percent y-o-y to reach ₱8.9 trillion during the period in review.

The PSEi continues its rally in Q4 to be one of the best performing indices in Asia.



Oversubscription of T-bill Auctions
In billion pesos



Debt spreads narrow to their lowest levels on strong economic data on both the international and domestic fronts.

Government Securities

During the fourth quarter of 2010, the very liquid market attributed to the huge portfolio inflows, the benign inflation environment, and the BSP's steady policy rates encouraged investors to park their excess funds in risk-free government securities (GS). Ample market liquidity and renewed uncertainties over the debt crisis in Europe also contributed to the larger oversubscription in Q4 2010 at ₱110.7 billion relative to ₱75.7 billion in the previous quarter.

The Government had rejected in full the bids for T-bills across all tenors during the last quarter of 2010 given indications of a comfortable cashflow position in 2011.

Taking into account the situation in Europe and Korea, interest rates on debt papers are expected to move up. However, this trend is seen to be offset by the possible decline in yields due to the NG's planned bond swap transactions involving the exchange of shorter-dated debt papers with longer-dated ones in 2011.

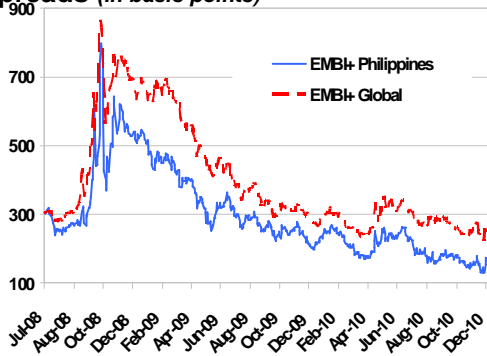
Sovereign bonds and CDS spreads

Debt spreads continued to narrow in Q4 2010, sustaining the tightening trend seen in the previous quarter. Spreads shrank to their lowest levels as waves of strong economic data—both from the international and domestic markets—fueled investor appetite for EM assets. The narrowing trend was bolstered further by the extended tax cuts in the US and the Fed's decision to purchase more government securities to help boost growth alongside the ECB's extended loan program.²² The decision of the US Fed to inject US\$600 billion into the faltering US economy was met with investor approval, renewing confidence in the prospects for global growth. On the domestic front, the upgrading of the Philippines' foreign currency

²² The ECB delayed its withdrawal of emergency liquidity measures to prevent the region's debt crisis from spreading. The ECB will offer unlimited loans through the first quarter of 2011 with a tenor of seven days, one month and three months.

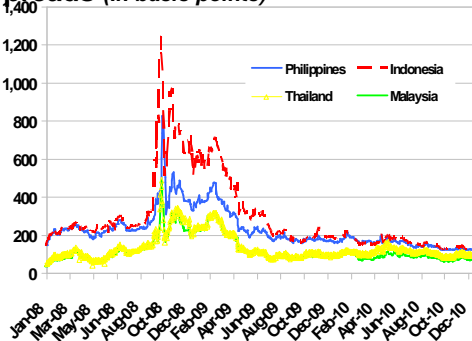
JP Morgan EMBI+ Sovereign Bond

Spreads (In basis points)



Philippine Senior 5-year CDS

Spreads (In basis points)



credit rating from BB- to BB by the Standard & Poor’s (S&P) contributed significantly to the narrowing of debt spreads.

However, amid the general tightening trend, widening pressures were also seen intermittently during the quarter on fears that the US quantitative easing would result in another wave of fresh capital inflows into emerging markets, which could fan asset price bubbles and lead to potential overheating in emerging Asia. Adding to market worries were the lingering uncertainties about the sovereign debt in the euro zone²³ along with Ireland’s credit downgrade combined with Dubai missing out on its loan payments and Vietnam’s credit downgrade. The political tension in the Korean peninsula also weakened the demand for riskier EM assets, resulting in a temporary widening of debt spreads during the quarter. In addition, growing inflationary pressures in some EMs in Asia have tempered the tightening trend in spreads.

Nonetheless, debt spreads ended the quarter on a positive note. As of end-December 2010, the emerging market bond index (EMBI) + Philippine spread stood at 159 bps, last seen during the pre-Lehman period. Local spreads also traded below the EMBI+ Global spread of 248 bps during the same period. Against neighboring economies, the Philippine credit default swap (CDS) spread traded at 128 bps, equal to Indonesia’s but wider than Malaysia’s 75 bps and Thailand’s 97 bps. Against these levels, debt spreads narrowed compared to those posted in the previous quarter and during the same period a year ago.

²³ Fellow euro zone debtors Portugal, Greece, and Spain were put on notice that their credit ratings would also be cut.

Banking System

Key performance indicators show sustained resilience of the banking system.

The Philippine banking system sustained its resiliency and strength during the review quarter as it continued to mobilize deposits and fund new loans. Credit quality in the system improved, posting lower NPL ratios and higher coverage ratios. With the BSP setting the pace, Philippine banks continued to comply with reforms implemented to clean up bank balance sheets, strengthen bank capitalization through Basel II, and improve further corporate governance structures.

Savings Mobilization

Savings and time deposits remained the banks' main sources of funds. Banks' total deposits²⁴ as of end-October 2010 amounted to ₱3.5 trillion, 7.8 percent higher than the year-ago level of ₱3.3 trillion. The growth in deposits reflected sustained depositor confidence in the banking system. Savings deposits registered a 10.1 percent growth and continued to account for nearly half of the funding base. Demand deposits expanded by 13.3 percent y-o-y while time deposits posted a moderate growth of 0.5 percent.

Institutional Developments

The total resources of the banking system rose by 8.6 percent to ₱6.8 trillion as of end-October 2010 from the year-ago level of ₱6.2 trillion. The increase could be traced to the growth in currency and deposits, indicative of the public's continued trust in the banking sector. Universal and commercial banks (U/KBs) continued to account for almost 90 percent of the total resources of the banking system.

The number of banking institutions (head offices) fell further to 764 as of end-September 2010 from the quarter- and year-ago levels of 773 and 797, respectively, reflecting the continued consolidation of banks as well as the exit of weaker players in the banking system. By banking classification, banks (head offices) consisted of 38 U/KBs, 73 thrift banks (TBs), and

²⁴ Total peso-denominated deposits.

653 rural banks (RBs). Meanwhile, the operating network (including branches) of the banking system increased to 8,740 as of September 2010 from 8,685 in Q2 2010 and 8,564 in the same period a year ago, due mainly to the increase in branches/agencies of commercial and rural banks.

Asset quality of the Philippine banking system continues to improve.

The asset quality of the Philippine banking system continued to improve. The NPL ratio eased further to 3.9 percent as of end-October 2010 from 4.0 percent a year ago but was slightly higher than the 3.8 percent level as of September 2010. The lower NPL ratio could be traced to the 2.6 percent y-o-y expansion in the industry's total loan portfolio (TLP) as well as the 0.2 percent drop in the NPL level. In particular, TLP expanded to ₱3,030.5 billion in end-October 2010 from ₱2,953.6 billion a year earlier. Meanwhile, the NPL level went down to ₱118.7 billion from the previous year's level of ₱118.9 billion.

Meanwhile, the NPL ratio of U/KBs dropped further to 3.2 percent as of end-October 2010 from 3.4 percent in the same period in 2009, but was higher than the 3.1 percent posted at end-September 2010.

The Philippine banking system's NPL ratio of 3.9 percent was comparatively lower than Thailand's 4.2 percent but higher than Indonesia's 3.1 percent, Malaysia's 2.0 percent, and Korea's 1.2 percent.²⁵ The lower NPL ratios of Malaysia and Korea could be attributed to the creation of publicly-owned asset management companies (AMCs), which purchased the bulk of their NPLs, a practice which was not resorted to in the Philippines.

The loan exposure of banks remained adequately covered as the banking system's NPL coverage ratio improved to 97.7 percent as of end-October 2010. The ratio was indicative of banks' continued compliance with the loan-loss provisioning requirements of the BSP to ensure adequate buffers against unexpected losses.

²⁵ Sources: Various central bank websites and IMF Global Financial Stability Report, Indonesia (Commercial banks, October 2010); Malaysia (Banking system, November 2010); Thailand (Commercial banks, September 2010); and Korea (Banking system, December 2009).

Banks remain adequately capitalized, exceeding prescribed levels set by the BSP and the Bank of International Settlements (BIS).

Likewise, the banking system remained adequately capitalized as major players in the banking industry successfully raised fresh equity through the issuance of various debt instruments. The average capital adequacy ratio (CAR) of the banking system as of end-June 2010 remained healthy at 15.2 percent on a solo basis and 16.2 percent on a consolidated basis. The ratios posted a slight improvement from the previous quarter as higher growth in qualifying capital offset the expansion in risk-weighted assets, particularly for CAR measured on solo basis. The industry's CAR continued to exceed both the statutory levels set by the BSP and the BIS at 10.0 percent and 8.0 percent, respectively.

The Philippine banking system's CAR continued to be slightly higher than those of Malaysia (14.4 percent) and Korea (14.6 percent), but lower than Thailand's (16.5 percent). Indonesia posted the highest CAR in the region at 17.0 percent.²⁶

Meanwhile, placements in the special deposit account (SDA) facility of the BSP went up by about 126 percent y-o-y to reach ₱1,238.0 billion as of end-December 2010 from the ₱548.5 billion posted during the same period a year ago. Similarly, bank placements under the BSP RRP window amounted to ₱285.1 billion, an increase of ₱19.8 billion compared to a year earlier.

Exchange Rate

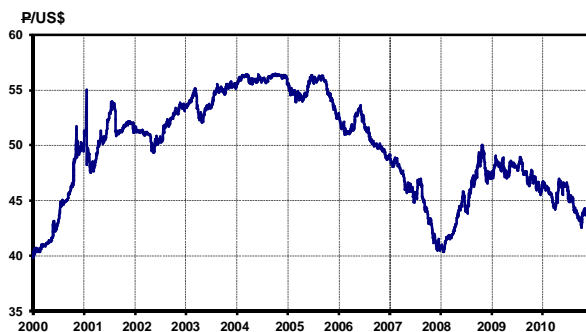
The peso appreciates further on sustained foreign exchange inflows from remittances, export receipts, and portfolio investments.

The peso averaged ₱43.63/US\$1 in Q4 2010, appreciating by 3.8 percent from the ₱45.27/US\$1 average in the previous quarter.²⁷ On a year-on-year basis, the peso appreciated by 7.2 percent from the ₱46.77/US\$1 average in Q4 2009. The peso's strength was supported by both structural and cyclical factors. In particular, structural flows from remittances and exports remained strong and had been the

²⁶ Sources: Various central bank websites, Malaysia (Banking System, November 2010); Korea (Commercial banks, December 2009); Thailand (Average Full Branch, September 2010) and Indonesia (Commercial banks, October 2010).

²⁷ Dollar rates or the reciprocal of the peso-dollar rates were used to compute for the percentage change. Figures were based on real-time transactions.

Daily Peso-US Dollar Rate



Changes in Selected Dollar Rates

	Year-to-date	
	Appr./ (Depr.), in percent	
	30 Sep*	30 Dec**
Philippine peso	5.3	5.4
Thai baht (onshore)	9.8	10.7
Chinese yuan	2.1	3.4
Malaysian ringgit	11.1	11.2
South Korean won	2.1	2.7
Singaporean dollar	6.8	8.7
New Taiwan dollar	2.5	9.9
Indonesian rupiah	5.4	4.7
Japanese yen	11.1	14.2
Indian Rupee	4.4	3.6

Source: Bloomberg, Reuters and PDEX

* As of 4:00 p.m., 30 September 2010

** As of 4:00 p.m., 30 December 2010

fundamental drivers of the peso appreciation against the US dollar.²⁸ Similarly, sustained inflow of portfolio investments buoyed up the peso appreciation further as yields in the US were expected to stay low during the review period following the US Fed’s latest quantitative easing measures.²⁹

However, during the middle and latter part of the review quarter, the peso’s appreciation was tempered by investors’ move to cut long positions on Asian currencies, including the peso, as a result of growing uncertainties on the policy actions of monetary authorities in the region.³⁰ Moreover, the tight dollar liquidity in the domestic forex market, along with the favorable US economic data, weighed down on the peso’s strength.³¹

On a year-to-date basis, the peso appreciated against the US dollar by 5.4 percent on 30 December 2010 as it closed at ₱43.84/US\$1, moving in tandem with other Asian currencies.³²

Meanwhile, volatility, as measured by the coefficient of variation of the daily average exchange rates, declined to 1.0 percent in the fourth quarter of 2010 compared to 1.9 percent in the third quarter of 2010.

On a real, trade-weighted basis, the peso lost external price competitiveness in the fourth quarter of 2010 relative to the previous quarter against the baskets of currencies of major trading partners (MTPs) and competitor countries in the narrow trading series as the nominal appreciation of the peso more than offset the narrowing inflation differential against these currency baskets. The real effective exchange rate (REER) index of the peso against the basket of MTPs and

²⁸ Based on BSP data, OF Remittance in October 2010 reached US\$1.7 billion, the highest monthly level posted during the year. Meanwhile exports for the same period grew by 26.4 year-on-year according to NSO.

²⁹ In November 2010, the US Federal Reserve announced the implementation of its second phase of quantitative easing.

³⁰ The BSP’s recent policy action not to roll over its forward dollar position to smoothen excessive volatility in the peso forced banks that are short in dollars to cover their dollar positions.

³¹ Monthly sales for retail and food services for November 2010 is estimated to expand by 0.8 percent, according to the US Census Bureau.

³² Based on the last done deal in the afternoon

competitors in the narrow series both increased by 0.6 percent in Q4 2010.³³ During the same period, the peso gained external price competitiveness against the broad basket of competitor countries. The REER index against competitor countries in the broad series declined by 0.2 percent as the narrowing inflation differential more than offset the nominal appreciation of the peso.³⁴

On a year-on-year basis, the peso gained external price competitiveness against the basket of competitor currencies in the narrow series in Q4 2010 as the REER index of the peso decreased by 1.2 percent. Meanwhile, the peso lost external price competitiveness against the basket of currencies of MTPs and competitor countries in the broad series during the same period as the REER index of the peso against these baskets of currencies increased by 10.9 percent and 0.8 percent, respectively.

³³ The basket of the major trading partners is composed of the currencies of US, Japan, the euro area, and the United Kingdom. The broad basket of competitor countries comprises the currencies of Singapore, South Korea, Taiwan, Malaysia, Thailand, Indonesia, and Hong Kong while the narrow basket is composed of the currencies of Indonesia, Malaysia, and Thailand only.

³⁴ The REER index represents the Nominal Effective Exchange Rate (NEER) index of the peso, adjusted for inflation rate differentials with the countries whose currencies comprise the NEER index basket. A decrease in the REER index indicates some gain in the external price competitiveness of the peso, while a significant increase indicates the opposite. The NEER index, meanwhile, represents the weighted average exchange rate of the peso vis-à-vis a basket of foreign currencies.

III. FISCAL DEVELOPMENTS

The January-November 2010 fiscal deficit is lower compared to its year-ago level.

National Government Fiscal Performance

January- November 2010

In billion pesos

	January-November		Growth (%)
	2009	2010	
Surplus/(Deficit)	-272.5	-269.8	-1.0
Revenues	1,021.7	1,104.8	8.1
Expenditures	1,294.2	1,374.6	6.2

**Totals may not add up due to rounding*

Source: BTR

The fiscal deficit in January-November 2010 was ₱269.8 billion, 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 to ₱1,104.8 billion in the first eleven months of 2010 compared to the ₱1,021.7 billion collected in the same period last year, accounting for 85.4 percent of the programmed amount of ₱1.3 trillion for the year 2010. The BIR and the BOC contributed ₱753.3 billion and ₱233.5 billion, respectively, to total revenues. The BIR and BOC collections went up by 10.5 percent and 15.9 percent, respectively, compared to the year-ago levels. On the other hand, collections by the Bureau of the Treasury (BTr) decreased by 13.4 percent to ₱52.4 billion from ₱60.5 billion in the comparable period last year. Likewise, revenues from other offices decreased by 15.8 percent to ₱65.5 billion.

Expenditures for January-November 2010 amounted to ₱1,374.6 billion, 6.2 percent higher than the disbursements in the comparable period in 2009, and represented about 84.9 percent of the 2010 programmed level of ₱1.6 trillion. Excluding interest payments, total disbursements rose by 6.3 percent to ₱1,099.6 billion. Interest payments also went up by 5.7 percent to reach ₱275.0 billion.

IV. EXTERNAL DEVELOPMENTS

Global economic recovery continues in Q3 but the multi-speed nature of recovery will likely extend going forward.

The global economic recovery continued in Q3 2010. Both the US and Japan grew stronger than expected during the quarter. Likewise, the expansion remained robust in EM economies despite some moderation observed in recent months. Survey-based indicators suggest that the global economic recovery will hold steady in the near term despite still lukewarm employment conditions and slowing external demand. Nonetheless, the multi-speed nature of the recovery will likely continue going forward, with dynamic EMs fueling global economic growth. The subdued economic prospects in AEs will continue to hold down employment conditions and private demand. Meanwhile, EM economies are faced with the challenge of dealing with strong capital inflows and averting potential overheating. At the same time, the need for internal and external rebalancing remains a crucial element in sustaining the global economic recovery.³⁵

Inflationary pressures in AEs remained subdued but had intensified somewhat in EMs, leading central banks in the latter economies to tighten further their monetary stance.³⁶ The recent surge in capital inflows to Asia, encouraged by the international yield differentials favoring EMs and improved risk appetite for EM assets, drove EM central banks to introduce various forms of capital control.³⁷ Meanwhile, the US Fed and the BOJ implemented further quantitative easing to help quicken the pace of recovery in their economies.

Strong consumption spending fuels US economic growth.

US economic growth edged up in Q3 2010 on account of strong consumption spending. The US economy grew at an annualized rate of 2.6 percent in Q3 2010 (quarter-on-quarter) from 1.7 in the previous quarter. Personal consumption expenditure and private inventory investments were the main drivers of economic expansion. Likewise, the trade gap weighed less

³⁵ Clift, Jeremy. Two-speed recovery to extend in 2011, says the IMF. IMF Survey online. December 2010.

³⁶ The Reserve Bank of India raised its policy rates by 100 bps beginning July 2010 while the People's Bank of China raised its policy rates by 25 bps in October 2010 in addition to the 100-bp hike in banks' reserve requirements from February to May 2010.

³⁷ These include Indonesia, South Korea, and Thailand.

heavily on output growth as import growth decelerated significantly. Consumption spending was seen to increase further in the months ahead in view of the holiday shopping season. The improvement in consumer sentiment in December, as evidenced by the uptick in the University of Michigan's consumer sentiment index, also bodes well for consumption spending despite no major improvement in the consumers' financial prospect in the past two years.³⁸

US manufacturing activity is likewise expected to strengthen further. The manufacturing PMI was broadly stable at 57.0 percent in December from 56.6 percent in the previous month, with new orders, production, and the backlog of orders expanding at a faster pace.

Stiff headwinds continued to afflict the US labor market. The seasonally-adjusted unemployment rate edged up to 9.8 percent in November after staying at 9.6 percent in the previous three months.

As regards price developments, y-o-y headline inflation fell to 1.1 percent in November from 1.2 percent in the previous month. Food prices rose by 1.5 percent while gasoline prices increased by 7.3 percent.

Euro area expansion slows down but momentum remains in place.

Euro zone output growth slowed down in the third quarter but underlying momentum remains in place. First estimates of euro area output growth showed that real GDP growth declined to 0.4 percent quarter-on-quarter in Q3 2010 from 1.0 percent in the previous quarter. Private consumption and exports were the main drivers of growth. Meanwhile, gross capital formation was unchanged, owing to subdued construction investment on account of ongoing adjustments in the housing market in a number of euro area countries. Non-construction investment, meanwhile, is expected to trend higher, bolstered by the strengthening economic momentum and less stringent financing conditions.

³⁸ Thomson Reuters and University of Michigan press release dated 24 November 2010

Economic sentiment in the euro area is gaining momentum. Consumer confidence rose by 1.5 index points in November on increased optimism about the general economic situation and easing employment concerns.³⁹

Euro area inflation was stable at 1.9 percent in October and November. Transport fuel, heating oil and gas had the largest upward impact on the November headline inflation rate while telecommunications had the biggest downward impact. Meanwhile, inflation is estimated to edge up to 2.2 percent in December.⁴⁰

Economic growth in Japan accelerates due to higher private demand.

The Japanese economy grew strongly in the third quarter. Real GDP growth accelerated to 1.1 percent (quarter-on-quarter) in Q3 2010 from 0.9 percent in the previous quarter. The expansion was traced mainly to the 1.5 percent growth in private demand. Meanwhile, public demand contracted on account of reduced spending on infrastructure. Export growth was also offset completely by the expansion in imports as Japanese companies grappled with the strong yen and renewed uncertainties about the global economic recovery.

Output growth, like in most advanced economies, is expected to slow down in the near term. For instance, the next quarter diffusion index in the December Tankan survey on business conditions turned negative for both manufacturing and non-manufacturing enterprises. In addition, employment conditions continued to be tepid with the unemployment rate rising anew to 5.1 percent in October from 5.0 percent in the previous month and new-job-openings-to-applicants ratio remaining broadly steady at 0.9.

Emerging Asia continues to lead global economic growth.

Q3 2010 output growth slowed down in emerging Asia but maintained robust momentum. In China, real GDP grew by 9.6 percent in Q3 2010, down slightly from the 10.3 percent growth posted in the previous quarter. Domestic demand remained robust despite the

³⁹ European Commission Business and Consumer Survey November 2010 Results

⁴⁰ Eurostat press release dated 4 January 2011 available online: http://epp.eurostat.ec.europa.eu/cache/ITY_PUBLIC/2-04012011-AP/EN/2-04012011-AP-EN.PDF

normalization of monetary and fiscal measures after the crisis. Inflationary pressures also continued to emerge, with inflation soaring to 5.1 percent in November, the highest for 2010, mainly on account of higher food prices. Amid elevated levels of inflation and strong domestic economic activity, the People's Bank of China (PBC) raised its reserve requirement by a total of 150 bps from November to December 2010.⁴¹

The Indian economy, meanwhile, grew at the same pace as it did in the previous quarter at 8.9 percent. The manufacturing and mining and quarrying sub-sectors continued to expand strongly. Likewise, services (particularly, trade, hotels, transport and communication, and financing and business services) provided strong support to output growth. Wholesale price inflation declined to 7.5 percent in November from 8.6 percent in October. Following the 25-bp hike on 2 November 2010, the Reserve Bank of India decided to maintain its key interest rates at 6.25 percent (repo rate) and 5.25 percent (reverse repo rate) during its 16 December 2010 policy meeting.

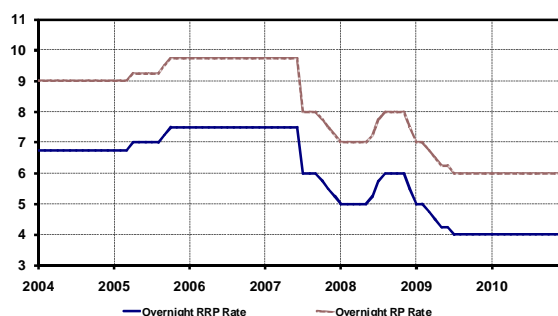
Output growth in South East Asia cooled down slightly in Q3 2010 following the rapid pace of expansion in the first half of 2010. Year-on-year real GDP growth in Indonesia, Malaysia, Thailand, and Vietnam declined to 5.8 percent, 5.3 percent, 6.7 percent, and 6.5 percent, respectively.

⁴¹ PBC raised reserve requirement by 50 bps each on the following dates: 11 November 2010, 23 November 2010, and 16 December 2010.

V. MONETARY POLICY DEVELOPMENTS

The Monetary Board decides to maintain policy rates throughout the quarter.

BSP Policy Interest Rates
In percent



However, upside risks to the inflation outlook increase in recent months.

The Monetary Board is of the view that credit and liquidity conditions are broadly consistent with the economic expansion amid benign inflationary pressures.

During Q4 2010, the Monetary Board (MB) kept the BSP's key policy interest rates steady at 4.0 percent for the overnight borrowing or reverse repurchase (RRP) facility and 6 percent for the overnight lending or repurchase (RP) facility. The BSP's policy rates have been steady since July 2009.

The MB's decision was based on its assessment that the inflation outlook remains favorable, indicating that current policy settings remain appropriate. Baseline forecasts during Q4 2010 showed inflation settling within the target ranges of 4.5 ± 1 percent for 2010 and 4 ± 1 percent for 2011 and 2012. The forecasts were also supported by well-contained inflation expectations, which continue to be within target over the policy horizon.

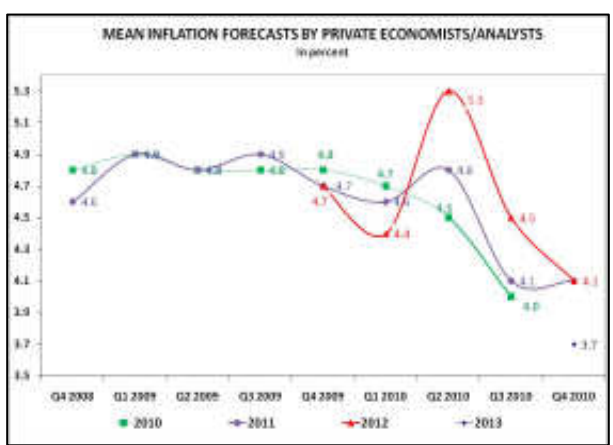
The Board, however, noted that upside risks to the central projection have increased in recent months. Possible inflation pressures could come from generally higher global food prices, reflecting supply constraints and adverse weather conditions; and persistent increases in world oil prices due to the build-up of oil demand in emerging and developing economies. The recently approved ₱1.50 increase in NFA rice prices and the scheduled tollway fee increase in January 2011 could also be a source of future price pressures. The solid domestic demand momentum, on the back of strong consumption expenditure and the rebound in investment spending, could also add to inflationary pressures in the short run.

The MB recognized that the continued strength of forex inflows in the months ahead could potentially add to inflation risks. However, the Board was of the view that the growth in credit and liquidity remains broadly consistent with the present economic expansion amid benign inflationary pressures. Moreover, the current movements of asset prices, particularly in the equities and property markets, do not appear to pose any short-term challenge to the economy. There continues to be limited evidence of stretched market valuations when compared to long-run averages.

VI. INFLATION OUTLOOK

Private Sector Economists' Inflation Forecasts

Mean inflation forecasts in the BSP survey of private economists during the quarter steady for 2011 but lower for 2012.

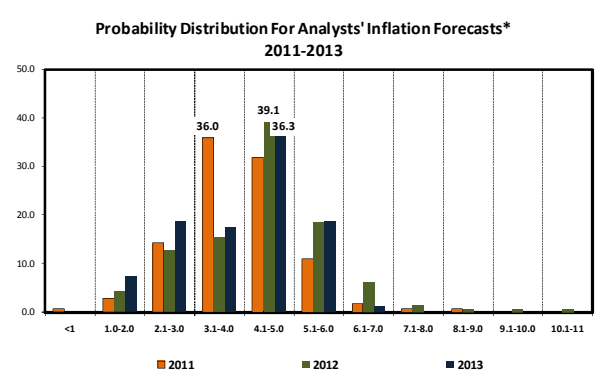


Based on the results of the BSP's survey of private economists for December 2010, inflation is expected to be within the target range for both 2011 and 2012. The mean inflation forecast for 2011 was steady at 4.1 percent while the mean inflation forecast for 2012 decreased to 4.1 percent from 4.5 percent in the previous quarter.⁴²

Analysts noted that while the recent rally in global commodity prices may lead to a pick-up in domestic inflation, the continued appreciation of the peso could temper imported inflation.

Based on the probability distribution provided by seven out of nine respondents, average inflation is viewed to have a 36.0 percent chance to lie within 3.1-4.0 percent in 2011, well within the 4.0 percent \pm 1.0 percentage point target range for the year.

The Asia Pacific consensus forecasts (for October, November, December) for Philippine inflation also showed within-target inflation expectations for 2011.



*Probability distributions were averages of those provided by 7 respondents.

⁴² For Q1 2011 and Q2 2011, inflation is expected at 3.4 percent and 3.7 percent, respectively.

Results of the BES for Q4 2010 show a smaller number of respondents anticipating inflation to increase in the survey quarter.

Relative to the previous survey, a smaller number of respondents expects inflation to move up in the survey quarter (from a diffusion index of 9.5 percent to 2.4 percent) as well as in the next quarter (from 12.3 percent to 6.5 percent).

Meanwhile, results of the CES for Q4 2010 show that consumers expect a higher inflation rate over the next 12 months.

Meanwhile, a higher inflation rate is expected by consumers over the next 12 months relative to the previous survey: from 5.7 percent to 7.6 percent. Respondents expect all the 14 items included in the survey to have higher inflation, with the following items registering the most significant increase: fish and seafood (from 6.1 percent to 10.0 percent); fruits and vegetables (from 7.2 percent to 11.2 percent); rice (from 4.7 to 6.6 percent); meat (from 4.2 percent to 6.3 percent); education (from 6.2 percent to 8.5 percent); and personal care (from 6.1 percent to 8.6 percent).

BSP Inflation Forecasts

Baseline forecasts indicate within-target outlook for 2011-2012.

Inflation is expected to track a target-consistent path over the policy horizon as latest baseline forecasts indicate inflation settling within the 4.0 percent \pm 1.0 percentage point target range for 2011 and 2012.

Near-term price movements will likely remain manageable in the absence of adverse shocks. Factors which may cause an upward shift in the inflation path relate to a potential rebound in oil prices, additional increase in rice prices, potential increase in the price of other non-oil commodities, the impact of adverse weather conditions on agriculture, petitions for electricity rate adjustments, and a stronger-than-expected domestic economic recovery that could induce demand-side price pressures.

On the other hand, downside risks, which could help temper the impact of imported inflation, relate to the slow recovery of global growth and a sustained strengthening of the peso-dollar exchange rate.

Demand Conditions

The domestic economy sustained its growth momentum in the third quarter of the year, with real GDP growth staying above trend. The expansion in demand was supported by the robust growth in private consumption, capital formation, and exports. Likewise, the performance of other demand indicators reflected the strength of domestic economic conditions. Average capacity utilization and production in the manufacturing sector remained high while energy consumption sustained its rise.

At the same time, business and consumer confidence remained upbeat for the current quarter as indicated by the business and consumer expectations surveys conducted by the BSP. Business sentiment reached a new record high, driven primarily by stronger OF remittances, capital inflows, and the continued confidence in the government. Similarly, consumer confidence registered a new all-time high for the second consecutive quarter, owing mainly to the optimism generated by the better-than-expected GDP growth for the first three quarters of the year. However, both surveys recorded slightly lower levels for the next quarter due mainly to the seasonally slower demand after the Christmas season.

Given the favorable economic developments in the first three quarters of the year, the full-year 2010 GDP growth is now expected to settle at the higher end of the DBCC assumption of 5.0-6.0 percent or even higher. Furthermore, the Government's plan to embark on a large-scale infrastructure program should help support domestic economic activity over the medium-term. If sustained, the above-trend economic growth could lead to a widening of the output gap and, in turn, could create demand-pull inflation pressures.

Supply Conditions

Growth in the AFF sector declined for the third straight quarter with the lingering impact of the *El Niño* weather phenomenon on the production of primary crops. *Palay* and sugarcane production declined by 24.8 percent and 82.8 percent, respectively, compared to the previous year's levels. The Bureau of Agricultural Statistics (BAS) revised downwards its *palay* production forecast for the current quarter as a result of the damages on crops brought by Typhoon Juan. Meanwhile, projections indicate that *palay* and corn production could pick up in Q1 2011 with the extension of the cropping season, more favorable weather conditions, and larger harvest area.

In the international market, the Food and Agriculture Organization (FAO) revised upwards its cereal production forecasts for 2010. At the projected level, production in 2010 is still 1.4 percent lower compared to the previous year's level. FAO expects global demand and supply of cereal to tighten as total utilization exceeds total production. Thus, ending stocks could drop by 6 percent, with a corresponding 2.0-percentage point reduction in global stocks-to-use ratio.⁴³

In the energy market, oil prices are expected to rise moderately with the gradual tightening of oil markets. Recovering oil demand coupled with declining OECD commercial oil inventories and potentially slower growth in non-OPEC oil production should support a firming of oil prices in the near term.⁴⁴ Moreover, the global oil market is expected to remain vulnerable to disruptions caused by geopolitical tensions as well as adverse weather conditions. Speculative activities could continue to influence oil price trends, highlighting the impact of wider financial market developments on commodity prices.

⁴³ FAO, *Global Food Security Review*, December 2010, available online at <http://www.fao.org>

⁴⁴ EIA, *Short-Term Energy Outlook*, 7 December 2010, available online at <http://www.eia.gov>

The balance of demand and supply conditions, as captured by the output gap (or the difference between actual and potential output), provides an indication of potential inflationary pressures in the near term. Inflation tends to rise (fall) when demand for goods and services exert pressure on the economy's ability to produce goods and services, i.e., when the output gap is positive (negative).

Output gap estimate narrows.

Based on the latest GDP data, preliminary estimates yielded an output gap of 3.2 percent in Q3 2010, down from 3.8 percent in the previous quarter. The slight contraction in the output gap resulted from the slower growth in actual output. However, growth continues to be above trend, suggesting that solid domestic demand conditions could lead to stronger inflationary pressures as actual output increases further over the medium term.

Key assumptions used to generate the BSP's inflation forecasts

The BSP's baseline inflation forecasts generated from the BSP's single equation model (SEM) and the multi-equation model (MEM) are based on the following assumptions:

- (a) NG fiscal deficits for 2011 and 2012, which are consistent with emerging estimates of the DBCC;
- (b) BSP's overnight RRP rate at 4.0 percent from January 2011 to December 2012;
- (c) 91-day T-bill rates, which are consistent with the DBCC-approved macroeconomic assumptions;
- (d) Dubai crude oil price assumptions, which are consistent with the futures prices of oil in the international market;
- (e) Annual increase in nominal wage of 6.2 percent and 5.8 percent for 2011 and 2012, respectively;
- (f) Real GDP growth, which is endogenously-determined in the BSP's MEM; and
- (g) Foreign exchange rate, which is endogenously-determined in the BSP's MEM through the purchasing power parity and interest rate parity relationships.

Risks to the Inflation Outlook

The latest fan chart suggests inflation will increase slightly until Q3 2011 and then stabilize gradually.

The risks to the inflation outlook may be presented graphically through a fan chart. The fan chart depicts the probability of different inflation outcomes based on the central projection (corresponding to the baseline forecast of the BSP) and the risks surrounding the inflation outlook.

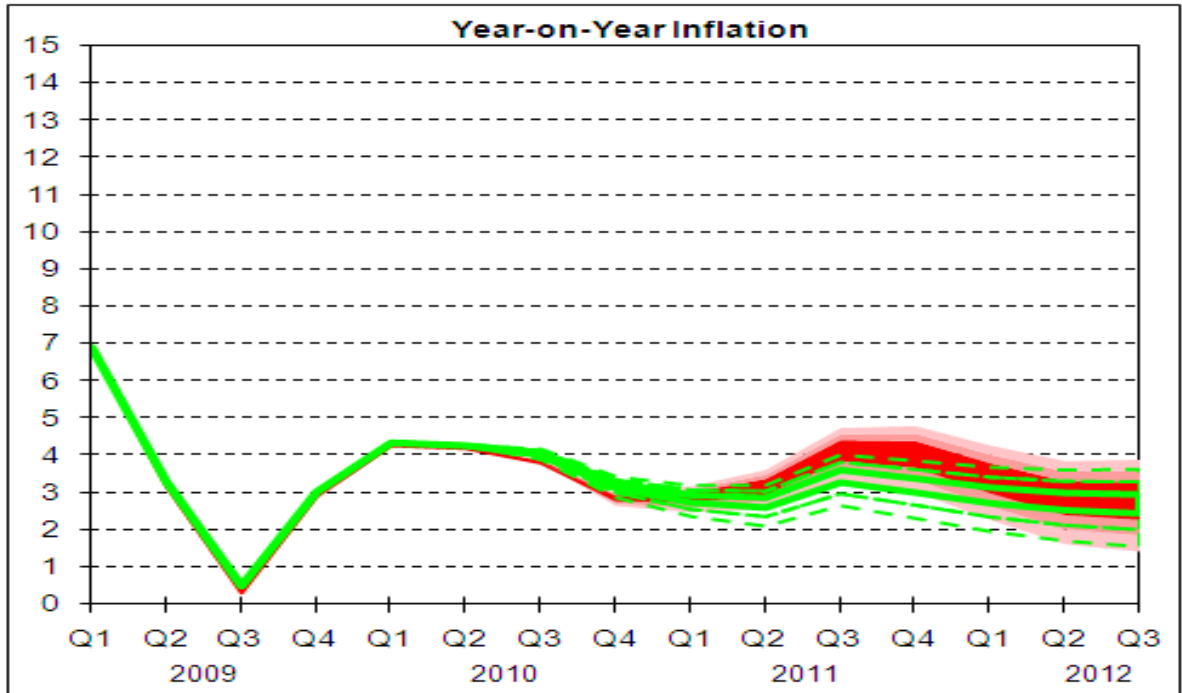
The latest fan chart suggests that inflation would rise until the third quarter of 2011 and then stabilize gradually into 2012. Compared to the previous report, the latest projection treads a slightly higher path, reflecting mainly the higher inflation turnouts in the fourth quarter of 2010. Despite the slight upward shift in the projected inflation path, average inflation in 2011 and 2012 are still expected to settle within the announced target range of 4.0 percent \pm 1.0 percentage point.

The latest fan chart also shows that there are uncertainties further out as depicted by the widening bands of the chart over time.

Risks around the central projection for inflation are skewed slightly to the upside but will likely remain manageable without adverse shocks.

The BSP's assessment of current price trends and risks to future inflation suggests that the balance of risks to the inflation outlook is tilted slightly to the upside. This is depicted in the latest fan chart by the moderately wider bands above the central projection than those below it. The upside risks to future inflation include: (i) potential upward pressures to commodity prices given sustained demand from emerging economies; (ii) demand-induced price pressures from a stronger-than-expected domestic economy; (iii) cost-side pressures from the likelihood of further adjustments in domestic rice prices and electricity charges; and (iv) potential price impact of weather disturbance on agricultural production.

There are also downside risks to the inflation outlook. In particular, considerable uncertainty over the pace of the global economic recovery (particularly for advanced economies) could temper commodity price increases. Similarly, the sustained appreciation of the peso represents a downside risk to the inflation outlook as it could help reduce the cost of imported goods and services.



The fan chart shows the probability of various outcomes for inflation over the forecast horizon. The darkest band depicts the central projection, which corresponds to the BSP's baseline inflation forecast. It covers 25 percent of the probability distribution. Each successive pair of bands is drawn to cover a further 25 percent of probability, until 75 percent of the probability distribution is covered. The bands widen (i.e., "fan out") as the time frame is extended, indicating increasing uncertainty about outcomes. The band in wire mesh depicts the inflation profile as of Q3 2010.

VII. IMPLICATIONS FOR THE MONETARY POLICY STANCE

The outlook for inflation remains favorable.

Latest baseline projections indicate that headline inflation will likely fall within the 4.0 percent \pm 1.0 percentage point target range for 2011-2012. Compared with the projections in the previous report, the latest forecasts follow a slightly higher trajectory, due mainly to higher actual inflation outturns. In addition, the endogenously-determined stronger output growth and liquidity expansion, as well as higher oil prices, also contributed to the increase in the baseline forecasts in the fourth quarter.

The within-target inflation outlook is also supported by well-contained inflation expectations based on survey-based measures, including private sector forecasts. In addition, various measures of core inflation pointed to a broadly stable trend for consumer prices.

However, the balance of risks to the inflation outlook is tilted slightly to the upside.

Domestic demand momentum remains relatively strong, and is facilitating overall output expansion. Despite the recent slowdown in industrial production and the drop in agricultural production, the underlying growth momentum continues to be robust. The deceleration is not surprising as the partly inventory-driven rebound in global trade in the first half of 2010 has been slowing down.

Solid domestic demand conditions point to the likelihood of stronger inflationary pressures over the policy horizon. While the rebound in investment is likely to add to productive capacity, and lead to higher potential output over the medium term, a stronger momentum in demand growth could add to inflationary pressures in the short term.

Moreover, supply-side pressures in the pipeline pose upside risks to the central inflation projection. The latest developments in the global market seem to show a gradual rise in international food prices, particularly wheat and rice, due to supply constraints caused by adverse weather conditions. At the same time, the price of Dubai crude oil is now well over US\$80 per barrel, reflecting partly the

depreciation of the US dollar and the build-up of oil demand momentum in emerging and developing economies which is likely to persist in 2011. The upside risks to future inflation also include cost-side pressures from the likelihood of further adjustments in domestic rice prices and electricity charges. Cost-side pressures stemming from potential increases in administered prices and costs of basic food items have also intensified in recent months.

Nevertheless, the downside risks relating to the slower-than-expected recovery of the global economy and to the continued strengthening of the peso could also help temper the impact of imported inflation.

The BSP, therefore, remains vigilant against any emerging risks to the inflation outlook and is ready to adjust policy settings if and when needed to ensure that future inflation will remain consistent with the medium-term target and that domestic liquidity conditions will remain supportive of sustainable economic growth.

The *BSP Inflation Report* is published every quarter by the Bangko Sentral ng Pilipinas. The report is available as a complete document in pdf format, together with other general information about inflation targeting and the monetary policy of the BSP, on the BSP's website:

www.bsp.gov.ph/monetary/inflation.asp

If you wish to receive an electronic copy of the latest BSP Inflation Report, please send an e-mail to bspmail@bsp.gov.ph.

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