INFLATION REPORT
FIRST Quarter 2011

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 target for annual headline inflation under the inflation targeting framework has been set at 4.0 percent with a tolerance interval of ± 1.0 percentage point for 2011. The inflation target range for 2011, therefore, is 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.

The Monetary Board approved this Inflation Report at its meeting on 6 May 2011.

AMANDO M. TETANGCO, JR.
Governor

13 May 2011
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<th>Definition</th>
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<td>AE</td>
<td>Advanced economy</td>
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<tr>
<td>AFF</td>
<td>Agriculture, Fishery, and Forestry</td>
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<td>AP</td>
<td>Asia Pacific</td>
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<td>AL</td>
<td>Auto Loans</td>
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<tr>
<td>BAS</td>
<td>Bureau of Agricultural Statistics</td>
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<td>BES</td>
<td>Business Expectations Survey</td>
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<td>BIR</td>
<td>Bureau of Internal Revenue</td>
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<td>Bank for International Settlements</td>
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<td>BOC</td>
<td>Bureau of Customs</td>
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<td>BPO</td>
<td>Business Processing Outsourcing</td>
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<td>BTr</td>
<td>Bureau of the Treasury</td>
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<td>CAMPI</td>
<td>Chamber of Automotive Manufacturers of the Philippines, Inc.</td>
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<tr>
<td>CAR</td>
<td>Capital Adequacy Ratio</td>
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<td>CBD</td>
<td>Central Business District</td>
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<td>CCRs</td>
<td>Credit Card Receivables</td>
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<td>CES</td>
<td>Consumer Expectations Survey</td>
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<td>CDS</td>
<td>Credit Default Swaps</td>
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<td>CI</td>
<td>Confidence Index</td>
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<td>CPI</td>
<td>Consumer Price Index</td>
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<td>DBCCC</td>
<td>Development Budget Coordination Committee</td>
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<td>DOF</td>
<td>Department of Finance</td>
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<td>EIA</td>
<td>Energy Information Administration</td>
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<td>Emerging economy</td>
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<td>EMBI</td>
<td>Emerging Market Bond Index</td>
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<td>Energy Regulatory Commission</td>
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<td>European Union</td>
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<td>FAO</td>
<td>Food and Agriculture Organization</td>
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<td>Gross Domestic Product</td>
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<td>GNP</td>
<td>Gross National Product</td>
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<td>GRAM</td>
<td>Generation Rate Adjustment Mechanism</td>
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<td>ICERA</td>
<td>Incremental Currency Exchange Rate Adjustment</td>
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<td>IEA</td>
<td>International Energy Agency</td>
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<td>IMF</td>
<td>International Monetary Fund</td>
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<td>IPP</td>
<td>Independent Power Producer</td>
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<td>KBs</td>
<td>Commercial banks</td>
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<td>LFS</td>
<td>Labor Force Survey</td>
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<td>LPG</td>
<td>Liquefied Petroleum Gas</td>
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<td>LTFRB</td>
<td>Land Transportation Franchising and Regulatory Board</td>
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<td>MB</td>
<td>Monetary Board</td>
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<td>MEM</td>
<td>Multi-Equation Model</td>
</tr>
<tr>
<td>Meralco</td>
<td>Manila Electric Company</td>
</tr>
<tr>
<td>MISSI</td>
<td>Monthly Integrated Survey of Selected Industries</td>
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<tr>
<td>MTP</td>
<td>Major Trading Partner</td>
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<td>NCCP</td>
<td>National Council for Commuters Protection</td>
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<tr>
<td>Acronym</td>
<td>Description</td>
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<tr>
<td>---------</td>
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<td>NDA</td>
<td>Net Domestic Assets</td>
</tr>
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<td>NEDA</td>
<td>National Economic and Development Authority</td>
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<td>NFA</td>
<td>Net Foreign Assets, National Food Authority</td>
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<td>NFIA</td>
<td>Net Factor Income from Abroad</td>
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<td>National Government</td>
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<td>National Power Corporation</td>
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<td>NPLs</td>
<td>Non-performing loans</td>
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<td>National Statistics Office</td>
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<td>Organization of the Petroleum Exporting Countries</td>
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<td>Personal Consumption Expenditure</td>
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<td>Purchasing Managers’ Index</td>
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<td>PSEi</td>
<td>Philippine Stock Exchange Composite Index</td>
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<td>PSIC</td>
<td>Philippine Standard Industrial Classification</td>
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<td>RB</td>
<td>Rural Banks</td>
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<td>REER</td>
<td>Real Effective Exchange Rate</td>
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<td>ROP</td>
<td>Republic of the Philippines</td>
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<td>RP</td>
<td>Repurchase</td>
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<td>RREL</td>
<td>Residential and Real Estate Loans</td>
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<td>RRP</td>
<td>Reverse Repurchase</td>
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<td>Single-Equation Model</td>
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<td>Short Message Service</td>
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<td>SDA</td>
<td>Special Deposit Account</td>
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<td>TCS</td>
<td>Transportation, Communications, and Storage</td>
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<td>U/KBs</td>
<td>Universal/commercial banks</td>
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<td>WEO</td>
<td>World Economic Outlook</td>
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<td>WESM</td>
<td>Wholesale Electricity Spot Market</td>
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THE MONETARY POLICY OF THE
BANCO 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) in consultation with the BSP. For 2011, the inflation target has been set at 4.0 ± 1.0 percentage point. Meanwhile, on 9 July 2010, the BSP announced its shift to a fixed inflation target for the medium term of 4.0 ± 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 between regular meetings, whenever it is deemed necessary. Prior to July 2006, the Committee met every four weeks.

**Chairman**
Amando M. Tetangco, Jr.

**Members**
Diwa C. Guinigundo
Deputy Governor
Monetary Stability Sector

Nestor A. Espenilla, Jr.
Deputy Governor
Supervision and Examination Sector

Ma. Cyd N. Tuano-Amador
Assistant Governor
Monetary Policy Sub-Sector

Ma. Ramona GDT Santiago
Assistant Governor
Treasury Department

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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.
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<th>Period</th>
<th>Advisory Committee (AC) Meeting</th>
<th>Monetary Board (MB) Meeting</th>
<th>MB Highlights Publication</th>
<th>Inflation Report (IR) Press Conference</th>
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<tr>
<td>Jan</td>
<td></td>
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<td>27 (Thu) 30 Dec 2010 MB meeting</td>
<td>28 (Fri) Q4 2010 IR</td>
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<tr>
<td>Feb</td>
<td>7 (Mon)  (AC Meeting No. 1)</td>
<td>10 (Thu)  (MB Meeting No. 1)</td>
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<tr>
<td>Mar</td>
<td>18 (Fri)  (AC Meeting No. 2)</td>
<td>24 (Thu)  (MB Meeting No. 2)</td>
<td>10 (Thu) 10 Feb 2011 MB meeting</td>
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<tr>
<td>Apr</td>
<td>29 (Fri)  (AC Meeting No. 3)</td>
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<td>20 (Wed) 24 Mar 2011 MB meeting</td>
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<tr>
<td>May</td>
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<td>5 (Thu)  (MB Meeting No. 3)</td>
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<td>13 (Fri) Q1 2011 IR</td>
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<tr>
<td>Jun</td>
<td>10 (Fri)  (AC Meeting No. 4)</td>
<td>16 (Thu)  (MB Meeting No. 4)</td>
<td>2 (Thu) 5 May 2011 MB meeting</td>
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<tr>
<td>Jul</td>
<td>22 (Fri)  (AC Meeting No. 5)</td>
<td>28 (Thu)  (MB Meeting No. 5)</td>
<td>14 (Thu) 16 Jun 2011 MB meeting</td>
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<tr>
<td>Aug</td>
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<td></td>
<td>25 (Thu) 28 Jul 2011 MB meeting</td>
<td>5 (Fri) Q2 2011 IR</td>
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<tr>
<td>Sep</td>
<td>2 (Fri)  (AC Meeting No. 6)</td>
<td>8 (Thu)  (MB Meeting No. 6)</td>
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</tr>
<tr>
<td>Oct</td>
<td>14 (Fri)  (AC Meeting No. 7)</td>
<td>20 (Thu)  (MB Meeting No. 7)</td>
<td>6 (Thu) 8 Sep 2011 MB meeting</td>
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<tr>
<td>Nov</td>
<td>25 (Fri)  (AC Meeting No. 8)</td>
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<td>17 (Thu) 20 Oct 2011 MB meeting</td>
<td>4 (Fri) Q3 2011 IR</td>
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<td>Dec</td>
<td></td>
<td>1 (Thu)  (MB Meeting No. 8)</td>
<td>29 (Thu) 1 Dec 2011 MB meeting</td>
<td></td>
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</tbody>
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* Note: AC meetings will be strictly every six weeks and are unadjusted for IMF/BIS meetings and Christmas holidays.
3 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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**OVERVIEW**

**Higher food and non-food inflation drive headline inflation.** Average inflation for Q1 2011 accelerated to 4.1 percent from the quarter-ago level of 3.0 percent but was slightly lower than the year-ago level of 4.2 percent. Food inflation climbed due to adverse weather conditions, with significant increases in the prices of fish and fruits and vegetables. Reflecting the elevated prices of imported food commodities, prices of cereal products and dairy products were also higher. Non-food inflation also rose, with higher transportation and communication services inflation tracking the upsurge in imported crude oil prices and leading to transport fare hikes in the first quarter. While the official core inflation was unchanged at 3.4 percent in Q1 2011, all three alternative measures of core inflation estimated by the BSP rose compared to the levels registered in the previous quarter. A significant increase in the number and weight of above-threshold items was also noted, suggesting that broad-based inflationary pressures could be emerging.

**The economy continues to expand robustly.** Gross Domestic Product (GDP) grew by 7.1 percent year-on-year (y-o-y) in Q4 2010, bringing the annual growth to 7.3 percent for 2010. Solid growth in domestic market-oriented sectors such as construction and services was recorded. On the expenditure side, firm domestic demand on the back of resilient consumer spending and a vigorous recovery in investments supported the expansion. Other demand indicators reflected the strength of the economy. Capacity utilization in the manufacturing sector was consistently above 80 percent, indicating robust manufacturing activity. The steady growth in vehicle sales pointed to the continued strength of consumer spending. Upbeat business sentiment is expected to lend further support to investment spending going forward.

**The global growth momentum remains strong.** Output expansion was sustained in the US, euro area, and emerging markets, while the recovery paused in Japan. The recovery is expected to proceed in 2011, although a modest slowdown is projected due to the waning expansionary impact of fiscal stimulus measures and inventory restocking. The downside risks to global growth have also diminished somewhat in recent months as underlying private demand improves. Despite challenges in pinning down precise estimates of the disaster’s impact, the impact of the Japanese earthquake on global growth is likely to be temporary and limited. Meanwhile, inflation pressures appeared to have broadened, mainly in emerging and developing (ED) economies, reflecting escalating global food and energy prices and the larger weight of these products in the CPI basket of these economies. In advanced economies (AEs), headline inflation is expected to remain below 2.0 percent going forward amid still weak labor markets and firmly anchored inflation expectations.

**Financial market sentiment turns cautious on negative developments overseas.** Concerns on the potential adverse impact on the global recovery of the continuing social unrest in the Middle East and tighter monetary policy settings in some emerging economies dampened investor confidence. The lingering sovereign debt crisis in Europe, longer-term effects of the natural disasters in Japan, and potential further increases in global commodity prices also contributed to increased uncertainties in domestic financial markets. These translated into cautious trading in the local bourse, generally wider Philippine bond debt spreads, and a marginal weakening of the peso. Meanwhile, the country’s solid macroeconomic performance, the upgrade on the Philippine credit outlook to positive from stable by

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4 The analyses in this report are based on information as of 31 March 2011.
7 AE headline inflation is projected to accelerate to 1.9 percent in 2011 before decelerating to 1.6 percent in 2012.
Moody’s, and the BSP’s policy rate hike to help anchor inflation expectations tempered in part the negative impact of uncertainties in the global markets. Ample liquidity in the financial system along with the sustained resiliency of the banking sector likewise supported local markets. Domestic liquidity and bank lending expanded in tandem with the pace of economic growth. This reflected the results of the Q1 2011 BSP Senior Bank Loan Officers’ Survey, which indicated an overall net increase in demand for loans from enterprises and households.

The Monetary Board (MB) decides to raise key policy rates on signs of broadening inflation pressures and with the balance of inflation risks tilting further to the upside. The MB noted that latest baseline inflation forecasts indicated that the 3-5 percent inflation target in 2011 could be at risk. At the same time, upside risks to the inflation outlook over the next few months remain substantial as international food and oil prices have continued to escalate due to the combination of sustained global demand growth and supply disruptions. The MB also noted the recent uptick in headline and official core inflation, along with the significant increase in the number and weight of above-threshold items, which suggested that inflationary pressures could be broadening. In addition, while inflation expectations remained within target for both 2011 and 2012, they have continued to rise. Given these developments, the MB was of the view that a preemptive response will help anchor firmly the public’s inflation expectations and minimize the overall impact of rising inflation on domestic economic activity. Buoyant domestic demand conditions provide room for a gradual policy rate tightening without any adverse consequences to economic growth.

Going forward, monetary policy needs to guide the public’s inflation expectations especially given the possibility that higher commodity prices could persist over the near term. The prospect of continued pressures from commodity prices could lead to possible second-round effects in the form of higher wage demands and faster price hikes among firms as they pass on higher input costs.

The BSP, therefore, remains cautious against emerging risks to the inflation outlook and possible second-round effects of commodity price pressures, and is ready to adjust policy settings if and when needed to ensure that future inflation will remain consistent with the medium-term target.

[On 5 May 2011, the Monetary Board decided to increase by another 25 basis points the BSP’s key policy interest rates to 4.5 percent for the overnight borrowing or reverse repurchase (RRP) facility and 6.5 percent for the overnight lending or repurchase facility (RP) facility. The interest rates on term RRPs, RPs, and special deposit accounts (SDAs) were also raised accordingly.]
I. INFLATION AND REAL SECTOR DEVELOPMENTS

Prices

*Inflation accelerates.*

Headline inflation averaged 4.1 percent, higher than the quarter-ago level of 3.0 percent but slightly lower than the year-ago level of 4.2 percent. Food inflation climbed due to adverse weather conditions, with significant increases in the prices of fish and fruits and vegetables. Reflecting the elevated prices of imported food commodities, the prices of cereal products and dairy products were also higher. Non-food inflation increased as well, with higher transportation and communication services inflation tracking the upsurge in imported crude oil prices and contributing to transport fare hikes in the first quarter.

Meanwhile, core inflation was unchanged at 3.4 percent in Q1 2011.

**Headline and Core Inflation**

Headline inflation accelerated to 4.1 percent relative to the previous quarter as a result of higher food and non-food inflation. Food inflation edged up due to increased prices of cereals, fish, and fruits and vegetables. Meanwhile, non-food inflation rose on account of higher inflation outturns for fuel and transportation and communication services.

Core inflation, which excludes some food and energy items to measure generalized price pressures, was unchanged during the quarter. The official NSO core inflation measure remained at 3.4 percent in Q1 2011 as the decrease in core non-food inflation, particularly light and water inflation, was offset by price increases in most commodity groups. Meanwhile, Q1 2011 core inflation was slightly lower compared to 3.5 percent in the same quarter a year ago.
The series has been recomputed using a new methodology that is aligned with NSO’s method of computing quarterly averages of year-on-year change in inflation. The net of volatile items method excludes the following items: educational services, fruits and vegetables, rice, and corn. 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. Meanwhile, all three alternative measures of core inflation estimated by the BSP reflected an uptrend in Q1 2011 relative to the levels registered in the previous quarter. The trimmed mean, weighted median, and net of volatile items measures inched up to 3.2 percent, 2.2 percent, and 4.4 percent from 2.5 percent, 1.8 percent, and 4.1 percent, respectively.

Core inflation contributed 3.1 percentage points (ppt) to headline inflation in Q1 2011, higher than the 2.9-ppt contribution in the previous quarter and the 3.0-ppt contribution in the same quarter a year ago. Meanwhile, non-core consumer price index (CPI) items contributed 1.0 ppt to headline inflation during the period, higher than the previous quarter’s 0.1-ppt contribution but lower than the 1.2-ppt 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 5.0 percent (the upper end of the inflation target for 2011) increased sharply to 26 in Q1 2011 from 14 in the previous quarter and 18 in Q1 2010. Accordingly, these items accounted for a higher proportion of the CPI basket at 16.3 percent compared to 10.5 percent in the previous quarter.

Dividing the CPI basket into food and non-food components showed more food items above the threshold. There were 18 food items with inflation rates above the threshold from 6 in the previous quarter. Meanwhile, there were 8 non-food commodities with inflation rates higher than the threshold in Q1 2011, same as in the previous quarter.
Higher inflation rates for cereals, fish, and fruits and vegetables spur food inflation.

Inflation Rates for Selected Food Items
Quarterly averages in percent (2000=100)

<table>
<thead>
<tr>
<th>Commodity</th>
<th>2009</th>
<th>2010</th>
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<th>2011</th>
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<td>Food, Beverage and Tobacco</td>
<td>4.6</td>
<td>3.7</td>
<td>1.9</td>
<td>3.9</td>
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<td>Food</td>
<td>4.7</td>
<td>3.8</td>
<td>2.0</td>
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<td>Cereal &amp; Cereal Products</td>
<td>2.6</td>
<td>2.1</td>
<td>1.4</td>
<td>1.9</td>
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<td>O/w Rice</td>
<td>2.7</td>
<td>2.2</td>
<td>1.0</td>
<td>1.3</td>
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<tr>
<td>Corn</td>
<td>0.5</td>
<td>-1.6</td>
<td>-0.6</td>
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<tr>
<td>Dairy Products</td>
<td>3.4</td>
<td>2.3</td>
<td>1.5</td>
<td>1.8</td>
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<td>Eggs</td>
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<td>4.6</td>
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<tr>
<td>Fruits &amp; Vegetables</td>
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Source of Basic Data: NSO, BSP

International food prices reach historic high in February, but ease slightly in March.

Food Inflation

Food, beverage, and tobacco inflation rose to 3.9 percent in Q1 2011 from 1.9 percent in the previous quarter and 3.7 percent a year ago, driven mainly by higher price increases of cereals, fish, and fruits and vegetables. Elevated global prices of imported wheat affected the domestic prices of cereal while the uptick in the prices of fruits and vegetables reflected crop damages from continuous heavy rains in the months of January and February. Fish inflation also went up as adverse weather conditions (i.e., strong winds and rough seas) forced fishermen to cut down on their fishing trips, resulting in very limited volume of fish unloaded in municipal and commercial landing centers.

Meanwhile, rice inflation was lower compared to the year-ago level, but was slightly higher compared to the previous quarter due to the modest increase in ordinary rice prices, reflecting consumers’ shifting preference in favor of lower-priced ordinary rice.

Based on the Food Price Index (FPI) of the Food and Agriculture Organization (FAO), food prices have reached historic highs beginning January 2011. The index averaged 231 points in February 2011, the highest since its inception in January 1990. This level was 5.6 percent higher than the previous peak of 224 points during the 2008 global food crisis. The recent uptrend in world food prices was driven largely by temporary factors relating to adverse weather conditions which reduced production of key food commodities, including the extended cold weather season in the Northern hemisphere, drought in Russia, South America and China, as well as above-normal rainfall in Thailand, Vietnam, Canada, and Australia. Meanwhile, strong food demand from emerging economies is a structural factor that is pushing up world prices. The FPI remained elevated in Q1 2011 though it eased slightly to 230 points in March.
Higher inflation rates for fuel and transport services drive the increase in non-food inflation.

**Non-food inflation**

Non-food inflation at 4.2 percent was higher relative to 3.9 percent a quarter ago but lower relative to 4.9 percent a year ago. In particular, higher fuel and transportation and communication services inflation accounted for the rise in non-food inflation in Q1 2011. From 3.9 percent in Q4 2010, transportation and communication services inflation increased to 6.5 percent during the quarter, reflecting the surge in global oil prices, which consequently led to transport fare hikes. Fuel inflation likewise rose to 9.6 percent in Q1 2011 from 6.4 percent in Q4 2010 due to the higher cost of LPG and kerosene.

**Energy Prices**

The international price of Dubai crude oil increased by 19.2 percent quarter-on-quarter (q-o-q) in Q1 2011 over lingering political tensions in the MENA region, fueling concerns of global crude oil supply disruptions. Following the regime change in Tunisia and Egypt, civilian protests in Libya intensified in February, causing the price of oil to rise to its highest level since mid-2008 and intensifying apprehensions about supply interruptions. According to the International Energy Agency (IEA), the escalation of violence in Libya, Africa’s third largest crude oil producer after Nigeria and Angola, has cut output by as much as 1 million barrels a day (mmbd) in February. World oil prices also rose on signs that the US economy is gaining strength and fuel demand is recovering.

The rise in oil prices was tempered by concerns over Europe’s debt problems and expectations
World oil prices are expected to track a higher path.

Local gasoline pump prices increase.

As of March 2011, global energy authorities revised upward their 2011 forecast for global oil demand due largely to expectations of continued global economic recovery led by emerging markets in Asia. The Organization of the Petroleum Exporting Countries (OPEC), Energy Information Agency (EIA), and IEA projected 2011 global demand to increase by 1.4 mb/d, 1.5 mb/d, and 1.4 mb/d, respectively. The bulk of the increase in 2011 world oil consumption is expected to come from non-OECD regions, particularly China and other emerging Asian markets.

The estimated future prices of Dubai crude oil in Q1 2011, based on movements in Brent crude oil futures, suggest a higher path for 2011 compared to the estimates in the previous quarter. This could be attributed to lingering geopolitical concerns in MENA, the world’s largest oil-producing region, which could have a significant adverse impact on global oil supply. A protracted crisis in the MENA region could result in a sustained rise in world oil prices given the sizable share of the region in global oil production and the region’s critical role in the transportation and distribution of crude oil. The triple disaster in Japan last March is also expected to support commodity prices through increased demand not only for food but also for fuel.

In Q1 2011, the domestic prices of diesel, kerosene, and unleaded gasoline increased by ₱8.05 per liter, ₱7.49 per liter, and ₱6.05 per liter, respectively.

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11 Prices have dropped by 6.1 percent in five days of losses, the longest losing streak in more than a month. The earthquake that hit northern Japan on 11 March has shut 29 percent of the domestic refining capacity, according to Bloomberg calculations based on Petroleum Association of Japan data.

12 Futures jumped as much as 2.2 percent after the UN voted to establish a no-fly zone over Libya and demanded a cease-fire with rebels.


16 Organization for Economic Cooperation and Development.
The impact of escalating global food prices is less pronounced in the Philippines.

Country-specific factors also contribute to the recent surge in inflation pressures in the region.

Global Food and Oil Prices and Philippine Inflation

The surge in inflation pressures observed in Asia earlier in the year appears to be less pronounced in the Philippines compared with other countries in the region despite the large weight of food in the country’s CPI basket at 46.4 percent. The lower food inflation in the Philippines was due in part to favorable domestic supply conditions owing to the timely importation of rice in 2010 and the recovery of domestic agricultural production in Q4 2010. Favorable domestic meat production likewise supported the decline of meat inflation in the country. The moderate growth in food demand in the Philippines relative to those in other Asian countries also contributed to comparatively lower food inflation. Nevertheless, food inflation in the Philippines tends to be persistent and has strong spillover effects on non-food inflation. Hence, a surge in food inflation could potentially spread to the wider economy going forward.

Recent inflation dynamics in the Philippines were observed to be different from other Asian economies because of less favorable supply conditions and other country-specific factors affecting the latter. In China, strong domestic demand (with rising domestic liquidity) coupled with supply-side concerns pushed up domestic inflation. Recently, countries like Indonesia and India began to remove subsidies in oil. Malaysia has also started to remove its subsidies in oil and sugar. Moreover, wage setting is more flexible in other...
Asian countries unlike the Philippines which has a 12-month restriction\textsuperscript{17} on the application of any new wage increase. There is no similar restriction in Vietnam, Malaysia, and Cambodia where wage rates are adjusted depending on certain factors, including prevailing economic conditions and cost of living. In Thailand, minimum wages are reviewed at least once a year. The minimum wage in Thailand is in reality an effective wage (the minimum wage is fairly close to the average wage), and minimum wage negotiations become the forum for collective bargaining on wages.

The price of crude oil has traditionally been an important inflation driver in the Philippines as well through its direct impact on the cost of petroleum products, particularly, household fuel, gasoline, diesel, and other lubricants.\textsuperscript{18} Oil companies tend to immediately reflect movements in the international prices of crude oil and finished products on domestic pump prices.\textsuperscript{19} This implies a more rapid transmission of external supply shocks on the oil market to domestic inflation.\textsuperscript{20} Rising energy costs could also further increase the cost of prepared food, transport, and power.

Higher food inflation erodes the purchasing power of the poor as it accounts for a larger share of the CPI basket in the case of poorer households. According to the National Statistics Office (NSO), the weight of food in the CPI for the bottom 30 percent income group (based on the 1994 CPI basket) is 72 percent compared with a weight of 55 percent for all income groups. In addition, the erosion of the purchasing power resulting from rising commodity, energy, and transport prices could subsequently fuel wage hike petitions in the future. The principal risk from the ongoing supply

\textsuperscript{17} However, two wage orders can be issued within a 12-month period when supervening conditions or “extraordinary” increases in prices of essential commodities are deemed to be existing.
\textsuperscript{18} Oil prices are classified as services allied to transport in the Philippine CPI basket.
\textsuperscript{19} According to the Department of Energy (DOE), in a 2009 meeting by stakeholders in the oil industry (including oil players, the government, and the transport sector), it was agreed that oil players will reflect the week-on-week movement in the international prices of petroleum products in the current week’s price adjustments. For example, the price movement in week 3 of the month will be a reflection of the comparison between the average international prices in week 2 and week 1 of the month. Consistent with the regime of deregulation, the DOE does not prescribe a specific formula on how international price changes will be reflected in domestic pump prices. The magnitude of the price movement is expected to be set by the oil players. Notwithstanding deregulation, the DOE actively monitors the oil price movement to ensure that price adjustments are reasonable.
\textsuperscript{20} Based on DOE’s estimates, a US$1 increase in Dubai crude is expected to result in a P0.40-per-liter increase in domestic gasoline (unleaded) prices, controlling for other factors.
shocks is that the inflationary pressure points generated by food and oil prices may become embedded in the psyche of consumers and price-setters. An extreme scenario was when sharply higher food prices sparked riots in many countries in 2008. According to the FAO, these forced at least 40 governments to impose emergency measures such as food price controls or export restrictions at that time.

### Transportation

In the transport sector, the Land Transportation and Franchising Regulatory Board (LTFRB) has granted Metro Manila bus operators a provisional authority to increase bus fares by P1.00 for the first five kilometers, both for air-conditioned and non-air-conditioned buses, effective 29 March 2011. With the provisional increase, fares for non-air-conditioned buses will now be P10.00 for the first five kilometers while the old P1.85 per kilometer rate will apply for the succeeding kilometers. Fares for air-conditioned buses, on the other hand, will be P12.00 for the first five kilometers, and P2.20 for every succeeding kilometer. The LTFRB is conducting public hearings with the Integrated Bus Operators (InterBOA), which filed an additional petition for a P5.00 and P6.00 increase in the minimum fares for ordinary and air-conditioned buses, respectively.

The implementation of the approved provisional fare increases for the EDSA-bound Metro Rail Transit (MRT) and the Light Railway Transit (LRT) remains pending. The increase was supposed to take effect on 1 March 2011, and would have brought the maximum fare for all three rail lines to P30.00.

### Water

The Metropolitan Waterworks and Sewerage System-Regulatory Office (MWSS-RO) approved the increase in basic water rates of Metro Manila concessionaires, effective February 2011. This brought the total tariff rate of Manila Water higher
by ₱3.45/m³ from ₱30.12/ m³ in the previous quarter to ₱33.57/m³ in Q1 2011. Meanwhile, Maynilad rates are also higher at ₱40.79/m³ in Q1 from ₱37.40/m³ in the previous quarter, representing an increase of ₱3.40/m³. On a quarter-on-quarter basis, the water rates of Manila Water and Maynilad increased by 11.5 percent and 9.1 percent, respectively.

The increase in water rates was due mainly to the annual adjustment in basic rates as part of the rate rebasing implemented by the MWSS to support the service improvement plan of the concessionaires.

**Power**

Notwithstanding the month-on-month uptick in February,\(^{23}\) electricity rates in Q1 2011 were generally lower relative to the previous year due to lower energy demand on account of cooler temperatures. It will be recalled that the country suffered from El Niño in the first half of 2010 which drove up demand for electricity. Meanwhile, La Niña prevailed from the latter half of 2010 until Q1 2011.

Nevertheless, 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 raise distribution rates under the Performance-Based Regulation (PBR) mechanism by about 4.0 percent on average for 2012-2015; (2) the NPC’s petition to recover actual and incremental fuel, independent power producers (IPP), and foreign exchange rate fluctuation costs under the 13th-17th generation rate adjustment mechanism (GRAM) and the 15th-16th incremental currency exchange rate adjustment (ICERA); and (3) the National Grid Corporation’s petition to recover the costs of repair on damages caused by the tropical storms and the bombings in Lanao del Norte in 2009.

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\(^{23}\) In February, retail electricity rates were higher on account of higher generation rates from independent power producers (IPPs). According to Meralco, rates from IPPs went up due to lower economic dispatch following low power demand in January. The utilization level of the IPPs fell below 80 percent for the first time since April 2010, as Meralco’s peak demand went down due to cooler temperatures.
Aggregate Demand and Supply

The economy continues to expand robustly.

GDP grew by an annual rate of 7.1 percent in Q4 2010, significantly faster than the 2.1 percent growth recorded in the same quarter in 2009 and the revised 6.3 percent increase in Q3 2010. This brought the full-year GDP growth for 2010 at 7.3 percent, well above the high end of the government’s target range of 5.0-6.0 percent.

On the expenditure side, expansion was led by personal consumption, capital formation, and exports, each contributing 5.7ppt, 3.5ppt, and 6.7ppt to GDP growth, respectively. On the production side, industry and services contributed 2.7ppt and 3.3ppt to GDP growth, respectively. Meanwhile, agriculture, fishery, and forestry (AFF) rebounded in Q4 2010 after declining for four consecutive quarters and contributed 1.0ppt to GDP growth.

The country’s gross national product (GNP) grew by 6.7 percent in Q4 2010 from 6.0 percent in Q3 2010 and 4.1 percent in the same period a year ago. GNP growth was supported by the 3.8 percent growth in net factor income from abroad (NFIA).

Meanwhile, seasonally-adjusted estimates show that GDP grew by 3.0 percent q-o-q in Q4 2010 following a contraction of 0.8 percent (revised) in Q3 2010.

Aggregate Demand

Expenditures by major economic sectors

Personal consumption expenditure (PCE), which accounted for 82.2 percent of GDP, continued to be the main driver of growth on the expenditure side. PCE increased by 7.0 percent in Q4 2010, a marked improvement from the year- and quarter-ago growth rates of 5.0 percent and 4.1 percent, respectively. Accelerated expansion in spending was observed across all major expenditure items, except tobacco (which posted a decline for the third consecutive quarter).
Other demand indicators reflect solid economic momentum.

Meanwhile, government consumption declined by 7.6 percent in Q4 2010 as government expenditure was kept in line with the revenue collection for the period.

Increased private construction activities and higher investment in durable equipment boosted capital formation in Q4 2010. Investments in durable equipment, which grew by 26.8 percent, were supported by the upswing in spending on transport equipment (particularly road vehicles and air transport), specialized machinery (particularly telecommunications and sound recording/reporting equipment), and other miscellaneous durable equipment. Fixed capital formation was also propped up by the growth of private construction at 14.6 percent, which offset the 14.3 percent decline in public construction.  

As global trade recovered, exports of goods and non-factor services continued to grow in Q4 2010. Exports sustained double-digit growth in Q4 2010 at 21.1 percent, lower compared to the 28.3 percent growth in the previous quarter but a sharp turnaround from the 6.7 percent contraction in Q4 2009. Merchandise exports grew by 16.4 percent, driven by finished electrical machinery (43.5 percent), semiconductors and electric microcircuits (52.4 percent), garments (10.3 percent), petroleum naphtha (128.5 percent), and crude coconut oil (5.2 percent). Similarly, exports of services expanded by 43.5 percent in Q4 2010.

Other Demand Indicators

Other demand indicators showed that domestic demand conditions remain firm. Average capacity utilization and production indices reflected robust expansion in manufacturing. The continued growth in vehicle sales also pointed to the sustained strength of consumer spending. The optimistic business confidence reading in the first quarter of the year is expected to provide further support to investment spending going forward.

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24 Funds for public works projects were frontloaded during the first half of the year.
Property Prices

Data from Colliers International indicated that, on a q-o-q basis, implied land values rose for the second consecutive quarter in Q4 2010. However, year-on-year, implied land values still showed a decline of 2.2 percent and 0.8 percent for the Makati Central Business District (CBD) and Ortigas Center, respectively, in the fourth quarter of 2010. Compared to the previous quarter, implied land values in the Makati CBD and Ortigas Center were slightly higher at P267,162/sq.m. and P122,714/sq.m. from P266,744/sq.m. and P121,200/sq.m., respectively. Colliers expects growth in land values to speed up in the next few months as developers intensify commercial and residential developments. Land values are presently at about 62-63 percent of their 1997 levels in nominal terms but only about 31-32 percent of their 1997 levels in real terms.

Vacancy Rates

The monthly office vacancy rate in the Makati CBD of 5.5 percent in Q4 2010 was lower compared to the quarter- and year-ago levels. Lower vacancy rates were recorded for all the office space segments (Premium, Grade A, and Grade B and below). Vacancy rates for all sub-markets fell, with the bulk of demand coming from both expansions and new entrants in the business processing outsourcing (BPO) industry. Meanwhile, the residential vacancy rate at 8.8 percent in Q4 2010 was higher relative to both the Q3 2010 and Q4 2009 levels. Vacancy rates in the residential sector continued to rise with more supply introduced in the market. Over the next 12 months, Colliers expects the Makati CBD vacancy rate to reach double digits. The large supply of studio and one-bedroom units—a segment where a large proportion of buyers are investors—will exert downward pressure on rents. In contrast, the rental market for larger-sized units is well supported by expatriate demand while supply remains limited.

25 In the absence of reported closed transactions, implied land values based on trends are used by Colliers International to monitor prices.
Office rental values increase owing to higher demand for expansion space.

Likewise, residential rental values trend higher.

Monthly office rents in the Makati CBD reached ₱637/sq.m. in Q4 2010, higher by 2.0 percent and 5.1 percent than the quarter- and year-ago levels. Makati CBD rental rates continued to rise in the fourth quarter as landlords enjoyed stronger pricing power due to the demand for expansion space from BPO companies. Office rental values in Q4 2010 remained below the 1997 levels for premium grade offices. In real terms, office rental values were about 39.0 percent of the comparable levels in 1997.

Monthly rents for 3-bedroom condominium units in the Makati CBD rose to ₱557/sq.m. in Q4 2010 from the previous quarter. Similarly, relative to the levels in the previous year, monthly rents for the 3-bedroom segment were higher by 2.9 percent. Residential rental values during the period were above their 1997 levels in nominal terms but were only about 58.2 percent of their 1997 levels in real terms.

Jones Lang LaSalle estimated average annual office rentals in the Makati CBD at ₱7,980/sq.m. in Q4 2010, higher by 6.4 percent compared to the previous quarter and by 11.6 percent compared to the same quarter in the previous year. The report noted that the significant increase reflects the rising demand for office space as the real estate market recovers and the expected recovery of demand from the off-shoring and outsourcing (O&O) industry in the near term. For the next 12 months, rental and capital values as well as demand for office space will be driven by the planned expansion of major O&O firms and the projected growth of the Philippine economy.

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.

This was computed as the average of the rental values for the Premium, Grade A, and Grade B segments. Premium refers to office space with capital values of ₱75,000/sq.m. and above; Grade A, between ₱65,000 and ₱75,000/sq.m.; and Grade B, ₱65,000/sq.m. and below.

Jones Lang LaSalle 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.
Capital values for office buildings increase, tracking the rise in rental values.

Capital values for office buildings in Makati CBD were higher in nominal terms than their quarter-and year-ago levels. Tracking the upward movement in office rental values in the fourth quarter of 2010, Grade A office capital values in the Makati CBD rose to ₱77,000/sq.m., higher by 1.1 percent and 3.6 percent compared to their levels in the previous quarter and the previous year, respectively. Office capital values in Q4 2010 were lower than the 1997 levels for grade A offices. In real terms, office capital values were about 48.1 percent of the comparable levels in 1997.

Similarly, capital values for luxury residential buildings in Makati CBD rose from their quarter-and year-ago levels. Average prices for residential condominium units increased by 0.7 percent q-o-q and 3.1 percent y-o-y in the fourth quarter of 2010. Residential capital values in Q4 2010 were above their 1997 levels for luxury residential buildings in nominal terms. However, in real terms, residential capital values were about 52.1 percent of the comparable levels in 1997.

Sales of passenger cars and commercial vehicles continue to grow.

Passenger car sales grew by 11.3 percent y-o-y in the first quarter of 2011. Based on the latest data from the Chamber of Automotive Manufacturers of the Philippines, Inc. (CAMPI), the number of units sold during the quarter went up to 12,426 from 11,164 in the same period in 2010. The growth in sales can be attributed to robust OF remittances, attractive financing packages, promotions, and availability of units.

Commercial vehicles, which account for more than half of total industry sales, likewise increased by 6.7 percent, albeit at a slower rate.

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29 Probable price that the property would have fetched if sold on the date of the valuation. The valuation includes imputed land and building value.
30 Vehicle sales for 2011 were adjusted to exclude the sales of four (4) members which left CAMPI in 2011, namely, Hyundai, Volvo, Chevrolet, and Chana.
31 Commercial vehicles include Asian utility vehicles (AUVs), sports utility vehicles (SUVs), light commercial vehicles (LCVs), light trucks, heavy-duty trucks, and buses.
32 Commercial vehicles have a market share of 65.8 percent of the total automotive industry while passenger cars account for 34.2 percent.
Energy sales decline due to lower industrial consumption.

Energy Sales

Power sales of the Manila Electric Company (Meralco) decreased by 0.1 percent y-o-y in the first quarter of 2011, a reversal of the quarter- and year-ago growth of 6.5 percent and 14.2 percent, respectively. Residential consumption was unchanged from the same quarter in the previous year while commercial consumption increased at a markedly lower rate. The decline in energy sales can be traced to lower consumption in the industrial sector with reduced activity in the semiconductor industry consistent with the book-to-bill ratio of less than 1 for the sixth consecutive month in March. The decline in total energy sales can also be partly attributed to base effects, as year-ago levels reflected higher-than-normal consumption due to rehabilitation efforts in the aftermath of Typhoon Ondoy and pre-election-related activities. Meanwhile, on a q-o-q basis, energy sales continued to decline in Q1 2011 by 7.9 percent from the 1.6 percent contraction in the previous quarter.

Capacity Utilization

The NSO’s Monthly Integrated Survey of Selected Industries (MISSI) showed that average capacity utilization for total manufacturing, which captures the intensity in which the factors of production are being used, declined in January and February 2011 after the historic peak reached in December 2010. This indicated that the margin of spare capacity in the economy widened. The average capacity utilization in manufacturing of 83.1 percent in January 2011 and 83.0 in February are comparable to the mid-year values in 2010. Capacity utilization in December 2010 was 83.5 percent (revised).
Volume and value of production indices sustain expansion.

Based on MISSI data, indicators for volume and value of production reflected continued expansion. Double-digit year-on-year growth was maintained for the volume of production index for the 15th consecutive month in February. The value of production index likewise continued to show respectable growth, posting double-digit expansion in the first two months of 2011 after registering lower growth in the last four months of 2010. Miscellaneous manufactures led the major sectors in reporting increases. Food manufacturing, petroleum products, and fabricated metal products were among those that also contributed significantly to the increases.

Business Expectations Survey (BES)

Business optimism continued to be strong in Q1 2011 even as the overall confidence index (CI) declined by 3.1 index points to 47.5 percent from 50.6 percent in the previous quarter. Meanwhile, the next quarter outlook reached a new all-time high at 59.4 percent.

Respondents attributed the less upbeat q-o-q outlook to the following: (a) usual slowdown in business activity after the Christmas and harvest seasons; (b) rising prices of oil and other commodities; and c) abnormal weather conditions in some parts of the country. Nonetheless, the index was the second highest reading recorded after the global financial crisis. The positive business sentiment likewise mirrored the improving business confidence in countries such as Australia, Canada, India, Germany, and Singapore.

Consumer Expectations Survey (CES)

Overall consumer CI declined in the first quarter of 2011 to -23.1 percent from -8.5 percent in the last quarter of 2010. Household respondents cited the continued increase in the prices of petroleum products, the high cost of goods and services, and the rise in household expenses as the reasons behind their weaker outlook. The outlook was aggravated by the tensions in the MENA region.

33 The survey was conducted between 14-21 March 2011.
The lower current quarter outlook mirrored the weaker sentiment of consumers in the United States, United Kingdom, Thailand, and Japan due to high fuel prices, as well as in New Zealand and Australia, which were hit recently by natural calamities.

The lower consumer confidence in Q1 2011 was reflected in weaker near-term and year-ahead expectations as consumers anticipate higher oil prices should tensions in the Middle East and North Africa linger. The next quarter CI reverted to negative territory at -6.2 percent in Q1 2011 from 11.9 percent in Q4 2010. The CI for the next 12 months remained positive but declined to 1.2 percent from 25.9 percent in the previous quarter.

### External Demand

#### Exports

Merchandise exports grew by 34.8 percent in 2010 after contracting for two consecutive years. Fourth quarter exports contributed to full-year growth, expanding by 22.4 percent as most major groups posted higher shipments. This was markedly higher than the 5.8 percent growth in the same quarter in 2009 but lower compared to the 41.3 percent expansion posted in the previous quarter.

The bulk of export growth can be traced to manufactured goods, which grew by 20.5 percent, boosted by shipments of semiconductor components, such as electronic integrated circuits and microassemblies, semiconductor devices, and parts of electrical/electronic machinery and equipment. According to the Semiconductor Industry Association, the wide range of electronic applications of semiconductors boosted sales. Shipments of chemicals likewise expanded due to strong demand. Coconut products also contributed to export growth as world prices of coconut oil, desiccated coconut and copra meal/cake went up. The sustained rise in gold prices in the international market and the use of gold as a hedge against the weakening US dollar supported exports of the precious metal. Exports of petroleum products also expanded.

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34 Exports declined by 2.5 percent and 22.1 percent in 2008 and 2009, respectively.
The agriculture sector recovers.

In parallel with the expansion in exports, full-year merchandise imports expanded by 31.5 percent, recovering from the 24.0 percent contraction in 2009. This was higher than the 20.0 percent Government target for imports growth in 2010. In Q4 2010, merchandise imports likewise sustained double-digit growth at 28.2 percent, higher than the quarter- and year-ago growth rates of 30.1 percent and 3.2 percent, respectively. Merchandise imports expanded as all major commodity groups continued to post double-digit growth in Q4 2010. The surge was largely due to imports of raw materials and intermediate goods. In particular, materials/accessories for the manufacture of electrical equipment grew by 30.8 percent in response to increasing orders for electronic products from the international market. This was followed by imports of mineral fuels and lubricants, due mainly to the higher volume and world price of crude petroleum. Inward shipments of capital and consumer goods also contributed to the increase in imports.

Aggregate Supply

AFF grew by 5.4 percent in Q4 2010 as the sector recovered after four consecutive quarters of decline. Palay production rebounded to a 21.1 percent growth while corn production accelerated to a 13.8 percent growth due to favorable weather conditions in almost all parts of the country during the quarter.

Meanwhile, the industry sector, which comprised 28.6 percent of GDP, expanded by 8.3 percent in Q4 2010, contributing 2.7 ppt to GDP growth. However, Q4 growth was slightly slower compared to the 8.6 percent expansion in the previous quarter. The growth in industry was supported by the faster expansion of the manufacturing sub-

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35 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 a 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.

36 There were fewer typhoons that visited the country in Q4 2010, i.e., only two typhoons compared to the seven recorded in 2009.
Labor Market Conditions

Unemployment rate inches up.

Based on seasonally-adjusted estimates, the quarter-on-quarter growth of GDP at 3.0 percent, from a contraction of 0.8 percent in Q3 2010, came from the faster growth of the AFF sector (4.2 percent from 1.0 percent) and the strong rebound of the industry sector (6.7 percent from -5.9 percent) which, in turn, tempered the impact of slower services sector growth (0.3 percent from 2.0 percent).

The services sector likewise boosted economic expansion, contributing 3.3 ppt to GDP growth. Services, which accounted for 48.4 percent of total GDP, grew by 6.9 percent y-o-y in Q4 2010, slower compared to the quarter-ago growth of 8.0 percent but significantly higher than the year-ago growth of 3.1 percent. The major growth drivers of the services sector in the fourth quarter were trade, private services, and finance. The robust expansion in the services sector was due to the thriving domestic investment, supported by the strong growth pace of BPO, hotels and restaurants, wholesale and retail trades, and import and export trading.

Economic Performance

Growth rate (in percent)

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<td>Finance</td>
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<tr>
<td>O. Dwellings &amp; real estate</td>
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<td>5.5</td>
</tr>
<tr>
<td>Private services</td>
<td>8.9</td>
<td>9.0</td>
</tr>
<tr>
<td>Government services</td>
<td>2.7</td>
<td>-4.2</td>
</tr>
</tbody>
</table>

Source: NSCB

Unemployment and Underemployment Rates

Unemployment rate inches up.

Based on the results of the January Labor Force Survey (LFS), the unemployment rate in January 2011 was estimated at 7.4 percent, marginally higher than the 7.3 percent registered in January 2010 and the 7.1 percent posted in October 2010. Meanwhile, the proportion of underemployed to total employed persons was lower at 19.4 percent in January 2011 from 19.7 percent in the same period last year and 19.6 percent in October 2010.
Employment increased modestly by 0.8 percent y-o-y in January 2011, driven mainly by the growth in the services and agriculture sectors. The number of employed persons in January 2011 was recorded at 36.3 million, higher by about 0.3 million compared to the level registered in the same period a year ago. The services sector employed 52.5 percent of the total employed persons, while the agriculture and industry sectors accounted for 32.9 percent and 14.5 percent, respectively.

In terms of major occupation groups, the y-o-y increase in the employment level was due mainly to the higher number of agriculture and service workers. However, the decline in the employment of laborers and supervisory workers pulled down employment growth in January 2011.

II. MONETARY AND FINANCIAL MARKET CONDITIONS

Domestic Liquidity and Credit Conditions

Liquidity conditions remained consistent with the pace of demand expansion in the country as evidenced by the steady growth in both domestic liquidity or M3 and the outstanding loans of commercial banks. M3 continued to grow in February 2011, although at a slightly slower pace of 9.8 percent from the end-Q4 2010 expansion of 10.6 percent. Fueling the increase in domestic liquidity was the sustained growth in net foreign assets (NFA), particularly the BSP’s NFA position, which continued to grow, largely on steady foreign exchange inflows from overseas Filipinos’ remittances as well as portfolio and direct investments. Meanwhile, the NFA of banks decreased further owing to the significant increase in foreign liabilities related to higher placements and time deposits made by the head offices/other branches of foreign banks, given the solid growth prospects of the domestic economy.
**NFA continues to expand while NDA contracts.**

Meanwhile, the continued contraction in net domestic assets (NDA) due largely to the accelerated expansion of the net other items account (which includes revaluation and capital and reserve accounts as well as the SDA placements of trust entities) pulled down domestic liquidity growth in February. Nonetheless, net domestic credits rose further by 7.5 percent on account of the stronger increase in credits extended to the private sector. This trend is consistent with the continued expansion in bank lending to the productive sectors of the economy.

**Bank lending growth is on an uptrend.**

The continued growth in bank lending largely reflects the buoyancy of domestic demand and improving prospects for the economy. As of February 2011, bank lending, net of banks’ reverse repurchase (RRP) placements with the BSP, expanded at a brisker pace of 12.3 percent from 8.9 percent at end-Q4 2010 and 5.0 percent at end-Q1 2010. The faster growth of bank lending was driven largely by lending to the following productive sectors: manufacturing; electricity, gas, and water; real estate, renting, and business services; wholesale and retail trade; and agriculture, hunting, and forestry. Likewise, the growth in consumer loans accelerated relative to the expansion at end-Q4 2010 due mainly to the stronger growth in credit card receivables.

**Meanwhile, overall credit standards remain generally unchanged.**

Results of the Q1 2011 Senior Bank Loan Officers’ Survey showed generally unchanged bank credit standards for the eighth consecutive quarter starting Q2 2009, based on the percentage of banks indicating whether they tightened, loosened, or maintained credit standards. Using the diffusion index approach, the survey results showed that for loans to enterprises, all banks reported unchanged credit standards for all firm sizes in Q1 2011 relative to Q4 2010. However, the survey indicated an

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37 Survey questions were sent to 35 commercial banks, with 21 banks responding, for a response rate of 60.0 percent. As of September 2010, commercial banks’ loans accounted for around 85.5 percent of the banking system’s total outstanding loans.

38 Prior 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.

39 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”).
overall net tightening of credit standards for loans to households, reflecting the tightening of credit standards for personal and salary loans.

**Lending to Enterprises**

The unchanged overall credit standards for enterprises in Q1 2011 suggest that banks had ceased tightening their credit standards after the continued net tightening recorded in the past quarters.

Based on banks’ responses regarding specific credit standards, overall credit standards for loans to enterprises during the quarter were unchanged as the reported net easing of standards on loan margins and sizes of credit lines offset the observed net tightening in terms of collateral requirements, loan covenants, and loan maturities.

Looking at the external and bank-specific factors affecting banks’ credit standards, the unchanged overall credit standards for loans to enterprises was due to the stable outlook for certain industries and steady access to market financing of banks.

**Lending to Households**

The reported net tightening of credit standards overall and for personal and salary loans can be traced to the reduced size of credit lines and shortened loan maturities. However, banks reported unchanged credit standards for housing loans following a net easing recorded in the previous quarter. Banks' credit standards for auto loans were also unchanged for the second consecutive quarter since Q4 2010 while standards for credit card loans showed a net easing.

Respondent banks reported no change in terms of collateral requirements and loan covenants and

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40 The 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.

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

42 Only one bank reported a tightening of credit standards. The net tightening of credit standards overall and for personal and salary loans was attributed to the economic outlook, financial system regulations, tolerance for risk, and borrowers’ profile.
recorded narrower loan margins overall as well as for all types of household loans.

**Loan demand**

The survey results also pointed to a sustained positive net change in demand\(^\text{43}\) for loans from enterprises (overall) and households, particularly for housing loans. Upbeat expectations about the general economic activity, the low interest rate environment, attractive terms of financing offered by banks, and higher cash flow requirements contributed to the net increase in demand for loans from both enterprises and households.

The overall positive net change in demand for household and corporate loans was consistent with the sustained growth in bank lending during the first two months of 2011 for which data are available.

**Interest Rates**

*Yields in the secondary market rise significantly on inflation concerns.*

<table>
<thead>
<tr>
<th>Maturity</th>
<th>Yield in percent</th>
</tr>
</thead>
<tbody>
<tr>
<td>3Mo</td>
<td>2.5</td>
</tr>
<tr>
<td>6Mo</td>
<td>2.8</td>
</tr>
<tr>
<td>1Yr</td>
<td>3.0</td>
</tr>
<tr>
<td>2Yr</td>
<td>3.2</td>
</tr>
<tr>
<td>3Yr</td>
<td>3.4</td>
</tr>
<tr>
<td>4Yr</td>
<td>3.6</td>
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<tr>
<td>5Yr</td>
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<td>6Yr</td>
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<td>7Yr</td>
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<td>14Yr</td>
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<td>15Yr</td>
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<td>16Yr</td>
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<td>18Yr</td>
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<td>19Yr</td>
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<td>20Yr</td>
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<td>21Yr</td>
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<td>23Yr</td>
<td>7.4</td>
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<tr>
<td>24Yr</td>
<td>7.6</td>
</tr>
<tr>
<td>25Yr</td>
<td>7.8</td>
</tr>
</tbody>
</table>

Secondary market yields rose, 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 higher as of end-March 2011 relative to end-December 2010 except for the 10- to 25-year tenors. This was due to inflation concerns during the quarter following the statement by the BSP that it expects heightened inflation risks in the near future, coming from higher electricity rates as well as escalating food and oil prices.

\(^{43}\)“Net change in demand” refers to the percentage difference between banks reporting an increase in loan demand and banks reporting a decrease. A positive net change in demand indicates that more banks reported an increase in loan demand compared to those stating the opposite, whereas a negative net change in demand implies that more banks reported a decrease in loan demand compared to those reporting an increase.
Interest rate differentials continue to narrow.

Interest Rate Differentials

The average positive differentials between domestic and US interest rates, net of tax, continued to narrow in Q1 2011 relative to the previous quarter due to the larger decline in the RP 91-day T-bill rate relative to the fall in the US 90-day T-bill rate and the marginal increase in the US 90-day LIBOR.

Meanwhile, the positive differential between the BSP’s policy interest rate (overnight borrowing or RRP rate) and the US federal funds target rate widened to 400 basis points (bps) in Q1 2011 from 375 bps in Q4 2010, reflecting the impact of the 25-bp increase in the BSP’s overnight borrowing rate to 4.25 percent during the 24 March 2011 BSP policy meeting. Adjusted for the risk premium—which is measured as the 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 continued to rise to 259 bps from 251 bps in Q4 2010. This development may be traced to the increase in the differential between the BSP RRP rate and the US federal funds target rate.

The rise in the average inflation rate to 4.1 percent in Q1 2011 from 3.0 percent in the previous quarter and the steady nominal bank lending rate at 6.4 percent resulted in the considerable decline in the real lending rate—measured as the difference between the average bank lending rate and inflation—to 2.3 percent in Q1 2011 from 3.4 percent in Q4 2010. Meanwhile, the real lending rate of the Philippines in March 2011 ranked fifth highest (from being the second highest in December 2010) in a sample of 10 Asian countries, with Indonesia recording the highest real lending rate at 5.6 percent during the same period.
Financial Market Conditions

Financial market sentiment turns cautious on negative developments overseas. Concerns on the potential adverse impact on the global recovery of the continuing social unrest in the Middle East and tighter monetary policy settings in some emerging economies dampened investor confidence. The lingering sovereign debt crisis in Europe, longer-term effects of the natural disasters in Japan, and potential further increases in global commodity prices also contributed to increased uncertainties in domestic financial markets. These translated into cautious trading in the local bourse, generally wider Philippine bond debt spreads, and a marginal weakening of the peso. Meanwhile, the country’s solid macroeconomic performance, the upgrade on the Philippine credit outlook to positive from stable by Moody’s, and the BSP’s policy rate hike to help anchor inflation expectations tempered in part the negative impact of uncertainties in the global markets. Ample liquidity in the financial system along with the sustained resiliency of the banking sector likewise supported local markets. Domestic liquidity and bank lending expanded in tandem with the pace of economic growth. This reflected the results of the Q1 2011 BSP Senior Bank Loan Officers’ Survey, which indicated an overall net increase in demand for loans from enterprises and households.

Stock Market

Trading in the Philippine stock market trended downwards in Q1 2011, reversing the strong rally posted in the preceding quarter. Concerns over the potential impact of negative developments overseas on global growth prospects and of rising domestic inflation on the outlook for the Philippine economy dampened investors’ risk appetite. The Philippine Stock Exchange Composite Index (PSEi) averaged 3,921.8 index points in Q1 2011, lower by 6.2 percent than the previous quarter’s average of 4,182.0 index points but still higher by 29.4 percent relative to the year-ago average of 3,030.4 index points.
Looking at developments month-on-month, however, reveal a more positive trend emerging as the quarter ended.

- The stock index trended downwards in the first two months of 2011 amid generally bearish sentiments brought about by rising domestic inflation and negative developments overseas. In particular, escalating political tension in the MENA region, as well as tighter monetary policy settings in several G-20 countries, resulted in more cautious trading in the local bourse. Meanwhile, Moody’s upgrade of the Philippines’ credit rating outlook on 6 January 2011 and news of the 7.1 percent Q4 2010 GDP growth for the Philippines resulted in limited gains.

- In March, the PSEi was supported by positive earnings reports of several listed companies as well as encouraging US economic data. However, concerns over the continuing social unrest in the MENA region, the lingering sovereign debt crisis in Europe, and concerns over the long-term impact of the disaster in Japan partly dampened market sentiments. Meanwhile, the 25-bp policy rate hike of the BSP has already been factored in by investors. Towards the end of March, the index broke the 4,000 benchmark for the first time since 20 January 2011 following the successful completion of the deal between the Philippine Long Distance Telephone Company (PLDT), JG Summit, and Digital Telecommunication Phils., Inc. (Digitel).

With the generally bearish sentiments during the quarter, foreign investors withdrew from the local bourse, resulting in a net selling position of ₱4.2 billion. This was a reversal of the substantial net foreign buying position recorded in Q4 2010. Stock market capitalization, meanwhile, inched up marginally by 0.7 percent (year-to-date) during the review quarter to reach ₱8.9 trillion as of end-March 2011.
Government Securities

Given ample liquidity and market expectations of future upward adjustments in the BSP’s policy interest rates stemming from renewed inflationary pressures, investors showed strong demand for short-term debt instruments during the quarter. In particular, investors continued to prefer placing their excess funds in safer instruments such as government securities (GS) as reflected by the net oversubscription in Q1 2011 amounting to ₱79.5 billion, albeit relatively lower compared to the oversubscription of ₱110.74 billion during the previous quarter.

Meanwhile, the Auction Committee awarded in full the bids on T-bills across all tenors during the first auction of the year, but rejected the bids during the second auction, as bid rates were deemed too high while market demand was insufficient. The Government subsequently doubled the size of the non-competitive awards on the 91-day and 182-day tenors during its 21 February and 7 March 2011 auctions due to the significant volume of tenders received during these two auction dates.

With the release of the favorable fiscal report for January 2011 and the maturing of ₱7 billion worth of T-bills during the first quarter of 2011, GS yields fell across all tenors. Additionally, the positive market reaction to the BSP’s efforts to stem inflation with its decision to raise key policy rates in March 2011 contributed to the decline in yields. Going forward, yields on government securities are expected to move in a tight range pending the release of data on government borrowing for the second quarter.

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44 Arising from the increased oil prices due to the political turmoil in the MENA region.
45 The government can exercise this prerogative if initially accepted non-competitive bids are less than 25 percent of the total non-competitive tenders.
Debt spreads widen generally on adverse developments in the international front.

Average debt spreads narrowed slightly during the review quarter compared to the average in Q4 2010, but were generally on a widening trend. Spreads increased beginning late January 2011 as sovereign debt woes in Europe resurfaced alongside worries over Japan’s credit downgrade by S&P and Moody’s. Likewise, investors’ sentiment retreated as uncertainties mounted over the political unrest in the MENA region and its potential upward pressure on oil prices. With US Treasury yields remaining low on a “flight-to-quality” trade, the rise in oil prices and its consequent impact on global headline inflation pushed bond yield curves higher and widened credit spreads. Furthermore, the downbeat impact to global recovery of Japan’s calamities and nuclear problems escalated market worries, causing debt spreads to widen towards the end of the quarter.

Despite the quarter’s widening trend, spreads remained tight on a y-o-y basis. The steady stream of favorable macroeconomic data, both from developed and emerging markets, tempered the expansion in spreads. In particular, the upgrade on the Philippine credit outlook to positive from stable by Moody’s, citing the country’s strengthened external payments position, well-anchored inflation expectations, and improved prospects for economic reform as bases, muted partly the negative impact of uncertainties in the global markets. The country’s better-than-expected GDP growth figures for 2010, coupled with reports of improved growth performance of advanced and emerging economies, likewise helped arrest spreads from widening significantly. There was also abundant liquidity in the local market due to the steady inflows of remittances from overseas Filipinos and strong foreign portfolio investment inflows.

During the review period, the EMBI+ Philippine spread averaged 159 bps, broadly steady relative to the previous quarter’s average of 160 bps but significantly tighter than the 208 bps average posted during the same period in 2010. Similarly, the country’s 5-year CDS spread averaged 135 bps,
slightly wider compared to the previous quarter’s 130 bps. Against neighboring economies, the Philippine CDS traded narrower than Indonesia’s 146 bps but wider than Malaysia’s 113 bps and Thailand’s 78 bps. Meanwhile, debt spreads narrowed compared to the same period a year ago.

Banking System

*Key performance indicators show sustained resilience of the banking system.*

The Philippine banking system remained sound, stable, and liquid during the review quarter. Lending, deposits, and profitability sustained their healthy growth while credit quality in the system continued to improve, posting lower NPL and higher coverage ratios. Moreover, capital adequacy ratio of over 15 percent remained comfortably above the BSP’s and the Bank for International Settlements’ (BIS) minimum requirements.

Savings Mobilization

Savings and time deposits remained the primary sources of funds for banks. Banks’ total deposits as of end-February 2011 amounted to ₱3.7 trillion, 11.1 percent higher than the year-ago level of ₱3.3 trillion. The continued growth in deposits reflected sustained depositor confidence in the banking system. Savings deposits registered a 12.4 percent growth and continued to account for nearly half of the funding base. Demand deposits expanded by 18.2 percent y-o-y while time deposits posted a moderate growth of 3.1 percent.

Institutional Developments

The total resources of the banking system rose by 8.1 percent to ₱6.9 trillion as of end-February 2011 from the year-ago level of ₱6.5 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.

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46 Total peso-denominated deposits.
The number of banking institutions (head offices) fell further to 758 as of end-December 2010 from the quarter- and year-ago levels of 764 and 785, respectively, reflective of 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 647 rural banks (RBs). Meanwhile, the operating network (including branches) of the banking system increased to 8,869 in Q4 2010 from 8,740 in Q3 2010 and 8,620 during the same period last year, due mainly to the increase in the branches/agencies of commercial and rural banks.

The asset quality of the Philippine banking system improved slightly as the NPL ratio eased moderately to 3.7 percent as of end-February 2011 from 3.9 percent a year ago; it was broadly steady relative to the end-December 2010 level of 3.6 percent. The lower NPL ratio could be traced to the 7.5 percent y-o-y expansion in the industry’s total loan portfolio (TLP), which offset the 2.6 percent increase in the level of NPL. In particular, TLP expanded to ₱3,230.5 billion in end-February 2010 from ₱3,005.2 billion a year earlier. Likewise, the NPL level went up to ₱119.9 billion from the previous year’s level of ₱116.8 billion.

Meanwhile, the NPL ratio of U/KBs dropped further to 2.9 percent as of end-February 2011 from the 3.2 percent posted in the same period in 2010, but was unchanged relative to the ratio posted at end-December 2010.

The Philippine banking system’s NPL ratio of 3.7 percent was comparatively higher than some of its neighbors like Thailand’s 3.6 percent, Indonesia’s 2.8 percent, Malaysia’s 2.0 percent, and Korea’s 2.3 percent. 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 not implemented in the Philippines.

47 Sources: Various central bank websites and financial stability reports, Indonesia (commercial banks, January 2011); Malaysia (banking system, December 2010); Thailand (commercial banks, December 2010); and Korea (banking system, September 2010).
The loan exposure of banks remained adequately covered as the banking system’s NPL coverage ratio improved to 97.6 percent as of end-February 2011 from 93.1 percent in the preceding year. The ratio was indicative of banks’ continued compliance with the loan-loss provisioning requirements of the BSP to ensure adequate buffers against unexpected losses.

The capital adequacy ratios (CARs) of the Philippine banking system continued to reflect the stability of the industry. The average CAR of the banking system rose to 16.0 percent on a solo basis and 17.0 percent on a consolidated basis as of end-September 2010 compared to the quarter-ago ratios of 15.2 percent and 16.2 percent, resulting from the growth in qualifying capital due mainly to the robust net profits reported by banks and issuances of capital instruments during the period. 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 (14.3 percent) and Korea (14.6 percent), but lower than Thailand (16.7 percent). Indonesia posted the highest CAR in the region at 17.4 percent.

Meanwhile, placements in the special deposit account (SDA) facility of the BSP increased by about 89.4 percent y-o-y to reach ₱1,487.4 billion as of end-March 2011 from the ₱785.2 billion posted during the same period a year ago. Meanwhile, bank placements under the BSP RRP window reached ₱231.4 billion, an increase of ₱71.9 billion compared to a year earlier.

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48 CAR on a solo basis includes the head office and branches/other offices while CAR on a consolidated basis includes the parent bank and financial allied subsidiaries excluding subsidiary insurance companies.

49 Sources: Various central bank websites and financial stability reports, Malaysia (banking system, February 2011); Korea (banking system, September 2010); Thailand (average full branch, December 2010) and Indonesia (commercial banks, January 2011).
Exchange Rate

Peso depreciates on bearish market sentiments.

The peso averaged ₱43.80/US$1 in the first quarter of 2011, depreciating by 0.38 percent from the ₱43.63/US$1 average in Q4 2010. However, on a y-o-y basis, the peso appreciated by 5.1 percent from the ₱46.03/US$1 average in the first quarter of 2010. Behind the peso’s slight weakening relative to the previous quarter’s level was the bearish market sentiment stemming from the political unrest in the MENA region and concerns over the risk of rising inflationary pressures among emerging Asian economies.

The peso was generally on a depreciating trend at the beginning of the review quarter as investors dumped riskier assets, prompted by geopolitical concerns in the MENA region. However, positive market developments such as the upgrade of the Philippines’ rating outlook, along with the country’s stronger-than-expected economic growth in 2010 enabled the peso to regain ground in the next two months of the quarter. Sustained inflows from overseas Filipinos’ (OF) remittances, portfolio and direct investments, and exports also helped support the peso. The peso likewise found support in the positive market reaction to the BSP’s decision to raise policy rates to stem mounting inflationary pressures.

On a year-to-date basis, the peso appreciated against the US dollar by 1.04 percent on 31 March 2011 as it closed at ₱43.39/US$1, moving in tandem with other Asian currencies except for the

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50 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.
51 In November 2010, Standard & Poors Rating Services upgraded the Philippines’ foreign currency rating to BB, while Moody’s Investor Service upgraded the outlook on the Philippines’ foreign and local-currency bond ratings to positive from stable in January 2011.
52 Annual GDP grew by 7.3 percent in 2010, the highest since the 8.8 annual GDP growth rate in 1976 (Source: National Statistics Office).
53 OF remittances continued to show strength in the first two months of 2011, rising by 6.9 percent year-on-year to US$2.98 billion. Meanwhile, Jan-Feb exports registered a double-digit growth of 10.0 percent based on NSO data. Foreign portfolio investments (FPI) registered with the BSP resulted in a net inflow of US$973 million in January-March 2011, 152.8 percent higher than the US$385 million net inflow in the same period a year ago. Meanwhile, foreign direct investment (FDI) net inflows reached US$207 million in January 2011, higher by 21.8 percent than the US$170 million net inflows recorded in the same month a year ago (Source: BSP).
54 On 24 March 2010, the Monetary Board decided to increase by 25 basis points the BSP’s key policy interest rates to 4.25 percent for the overnight borrowing or reverse repurchase (RRP) facility and 6.25 percent for the overnight lending or repurchase (RP) facility.
55 Based on the last done deal in the afternoon.
Japanese yen, Taiwanese dollar, and Thai baht, which depreciated vis-à-vis the US dollar.

Meanwhile, volatility, as measured by the coefficient of variation of the daily average exchange rates, declined to 0.85 percent in the first quarter of 2011 compared with 0.97 percent in the preceding quarter of 2010.

On a real, trade-weighted basis, the peso lost external price competitiveness against the baskets of currencies of major trading partners (MTPs) in the first quarter of 2011. On a q-o-q basis, the positive inflation differential relative to the MTPs more than offset the nominal depreciation of the peso against this currency basket and led to an increase of the real effective exchange rate (REER) index of the peso by 0.24 percent.\(^{56}\) The peso gained external price competitiveness, however, against the basket of competitor countries in the broad and narrow series during the same period as the nominal depreciation of the peso against these baskets of currencies drove the REER index down and resulted in a real depreciation of the peso by 3.0 percent and 1.5 percent, respectively.\(^{57}\)

On a y-o-y basis, the peso lost external price competitiveness against the basket of currencies of MTPs as the REER index of the peso increased by 6.0 percent due to the combined effect of the nominal appreciation of the peso and the widening inflation differential against this basket of currencies. Meanwhile, the peso gained external price competitiveness against the basket of competitor currencies in both the broad and narrow series during the same period as the nominal depreciation of the peso against these baskets of currencies led to a decrease in the REER index of the peso by 2.5 percent and 1.5 percent, respectively.\(^{57}\)

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\(^{56}\) 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.

\(^{57}\) 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.
III. FISCAL DEVELOPMENTS

Q1 2011 fiscal deficit is lower compared to Q1 2010.

National Government Fiscal Performance

<table>
<thead>
<tr>
<th></th>
<th>Jan-Mar 2011</th>
<th>Growth (%)</th>
<th>% to Q1 2011 Program</th>
</tr>
</thead>
<tbody>
<tr>
<td>Surplus/(Deficit)</td>
<td>-134.2</td>
<td>-80.5</td>
<td>23.4</td>
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<tr>
<td>Revenues</td>
<td>265.8</td>
<td>21.5</td>
<td>101.2</td>
</tr>
<tr>
<td>Expenditures</td>
<td>400.0</td>
<td>-12.7</td>
<td>81.0</td>
</tr>
</tbody>
</table>

*Totals may not add up due to rounding
Source: BTR

The fiscal deficit for Q1 2011 was P26.2 billion, 80.5 percent lower than the P134.2 billion deficit incurred during the same period last year. This represents 23.4 percent of the P112.0 billion programmed deficit for Q1 2011.

Revenue collections increased by 21.5 percent to P323.1 billion in Q1 2011 compared to P265.8 billion in the same period last year and accounted for 101.2 percent of the program amounting to P319.3 billion for Q1 2011. The BIR and the BOC contributed P199.5 billion and P62.6 billion, respectively, to total revenues. The BIR and BOC collections went up by 14.8 percent and 3.4 percent, respectively, compared to the levels in same period last year. The collections by the Bureau of the Treasury (BTr) likewise increased by 176.8 percent to P38.3 billion from P13.8 billion in the same period in 2010. Revenues from other offices also increased by 29.2 percent to P22.7 billion.

Expenditures in January-March 2011 amounted to P349.3 billion, 12.7 percent lower than the disbursements in the same period in 2010, reaching 81.0 percent of the Q1 2011 program of P431.3 billion. Excluding interest payments, total disbursements declined by 11.2 percent to P258.6 billion. Interest payments also went down by 16.7 percent to reach P90.7 billion.
IV. EXTERNAL DEVELOPMENTS

Global economic recovery continues with the balance of risks to growth on the downside.

The global economic recovery proceeded in Q4 2010 with output growth estimated at 4.7 percent.\textsuperscript{58} Output expansion was sustained in the US, euro area, and major emerging markets, while the recovery paused in Japan. The recovery is expected to proceed in 2011, although a modest slowdown is projected due to the waning expansionary impact of fiscal stimulus measures and inventory restocking. The downside risks to global growth have also diminished somewhat in recent months as underlying private demand improves. Key downside risks to the global expansion relate to sustained increases in global commodity prices, particularly oil, and the possibility that the financial turbulence in the euro area periphery could spread to the rest of Europe. Despite challenges in pinning down precise estimates of the disaster’s impact, the impact of the Japanese earthquake on global growth is likely to be temporary and limited.\textsuperscript{59} However, the global energy market is the one area where the earthquake may have a lasting and sizeable impact as concerns on Japan’s nuclear crisis could result in a structural shift in the global energy mix.\textsuperscript{60}

Meanwhile, inflation pressures appeared to have broadened, mainly in ED economies, reflecting escalating global food and energy prices and the larger weight of these components in the CPI basket of these economies.\textsuperscript{61} Narrowing output gaps and overheating pressures have also contributed to heightened inflation pressures in ED economies.

\textsuperscript{58} IMF WEO Update, January 2011.
\textsuperscript{59} Asian Development Outlook 2011.
\textsuperscript{60} Asian Development Outlook 2011.
\textsuperscript{61} IMF WEO, April 2011.
US economic growth slows in Q1 2011.

Advance estimates showed that US real GDP grew at an annual rate of 1.8 percent in Q1 2011 from 3.1 percent in Q4 2010. The slowdown can be traced to the sharp increase in imports, larger decrease in federal government spending, along with decelerations in personal consumption expenditure, nonresidential fixed investment, and exports. On a full-year basis, output grew by 2.8 percent in 2010 after contracting by 2.6 percent in the previous year due to the recovery of consumption expenditures and private investment, inventory build-up, and a smaller trade gap.

Latest available information indicates that the recovery in the US continues to gain traction. Manufacturing PMI was broadly stable in March at 61.2 percent after rising to 61.4 percent in the previous month, highest since June 2004, pointing to the strong performance of the manufacturing sector in the first quarter of the year. Similarly, the industrial production index was generally steady in February at 95.5 following a four-month uptrend beginning October 2010. The manufacturing and mining sectors continued to post output gains, offset partially by the slowdown in the utilities sector.

Employment conditions also slightly improved as the seasonally-adjusted unemployment rate fell for the fourth consecutive month in March to 8.8 percent from 8.9 percent in the previous month and the nonfarm payroll employment increased by 216,000 during the month. Year-on-year headline inflation, meanwhile, rose further to 2.1 percent in February from 1.6 percent in the previous month due to higher food and energy prices.

Euro zone recovery remains moderate.

Q-o-q real GDP growth in the euro zone was maintained at 0.3 percent in Q4 2010. Private consumption and net exports contributed positively to growth. Meanwhile, gross fixed capital formation contracted on account of subdued investments in construction related to the ongoing correction in the housing market. Changes in inventories also pulled down output growth as inventory restocking further slowed down during the quarter.

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Recent economic data and information from business surveys confirm the broadening of the underlying growth momentum. The Eurozone Composite PMI was 57.6 in March, down from February’s four-and-a-half-year high index of 58.2, but remained higher than initial flash estimates. Growth continued to be led by manufacturing, but business activity in the services sector is beginning to gather pace. Strong growth continued in the big two economies of Europe, namely Germany and France, but domestic market weaknesses persisted at the periphery. Similarly, the EU Economic Sentiment Indicator (ESI) was broadly unchanged at 107.4 in March from 107.2 in the previous month with sentiment gains in industry and services offsetting the declines observed in retail trade and construction and from consumers.

Euro area inflation rose slightly to 2.4 percent in February from 2.3 percent in the previous month. Fuels for transport, heating oil, electricity, and gas had the largest upward impact on the headline inflation rate. For March, flash estimates on inflation edged up further to 2.6 percent.

Real output shrank by 0.3 percent q-o-q in Q4 2010 from a growth of 0.8 percent in the previous quarter. Domestic demand contracted by 0.2 percent as the government phased out stimulus measures to increase demand for environmentally friendly goods. Meanwhile, exports of goods and services suffered due to the appreciation of the yen.

While the recent tragedy clouds the immediate prospects for Japan, survey-based indicators point to a return to a moderate recovery path. Before decelerating sharply to 46.4 in March, the manufacturing PMI rose for two consecutive months to 52.9 in February, the highest in eight months. PMI survey data suggest a solid improvement in Japanese manufacturing sector

63 Markit Eurozone Manufacturing PMI™ – final data, dated 5 April 2011.
64 European Commission Business and Consumer Survey Results, March 2011.
66 Government ended its subsidy for buying low emission automobiles in September 2010.
67 Speech of Hidetoshi Kamezaki, member of the BOJ Policy Board, at the 2 February 2011 Meeting with business leaders in Saga.
operating conditions before the Tohoku earthquake in response to greater inflows of new businesses. In addition, employment conditions improved slightly with the unemployment rate falling to 4.6 percent in February 2011 from 4.9 percent in the previous month and the growth in new job openings accelerating to 22.9 percent from 18.8 percent in January 2011.

Headline inflation remained at zero for the third consecutive month in February. Core inflation, meanwhile, further declined to -0.3 percent from -0.2 percent in January.

Emerging Asia maintained its strong growth momentum. In China, real GDP growth sped up to 9.8 percent in Q4 2010 from 9.6 percent in Q3 2010. Full-year growth picked up to 10.3 percent from 9.2 percent in 2009. The agriculture sector expanded by 2.9 percent on the back of solid gains in grains output while industry output increased by 15.7 percent. CPI inflation remained at 4.9 percent in February, pointing to the continued build-up in inflationary pressures on account of high global food and oil prices. Amid elevated levels of inflation and overheating concerns, the People’s Bank of China (PBoC) increased interest rates for the fourth time in less than six months. It raised further the benchmark deposit and loan rates by 25 bps on 6 April 2011 and its reserve requirement by another 50 bps on 25 March 2011. The PBoC had increased its policy rates and reserve requirements by a total of 100 bps and 450 bps, respectively, since January 2010.

The Indian economy continued to expand rapidly in Q4 2010 at 8.2 percent from 8.9 percent in the previous quarter. Agriculture, services, and construction provided strong support to output growth. Mining and quarrying and manufacturing likewise grew at a robust pace. Wholesale price inflation remained elevated at 8.3 percent in February from 8.2 percent in the previous month, accompanied by a sharp increase in non-food manufactured products inflation.69 The Reserve Bank of India raised key policy rates by 50 bps during the review quarter to help anchor inflation expectations given heightened underlying

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inflationary pressures amid rising global commodity prices and emerging demand-side inflation risks.\textsuperscript{70}

Output expansion in South East Asia remained generally robust in Q4 2010, albeit with some moderation. Year-on-year real GDP growth in Indonesia, Malaysia, Thailand, and Vietnam reached 6.9 percent, 4.8 percent, 3.8 percent, and 6.8 percent, respectively.

\textsuperscript{70} Ibid.
V. **MONETARY POLICY DEVELOPMENTS**

*The Monetary Board decides to raise policy rates.*

The Monetary Board raised by 25 basis points the BSP’s key policy interest rates to 4.25 percent for the overnight borrowing or reverse repurchase (RRP) facility and 6.25 percent for the overnight lending or repurchase (RP) facility during its 24 March 2011 policy meeting. The interest rates on term RRPs, RPs, and special deposit accounts (SDAs) were also raised accordingly.

The MB’s decision was based on signs of stronger and broadening inflation pressures as well as a further upward shift in the balance of inflation risks. Baseline inflation forecasts indicated that inflation in 2011 could settle above the medium-term target range of 4.0 percent ± 1.0 percentage point before decelerating by year-end and reverting to the target range in 2012. Upside risks to the inflation outlook over the next few months remained substantial. International food and oil prices have continued to escalate due to the combination of sustained strong global demand and supply disruptions and constraints. Additional petitions for electricity rate hikes, higher-than-anticipated wage adjustments, and a possible further increase in rice prices given expected adjustments in NFA rice prices presented further upside risks to the inflation outlook. On the other hand, the downside risks to inflation could continue to arise from the slow recovery of global growth and a sustained strengthening of the peso which could help temper the impact of imported inflation.

The MB was also of the view that the broadening price pressures amid a positive output gap support measured policy tightening. In February, headline and core inflation posted the highest month-on-month increase since July 2008 while an uptick in all three alternative measures of core inflation estimated by the BSP was recorded. A significant increase in the number and weight of above-threshold items was likewise noted, suggesting that broad-based inflationary pressures could be emerging. The rising positive output gap was also suggestive of growing demand-based inflationary pressures. At the same time, buoyant domestic demand conditions provided room for a policy interest rate hike without affecting the country’s economic growth prospects.
Preemptive policy response will help anchor firmly the public’s inflation expectations.

Expectations of continued expansion in aggregate demand on the strength of consumer spending and improving economic prospects provided monetary authorities some flexibility to undertake a measured monetary policy tightening.

The MB also noted that, while inflation expectations remained within target for both 2011 and 2012, they have continued to rise. The mean inflation forecasts of private analysts polled by the BSP and the Asia Pacific Consensus surveys have been rising. Secondary market yields and term spreads have also risen across all tenors, suggesting higher inflation expectations.

Given these developments, the MB decided to act promptly to rein in inflation expectations. The prospect of continued pressures from international commodity prices raised the likelihood of second-round effects in the form of higher wage demands this year and faster price hikes among firms as they pass on higher input costs. The MB believed that a preemptive response will minimize the overall impact of rising inflation on domestic economic activity by helping to firmly anchor the public’s inflation expectations. Well-anchored inflation expectations would safeguard price stability and, therefore, preserve the public’s purchasing power.
VI. INFLATION OUTLOOK

Private Sector Economists’ Inflation Forecasts

**Mean inflation forecasts in the BSP survey of private economists rise but remain within the target range.**

Based on the results of the BSP’s survey of private economists for March 2011, inflation is expected to be within the target range for both 2011 and 2012. However, the mean inflation forecasts for 2011 and 2012 rose to 4.9 percent and 4.8 percent, respectively, from 4.1 percent in the previous quarter.

Analysts noted that sustained increases in global food and oil prices, heightened by lingering political tensions in the Middle East and North Africa and the impact of adverse weather conditions on agriculture, could lead to a substantial pickup in inflation over the next few months. On the other hand, the sustained strengthening of the peso is expected to help temper the impact of imported inflation.

Based on the probability distribution provided by 10 out of 15 respondents, there is a 48.3 percent chance that average inflation for 2011 could be within 4.1-5.0 percent in 2011, still within the 4.0 percent ± 1.0 percentage point target range for the year.

The Asia Pacific consensus forecasts (for the period January-March 2011) for Philippine inflation also showed higher but still within-target inflation expectations for 2011.
Results of the BES for Q1 2011 show a higher number of respondents anticipating inflation to increase in the first and second quarters of 2011. Likewise, results of the CES for Q1 2011 show that consumers expect a higher inflation rate over the next 12 months.

Relative to the previous survey, the majority of respondents expecting inflation to move up in the survey quarter (from a diffusion index of 2.4 percent to 21.3 percent) as well as in the next quarter (from 6.5 percent to 23.5 percent) increased. Increasing costs of fuel and other commodities in the global market and the strong performance of the domestic economy were cited by respondents as the main factors for their expectations of higher inflation.

Consumers also projected inflation rates to go up over the next 12 months relative to the previous survey as the continued rise in world oil prices is expected to put upward pressure on the price of basic commodities. Over the next 12 months, respondents anticipate inflation to rise to 9.8 percent from 7.6 percent in the previous survey. Respondents expect all the 14 items included in the survey to have higher inflation, with the following items registering the most significant increases: transportation (from 10.1 percent to 17.5 percent); fruits and vegetables (from 11.2 percent to 14.4 percent); rice (from 6.6 percent to 9.2 percent); fuel (from 7.3 percent to 9.9 percent); and personal care (from 8.6 percent to 11.1 percent).
BSP Inflation Forecasts

**Emerging baseline forecasts indicate that the 2011 inflation target could be at risk given elevated price pressures.**

The emerging baseline forecasts indicate an elevated inflation path over the policy horizon. Compared with the outlook in the previous Inflation Report, the current inflation outlook shows a hump-shaped path indicating that the government-announced target for 2011 could be at risk while the target for 2012 will be achieved. The tightening of global commodity markets represents the principal upside risk to inflation. Geopolitical risks have already led to a surge in oil prices while adverse weather conditions against increasing demand pose a risk to global agricultural prices. Additional petitions for adjustments in electricity rates, higher-than-anticipated wage increases, and rising inflation sentiments could also lead to higher inflation.

Meanwhile, downside risks to inflation could come from a slow global economic recovery and a sustained strengthening of the peso-dollar exchange rate, which could help temper the impact of imported inflation.

**Demand Conditions**

The domestic economy continued to expand—robustly in the latest quarter. The national accounts data show firm domestic demand conditions and solid growth in domestic market-oriented sectors such as construction and services. Investments also provided strong support to growth. Meanwhile, consistent with the strong pickup in domestic demand and the normalization of global trade, industry outpaced the performance of services and agriculture.

Similarly, other demand indicators reflected the buoyancy of the domestic economy. Average capacity utilization remained high and production indices in the manufacturing sector continued to rise. In addition, the office vacancy rate in the central business district has declined given the strong demand from the BPO industry.
Meanwhile, business and consumer confidence weakened slightly as indicated by the BSP-conducted surveys on business and consumer expectations. Based on business respondents’ replies, the less upbeat quarter-on-quarter outlook was due to the following: (a) usual slowdown in business activity after the Christmas and harvest seasons, (b) rising prices of oil and other commodities, and (c) abnormal weather conditions in some parts of the country. The household respondents cited the following reasons behind their weaker outlook: (a) continued increase in the prices of petroleum products, (b) high cost of goods and services, (c) tensions in the Middle East and North Africa, and (d) rise in household expenses.

**Supply Conditions**

The agriculture sector recovered in Q4 2010 but not enough to offset the contractions in the previous quarters. Relative to the previous year, agricultural output declined in 2010, reflecting largely the adverse impact of *El Niño*. In the first semester of 2011, *palay* and corn outputs are expected to expand with improvements in harvest areas and yields. Looking ahead, agricultural production is expected to be sustained by increased public spending on research and extension work and the adoption of strategies to counter the impact of weather-related disturbances.

In the international market, the FAO noted that the demand and supply balance in cereals is likely to remain tight with global utilization exceeding global production in 2010/11. Nevertheless, the FAO noted that under the assumption of normal weather conditions for the rest of the planting season, cereal production in 2011 should still be higher than the 2010 production. *72* Meanwhile, conditions in the global rice market appear to be more favorable as FAO expects rice closing stocks to increase in 2011 given forecasts of favorable production. *73*

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72 FAO, *Crops Prospects and Food Situation No. 4*, December 2010, available online at http://www.fao.org  
In the energy market, the sustained spike in both spot and futures prices of oil in the global market is driven mainly by concerns over the political turmoil in the MENA region given its sizable share in the global production of crude oil and other petroleum liquid. Looking ahead, the EIA expects oil prices to rise over the next two years with the continued tightening in oil markets. World oil consumption is expected to pick up while growth in non-OPEC production is likely to remain modest, leaving the global oil market to rely on OPEC production. At the same time, geopolitical uncertainties in oil-producing countries could push oil prices higher.\(^4\)

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).

Based on the latest GDP data, preliminary estimates yielded an output gap of 5.0 percent in Q4 2010, up from 3.2 percent in the previous quarter. The expansion in the output gap emerged as growth in actual output outpaced the growth in potential output. As actual output continues to grow above trend, solid domestic demand conditions could lead to stronger inflationary pressures over the short to medium term.

\(^{74}\) EIA, Short-Term Energy Outlook, 8 March 2011, available at http://www.eia.doe.gov
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 the DBCC-approved estimates;
(b) BSP’s overnight RRP rate at 4.25 percent from April 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 current fan chart depicts an elevated inflation path relative to that of the previous quarter. 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 current fan chart presents an upward shift from that of the previous quarter. The elevated inflation path from the latest report reflects mainly the impact of the higher-than-projected inflation outturns for Q1 2011 due to the surge in the world oil prices, increase in transport fares, and higher food prices. The current fan chart is consistent with the BSP’s view of stronger and broadening inflation pressures.

Similar to the previous quarter, the current fan chart suggests that inflation would rise until the third quarter of 2011 and then would stabilize gradually into 2012. Emerging baseline forecasts suggest that the 2011 inflation target range of 4.0 percent ± 1.0 percentage point could be at risk. Nevertheless, inflation is expected to ease in 2012.

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

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 reflected 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: (a) tightening of global commodity markets against a backdrop of structurally strong demand and supply constraints; (b) impact of geopolitical risks on oil prices; (c) impact of adverse weather conditions on food production; (d) additional petitions for adjustments in electricity prices; (e) higher-than-anticipated wage increases; (f) rising inflation sentiments; and (g) stronger-than-expected domestic economic activity.
Meanwhile, the downside risks to the inflation outlook include: (a) a slower-than-expected growth in the global economy; and (b) a sustained appreciation of the peso which 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 is the latest central projection corresponding to the BSP’s baseline inflation forecast and 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 the wire mesh reflects the inflation profile as of Q4 2010.
VII. IMPLICATIONS FOR THE MONETARY POLICY STANCE

The emerging baseline forecasts indicate an elevated inflation path over the policy horizon...

...with risks to the inflation outlook predominantly on the upside.

Commodity prices pose a key challenge for monetary policy in the near term.

The inflation environment in the next few months is expected to be challenging given the prevailing cost-side pressures. Compared with the outlook in the previous Inflation Report, the current inflation outlook shows a hump-shaped path indicating that the government-announced target for 2011 could be at risk while the target for 2012 will be achieved. The elevated inflation path from the latest report reflects mainly the impact of the higher-than-projected inflation outturns for Q1 2011 due to the surge in the world oil prices, increase in transport fares, and higher food prices.

The prevailing assessment of the current inflation environment and risks to inflation suggests an upward shift in the balance of inflation risks. The tightening of global commodity markets represents the principal upside risk to inflation while petitions for adjustments in electricity rates, higher-than-anticipated wage increases, and rising inflation sentiments could also lead to higher inflation. Meanwhile, downside risks to inflation could come from a slow global economic recovery and a sustained strengthening of the peso, which could help temper the impact of imported inflation.

Oil prices continue to be a growing source of risk given the ongoing political tensions in the Middle East and North Africa. Oil accounts for nearly 33 percent of the country’s energy requirements, with 80 percent of imported oil coming from the Middle East. Meanwhile, non-oil commodity prices may remain elevated given continued strong demand from emerging and developing economies. At the same time, the FAO’s latest forecast confirms that a tightening of the global cereal supply and demand balance is still expected due to higher cereal utilization, reflecting largely the increased use of corn for ethanol production. These developments in the global commodities market pose a considerable risk to domestic inflation as food and fuel prices figure prominently in Filipino consumers’ expectations. If this principal risk persists, monetary authorities will need to act preemptively and proceed with the cycle of policy tightening. The strong Philippine growth performance in 2010 and robust demand in Q1 2011 suggest that the
Unfavorable shifts in the public’s inflation expectations continue to be a major policy concern.

Monetary policy needs to guide the public’s inflation expectations especially given the possibility that higher commodity prices could persist over the near term. The prospect of continued pressures from commodity prices could lead to possible second-round effects in the form of higher wage demands and faster price hikes among firms as they pass on higher input costs. Given that monetary policy works with a lag, it is important to recognize that the main priority is to respond preemptively to contain the build-up in inflation expectations from ongoing supply-side price pressures.

[On 5 May 2011, the Monetary Board decided to increase by another 25 basis points the BSP’s key policy interest rates to 4.5 percent for the overnight borrowing or reverse repurchase (RRP) facility and 6.5 percent for the overnight lending or repurchase facility (RP) facility. The interest rates on term RRPs, RPs, and special deposit accounts (SDAs) were also raised accordingly.]
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:


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

The BSP also welcomes feedback from readers on the contents of the Inflation Report as well as suggestions on how to improve the presentation. Please send comments and suggestions to the following addresses:

**By post:**
BSP Inflation Report  
c/o Department of Economic Research  
Bangko Sentral ng Pilipinas  
A. Mabini Street, Malate, Manila  
Philippines 1004

**By e-mail:**
bspmail@bsp.gov.ph