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 percent ±1.0 percentage point for 2012-2014.

The report is published on a quarterly basis, presenting a survey of the various factors affecting inflation. These include recent price and cost developments, prospects for aggregate demand and output, labor market conditions, monetary and financial market conditions, fiscal developments, and the international environment. A section is devoted to a discussion of monetary policy developments in the last quarter, as well as a comprehensive analysis of the BSP’s view of the inflation outlook for the policy horizon. This issue also features a box article on the decision of the BSP to raise the reserve requirement ratio by 100 basis points effective on the reserve week beginning on 24 June 2011.

The Monetary Board approved this Inflation Report at its meeting on 29 July 2011.

8 August 2011
### List of Acronyms, Abbreviations, and Symbols

<table>
<thead>
<tr>
<th>Acronym</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>AE</td>
<td>Advanced economy</td>
</tr>
<tr>
<td>AFF</td>
<td>Agriculture, Fishery, and Forestry</td>
</tr>
<tr>
<td>AP</td>
<td>Asia Pacific</td>
</tr>
<tr>
<td>AL</td>
<td>Auto Loans</td>
</tr>
<tr>
<td>BAS</td>
<td>Bureau of Agricultural Statistics</td>
</tr>
<tr>
<td>BES</td>
<td>Business Expectations Survey</td>
</tr>
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<td>BIR</td>
<td>Bureau of Internal Revenue</td>
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<td>BIS</td>
<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 Process 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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<tr>
<td>CBD</td>
<td>Central Business District</td>
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<tr>
<td>CCRs</td>
<td>Credit Card Receivables</td>
</tr>
<tr>
<td>CES</td>
<td>Consumer Expectations Survey</td>
</tr>
<tr>
<td>CDS</td>
<td>Credit Default Swaps</td>
</tr>
<tr>
<td>CI</td>
<td>Confidence Index</td>
</tr>
<tr>
<td>CPI</td>
<td>Consumer Price Index</td>
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<tr>
<td>DBCC</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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<tr>
<td>EM</td>
<td>Emerging Market</td>
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<tr>
<td>EMBI</td>
<td>JP Morgan Emerging Market Bond Index</td>
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<td>ERC</td>
<td>Energy Regulatory Commission</td>
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<td>EU</td>
<td>European Union</td>
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<tr>
<td>FAO</td>
<td>Food and Agriculture Organization</td>
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<tr>
<td>GDP</td>
<td>Gross Domestic Product</td>
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<tr>
<td>GNP</td>
<td>Gross National Product</td>
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<tr>
<td>GRAM</td>
<td>Generation Rate Adjustment Mechanism</td>
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<tr>
<td>ICEREA</td>
<td>Incremental Currency Exchange Rate Adjustment</td>
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<td>IEA</td>
<td>International Energy Agency</td>
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<tr>
<td>IMF</td>
<td>International Monetary Fund</td>
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<td>IPP</td>
<td>Independent Power Producer</td>
</tr>
<tr>
<td>KBs</td>
<td>Commercial banks</td>
</tr>
<tr>
<td>LFS</td>
<td>Labor Force Survey</td>
</tr>
<tr>
<td>LPG</td>
<td>Liquefied Petroleum Gas</td>
</tr>
<tr>
<td>LTFRB</td>
<td>Land Transportation Franchising and Regulatory Board</td>
</tr>
<tr>
<td>MB</td>
<td>Monetary Board</td>
</tr>
<tr>
<td>MEM</td>
<td>BSP 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>
</tr>
<tr>
<td>MTP</td>
<td>Major Trading Partner</td>
</tr>
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<td>NCCP</td>
<td>National Council for Commuters’ Protection</td>
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<tr>
<td>NDA</td>
<td>Net Domestic Assets</td>
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<tr>
<td>NEDA</td>
<td>National Economic and Development Authority</td>
</tr>
<tr>
<td>Acronym</td>
<td>Description</td>
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<tr>
<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>NG</td>
<td>National Government</td>
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<td>NPC</td>
<td>National Power Corporation</td>
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<tr>
<td>NPLs</td>
<td>Non-performing loans</td>
</tr>
<tr>
<td>NSO</td>
<td>National Statistics Office</td>
</tr>
<tr>
<td>OPEC</td>
<td>Organization of the Petroleum Exporting Countries</td>
</tr>
<tr>
<td>PBR</td>
<td>Performance-based Rate</td>
</tr>
<tr>
<td>PCE</td>
<td>Personal Consumption Expenditure</td>
</tr>
<tr>
<td>PMI</td>
<td>Purchasing Managers’ Index</td>
</tr>
<tr>
<td>PSEi</td>
<td>Philippine Stock Exchange Composite Index</td>
</tr>
<tr>
<td>PSIC</td>
<td>Philippine Standard Industrial Classification</td>
</tr>
<tr>
<td>RB</td>
<td>Rural Banks</td>
</tr>
<tr>
<td>REER</td>
<td>Real Effective Exchange Rate</td>
</tr>
<tr>
<td>ROP</td>
<td>Republic of the Philippines</td>
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<tr>
<td>RP</td>
<td>Repurchase</td>
</tr>
<tr>
<td>RREL</td>
<td>Residential and Real Estate Loans</td>
</tr>
<tr>
<td>RRP</td>
<td>Reverse Repurchase</td>
</tr>
<tr>
<td>SEM</td>
<td>BSP Single-Equation Model</td>
</tr>
<tr>
<td>SMS</td>
<td>Short Message Service</td>
</tr>
<tr>
<td>SDA</td>
<td>Special Deposit Account</td>
</tr>
<tr>
<td>TCS</td>
<td>Transportation, Communications, and Storage</td>
</tr>
<tr>
<td>U/KBs</td>
<td>Universal/commercial banks</td>
</tr>
<tr>
<td>WEO</td>
<td>World Economic Outlook</td>
</tr>
<tr>
<td>WESM</td>
<td>Wholesale Electricity Spot Market</td>
</tr>
</tbody>
</table>
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’s primary monetary policy instrument is its overnight reverse repurchase (RRP) or its borrowing rate. Other instruments to implement the desired monetary policy stance to achieve the inflation target include (a) increasing/decreasing the reserve requirement; (b) encouraging/discouraging deposits in the special deposit account (SDA) facility by banks and trust entities of BSP-supervised financial institutions; (c) adjusting rediscount rate on loans extended to banking institutions on a short-term basis against eligible collateral of banks’ borrowers; and (d) outright sales/purchases of the BSP’s holdings of government securities.

Policy Target

The BSP’s target for monetary policy uses the Consumer Price Index (CPI) or headline inflation rate which is compiled and released to the public by the National Statistics Office (NSO) target for monetary policy. The policy target is set by the Development Budget Coordination Committee (DBCC)\(^1\) in consultation with the BSP. For 2011, the inflation target has been set at 4.0 percent ± 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 percent ± 1.0 percentage point for 2012-2014.

BSP’s Explanation Clauses

These are the predefined set of acceptable circumstances under which an inflation-targeting central bank may fail to achieve its inflation target. These clauses reflect 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 has met 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
- Alfredo C. Antonio
- Ignacio R. Bunye
- Peter B. Favila
- Felipe M. Medalla

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.
Governor

Members:
- Diwa C. Guinigundo
  Deputy Governor
  Monetary Stability Sector

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

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

  Ma. Ramona GDT Santiago
  Assistant Governor
  Treasury Department

2 The Advisory Committee is supported by a Technical Secretariat composed of officers and staff from the Department of Economic Research, Center for Monetary and Financial Policy, and the Treasury Department.
## 2011 SCHEDULE OF MONETARY POLICY MEETINGS, INFLATION REPORT PRESS CONFERENCES, AND PUBLICATION OF MB HIGHLIGHTS

<table>
<thead>
<tr>
<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>
</tr>
</thead>
<tbody>
<tr>
<td>Jan 2011</td>
<td>27 (Thu) (30 Dec 2010 MB meeting)</td>
<td>28 (Fri) (Q4 2010 IR)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>2011 Feb</td>
<td>7 (Mon) (AC Meeting No. 1)</td>
<td>10 (Thu) (MB Meeting No. 1)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>2011 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>
<td></td>
</tr>
<tr>
<td>2011 Apr</td>
<td>29 (Fri) (AC Meeting No. 3)</td>
<td>5 (Thu) (MB Meeting No. 3)</td>
<td>20 (Wed) (24 Mar 2011 MB meeting)</td>
<td>13 (Fri) (Q1 2011 IR)</td>
</tr>
<tr>
<td>2011 May</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>
<td></td>
</tr>
<tr>
<td>2011 Jun</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>
<td></td>
</tr>
<tr>
<td>2011 Jul</td>
<td>2 (Fri) (AC Meeting No. 6)</td>
<td>8 (Thu) (MB Meeting No. 6)</td>
<td></td>
<td>8 (Mon) (Q2 2011 IR)</td>
</tr>
<tr>
<td>2011 Aug</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>
<tr>
<td>2011 Oct</td>
<td>25 (Fri) (AC Meeting No. 8)</td>
<td>17 (Thu) (20 Oct 2011 MB meeting)</td>
<td>4 (Fri) (Q3 2011 IR)</td>
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<tr>
<td>2011 Nov</td>
<td>1 (Thu) (MB Meeting No. 8)</td>
<td>29 (Thu) (1 Dec 2011 MB meeting)</td>
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</table>

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

MB highlights publication scheduled on 21 April 2011 (Thursday) was be moved to 20 April 2011 (Wednesday). 21 April 2011 (Maundy Thursday) was a regular holiday.
## CONTENTS

**Overview**  
1

**I. Inflation and Real Sector Developments**  
3  
  Prices  
  Aggregate Demand and Supply  
    Aggregate Demand  
    Other Demand Indicators  
    Aggregate Supply  
  Labor Market Conditions  
5  

**II. Monetary and Financial Market Conditions**  
17  
  Domestic Liquidity and Credit Conditions  
  Interest Rates  
  Financial Market Conditions  
  Banking System  
  Exchange Rate  
26

**III. Fiscal Developments**  
30

**IV. External Developments**  
31

**V. Monetary Policy Developments**  
35  
  Box Article: The Increase in the BSP’s Reserve Requirements  
36

**VI. Inflation Outlook**  
38  
  Private Sector Economists’ Inflation Forecasts  
  BSP Inflation Forecasts  
  Risks to the Inflation Outlook  
43

**VII. Implications for the Monetary Policy Stance**  
46
Overview

Headline inflation rises due mainly to higher oil and food prices. Average inflation for Q2 2011, using the 2000-based CPI, accelerated further to 4.5 percent compared to the quarter-ago and year-ago levels of 4.1 percent and 4.3 percent, respectively. The uptick was traced mainly to higher inflation rates for fuel and transportation and communication services, reflecting the rise in international oil prices. Food inflation inched up as well, with most commodity groups posting higher prices due to supply constraints brought about by weather disturbances. Similarly, the official core inflation rose to 3.6 percent in Q2 2011 from 3.5 percent in the previous quarter, as price increases in most commodity groups offset the decline in non-food core inflation, particularly light. All three alternative measures of core inflation estimated by the BSP also reflected an uptrend in Q2 2011 relative to the levels registered in the previous quarter. The number and weight of above-threshold items continued to increase, indicating that the recent rounds of price increases could be at risk of becoming more generalized or broad-based.

The underlying strength of the economy remains intact. Despite some weakness in external demand and the slowdown in government spending, the Philippine economy continued to expand in line with the long-run trend. Economic growth in the first quarter was supported by strong private consumption, robust capital formation, and solid contributions from the industry sector, particularly from manufacturing. Other demand indicators also signaled buoyant demand conditions. Average capacity utilization remained above 80 percent, reflecting the strength of the manufacturing sector, while results of the April 2011 Labor Force Survey (LFS) pointed to improved employment conditions. Key indicators in the property sector likewise picked up further in the first quarter, indicating sustained recovery in property prices. Business confidence readings also remained favorable despite some weakening due to rising commodity prices and adverse external developments, particularly the ongoing political conflict in the Middle East and North African (MENA) region and the twin disasters in Japan in March. At the same time, the decline in specific demand indicators, particularly energy and vehicle sales, did not necessarily suggest a potential weakness in aggregate demand. For example, the fall in vehicle sales was a result of global supply constraints following the earthquake in Japan while the decline in energy sales was mainly due to the cooler temperature this year compared to the previous year, when the country experienced the brunt of the El Niño weather phenomenon.

The global economic recovery continues, albeit at a slower pace. The expansion in emerging and developing (ED) economies continued to outpace that of advanced economies (AEs), with the greater-than-expected weakness in US economic activity and the recession in Japan, the latter due largely to the impact of the disasters in March. Going forward, downside risks to global expansion have increased in recent months. Elevated prices of global commodities, renewed uncertainty surrounding the sovereign debt problems in the euro area, and potential overheating concerns in some emerging economies represent key risks to the recovery process. At the same time, medium-term fiscal adjustments in the US and Japan are likely to provide further downside risks to global growth. Meanwhile, global inflation picked up during the quarter, on account of higher commodity prices. In ED economies, inflation pressures appeared to have broadened, reflecting the higher share of food and fuel in the CPI basket of these economies as well as solid demand.

Domestic financial conditions remain stable despite adverse developments in the international front. Lingering uncertainty in the European financial markets, ongoing tensions in the MENA region and the potential slowdown of the recovery in the US dampened overall market sentiment. Nonetheless, the country’s strong fiscal and employment numbers in April along with news of Moody’s and Fitch’s upgrades of the Philippines’ sovereign credit rating boosted investor confidence in the domestic economy. As a result, local trading in the equities market was generally upbeat, with the Philippine Stock Exchange composite

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4 The analyses in this report are based on information as of 30 June 2011.
index (PSEi) reaching its highest level for the first half of the year. The EMBI+ Philippine spreads widened in Q2 2011 on account of external events which led to the perception of higher overall risk relative to the previous quarter, while Philippine credit default swap (CDS) spreads narrowed slightly, influenced by market perception of stable domestic macroeconomic fundamentals given the BSP’s policy actions, the NG’s fiscal prudence, and the recent credit rating upgrades. The peso strengthened on sustained inflows from OF remittances, exports revenues, and portfolio investment. At the same time, T-bill auctions during the quarter were generally oversubscribed on the back of ample liquidity in the financial system. The yield curve also flattened reflecting the rise in the secondary market yields of short-term debt papers, while yields in the longer segment of the curve declined relative to their levels in the previous quarter. Domestic liquidity continued to grow in step with domestic economic activity, while credit activity has been strengthening on the back of increased bank lending to the productive sectors of the economy. This is in line with results of the Q2 2011 BSP Senior Bank Loan Officers’ Survey indicating an overall net increase in demand for loans from enterprises and households.

The BSP hikes policy rates anew. The Monetary Board (MB) decided to raise key policy rates by 25 basis points (bps) for the second consecutive policy meeting in May 2011 as baseline projections indicated that the inflation target for 2011 could be at risk. The MB noted that while commodity prices had moderated somewhat in recent months, they continued to pose a risk to the inflation outlook given structurally strong demand from emerging economies amid persistent supply constraints. The follow-through policy action was also intended to firmly anchor inflation expectations and contain any second-round effects. Further increases in expected inflation, which could potentially influence future wage and price outcomes, argued for a tighter monetary policy stance.

The reserve requirement (RR) ratio is also raised. The Board also decided to increase the RR on deposits and deposit substitutes of all banks and non-banks with quasi-banking functions by one percentage point (ppt) effective 24 June 2011 to prevent possible additional inflationary pressures from excess liquidity. The MB believed that expectations of continued strong capital inflows, driven by positive market sentiment over the favorable prospects for the Philippine economy, could fuel domestic liquidity growth and add to future inflation risks.

Risks around the inflation projection imply maintaining a cautious monetary stance. The within-target inflation outlook provides the BSP room to allow previous policy actions to exert their full impact on the economy. Supporting the latest forecasts, inflation expectations also appear to be well contained as the manageable inflation outturns and the cumulative policy actions of the BSP have provided a stabilizing influence. However, the emerging balance of risks continues to point towards stronger upside risks to inflation, implying that the monetary policy stance should continue to maintain a cautious stance. Upside risks to the domestic inflation outlook include further increases in global oil prices and petitions for adjustments in electricity rates. At the same time, a continued surge in foreign exchange inflows could result in the rapid growth of domestic monetary aggregates, fueling credit demand and stretched asset market valuations. These could contribute to financial imbalances that could also weaken the transmission channels of monetary policy. Macroprudential measures can address the risks posed by strong capital inflows as these measures typically serve as the first line of defense against the build-up of financial imbalances. Going forward, the BSP still needs to be cautious and vigilant with respect to the policy stance.

[On 28 July 2011, the MB decided to maintain the BSP RRP and RP rates at 4.5 and 6.5 percent, respectively. The MB also kept the current interest rates on term RRPs, RPs and SDAs. Meanwhile, the Board increased anew the reserve requirement on deposits and deposit substitutes of all banks and non-banks with quasi-banking functions by one ppt effective on 5 August 2011.]
I. INFLATION AND REAL SECTOR DEVELOPMENTS

Prices

Headline inflation accelerates further.

Headline Inflation
Quarterly average in percent (2000=100)

Headline inflation rises due to higher oil prices.

Headline and Core Inflation
Quarterly average of year-on-year change

Official core inflation also rises.

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

Headline inflation for Q2 2011 accelerated further to 4.5 percent compared to the quarter-ago and year-ago levels of 4.1 percent and 4.3 percent, respectively, using the 2000-based Consumer Price Index (CPI) series. Similarly, the new 2006-based CPI series released by the National Statistics Office (NSO)—which was derived using an updated consumer basket of goods and services—showed higher headline inflation for Q2 2011 at 4.9 percent from 4.5 percent in Q1 2011.

Based on the 2000-based CPI series, the uptick in headline inflation was traced mainly to higher fuel and transportation and communication services inflation, due, in turn, to the rise in international oil prices.

Similarly, core inflation, which excludes some food and energy items to measure generalized price pressures, rose to 3.6 percent from 3.5 percent in the previous quarter.

Headline and Core Inflation

Headline inflation of 4.5 percent in Q2 2011 was spurred by higher inflation outturns for fuel and transportation and communication services, which tracked the rise in international oil prices. Food inflation advanced as well, with most commodity groups posting higher prices due to supply constraints brought about by weather disturbances.

The official NSO core inflation measure increased slightly to 3.6 percent in Q2 2011 as the decrease in non-food core inflation, particularly light, was more than offset by price increases in most commodity groups, including fish and meat. Nonetheless, Q2 2011 core inflation was lower compared to the 3.9 percent recorded in the same quarter a year ago.

Meanwhile, all three alternative measures of core inflation estimated by the BSP reflected an upturn in Q2 2011 relative to the levels registered in the previous quarter. The trimmed mean, weighted median, and net of volatile items measures inched up to 3.7 percent, 2.6 percent, and 5.0 percent from 3.2 percent, 2.2 percent, and 4.4 percent, respectively.

Notes:
1) The term “core” refers to the trimmed mean, or median, inflation rate. It is equal to the highest ranking of prices post-inflation rate for all CPI components.
2) The weighted median represents the middle inflation rate (corresponding to a cumulative CPI weight of 50 percent) of the highest ranking of prices post-inflation rate.
3) The net of volatile items method excludes the following items: educational services, fruits and vegetables, personal services, services, and fuels.
* Revised.
Core inflation contributed 3.3 percentage points (ppt) to headline inflation in Q2 2011, higher than the 3.0-ppt contribution in the previous quarter but lower than the 3.4-ppt contribution in the same quarter a year ago. Meanwhile, non-core CPI items contributed 1.2 ppts to headline inflation during the period, higher than the previous quarter’s 1.1-ppt contribution and the 0.9-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. In Q2 2011, the number of items with inflation rates greater than the threshold of 5.0 percent (the upper end of the inflation target for 2011) climbed to 29 from 26 in the previous quarter and 20 in Q2 2010. Accordingly, these items accounted for a greater proportion of the CPI basket at 16.7 percent compared to 16.3 percent in the previous quarter.

Grouping the CPI basket into food and non-food components showed that more food items were above the threshold. In particular, there were 22 food items with inflation rates above the threshold from 18 in the previous quarter. Meanwhile, there were 7 non-food items with inflation rates higher than the threshold in Q2 2011, which was less than the previous quarter’s 8 items.

### Food Inflation

Food, beverage, and tobacco inflation advanced further to 4.2 percent in Q2 2011 from 3.9 percent in the previous quarter and 3.1 percent a year ago, driven mainly by faster price increases of cereals, fish, and meat. Reflecting supply constraints due to weather disturbances, prices picked up for most food products, including rice, corn, fish, and meat. Meanwhile, lower prices of fruits and vegetables, as domestic supply remained adequate, tempered the increase in food inflation.
Non-food inflation

Non-food inflation at 4.9 percent was higher relative to 4.3 percent a quarter ago, but was lower compared to the 5.4 percent posted a year ago. Similar to the previous quarter, higher inflation for fuel and transportation and communication services accounted for the rise in non-food inflation in Q2 2011. In particular, from 6.5 percent in Q1 2011, transportation and communication services inflation rose to 9.8 percent in Q2 2011, reflecting the surge in global oil prices. Fuel inflation likewise climbed to 15.3 percent from 9.6 percent due to the higher cost of LPG and kerosene.

Energy Prices

The international price of Dubai crude oil increased by 10.2 percent quarter-on-quarter (q-o-q) in Q2 2011. In April, oil prices accelerated as the North Atlantic Treaty Organization (NATO) intensified its air campaign over Libya, bolstering concerns that the conflict might spread to other energy-exporting countries in the region and curb oil shipments. Nonetheless, oil prices dipped in May after reports indicating economic weakness in both the US and Europe tempered fuel demand. Oil prices also declined on concerns that China would tighten further its monetary policy settings to manage price increases. Meanwhile, oil prices were broadly steady in June amid persistent concerns that the US economy is slowing and as the International Energy Agency (IEA) announced that it is prepared to release more stockpiles to stabilize prices.

The estimated futures prices of Dubai crude oil in Q2 2011, based on movements in Brent crude oil futures, suggest a lower path for 2011 compared to the estimates in the previous quarter. This could be attributed to the cautious stance adopted by investors amid continued uncertainty in Europe’s financial markets and the possibility of slower global economic growth. Furthermore, IEA’s decision to provide 60 million barrels of oil in the coming months in response to the ongoing disruption of oil supplies in Libya also contributed to the lower oil price outlook.

*Futures prices derived using Brent crude futures data.

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6 US Labor Department figures showed that applications for jobless benefits in the US jumped by 43,000 to 474,000 in the week ended 30 April 2011. Economists in a Bloomberg News survey estimated they would fall to 410,000.

7 European Central Bank (ECB) President Jean-Claude Trichet’s suggestion that the ECB may hold off any adjustment in its key interest rates until new data become available, also drove oil prices lower in May.

Forecasts for the 2011 global oil demand are diverging.

Local gasoline pump prices increase.

<table>
<thead>
<tr>
<th>Quarter</th>
<th>Gasoline**</th>
<th>Kerosene</th>
<th>Diesel</th>
<th>LPG</th>
</tr>
</thead>
<tbody>
<tr>
<td>2010 Q1</td>
<td>44.25</td>
<td>41.37</td>
<td>33.75</td>
<td>32.66</td>
</tr>
<tr>
<td>2010 Q2</td>
<td>44.00</td>
<td>42.12</td>
<td>34.75</td>
<td>31.72</td>
</tr>
<tr>
<td>2010 Q3</td>
<td>45.40</td>
<td>40.12</td>
<td>33.00</td>
<td>31.41</td>
</tr>
<tr>
<td>2010 Q4</td>
<td>48.50</td>
<td>45.62</td>
<td>38.00</td>
<td>38.92</td>
</tr>
<tr>
<td>2011 Q1</td>
<td>54.80</td>
<td>53.11</td>
<td>47.10</td>
<td>37.27</td>
</tr>
<tr>
<td>2011 Q2</td>
<td>54.85</td>
<td>49.77</td>
<td>44.20</td>
<td>39.22</td>
</tr>
<tr>
<td>Q-o-Q</td>
<td>0.75</td>
<td>-3.14</td>
<td>-2.50</td>
<td>1.95</td>
</tr>
<tr>
<td>Y-o-Y</td>
<td>10.65</td>
<td>8.15</td>
<td>9.95</td>
<td>7.50</td>
</tr>
</tbody>
</table>

* Average retail pump price for the Big Three oil companies—Caltex, Petron, and Shell, Metro Manila prices only.
** Average price for unleaded gasoline

Source: Department of Energy (DOE)

For this year’s global oil demand, global energy authorities have diverging forecasts, as of June 2011 relative to their March forecasts. The OPEC retained its March forecast of 1.4 million barrels per day (mmbd) while the Energy Information Agency (EIA) increased its projection to 1.7 mmbd from 1.4 mmbd. Meanwhile, the IEA projected global oil demand to increase by 1.3 mmbd in 2011, down from its earlier projection of 1.4 mmbd. The bulk of the increase in 2011 world oil consumption is expected to come from non-OECD regions, particularly China, Brazil, and the Middle East.

As a result of global price movements, the domestic prices of LPG and unleaded gasoline increased by ₱1.95 per liter and ₱0.75 per liter in Q2 2011, respectively, relative to end-Q1 2011 levels. By contrast, the prices of kerosene and diesel oil fell by ₱3.14 per liter and ₱2.50 per liter, respectively.

Tracking the upsurge in imported crude oil prices, the pump prices of petroleum products were all higher during the review quarter, compared to end-Q2 2010 levels. In particular, the prices of unleaded gasoline, diesel oil, kerosene, and LPG increased by ₱10.65 per liter, ₱9.95 per liter, ₱8.15 per liter, and ₱7.50 per liter, respectively, during this period.

Cooler temperatures ease demand for energy.

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Power

Similar to the previous quarter, retail electricity rates were lower on a y-o-y basis in Q2 2011 on account of lower energy demand due, in turn, to 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 Q2 2011 which brought cooler temperatures.

Meanwhile, the Energy Regulatory Commission (ERC) has approved Meralco’s petition to raise distribution, metering, and supply charges under the Performance-Based Regulation (PBR) mechanism in

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12 Organization for Economic Cooperation and Development
The economy continues to expand.

Based on the national accounts data using constant 2000 prices, the economy continued to grow in Q1 2011, expanding at an annual rate of 4.9 percent, although slower than the 8.4 percent real GDP growth recorded in the same quarter a year ago and the 6.1 percent increase in Q4 2010.

On the expenditure side, expansion was led by capital formation and household consumption, contributing 6.8 ppts and 3.4 ppts to GDP growth, respectively. On the production side, GDP growth was led by industry and services which contributed 2.3 ppts and 2.1 ppts, respectively. The country’s gross national income (GNI) increased at a slower pace of 3.6 percent in Q1 2011 from 5.6 percent in Q4 2010 and 11.5 percent in the same period last year. GNI growth slowed down as net primary income (NPI) registered a flat growth on account of the political crisis in the MENA region.

Meanwhile, seasonally-adjusted GDP expanded at a faster pace of 1.9 percent q-o-q in Q1 2011 from a growth of 0.5 percent in the previous quarter.
Strong investment drives output growth.

Economic Performance
At constant 2000 prices
Growth rate (in percent)

<table>
<thead>
<tr>
<th>Sector</th>
<th>2010 Q1</th>
<th>2010 Q4</th>
<th>2011 Q1</th>
</tr>
</thead>
<tbody>
<tr>
<td>By expenditure item</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Household consumption</td>
<td>4.0</td>
<td>4.9</td>
<td>4.9</td>
</tr>
<tr>
<td>Government consumption</td>
<td>21.4</td>
<td>-6.6</td>
<td>-17.2</td>
</tr>
<tr>
<td>Capital formation</td>
<td>31.9</td>
<td>25.7</td>
<td>37.0</td>
</tr>
<tr>
<td>Fixed capital formation</td>
<td>19.0</td>
<td>16.1</td>
<td>12.0</td>
</tr>
<tr>
<td>Exports</td>
<td>18.8</td>
<td>16.8</td>
<td>3.3</td>
</tr>
<tr>
<td>Imports</td>
<td>24.2</td>
<td>21.9</td>
<td>8.8</td>
</tr>
</tbody>
</table>

Source: NSCB

Other demand indicators still signal buoyant demand conditions.

Aggregate Demand
Private investment continued to grow vigorously at 37.0 percent, driven by increased fixed capital formation, particularly durable equipment. This expansion, in turn, was buoyed by the upswing in spending on transport equipment, other special industrial machineries, and other miscellaneous durable equipment. The build-up of inventories, which amounted to B317.5 billion in Q1 2011 against a drawdown of B39.1 billion in the same period a year earlier, likewise supported the growth in capital formation. Meanwhile, the 21.6 percent increase in private construction led to a Q1 level, which more than offset the 37.3 percent drop in public construction, resulting in a 7.2 percent growth in the construction subsector.

Household consumption, accounting for 69.3 percent of GDP, also expanded by 4.9 percent in Q1 2011. Increases were recorded across major expenditure items, except alcoholic beverages and tobacco (which decreased for the third consecutive quarter) and housing, water, electricity, gas, and other fuels. Meanwhile, government consumption declined for the third consecutive quarter as the government remained conservative in its expenditure program for 2011.

Exports of goods and non-factor services continued to grow, albeit at a weaker pace of 3.3 percent in Q1 2011 from 18.8 percent in the same period in 2010. The sustained double-digit growth in exports of goods was tempered by the double-digit decline in exports of services. Merchandise exports increased by 10.1 percent, driven mainly by electronic components (13.9 percent growth).

Other Demand Indicators
Average capacity utilization remained consistently above 80 percent reflecting the strength of the manufacturing sector, while results of the April 2011 LFS pointed to improved employment conditions. Key indicators in the property sector likewise indicated a sustained pick-up in the first quarter. Business confidence readings also remained favorable despite some weakening due to rising commodity prices and adverse external developments. Meanwhile, the decline in some demand indicators, particularly energy and vehicle sales, did not necessarily indicate a potential weakness in overall aggregate demand.

13 Largely road vehicles
Implied land values continue to trend higher.

Data from Colliers International indicated that, on a q-o-q basis, implied land values rose for the third consecutive quarter in Q1 2011. However, implied land values in the Makati Central Business District (CBD) showed a slight decline of 0.6 percent y-o-y while those in the Ortigas Center increased by 2.9 percent. Compared to the previous quarter, implied land values in the Makati CBD and Ortigas Center were slightly higher at ₱268,202/sq.m. and ₱123,942/sq.m., respectively. For 2011, Colliers expects land values to post a modest growth of 3.0-5.0 percent given a moderation in planned developments in the traditional business districts, particularly in the Makati CBD and Ortigas Center. Land values during the review period were about 63-64 percent of their 1997 levels in nominal terms, but only about 30-31 percent of their 1997 levels in real terms.

Vacancy Rates

Office vacancy rates decline due to higher demand...

The average office vacancy rate in the Makati CBD of 3.8 percent in Q1 2011 was lower compared to the quarter- and year-ago levels. The higher demand for office space pushed vacancy rates lower for all office space segments (Premium, Grade A, and Grade B and below). According to Colliers, vacated office spaces across all grades were easily occupied due to heavy demand coming from the off-shoring and outsourcing (O&O) industry.

...while residential vacancy rates edge up with more supply introduced in the market.

Meanwhile, the residential vacancy rate of 9.4 percent during the quarter was higher compared to their quarter- and year-ago levels. Vacancy rates in the residential sector continued to rise with more supply introduced in the market. While demand for luxury residential units remained high, the continuous inflow of smaller-sized units—a segment where a large proportion of buyers are investors—could increase vacancy rates going forward as more of these spaces are left for lease.

14 In the absence of reported closed transactions, implied land values based on trends are used by Colliers International to monitor prices.
Likewise, residential rental values remain on an uptrend.

Monthly rents for prime 3-bedroom condominium units in the Makati CBD rose to P8,156/sq.m. in Q1 2011 from the previous quarter. The monthly rents for this segment were higher by 3.8 percent relative to the levels in the previous year. Rents for the luxury 3-bedroom units are expected to increase given the limited availability of these unit types coupled with sustained demand. Residential rental values were above their 1997 levels in nominal terms but were only about 57.2 percent of their 1997 levels in real terms.

Jones Lang LaSalle estimated average office rentals in the Makati CBD at P8,156/sq.m. per annum in Q1 2011, higher by 2.2 percent compared to the previous quarter and by 9.7 percent compared to the same quarter in the previous year. The report noted that the uptick in office rental values was due to sustained demand for office space from the O&O industry and limited new office supply. Despite the threat of external events, such as the unrest in the MENA region and the natural disaster that hit Japan, Jones Lang LaSalle expects rental values to increase in the coming quarters as the O&O industry is projected to continue propping up demand for office space.

15 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 P300 to P10,000/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.

16Computed as the average of rental values for the Premium, Grade A and Grade B segments. Premium refers to office space with capital values of >P75,000/sq.m. and above; Grade A, between P65,000 and P75,000/sq.m.; and Grade B, P55,000/sq.m. and below.

17Jones Lang La Salle is one of the world’s leading real estate services and money management firms, with approximately 160 offices worldwide. It has over 45 years of experience in Asia Pacific, with over 12,500 employees operating in more than 60 offices in 13 countries across the region.
Capital Values

Likewise, capital values\(^{18}\) for office buildings in the Makati CBD were higher in nominal terms than their quarter- and year-ago levels. Consistent with the uptrend in office rental values in the first quarter of 2011, Grade A office capital values in the Makati CBD rose to ₱78,595/sq.m., higher by 2.1 percent and 6.2 percent compared to their quarter- and year-ago levels, respectively. Office capital values in Q1 2011 remained below the pre-Asian financial crisis levels for grade A offices. In real terms, office capital values were about 48.0 percent of the comparable levels in 1997.

Capital values for luxury residential buildings in Makati CBD were also higher than their quarter- and year-ago levels, increasing by 0.9 percent and 4.1 percent, respectively. Residential capital values in Q1 2011 were above their 1997 levels in nominal terms, but remained below the pre-Asian financial crisis levels in real terms at about 51.4 percent of the comparable levels in 1997.

Vehicle Sales\(^{19}\)

Based on the preliminary data from the Chamber of Automotive Manufacturers of the Philippines, Inc. (CAMPI), vehicle sales fell by 10.3 percent in Q2 2011, given lower unit sales for passenger cars and commercial vehicles due to industry production disruptions in the aftermath of the twin disasters in Japan last March.

- Passenger car sales declined by 17.3 percent y-o-y in Q2 2011, a reversal of the quarter-ago growth of 11.3 percent.
- Likewise, commercial vehicles\(^{20}\) which account for more than half of total industry vehicle sales, contracted by 6.5 percent from a 6.7 percent growth in the previous quarter. The decline in commercial vehicles was due mainly to limited supply of models on the back of delayed shipments of units and parts.

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\(^{18}\) Probable price that the property would have fetched if sold on the date of the valuation. The valuation includes imputed land and building value.

\(^{19}\) Vehicle sales starting 2011 were adjusted to exclude the sales of four (4) members which left CAMPI, namely, Hyundai, Volvo, Chevrolet, and Chana.

\(^{20}\) Commercial vehicles include Asian utility vehicles (AUVs), sports utility vehicles (SUVs), light commercial vehicles (LCVs), light trucks, heavy-duty trucks, and buses.
Energy sales decrease further given lower household consumption.

<table>
<thead>
<tr>
<th>Capacity</th>
<th>Value</th>
<th>Capacity</th>
<th>Value</th>
<th>Capacity</th>
<th>Value</th>
<th>Capacity</th>
<th>Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>76.0</td>
<td></td>
<td>77.0</td>
<td></td>
<td>78.0</td>
<td></td>
<td>79.0</td>
<td></td>
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<tr>
<td>80.0</td>
<td></td>
<td>81.0</td>
<td></td>
<td>82.0</td>
<td></td>
<td>83.0</td>
<td></td>
</tr>
<tr>
<td>84.0</td>
<td></td>
<td>85.0</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Energy Sales

Year-on-year power sales of Meralco continued to decline in Q2 2011 by 2.0 percent from a 0.1 percent contraction in the previous quarter. This was also a reversal of the 13.7 percent growth posted in the same period a year-ago. Energy sales were pulled down largely by the lower consumption of residential users given cooler weather. The contraction was also due in part to base effects, as year-ago levels reflected higher-than-normal consumption due to rehabilitation efforts in the aftermath of Typhoon Ondoy and election-related activities.

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—continued to be above 80 percent. In May 2011, capacity utilization rate improved after dipping in the previous month to reach the same level posted in March at 83.2 percent (revised).

Volume and Value of Production

MISSI data sustained positive but slower growth in May 2011. The growth rate of the value of production index (VAPI) moderated to 2.4 percent y-o-y in May 2011 from 3.8 percent (revised) in April 2011. Likewise, the volume of production index (VOPI) grew at a weaker pace for the sixth consecutive month since December 2010 at 0.9 percent in May from 2.2 percent y-o-y (revised) in the previous month. The lower growth rates of both indices can be attributed to the slowdown in both the production value and volume of paper and paper products as well as non-metallic mineral products. For the VAPI, it can also be traced to weaker growth in the production value of fabricated metal products at 9.7 percent y-o-y after recording consecutive double-digit growth rates since September 2010.
Increasing commodity prices weaken business sentiment in the current quarter.

Business Expectations Survey

<table>
<thead>
<tr>
<th>Index</th>
<th>2010</th>
<th>2011</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Q2</td>
<td>Q1</td>
</tr>
<tr>
<td>Business Outlook Index</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Current Quarter</td>
<td>43.9</td>
<td>47.5</td>
</tr>
<tr>
<td>Next Quarter</td>
<td>46.3</td>
<td>59.4</td>
</tr>
</tbody>
</table>

Source: BSP

Higher prices of goods and services weigh down on consumer sentiment.

Consumer Expectations Survey

<table>
<thead>
<tr>
<th>Index</th>
<th>2010</th>
<th>2011</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Q2</td>
<td>Q1</td>
</tr>
<tr>
<td>Current Quarter</td>
<td>-28.7</td>
<td>-23.1</td>
</tr>
<tr>
<td>Next 3 months</td>
<td>-1.8</td>
<td>-6.2</td>
</tr>
<tr>
<td>Next 12 months</td>
<td>10.0</td>
<td>1.2</td>
</tr>
</tbody>
</table>

Source: BSP

Business sentiment remained broadly favorable but has weakened in Q2 2011 relative to Q1 due to higher commodity prices. Business sentiment for the next quarter also remained positive, albeit less upbeat. The outlook for Q2 and Q3 2011 suggests that the positive growth momentum could be sustained, but a slowdown is nonetheless inevitable after the record-high GDP growth in 2010.

Respondents attributed the less buoyant business outlook to global developments which are expected to have a negative impact on the overall economy’s performance and on their own business operations. The adverse external developments cited include: (a) rising prices of oil and other commodities, (b) continuing geo-political tensions in the MENA region, and (c) the string of calamities that hit Japan. This prevailing sentiment tracked the less optimistic outlook of businesses in Australia, Germany, Canada, Hong Kong and Singapore, which were dampened by rising commodity prices and weaker trade conditions.

Consumer Expectations Survey (CES)

Results of the Q2 2011 BSP CES showed broadly steady consumer confidence for the current quarter, with the confidence index (CI) decreasing slightly to -24.1 percent from -23.1 percent in the previous quarter. The current quarter CI declined slightly as the number of respondents that reported higher family incomes were offset by those that indicated that they were negatively affected by the elevated prices of petroleum products and general goods and services. This outlook also reflected the consumer sentiments prevailing in Germany, France, and New Zealand.

The broadly steady consumer sentiment in Q2 2011 was carried to the next quarter (CI at -7.8 percent from -6.2 percent a quarter ago). Meanwhile, consumers turned more bullish for the following year, with CI climbing to 4.4 percent from 1.2 percent a quarter ago. The respondents’ brighter year-ahead outlook was boosted by expectations of stable prices,

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21 Respondents cited the country’s sound macroeconomic fundamentals, continued investment inflows, and seasonal uptick in demand during the summer and school opening in June as reasons for their broadly favorable view of the macroeconomy.

22 The confidence index is computed as the percentage of firms that answered in the affirmative less the percentage of firms that answered in the negative with respect to their views on a given indicator.

23 Taken from the Consumer Expectations Survey for Q2 2011 dated 8 June 2011.

24 The survey was conducted during the period 18-30 April 2011.
better employment opportunities, and increased salaries alongside the resolution of political conflict in the MENA region, which in their view could help bring down the cost of fuel.

External Demand

Exports

Merchandise exports in the first quarter of 2011 grew by 8.1 percent, albeit lower than the quarter- and year-ago growth rates of 22.4 percent and 43.5 percent, respectively. The expansion of merchandise exports in Q1 2011 was led by manufactures, growing by 3.7 percent and contributing 3.4 ppts to overall exports growth. Exports of coconut products also contributed significantly (by 2.0 ppts) to exports growth, reflecting robust demand for coconut oil, especially from the US and Netherlands. Petroleum products, which grew by 98.7 percent, continued its double-digit growth driven by higher shipments of naptha, reformates, and other fuel oils. Shipments of other agro-based products likewise sustained its double-digit growth due to the combined effects of increased demand and improved selling price of dried seaweeds. Higher shipments of fruits and vegetables along with mineral products also provided support to total exports performance.

Imports

Imports of goods sustained double-digit growth at 13.9 percent in Q1 2011, although lower than the quarter- and year-ago growth rates of 28.2 percent and 38.9 percent, respectively. Merchandise imports expanded due mainly to higher imports of raw materials and intermediate goods due to the higher imports value of the following commodities: animal and vegetable oils and fats (114.9 percent), embroideries (69.0 percent), manufactured goods (46.9 percent) and chemicals (40.2 percent). In addition, imports of mineral fuels, lubricants and other related materials also contributed significantly on account of increased international oil prices owing to supply concerns.

Aggregate Supply

The industry sector, which comprised 32.6 percent of GDP, grew by 7.2 percent in Q1 2011. The rate of expansion was faster than a quarter-ago but was significantly slower than the growth posted in the same quarter last year. Industrial activity was
Industry

Economic Performance
At constant 2000 prices
Growth rate (in percent)

<table>
<thead>
<tr>
<th>Sector</th>
<th>2010</th>
<th>2011</th>
</tr>
</thead>
<tbody>
<tr>
<td>By industrial origin</td>
<td>Q1</td>
<td>Q4</td>
</tr>
<tr>
<td>Agriculture, Fishery &amp; Forestry</td>
<td>-1.8</td>
<td>4.1</td>
</tr>
<tr>
<td>Fishing</td>
<td>-1.1</td>
<td>-1.4</td>
</tr>
<tr>
<td>Industry</td>
<td>15.4</td>
<td>6.5</td>
</tr>
<tr>
<td>Mining and quarrying</td>
<td>2.4</td>
<td>6.9</td>
</tr>
<tr>
<td>Manufacturing</td>
<td>18.3</td>
<td>6.5</td>
</tr>
<tr>
<td>Construction</td>
<td>9.7</td>
<td>4.6</td>
</tr>
<tr>
<td>Electricity, gas and water</td>
<td>9.8</td>
<td>9.4</td>
</tr>
<tr>
<td>Services</td>
<td>7.2</td>
<td>6.4</td>
</tr>
<tr>
<td>Transport, Storage, &amp; Comm.</td>
<td>-2.2</td>
<td>1.4</td>
</tr>
<tr>
<td>Trade</td>
<td>11.6</td>
<td>5.0</td>
</tr>
<tr>
<td>Real estate, Rent, &amp; Bus. Act.</td>
<td>8.3</td>
<td>13.6</td>
</tr>
<tr>
<td>Government services</td>
<td>7.5</td>
<td>-0.8</td>
</tr>
<tr>
<td>Other services</td>
<td>9.8</td>
<td>8.7</td>
</tr>
</tbody>
</table>

Source: NSCB

Labor Market Conditions

Unemployment rate declines.

Based on the preliminary results of the April 2011 LFS, the unemployment rate in April 2011 was estimated at 7.2 percent, lower than the 8.0 percent and 7.4 percent posted in April 2010 and January 2011, respectively. Meanwhile, the proportion of underemployed to total employed persons was unchanged at 19.4 percent in April 2011 relative to the January 2011 level, but was higher compared to 17.8 percent in April 2010.

Employment increased by 4.0 percent y-o-y in April 2011, driven largely by the growth in the agriculture and services sectors. In particular, the number of employed persons in April 2011 was recorded at 36.8 million, higher by about 1.4 million compared to the level registered in the same period a year ago. The supported by the sustained expansion of the manufacturing sub-sector, due in part to the continued recovery in domestic demand and global trade.

Output growth was likewise supported by the services sector. Services, which accounted for 55.2 percent of total GDP, grew by 3.7 percent y-o-y in Q1 2011, slower than the quarter- and year-ago growth rates of 6.4 percent and 7.2 percent, respectively. The major drivers of the services sector were real estate, renting, and other business activities; transport, storage, and communication; financial intermediation; and other services. Meanwhile, the decline in government services and the significant slowdown in trade services dragged down the services sector.

Agriculture expanded for the second consecutive quarter, growing by 4.2 percent in Q1 2011, from the 1.8 percent contraction in the same quarter a year ago. Higher yield, increased harvest areas, and full milling operations in major production areas of palay, sugarcane, and corn underpinned recovery in agriculture. Poultry production was boosted similarly by higher demand for chicken meat from households and fastfood chains.

25 Agriculture sector grew by 15.4 percent, 26.3 percent, and 19.6 percent, respectively
26 Underemployed persons include all employed persons who express the desire to have additional hours of work in their present job or an additional job, or to have a new job with longer working hours. Visibly underemployed persons are those who work for less than 40 hours during the reference period and want additional hours of work.
services sector employed 51.7 percent of the total employed persons, while the agriculture and industry sectors accounted for 33.0 percent and 15.3 percent, respectively.

In terms of major occupation groups, the y-o-y increase in the employment level was brought about by the higher growth of laborers, officials of government and special interest organizations, service workers, clerks, farmers, and technicians.

However, the decline in the employment of workers in special occupations, trades, and plants pulled down employment growth in April 2011.
II. MONETARY AND FINANCIAL MARKET CONDITIONS

Domestic Liquidity and Credit Conditions

*Domestic liquidity grows at a slower pace as NFA expands.*

M3 continued to grow in May 2011, although at a slightly slower pace of 8.0 percent from the end-Q1 2011 expansion of 10.3 percent. The growth of domestic liquidity was fueled by the steady expansion in net foreign assets (NFA), particularly in the BSP’s NFA position, as foreign exchange inflows from overseas Filipinos’ remittances, as well as portfolio and direct investments, continued to increase. Meanwhile, the NFA of banks decreased further owing to the significant increase in foreign liabilities coupled with a decline in foreign assets. On the one hand, banks’ foreign liabilities rose with the increase in bonds and bills payables as well as higher placements and time deposits made by the head offices/other branches of foreign banks with their Philippine branches. On the other hand, the contraction of banks’ foreign assets was due in part to the decrease in loan receivables from foreign banks.

*...while NDA continues to contract.*

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 SDA placements of trust entities), pulled down domestic liquidity growth in May. Nonetheless, net domestic credits grew by 7.7 percent due to the larger increase in credits extended to the private sector. This trend is consistent with the faster growth of bank lending to the productive sectors of the economy. Meanwhile, credits extended to the public sector contracted due mainly to the decline in credits extended to the National Government (NG) given the increase in NG deposits with the BSP and other banks during the period.

*Bank lending growth accelerates.*

Credit activity continued to grow at a brisk pace, indicating that the underlying strength of domestic economic activity remained intact. As of May 2011, bank lending growth, net of banks’ reverse repurchase (RRP) placements with the BSP, accelerated to 18.8 percent y-o-y from a growth of 14.1 percent at end-Q1 2011 and 9.6 percent at end-Q2 2010. The faster growth of bank lending was driven largely by lending to the following productive sectors: electricity, gas and water; manufacturing; real estate, renting and business services; agriculture, hunting and forestry; financial intermediation; and wholesale and retail trade. The growth in consumer loans also increased due largely to the stronger growth in credit card receivables.
Meanwhile, overall credit standards remain generally unchanged.

Results of the Q2 2011 Senior Bank Loan Officers’ Survey showed generally unchanged bank credit standards for the ninth 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 indicated an overall net tightening of credit standards for loans to enterprises, while credit standards for loans to households showed an overall net easing in Q2 2011 relative to Q1 2011.

Lending to Enterprises

The overall net tightening of credit standards for loans to enterprises reflected the banks’ less optimistic outlook on the economy and certain industries. This in line with the results of the Q2 2011 BSP Business Expectations Survey which showed a positive but less buoyant business confidence index for the current quarter relative to Q1 2011 on account of rising global commodity prices and adverse external developments. Banks’ reduced tolerance for risk and access to market financing also contributed to the net tightening of credit standards to enterprises in the second quarter.

With regard to firm size, banks reported a net tightening of credit standards for loans to large middle-market and small and medium enterprises (SMEs), consistent with the overall net tightening of credit standards. However, credit standards for loans to top corporations have been unchanged since Q1 2011. Likewise, the results indicated unchanged credit standards for loans to micro enterprises for the fourth consecutive quarter.

In terms of specific credit standards, loan maturities for large middle-market enterprises appeared to have shortened. Meanwhile, banks indicated an overall net easing of standards on collateral requirements and loan covenants. Likewise, banks’ standards on loan margins and sizes of credit lines have been eased for

<table>
<thead>
<tr>
<th>General Credit Standards to Enterprises (Overall)</th>
<th>Q1 2010</th>
<th>Q2 2010</th>
<th>Q3 2010</th>
<th>Q4 2010</th>
<th>Q1 2011</th>
<th>Q2 2011</th>
</tr>
</thead>
<tbody>
<tr>
<td>Tightened considerably</td>
<td>1.5</td>
<td>0.0</td>
<td>0.0</td>
<td>0.0</td>
<td>0.0</td>
<td>0.0</td>
</tr>
<tr>
<td>Tightened somewhat</td>
<td>10.5</td>
<td>4.5</td>
<td>9.5</td>
<td>15.0</td>
<td>0.0</td>
<td>5.6</td>
</tr>
<tr>
<td>Remained basically unchanged</td>
<td>84.2</td>
<td>95.5</td>
<td>90.5</td>
<td>80.0</td>
<td>100.0</td>
<td>94.4</td>
</tr>
<tr>
<td>Eased somewhat</td>
<td>0.0</td>
<td>0.0</td>
<td>0.0</td>
<td>0.0</td>
<td>1.0</td>
<td>0.0</td>
</tr>
<tr>
<td>Eased considerably</td>
<td>0.0</td>
<td>0.0</td>
<td>0.0</td>
<td>0.0</td>
<td>0.0</td>
<td>2.0</td>
</tr>
<tr>
<td>Total</td>
<td>100.0</td>
<td>100.0</td>
<td>100.0</td>
<td>100.0</td>
<td>100.0</td>
<td>100.0</td>
</tr>
<tr>
<td>Diffusion Index</td>
<td>15.5</td>
<td>4.5</td>
<td>9.5</td>
<td>10.0</td>
<td>0.0</td>
<td>5.6</td>
</tr>
<tr>
<td>Weighted Diffusion Index</td>
<td>22.5</td>
<td>3.2</td>
<td>6.2</td>
<td>5.6</td>
<td>0.0</td>
<td>2.0</td>
</tr>
<tr>
<td>Mean</td>
<td>2.8</td>
<td>2.0</td>
<td>2.9</td>
<td>2.9</td>
<td>3.5</td>
<td>2.9</td>
</tr>
</tbody>
</table>

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

27 Survey questions were sent to 35 commercial banks, with 21 banks responding, or 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. Meanwhile, the banks that responded to the Q2 2011 survey accounted for 79.0 percent of the total universal and commercial bank loans for May 2011.

28 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.

29 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”).

30 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.
most firm sizes. Survey results have been showing a net narrowing of loan margins since Q4 2010 while credit line sizes have been exhibiting a net increase since Q2 2010 particularly for top corporations and large middle-market enterprises.

Lending to Households

The survey results indicated a net easing of credit standards for loans to households,31 reflecting the net easing of standards for housing and credit card loans. Meanwhile, banks’ credit standards for auto and personal/salary loans showed a net tightening. Improved profile of borrowers, as well as increased competition from other banks or non-bank lenders contributed to the easing of standards for housing loans.

The banks’ responses regarding specific credit standards showed unchanged standards on the size of credit lines, collateral requirements, and loan maturities across all types of household loans, except housing loans. For housing loans, meanwhile, most of the specific credit standards have been eased, except loan margins, which were unchanged from the previous quarter.

Loan demand

The survey results also pointed to a sustained positive net change in loan demand32 from enterprises (except micro enterprises) and households (particularly for housing and auto loans). The net increase in demand for loans from both enterprises and households could be traced to still upbeat expectations of borrower firms and households about the general economic activity, the generally low interest rate environment, and higher cash flow requirements.

The overall positive net change in demand for household and corporate loans was consistent with the steady pick-up in bank lending growth during the first two months of Q2 2011 for which data are available.

31 Loans extended to households include: (1) housing loans; (2) credit card loans; (3) auto loans; and (4) personal/salary loans.
32 “Net change in loan demand” refers to the percentage difference between banks reporting an increase in loan demand and banks reporting a decrease. A positive net change in loan demand indicates that more banks reported an increase in loan demand compared to those stating the opposite, whereas a negative net change in loan demand implies that more banks reported a decrease in loan demand compared to those reporting an increase.
Special questions on commercial real estate loans

For the Q2 2011 survey round, specific questions on commercial real estate loans were included for the BSP to have a better sense of banks’ views on the property sector. Most of the respondent banks reported unchanged credit standards for commercial real estate loans in Q2 2011 relative to Q1 2011. Using the diffusion index approach, however, credit standards showed a net tightening. Meanwhile, banks’ loan-to-value ratios for commercial real estate loans (which ranged from 50 percent to 80 percent) have been unchanged from the previous quarter.

Interest Rates

T-bill rates show mixed trends.

Yield curve flattens.

Yield of Government Securities in the Secondary Market

Interest rate differentials widen.

Primary Interest Rates

During Q2 2011, the average 91-day T-bill rate rose to 1.5 percent from 1.2 percent in Q1, but declined relative to Q2 2010’s level of 3.9 percent. The average 182- and 364-day T-bills, however, both declined in Q2 2011 to 1.1 percent and 2.4 percent from 2.1 percent and 2.9 percent, respectively. These trends reflect how investors are moving into shorter-dated papers in Q2 given the higher inflation outlook. Meanwhile, interest rates for 182-day and 364-day T-bills were lower due mainly to positive market perception on the recent upgrade by Moody’s and Fitch Ratings and the BSP’s recent policy moves to curb inflation.

Yield Curve

Secondary market yields of short-term papers rose in end-June 2011 relative to the levels in end-March 2011, reflecting investors’ preference for shorter-dated instruments amid inflation concerns. Meanwhile, yields in the longer segment of the curve were lower due in part to positive investor sentiment over the longer term stemming, in turn, from the recent upgrade by Fitch Ratings of the country’s long-term foreign currency bond rating to BB+ from BB, bringing the country’s credit rating to only one step below investment grade. Relative to the 29 June 2010 levels, yields were lower across all tenors.

Interest Rate Differentials

The average positive differentials between domestic and US interest rates, net of tax, widened in Q2 2011 relative to the previous quarter, following the rise in
the average T-bill rate to 1.5 percent in Q2 2011 from 1.2 percent in Q1 2011 and the decline in the average US 90-day LIBOR and the average US 90-day T-bill rate to 0.26 percent and 0.07 percent, respectively, from 0.31 percent and 0.17 percent in Q1 2011.

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 425 bps in Q2 2011 from 400 bps in the previous quarter, reflecting the impact of the 25-bp increase in the BSP’s overnight borrowing rate to 4.50 percent during the 5 May 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 rose further to 293 bps from 258 bps in Q1 2011. This development may be traced to the increase in the differential between the BSP RRP rate and the US federal funds target rate and the small decline in the risk premium.

The rise in both the average nominal bank lending rate and the inflation rate to 7.1 percent and 4.6 percent (2000-based CPI series) in June 2011, respectively, from 6.4 percent and 4.3 percent in March, resulted in the rise in the real lending rate—measured as the difference between the average bank lending rate and inflation—to 2.5 percent as of June 2011 from 2.1 percent in March.

Using the 2006-based CPI inflation series, the real lending rate likewise rose to 1.9 percent in June 2011 from 1.6 percent in March, as the inflation rate rose to 5.2 percent in June from 4.8 percent in March.

Based on the 2000-based CPI series, the real lending rate of the Philippines in June 2011 ranked the fourth highest in a sample of 10 Asian countries, with Indonesia recording the highest real lending rate at 6.7 percent in June 2011 and 5.5 percent in March 2011. Likewise, based on the 2006-CPI series, the Philippines’ real lending rate ranked the fourth highest in June 2011 for the same sample.
Financial Market Conditions

Domestic financial conditions remain favorable.

The stock market index rises due to a stable macroeconomy and the positive outlook on several locally listed issues.

Average PSEI*/

Domestic financial conditions remained stable despite adverse developments on the international fronts. Lingering uncertainty in the European financial markets, ongoing geopolitical crisis in the MENA region and the potential slowdown of the recovery in the US dampened market sentiment. Nonetheless, the country’s strong fiscal and employment numbers in April along with news of Moody’s and Fitch’s upgrades of the Philippines’ sovereign credit rating boosted investor confidence. As a result, local trading was generally upbeat, with the PSEi reaching its highest level thus far for 2011 in May. The EMBI+ Philippine spreads widened in Q2 2011 relative to the previous quarter but Philippine CDS spreads declined slightly. The peso also kept its strength on sustained inflows from OF remittances, export revenues, and portfolio inflows. At the same time, T-bill auctions during the quarter were generally oversubscribed on the back of ample liquidity in the financial system.

The stock market index rises due to a stable macroeconomy and the positive outlook on several locally listed issues.

Average PSEI*/

Stock Market

In the second quarter of 2011, the local stock market recovered from the retreat posted in the first three months of the year. The Philippine Stock Exchange Composite Index (PSEi) averaged 4,253.1 index points, higher by 8.4 percent than the previous quarter’s average of 3,921.7 index points. Notwithstanding global economic woes that muted risk appetite, the local index rose on a q-o-q basis, boosted by the positive outlook on several listed firms and a generally stable macroeconomy.

Trends were mixed within the quarter, however, as negative developments abroad occasionally dampened local trading sentiments.

- The rally that began in late-March continued in April, with the PSEi breaching the 4,200 level on market-making news from Philippine Long Distant Telephone (PLDT), the steady inflation for March, better fiscal performance, and the US Fed’s decision to maintain its monetary stimulus efforts. Partly dampening trading sentiments, however, were profit-taking, the continued surge in oil prices due to troubles in the MENA region, the impact on Japan’s economy of the March earthquake, and resurfacing concerns over the European sovereign debt crisis.
Adverse overseas developments kept pushing the index lower. The index rose initially to reach its highest level in 2011 at 4,335.0 index points on 11 May due to bargain hunting and a better-than-expected US employment data. However, the rally was temporary as the index weakened due to negative global sentiments that raised investors’ risk perception stemming from: (a) the continued rise in global commodity and oil prices, (b) the failure of the US Congress to raise government debt ceilings, (c) Japan’s economic recession, (d) the European sovereign debt crisis, and (e) the US economic slowdown.

Global woes continued to keep trading volatile in June. In addition to heavy losses in Wall Street on weak US jobs and auto sales data early in the month, the PSEI posted losses amid increasing signs that recovery was slowing in advanced economies, heightened concern of a sovereign debt default after S&P downgraded Greece to “CCC”, China’s steps to curb inflation, and expectations of higher domestic inflation in May. Occasional gains were registered during the period following the slight dip in the Philippine unemployment rate, Moody’s and Fitch’s upgrades of the Philippines’ sovereign credit ratings, the release of better-than-expected retail sales numbers for the US in May, Japan’s industrial production rising for a second month in May as well as investors’ optimism on easing Greece default concerns after lawmakers passed austerity measures. The index closed at 4,291.2 index points on 30 June, higher by 1.1 percent relative to the end-May level and by 2.1 percent year-to-date.

Notwithstanding generally bearish sentiments abroad, foreign investors returned to the local bourse during the quarter in review. They were net buyers at ₱20.0 billion in Q2 2011, a reversal of the net selling level of ₱4.9 billion in the previous quarter. However, total market capitalization dipped slightly by 0.2 percent to ₱8.91 trillion in June from the ₱8.93 trillion posted in end-March 2011.

31 The S&P downgrade of Greece’s sovereign rating on 13 June indicated S&P’s perception that the country was increasingly likely to face a debt restructuring and the first sovereign default in the euro area’s history.
32 Data released by the NSO on 7 June shows inflation rising slightly to 4.5 percent in May, from the revised 4.3 percent inflation in April.
33 However, this can be traced largely to the positive response to the block sale of SMC and Lepanto in April. Net foreign buying was muted in the succeeding months of May and June.
34 The data on foreign transactions and stock market capitalization were lifted from the PSE website and are still preliminary.
Government Securities

With the prevailing ample liquidity, moderate inflationary pressures, and market expectations of further policy tightening by the BSP in the second quarter of 2011, investors opted to park their excess funds in short-term government securities (GS). The auctions during the quarter were mostly oversubscribed (except on 16 May and 13 June), with oversubscription amounting to P72.9 billion compared to P79.5 billion in January-March 2011.

For the first three consecutive auctions, the Auction Committee awarded in full the bids on 182-day and 364-day T-bills, while awards for the non-competitive 91-day T-bills were doubled. 37 In May to June, however, bids for the 182-day and 364-day T-bills were rejected, as tenders were generally lower than programmed while bid rates were higher than the secondary market rates. The government’s relatively comfortable levels of cash balances also allowed the rejection of bids on 182-day 38 and 364-day 39 GS while bids for the 91-day T-bills during Q2 2011 were generally awarded.

Though GS yields moved higher in the first half of Q2 2011, the recent Fitch Ratings 40 upgrade on the country’s credit rating could trigger a higher demand for GS and cause debt paper yields to decline for the rest of the year.

Sovereign Bond and CDS Spreads

Debt spreads were on a widening trend in the second quarter. The EMBi+ Philippine spreads, or the extra yield investors demand to hold Philippine debt securities over US Treasuries, averaged 182 bps during the review period, wider than the first quarter’s average of 159 bps but narrower than the 216 bps posted during the same period in 2010. On the other hand, the CDS spread, or the cost of insuring the country’s 5-year sovereign bonds against default, remained broadly steady at 133 bps from 135 bps in Q1 2011. Against neighboring economies, the Philippine CDS traded narrower than Indonesia’s 137 bps but wider than Malaysia’s 79 bps and Thailand’s 121 bps.

37 The government can exercise this prerogative if initially accepted non-competitive bids are less than 25.0 percent of the total non-competitive tenders.
38 16 May, 13 June, and 27 June auctions.
39 16 and 30 May auctions.
40 Fitch Ratings is a global rating agency committed to providing the world’s credit markets with independent and prospective credit opinions, research, and data.
Market perception on the possibility of another contagion arising from recent external developments contributed largely to the widening trend of the country’s debt spreads. Beginning in mid-April, spreads started to increase as investors turned risk-averse due to renewed sovereign debt concerns in the euro area, particularly over a possible debt default by Greece. The greater-than-anticipated weakness in US economic activity also dampened investor risk appetite.41

The persistently low interest environment in most advanced economies prompted investors to move capital into higher-yielding emerging market (EM) assets, including that of ROPs. Investors’ search for high yield tempered spreads from widening during the review period as increased demand for EM bonds pushed yields lower, tightening the spread over US Treasuries. In the domestic front, the upgrades in the country’s credit ratings by Moody’s and Fitch kept spreads stable. By end-June, the country’s CDS remained broadly steady at 139 bps, even lower than similarly-rated Indonesia (142 bps).

Banking System

Key performance indicators show sustained stability in the banking system.

The Philippine banking system remained stable during the quarter as banks continued to adhere to banking rules and regulations set by the BSP. Lending, deposits, and profitability sustained their healthy growth. Credit quality in the system also continued to improve, with banks posting lower non-performing loans (NPL) and higher loan-loss provisioning ratios. The system’s capital adequacy ratio of over 15 percent likewise 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-April 2011 amounted to ₱3.7 trillion, 8.5 percent higher than the year-ago level of ₱3.4 trillion.

41 The downgrade by S&P in US credit outlook from “stable” to “negative” in April. A negative outlook means there is a one-third chance of a downgrade in the next two years. The market was also pessimistic about the possibility of S&P cutting US’ AAA credit rating unless the government reduces its burgeoning budget deficit in the near term. The possible contagion effect from this development likewise contributed to the widening of debt spreads.
continued growth in deposits reflected sustained depositor confidence in the banking system. Savings deposits registered a 10.8 percent growth and continued to account for nearly half of the funding base. Demand deposits expanded by 12.9 percent y-o-y while time deposits posted a moderate growth of 1.3 percent.

Institutional Developments

The total resources of the banking system rose by 8.4 percent to P7.0 trillion as of end-April 2011. 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) accounted for the bulk almost 90 percent of the total resources of the banking system.

The number of banking institutions (head offices) fell further to 746 as of end-March 2011 from the quarter- and year-ago levels of 758 and 779, 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 635 rural banks (RBs). Meanwhile, the operating network (including branches) of the banking system increased to 8,870 in Q1 2011 from 8,869 in Q4 2010 and 8,663 during the same period last year, due mainly to the increase in the branches/agencies of commercial and rural banks.

The banking system’s asset quality further improved as the NPL ratio declined to 3.7 percent as of end-April 2011 from 4.0 percent registered a year ago. Banks’ continued adoption of prudent lending standards helped minimize the incidence of problem loans. The low NPL ratio was maintained as the 10.0 percent expansion in the industry’s total loan portfolio (TLP) outpaced the 1.0 percent growth in NPLs. TLP expanded to P3.3 trillion at end-April 2011 from P3.0 trillion during the same period last year, while the NPL level grew to P121.6 billion during the period from the previous year’s level of P120.5 billion.

Meanwhile, the NPL ratio of U/KBs dropped further to 2.9 percent as of end-April 2011 from the 3.3 percent posted in the same period in 2010, but was broadly unchanged relative to the ratio posted in end-December 2010.
The Philippine banking system’s NPL ratio of 3.7 percent was higher compared to the NPL of neighboring countries, like Indonesia’s 2.8 percent, Malaysia’s 2.1 percent and Korea’s 2.3 percent, but lower than Thailand’s 3.9 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.

The loan exposure of banks remained adequately covered as the banking system’s NPL coverage ratio improved to 98.9 percent as of end-April 2011 from 92.1 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, respectively, 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 remained slightly higher than those of Malaysia (14.5 percent), Korea (14.6 percent) and Thailand (16.4 percent). Indonesia posted the highest CAR in the region at 17.6 percent.

Meanwhile, placements in the special deposit account (SDA) facility of the BSP increased by about 66.4 percent y-o-y to reach ₱1,388.0 billion as of end-June 2011 from the ₱834.4 billion posted during the same period a year ago. Meanwhile, bank placements under the BSP RRP window reached ₱295.2 billion, an increase of ₱88.4 billion or 42.7 percent compared to a year earlier.

Sources: Various central bank websites and financial stability reports, Indonesia (commercial banks, March 2011); Malaysia (banking system, April 2011); Thailand (commercial banks, May 2011); and Korea (banking system, September 2010).

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.
Exchange Rate

Peso appreciates on sustained forex inflows.

Quarterly Peso-Dollar Rate
Q1 2007 - Q2 2011

Changes in Selected Dollar Rates

<table>
<thead>
<tr>
<th>Year-to-date</th>
<th>Appr./(Depr.), in percent</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>31 Mar*</td>
</tr>
<tr>
<td>Philippine peso</td>
<td>1.0</td>
</tr>
<tr>
<td>Thai baht (onshore)</td>
<td>-0.7</td>
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<tr>
<td>Chinese yuan</td>
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<td>South Korean won</td>
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<tr>
<td>Japanese yen</td>
<td>-2.1</td>
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<tr>
<td>Indian Rupee</td>
<td>0.2</td>
</tr>
</tbody>
</table>

Source: Bloomberg, Reuters and PDEX

* As of 4:00 p.m., 31 March 2010
** As of 4:00 p.m., 30 June 2011

The peso averaged 43.24/US$1 in the second quarter of 2011, appreciating by 1.3 percent from the 43.79/US$1 average in the previous quarter. On a y-o-y basis, the peso appreciated by 5.3 percent from the 45.53/US$1 average in the same quarter a year ago. Sustained inflows of OF remittances, exports revenues, and foreign portfolio and direct investments (FDI) remained fundamental drivers of the peso’s strength.

The peso appreciated in the first two months of the review quarter as the sustained bullish outlook for emerging Asian economies supported the continued inflow of foreign exchange into the country. Likewise, the country’s strong external payments position provided support to the peso. However, the peso weakened slightly in June due to heightened risk aversion arising from concerns over a possible global economic slowdown and the debt crisis in Greece. However, the upgrade by Moody’s Investors Service on the Philippine’s sovereign credit ratings in June 2011 moderated the peso’s depreciation.

On a year-to-date basis, the peso appreciated against the US dollar by 1.2 percent on 30 June 2011 as it closed at 43.33/US$1, moving in tandem with other Asian currencies except for the Thai baht and Indian rupee, which depreciated vis-à-vis the US dollar by 2.1 percent and 0.01 percent, respectively.

Meanwhile, volatility, as measured by the coefficient of variation of the daily average exchange rates declined to 0.46 percent in the second quarter of 2011 compared with 0.85 percent in the first quarter.

On a real, q-o-q trade-weighted basis, the peso slightly improved its external price competitiveness against the baskets of currencies of major trading partners (MTPs) in the second quarter of 2011. This mainly reflects the nominal depreciation of the peso relative to those of major countries, which led to a decrease in the real average effective exchange rate (REER) for the quarter.

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.

For the first four months of 2011, OF remittances summed up to US$6.2 billion, higher by 6.0 percent compared to the US$5.9 billion level recorded in the same period last year. Meanwhile, transactions in foreign portfolio investments for first five months of 2011 netted US$2.0 billion in inflows, 160.3 percent higher than the US$772 million recorded for the comparable period in 2010. Likewise, FDI registered net inflows of US$471 million for the first quarter of 2011.

In April 2011, the country’s balance of payments yielded a surplus of US$1.08 billion.

Based on the last transaction for the day.

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...
Meanwhile, the peso lost external price competitiveness against competitor countries in the broad and narrow series due to the widening inflation differential relative to those of narrow competitor countries which more than offset the nominal depreciation of the peso against these currency baskets. This resulted to a real appreciation of the peso by 0.04 percent and 0.20 percent, respectively. 49

On a year-on-year basis, the peso lost external price competitiveness against the basket of currencies of MTPs and competitor countries in the narrow series as the peso appreciated in real terms by 0.2 percent and 2.3 percent, respectively. This developed as the widening inflation differential more than offset the nominal depreciation of the peso against these baskets of currencies. Meanwhile, the peso gained external price competitiveness against the basket of competitor currencies in the broad series during the same period as the significant nominal depreciation of the peso against this basket of currencies more than offset the widening inflation differential and led to a decrease in the REER index of the peso by 3.6 percent.

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49 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

Fiscal balance continues to improve.

National Government Fiscal Performance

<table>
<thead>
<tr>
<th></th>
<th>January-May 2010</th>
<th>January-May 2011</th>
<th>Growth (%)</th>
<th>% to 1H 2011 Program</th>
</tr>
</thead>
<tbody>
<tr>
<td>Surplus/(Deficit)</td>
<td>-162.1</td>
<td>-9.5</td>
<td>94.1</td>
<td>6.3</td>
</tr>
<tr>
<td>Revenues</td>
<td>500.0</td>
<td>581.5</td>
<td>16.3</td>
<td>84.7</td>
</tr>
<tr>
<td>Expenditures</td>
<td>662.1</td>
<td>591.0</td>
<td>-10.7</td>
<td>70.5</td>
</tr>
</tbody>
</table>

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

The fiscal deficit in January to May 2011 reached ₱9.5 billion, 94.1 percent lower than the ₱162.1 billion deficit incurred during the same period last year. This represents 6.3 percent of the ₱152.1 billion programmed deficit for the first half of 2011.

Revenue collections increased by 16.3 percent to ₱581.5 billion in January-May 2011 period compared to ₱500.0 billion in the same period last year, accounting for 84.7 percent of the ₱686.4 billion program for Q1-Q2 2011. The Bureau of Internal Revenues (BIR) and the Bureau of Customs (BOC) contributed ₱391.1 billion and ₱106.9 billion, respectively, to total revenues. The BIR collections went up by 13.7 percent while the BOC collections declined by 0.5 percent, compared to their respective levels in same period last year. The collections by the Bureau of the Treasury (BTr) likewise increased by 124.3 percent to ₱48.5 billion from 21.6.0 billion in the same period in 2010. Revenues from other offices also increased by 30.6 percent to ₱35.0 billion.

Expenditures in January-May 2011 amounted to ₱591.0 billion, 10.7 percent lower than the disbursements in the same period in 2010, representing 70.5 percent of the Q1-Q2 2011 program of ₱838.5 billion. Excluding interest payments, total disbursements declined by 10.0 percent to ₱473.2 billion. Interest payments also went down by 13.6 percent to reach ₱117.8 billion.
IV. EXTERNAL DEVELOPMENTS

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

Global economic activity has continued to expand at a steady pace composite amid improving global financial conditions. The JP Morgan global composite index slowed in June at 52.2 from 52.7 in May, the second-lowest reading from a 21-month low of 51.8 in April. June PMI data pointed to market decelerations in output growth in both the manufacturing and service sectors. Signal indicators show some loss of momentum in global trade, as the June index for global new export orders stood at 52.0 compared to the previous month’s 53.0.50

Meanwhile, global headline inflation continued to increase, due mainly to higher commodity prices. In advanced economies (AE), inflation rates rose steadily on account of elevated oil and non-oil commodity prices. Meanwhile, in EM economies, inflationary pressures have become more pronounced amid increasing capacity constraints and the higher weight of food commodities in the consumption basket, as well as faster liquidity growth and asset price increases particularly in China.

The second estimate by the Bureau of Economic Analysis showed that US real GDP grew at an annual rate of 1.8 percent q-o-q in Q1 2011 from 3.1 percent in the previous quarter. The slowdown reflected a softer growth in personal consumption. Meanwhile, federal government spending and net exports contributed negatively to output growth.

Latest available information on consumer sentiment and demand indicates that confidence among American consumers dropped more than forecasted in May as households contended with higher prices that are eating into incomes amid slowing job growth. The Conference Board Consumer Confidence Index, which had improved in April, decreased anew in May. The Index now stands at 60.8, from an index of 66.0 in April. Similarly, the Thomson Reuters/University of Michigan preliminary index of consumer sentiment decreased to an average of 72.0 in the second quarter from 73.0 in the first quarter of 2011. A more pessimistic outlook is the primary reason for the decline in consumer confidence, as consumers were considerably more apprehensive about future business and labor market conditions as well as their income prospects.

As regards price developments, y-o-y headline inflation accelerated for the sixth consecutive month to 3.6 percent in May from 3.2 percent in the previous month, reflecting a further acceleration in the energy index and, to a lesser extent, in the food index as well. On a quarterly basis, second quarter inflation (April-May) rose to 3.4 percent from 1.9 percent average for January-February in the first quarter.

According to Eurostat’s second estimate, euro area real GDP grew by 0.8 percent on a quarterly basis in Q1 2011, which compares with the 0.3 percent expansion in the previous quarter.

Available indicators point towards some weakening in economic activity in the euro area in the coming quarter. The Purchasing Managers’ Index (PMI) for retail sales was above 50 on average in April 2011, but fell to 48.8 in May. According to European Commission surveys, retail confidence in May also declined by 0.6 points from the previous month to 105.5, resulting from weakening confidence in all business sectors. Both indicators point to slower growth in retail sales in the second quarter of 2011.

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.  

Japanese real output shrank anew by 0.9 percent q-o-q in Q1 from a decline 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 environment-friendly goods. Meanwhile, exports of goods and services suffered due to the appreciation of the yen.

The Japanese PMI increased to a seasonally adjusted index of 50.7 in June from 51.3 in May and 45.7 in April, remaining above the threshold that separates expansion from contraction. The PMI survey data pointed to a welcome rebound in Japanese manufacturing activity in June, as a sharp easing in supply chain pressures enabled firms to restart production lines following the disruption caused by March’s disasters.

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Japanese economic activity in the second quarter of 2011 is still expected to be negatively affected by the recent earthquake and tsunami. Nonetheless, the experience of past natural disasters suggests that reconstruction demand, together with a gradual normalization of supply conditions, are likely to provide support to economic activity in the second half of the year.

Headline inflation remained flat at 0.3 percent in the first two months of the second quarter, reflecting mainly the end of the negative base effect due to the elimination of high-school tuition fees in April 2010 and recent energy price developments.

Hongkong and Shanghai Banking Corporation’s (HSBC) preliminary manufacturing index, the China manufacturing PMI, the earliest available indicator of China’s industrial activity, eased to a seasonally-adjusted index of 50.1 in June from 51.6 in May, amid falling new export orders and employment. This was the lowest recorded index since July 2010 and was near the threshold indicating neither an expansion nor a contraction.

Headline inflation in China increased to its fastest rate in nearly three years at 6.4 percent in June, from 5.5 percent in the previous month and 2.9 percent in the same period a year ago. This is the biggest increase in 35 months, driven by persistent food price increases.

Meanwhile, domestic liquidity expansion has started to slow down at 15.9 percent as of end-June compared to the 16.6 percent and 18.5 percent growth registered as of end-March 2011 and end-June 2010, respectively. This development was in response to the tightening of monetary policy. The People’s Bank of China raised the reserve requirement ratio for the fifth time this year by 50 basis points last May 2011 to 21 percent for large banks and 19 percent for medium and small financial institutions.
V. MONETARY POLICY DEVELOPMENTS

The Monetary Board decides to raise policy rates further.

Commodity price increases shift the balance of risks further upward.

Moderating but still elevated inflation expectations remain a major policy consideration.

The Monetary Board raises reserve requirements.

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

In deciding to increase policy rates for the second time, the Monetary Board noted that the BSP’s baseline inflation forecasts continued to suggest that the 3-5 percent inflation target for 2011 remained at risk, mainly as a result of expected pressures from oil prices. International oil prices have remained elevated due to strong global demand as well as concerns about supply gaps. Global non-oil markets also continued to tighten.

Surveys data for the review period, including the Asia Pacific Consensus Forecasts, the Consumer Expectations Survey, and the BSP’s survey of private sector economists, showed elevated inflation forecasts for 2011 and higher expected inflation for 2012. Sustained price pressures and higher inflationary expectations could influence future wage and price outcomes. With these considerations, the Board deemed it prudent to rein in inflation expectations further and contain second-round effects with a follow-through policy action.

Capacity utilization of the manufacturing sector has remained consistently above 80 percent while lending for production activities continued to expand, indicating the sustained pick-up in private investment. Consumer lending remained robust while vehicle sales were sustained despite rising fuel costs. The Monetary Board also noted that, while domestic liquidity and credit grew at a reasonable pace, sustained strong foreign capital inflows warrant careful attention to ensure that they do not exacerbate domestic liquidity levels and fan inflationary pressures in the future.

At its 16 June 2011 meeting, the Monetary Board decided to keep policy rates steady. At the same time, the Board decided to raise the reserve
Increasing reserve requirements is a preemptive move to counter potential inflationary pressures from excess liquidity.

In deciding to maintain policy rates, the Monetary Board noted that the baseline forecasts show a lower path and that inflation expectations have shown some signs of leveling off. These developments suggest that the two previous policy rate adjustments are starting to work their way through the system. Meanwhile, the Monetary Board’s decision to raise the reserve requirement is a preemptive move to counter any additional inflationary pressures from excess liquidity. The Monetary Board believed that expectations of continued strong capital inflows, driven by positive market sentiment over the favorable prospects for the Philippine economy, could fuel domestic liquidity growth and add to inflation risks. The move to raise the reserve requirements—which will apply to regular reserves—was also part of the normalization of the liquidity-enhancing measures adopted during the global financial crisis.
The Increase in the BSP’s Reserve Requirements

Reserve requirements (RRs) refer to the proportion of banks’ deposits and deposit substitute liabilities that banks are required to hold as reserves. As a liquidity tool, RRs are generally considered to be a powerful but blunt instrument since even small changes in the RR ratio can significantly impact the level of liquidity in the financial system. RRs are also imposed to ensure that banks hold a certain proportion of high quality, liquid assets to provide some protection against both liquidity and solvency risks. RRs in the Philippines are categorized as either regular (statutory) or liquidity reserves. Regular reserves pertain to the proportion of deposits and deposit substitute liabilities which must be held either as deposits with the BSP through the banks’ Demand Deposit Account (DDA) or as cash kept in banks’ vaults. Liquidity reserves refer to the proportion of deposits and deposit substitute liabilities that banks place as deposits in the Reserve Deposit Account (RDA) with the BSP.

The increase in the regular RR ratio effective 24 June 2011 was the first since it was reduced by two ppts during the height of the global financial crisis in 2008. The regular reserve and liquidity reserve ratios for savings, demand and time deposits as well as deposit substitutes for universal/commercial banks currently stand at 9 percent and 11 percent, respectively.

RRs as a Monetary Policy Instrument

A number of EM central banks have used RRs in recent months to manage the build-up of liquidity or tighten their monetary policy settings. Asian central banks which have recently adjusted their RRs include the People’s Bank of China (PBoC), Bank Negara Malaysia (BNM) and Bank Indonesia (BI). As of June 2011, the PBoC has increased its RR ratio by a total of six ppts since January 2010. Meanwhile, the BNM raised its statutory reserve ratio by one ppt to 3 percent effective 16 May 2011 as a preemptive measure to manage the significant build-up of liquidity, which could result in financial imbalances and create risks to financial stability. The BNM emphasized, however, that the increase in the statutory reserve ratio is meant to be a liquidity management measure and not a signal of the BNM’s stance of monetary policy. On 3 September 2010, the BI increased the primary RR ratio for ruhipah funds to 8 percent to curb mounting inflationary pressure through management of excess banking liquidity. Recent adjustments in the RR ratios of these three central banks were carried out alongside their policy rate adjustments. Other EM central banks which also recently raised their RRs include the Central Reserve Bank of Peru, the Central Bank of the Republic of Turkey (CBRT) and the Central Bank of Uruguay. However, the current RR ratios of these central banks have yet to reach their pre-2008 crisis levels except in the case of the PBoC and the CBRT (Figure 1).

Figure 1. Reserve Requirement Ratios*

<table>
<thead>
<tr>
<th></th>
<th>Pre-Crisis</th>
<th>Crisis Period (Lowest)</th>
<th>Post-Crisis (Latest)**</th>
</tr>
</thead>
<tbody>
<tr>
<td>China</td>
<td>15</td>
<td>10</td>
<td>5</td>
</tr>
<tr>
<td>Indonesia</td>
<td>10</td>
<td>5</td>
<td>3</td>
</tr>
<tr>
<td>Malaysia</td>
<td>15</td>
<td>10</td>
<td>5</td>
</tr>
<tr>
<td>Peru</td>
<td>10</td>
<td>7</td>
<td>5</td>
</tr>
<tr>
<td>Turkey</td>
<td>15</td>
<td>10</td>
<td>5</td>
</tr>
<tr>
<td>Uruguay</td>
<td>15</td>
<td>10</td>
<td>5</td>
</tr>
<tr>
<td>Philippines</td>
<td>10</td>
<td>7</td>
<td>5</td>
</tr>
</tbody>
</table>

*Pre and Crisis Period refer to required deposits and deposit substitutes
**Post-Crisis refer to RDA

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52 Deposit substitutes evidenced by repo agreements covering government securities up to the amount equivalent to the adjusted Tier 1 capital of the bank/quasi-bank and which comply with the conditions provided under Subsection X253.1/4253Q of the Manual of Regulations for Banks/Manual of Regulations for Non-Bank Financial Institutions are imposed lower RR.

53 BNM’s press release on the increase in the statutory reserve requirement ratio dated 5 May 2011 at www.bnm.gov.my

54 BNM added that the overnight policy rate remained the key instrument for signaling the monetary policy stance.

55 Key explanations on the rupiah statutory reserve requirement report at www.bi.go.id.
BSP’s Policy Considerations

The increase in the RR ratio was a preemptive move to counter any additional inflationary pressures from excess liquidity. The strong inflow of foreign exchange was expected to be sustained by favorable prospects for the Philippine economy underpinned by sound macroeconomic fundamentals, a stable banking sector, and improved fiscal position. At the same time, the global movement of capital is currently driven by a return in investor risk appetite particularly toward EM economies, which is anticipated to remain strong, compared to the slow recovery in advanced countries. The continued accommodative policies in advanced economies combined with the gradual tightening in many EMEs, in response to peaking inflation rates, will also keep interest rate differentials wide and encourage further capital inflows to EMs. In the Philippines, transactions in BSP-registered foreign portfolio investments yielded a year-to-date net inflow of US$2,151.6 million as of 10 June 2011, about 3.1 times the level recorded in the same period last year. Foreign direct investments (FDI) also continued to post a net inflow in March 2011 amounting to US$167 million, more than twice the level recorded in the same month a year ago. Other foreign exchange receipts such as overseas Filipino (OF) remittances also continued to grow in the first semester of 2011. Additional monetary measures were, therefore, deemed necessary to address any resulting excess liquidity and control inflation.

The BSP considers the RR as a powerful instrument in managing liquidity due to its mandatory nature. Additionally, it could help strengthen the transmission of monetary policy changes to the real economy by helping contain excessive liquidity which could dampen the impact of policy rate adjustments to market interest rates. An increase in the RR ratio would also allow monetary tightening without encouraging short-term capital inflows, which tend to complicate the conduct of monetary policy.

However, the BSP remains committed to reduce the RR ratio over the medium term. In February 2005, the Board decided to rationalize the system of RRs to help reduce banks’ intermediation costs. The rationalization envisioned a measured reduction in the RR ratio spread over the medium term, consistent with the government’s inflation target and output growth assumptions. The BSP recognizes that at present, it imposes one of the highest RR ratios compared to select Asian countries and some advanced and emerging economies (Figure 2). In a survey of 15 countries, the Philippines ranked second to China in terms of the level of RR ratios on domestic currency-denominated deposits and deposit substitutes. The Philippines was followed by Turkey, Taiwan, Indonesia, and the US.

![Figure 2. Cross-country Comparison of RR ratios](image)

56 This is based on reports of custodian banks. Registration of inward foreign investments with the BSP is voluntary. It entitles the investor or his representative to buy foreign exchange from authorized agent banks or their subsidiary/affiliate foreign exchange corporations for repatriation of capital and remittance of related earnings.
VI. INFLATION OUTLOOK

Private Sector Economists’ Inflation Forecasts

Mean inflation forecasts in the BSP survey of private economists edge lower and remain within the target range.

![BSP Survey of Private Economists/Analysts Mean Inflation Forecasts in percent](image)

### Private Sector Forecasts for Inflation, June 2011

<table>
<thead>
<tr>
<th>Item</th>
<th>2011</th>
<th>2012</th>
<th>2013</th>
</tr>
</thead>
<tbody>
<tr>
<td>1) Asia ING</td>
<td>Q1</td>
<td>5.00</td>
<td>5.10</td>
</tr>
<tr>
<td>2) Banco de Oro</td>
<td>Q1</td>
<td>4.50</td>
<td>4.50</td>
</tr>
<tr>
<td>3) Bank of America Merrill Lynch</td>
<td>Q1</td>
<td>5.10</td>
<td>5.70</td>
</tr>
<tr>
<td>4) Bank of Oslo (Matsa branch)</td>
<td>Q1</td>
<td>4.75</td>
<td>5.10</td>
</tr>
<tr>
<td>5) Bank of Commerce</td>
<td>Q1</td>
<td>4.10</td>
<td>3.60</td>
</tr>
<tr>
<td>6) Deutsche Bank</td>
<td>Q1</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>7) ForecastBank</td>
<td>Q1</td>
<td>4.50</td>
<td>3.80</td>
</tr>
<tr>
<td>8) Goldman Sachs</td>
<td>Q1</td>
<td>5.80</td>
<td>4.80</td>
</tr>
<tr>
<td>9) HSBC</td>
<td>Q1</td>
<td>5.10</td>
<td>5.70</td>
</tr>
<tr>
<td>10) Metrobank</td>
<td>Q1</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>11) MB</td>
<td>Q1</td>
<td>5.10</td>
<td>4.40</td>
</tr>
<tr>
<td>12) Phil. Equity Partners</td>
<td>Q1</td>
<td>5.10</td>
<td>5.70</td>
</tr>
<tr>
<td>13) RCBC</td>
<td>Q1</td>
<td>4.8±0.9</td>
<td>4.7±1.3</td>
</tr>
<tr>
<td>14) UBS</td>
<td>Q1</td>
<td>5.00</td>
<td>5.10</td>
</tr>
</tbody>
</table>

**Median Forecast**: 5.0, 5.1, 4.8, 4.2, 4.5

**Mean Forecast**: 4.9, 4.9, 4.7, 4.3, 4.4

**High**: 5.8, 5.7, 5.5, 5.3, 5.5

**Low**: 4.1, 3.6, 4.0, 3.3, 3.5

**Number of observations**: 12, 12, 14, 13, 10

Based on the results of the BSP’s survey of private economists for June 2011, inflation is expected to be within the target range for both 2011 and 2012. In particular, the mean inflation forecasts for 2011 and 2012 edged lower to 4.7 percent and 4.3 percent compared to 4.9 percent and 4.8 percent in the previous quarter.67

Analysts were of the view that, Europe’s financial woes as well as the IEA’s recent release of strategic oil reserves to prevent high oil prices from undermining the fragile global economic recovery, would dampen inflation pressures. However, higher prices of commodities are expected to put pressure on inflation.

Based on the probability distribution on the forecasts provided by 10 out of 14 respondents, there is a 71.5 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.

Meanwhile, the Asia Pacific consensus forecasts (for the period April-June 2011) for Philippine inflation were broadly steady and still within the announced target range for 2011.

![Probability Distribution For Analysts’ Inflation Forecasts* 2011-2013](image)

*Probability distribution were averages of those provided by 10 respondents.

67 For Q3 2011 and Q4 2011, inflation is both estimated to be at 4.9 percent.
Results of the BES for Q2 2011 show a higher number of respondents anticipating inflation to increase in Q2-Q3 of 2011.

Likewise, results of the CES for Q2 2011 show that consumers expect a higher inflation 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 21.3 percent to 38.7 percent) as well as in the next quarter (from 23.5 percent to 34.8 percent) increased significantly. Rising costs of oil and other commodities in the global market amid continuing geopolitical tensions in the MENA region were cited by respondents as the main factors behind their expectation of higher inflation.

Consumers also projected inflation 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 prices of basic commodities. Over the next 12 months, respondents anticipate inflation to rise to 10.4 percent from 9.8 percent in the previous survey round. Respondents expect most items included in the survey to have higher inflation, with the following items registering the most significant increases: house rent (from 6.9 percent to 8.2 percent); medical care (from 11.6 percent to 12.8 percent); personal care (from 11.1 percent to 12.3 percent); fuel (from 9.9 percent to 10.9 percent); and water (from 7.7 percent to 8.7 percent).
BSP Inflation Forecasts

Emerging baseline forecasts show that inflation could settle within inflation target ranges for 2011 and 2012.

The emerging baseline forecasts point to average inflation settling at the higher end of the 4.0 percent ± 1.0 percentage point target range in 2011. Thereafter, inflation is expected to ease and remain within the same target range in 2012.

In response to rising inflationary pressures, the BSP has begun tightening its policy stance in March 2011. The Monetary Board has since then raised its key policy rates by a total of 50 bps and the reserve requirement by 1 ppt. These helped temper the impact of the risks to inflation by anchoring inflation expectations and thereby reducing the likelihood of second-round effects. In part, these tightening measures alongside softening commodity prices in recent months contributed to the lower projected inflation path relative to the first quarter.

Despite the lower 2011 inflation forecast profile generated during the quarter, the balance of risks to the inflation outlook remains tilted to the upside. Commodity prices have moderated but will continue to pose a risk to the inflation outlook given structurally strong demand from emerging economies and global supply constraints. Additional petitions for adjustments in electricity rates, and still elevated (though moderating) inflation sentiments could also lead to higher inflation.

Meanwhile, downside risks to inflation could come from slower global economic recovery and a sustained strengthening of the peso-dollar exchange rate.

Demand Conditions

The domestic economy continued its steady expansion during the period in review. However, economic activity appears likely to proceed at a slower pace in the second half of the year. Although capacity utilization remained above 80 percent, there are already some signs of a slowdown in manufacturing activity based on MISSI, with VOPI growth slowing down for the fifth consecutive month in April. Risks seen to affect the country’s economic performance on the second half of the year are the possible weakening of the global inventory cycle, output effects of the Japan disasters, and higher oil prices.
Meanwhile, business and consumer confidence remained stable as indicated by the BSP-conducted surveys on business and consumer expectations. Business respondents’ replies continued to be favorable but declined slightly in Q2 2011 due mainly to increasing commodity prices and adverse external developments. On the other hand, household respondents remained positive based on the Q2 2011 survey but are more optimistic on the year ahead. According to them, their brighter year-ahead outlook was boosted by expectations of stable prices, better employment opportunities, and increased salaries.

**Supply Conditions**

The agriculture sector continued to grow for the second consecutive quarter, registering a 4.2 percent growth in Q1 2011, which reverses the 1.8 percent contraction recorded in the same quarter last year.

In the international market, the Food and Agriculture Organization (FAO) noted that global cereal production could recover during the year but may not be enough to rebuild stocks. The FAO estimates world cereal production to grow by 3.5 percent in 2011 to 2,314.9 million tonnes with expected increases in the harvests of wheat, coarse grains and rice. This represents a rebound from the 1.0 percent contraction in global cereal harvests a year ago. Meanwhile, global cereal utilization could rise by 1.4 percent in 2011 to reach 2,311.3 million tonnes. Given these prospects for global cereal supply and demand, the FAO believes that international cereal prices could remain high this year as supply is just sufficient to meet demand.\(^5\)

Meanwhile, oil prices have stabilized in May and June. Looking ahead, the EIA still expects oil markets to tighten for the rest of the year until 2012, given projected world oil demand growth and slowing growth in production from countries that are not members of the Organization of the Petroleum Exporting Countries (OPEC).\(^5\)

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

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Positive output gap estimate widens.

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).

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 5.8 percent in Q1 2011, up from 5 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.

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 4.5 percent from June 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 4.2 percent for 2012;
(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 presents a downward shift in the 2011 inflation path.

Inflation pressures have moderated of late but risks to inflation remain tilted to the upside.

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 a downward shift in 2011 inflation compared to that of the previous quarter. The lower 2011 inflation path generated during the quarter incorporates the impact of the lower-than-projected inflation outturns for April and May 2011. Meanwhile, the 2012 inflation path is slightly higher than the previous quarter’s projections. This is due largely to higher oil price assumptions. While oil prices have moderated off late, the assumptions used in the current quarter are still higher relative to the previous quarter. The higher path for 2012 also reflects the base effect from a lower inflation path for 2011.

The current fan chart suggests that inflation would rise until the fourth quarter of 2011 and then stabilize into 2012. The emerging baseline forecasts show within target inflation for both 2011 and 2012 with the 2011 inflation settling at the upper-end of the target range.

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 remains tilted to the upside. This is depicted by the latest fan chart by the wider bands above the central projection than those below it. The upside risks to future inflation include: elevated commodity prices on account of structurally strong demand from emerging economies against limited global reserves; additional petitions for adjustments in electricity prices; and still elevated inflation expectations.

- Both oil and food commodity prices have stabilized of late. This reflects easing geopolitical tensions in the Middle East for oil products and expectations of improving crop harvests for food commodities. Nonetheless, considerable uncertainty continues to weigh on the outlook for commodity prices. Strong demand for emerging
economies against a backdrop of modest increases in non-OPEC production and a resurgence in geopolitical risks imply that a large decline in oil prices is unlikely. Meanwhile, current crop forecasts indicate that production may just be sufficient to meet demand. This implies no significant additions to global inventories rendering food prices susceptible to shocks.

- Moreover, petitions for power rate adjustments to recover stranded contract cost and debts as well as those to recover actual and incremental fuel, independent power producers (IPPs), and foreign exchange rate fluctuation costs represent additional risks to future inflation as these are not yet included in the baseline forecasts.

- Inflation expectations have remained broadly in line with the government’s inflation target but remain high as a result of the impact of past commodity price shocks on consumer and producer sentiments. A disanchoring of inflation expectations from the target could lead to second round effects on inflation and thus, constitute a risk to the inflation outlook.

Meanwhile, there are also downside risks to the inflation outlook. A slower growth in the global economy due to the financial stress in euro area and overheating pressures in emerging economies could result to slower inflation as the cyclical component of global price trends are tied to the pace of global economic activity. Finally, a sustained appreciation of the peso could help reduce the cost of imported goods and services.
The fan chart shows the probability of various outcomes for inflation over the forecast horizon. The darkest band depicts the central projection, which corresponds to the BSP’s baseline inflation forecast. It covers 25 percent of the probability distribution. Each successive pair of bands is drawn to cover a further 25 percent of probability, until 75 percent of the probability distribution is covered. The bands widen (i.e., “fan out”) as the time frame is extended, indicating increasing uncertainty about outcomes. The bands shown in broken lines represent the inflation profile as of Q1 2011.

The shaded area, which measures the range of uncertainty, is based on the forecast errors from the past years. In greater detail, it can be enhanced by adjusting the level of skewness of the downside and upside shocks that could affect the inflationary process over the next two years in order to change the balance of the probability area lying above or below the central projection.
VII. IMPLICATIONS FOR THE MONETARY POLICY STANCE

The latest outlook for inflation shows a target consistent inflation path.

The latest baseline inflation projections are on a lower path than that of the previous Inflation Report, with average headline inflation rates for 2011-2012 projected to settle within the 3-5 percent inflation target range. The policy tightening measures alongside softening commodity prices in recent months contributed to the downward adjustment in the forecast path.

Supporting the latest forecasts, inflation expectations also appear to be well contained and within the target band for 2011 and 2012. The manageable inflation outturns along with the cumulative policy actions of the BSP have provided a stabilizing influence on inflation expectations as indicated in the generally lower inflation forecasts by private sector analysts.

However, risks around the inflation projection remain skewed to the upside, implying that monetary policy should continue to maintain a cautious stance.

Protracted geopolitical instability in the MENA region is likely to continue to push up the oil price fear premium. In addition, global commodity prices continue to pose a risk to the inflation outlook given structurally strong demand from emerging economies and low global reserves. Upside risks to the domestic inflation outlook also include petitions for adjustments in electricity rates and still elevated inflation expectations.

Nevertheless, given the within-target inflation outlook, the BSP has room to allow previous policy actions to exert their full impact on the economy. The recent policy measures have begun working their way through the traditional channels of monetary policy. Lending rates are increasing while liquidity growth has remained manageable.

The softening of the global growth momentum should dampen inflationary pressures.

Risks to global output conditions through the second half of the year are leaning towards a slower pace of world economic activity. In its June 2011 World Economic Outlook (WEO) Update, the IMF is of the view that downside risks to growth have intensified. These risks include the possibility of spillovers from financial volatility emanating from fiscal issues in the euro area periphery, a slowdown in the US economy, and overheating pressures in many emerging economies. At the same time, medium-term fiscal issues in the US and Japan also pose a further downside risk to global growth.60

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60 IMF, World Economic Outlook Update, June 2011, available online at http://www.imf.org
Meanwhile, the risks related to sustained foreign exchange inflows continue to require close monitoring.

Amid the fragile global economic recovery, domestic macroeconomic conditions are likely to be more challenging in the second half of the year. In the past, domestic demand has proven to be fairly resilient amid global growth slowdowns. However, weaknesses in the external environment are still likely to be felt within the region as two-thirds of final demand for Asian exports comes from outside the area.61 There is a need, therefore, to keep a close watch on external demand conditions.

A continued surge in foreign exchange inflows and the resulting additional liquidity in the banking system could result in the rapid growth of monetary aggregates that could further fuel domestic credit demand and contribute to stretched valuations in the asset markets. The build-up of credit and asset market imbalances could, in turn, contribute to financial stability risks which would, among other things, weaken the transmission channels of monetary policy. Depending on the assessment of the risks of asset market imbalances, there may be scope to consider preventive measures to address potential asset price bubbles.

On a broader level, it remains important to address the macroeconomic effects of strong foreign inflows and liquidity expansion in the financial system. Macroprudential measures can address the additional challenge posed by recurrent capital inflows as these measures typically serve as the first line of defense against the build-up of financial imbalances.

61 IMF, World Economic Outlook, April 2011, available online at http://www.imf.org
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:

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