INFLATION REPORT
THIRD Quarter 2011
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 economic analysis behind the formulation 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 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 most recent, as well as a comprehensive analysis of the BSP’s view of the inflation outlook for the policy horizon.

The Monetary Board approved this Inflation Report at its meeting on 27 October 2011.
List of Acronyms, Abbreviations, and Symbols

AE  Advanced economy
AFF  Agriculture, Fishery, and Forestry
AP  Asia Pacific
AL  Auto Loans
BAS  Bureau of Agricultural Statistics
BES  Business Expectations Survey
BIR  Bureau of Internal Revenue
BIS  Bank for International Settlements
BOC  Bureau of Customs
BPO  Business Process Outsourcing
BTr  Bureau of the Treasury
CAMPI  Chamber of Automotive Manufacturers of the Philippines, Inc.
CAR  Capital Adequacy Ratio
CBD  Central Business District
CCRs  Credit Card Receivables
CES  Consumer Expectations Survey
CDS  Credit Default Swaps
CI  Confidence Index
CPI  Consumer Price Index
DBCC  Development Budget Coordination Committee
DOF  Department of Finance
EIA  Energy Information Administration
EM  Emerging Market
EMBI  JP Morgan Emerging Market Bond Index
ERC  Energy Regulatory Commission
EU  European Union
FAO  Food and Agriculture Organization
GDP  Gross Domestic Product
GNI  Gross National Income
GRAM  Generation Rate Adjustment Mechanism
ICERA  Incremental Currency Exchange Rate Adjustment
IEA  International Energy Agency
IMF  International Monetary Fund
IPP  Independent Power Producer
KBs  Commercial banks
LFS  Labor Force Survey
LPG  Liquefied Petroleum Gas
LTFRB  Land Transportation Franchising and Regulatory Board
MB  Monetary Board
MEM  BSP Multi-Equation Model
Meralco  Manila Electric Company
MISSI  Monthly Integrated Survey of Selected Industries
MTP  Major Trading Partner
NCCP  National Council for Commuters’ Protection
NDA  Net Domestic Assets
NEDA  National Economic and Development Authority
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<th>Abbreviation</th>
<th>Full Form</th>
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<tr>
<td>NEER</td>
<td>Nominal Effective Exchange Rate</td>
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<td>NFA</td>
<td>Net Foreign Assets/ National Food Authority</td>
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<td>NFIA</td>
<td>Net Factor Income from Abroad</td>
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<td>NG</td>
<td>National Government</td>
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<td>NPC</td>
<td>National Power Corporation</td>
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<td>NPI</td>
<td>Net Primary Income</td>
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<td>NPLs</td>
<td>Non-performing loans</td>
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<td>NSO</td>
<td>National Statistics Office</td>
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<td>OPEC</td>
<td>Organization of the Petroleum Exporting Countries</td>
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<td>PBR</td>
<td>Performance-Based Rate</td>
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<td>PCE</td>
<td>Personal Consumption Expenditure</td>
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<td>PMI</td>
<td>Purchasing Managers’ Index</td>
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<td>PSEi</td>
<td>Philippine Stock Exchange Composite Index</td>
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<td>PSIC</td>
<td>Philippine Standard Industrial Classification</td>
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<td>RB</td>
<td>Rural Banks</td>
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<td>REER</td>
<td>Real Effective Exchange Rate</td>
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<td>ROP</td>
<td>Republic of the Philippines</td>
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<td>RP</td>
<td>Repurchase</td>
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<td>RREL</td>
<td>Residential and Real Estate Loans</td>
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<td>RRP</td>
<td>Reverse Repurchase</td>
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<td>SEM</td>
<td>BSP Single-Equation Model</td>
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<td>SMS</td>
<td>Short Message Service</td>
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<td>SDA</td>
<td>Special Deposit Account</td>
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<td>TCS</td>
<td>Transportation, Communications, and Storage</td>
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<td>U/KBs</td>
<td>Universal/commercial banks</td>
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<td>WEO</td>
<td>World Economic Outlook</td>
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<td>WESM</td>
<td>Wholesale Electricity Spot Market</td>
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The 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 the 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). The policy target is set by the Development Budget Coordination Committee (DBCC) in consultation with the BSP. For 2011, the inflation target has been set at 4.0 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.

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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
Armando L. Suratos

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. Tuaño-Amador
Assistant Governor
Monetary Policy Sub-Sector

Ma. Ramona GDT Santiago
Assistant Governor
Treasury Department

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

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2 The Advisory Committee is supported by a Technical Secretariat composed of officers and staff from the Department of Economic Research, Center for Monetary and Financial Policy, and the Treasury Department.
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<tr>
<th>Period</th>
<th>Advisory Committee (AC) Meeting</th>
<th>Monetary Board (MB) Meeting</th>
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* Note: AC meetings will be strictly every six weeks and are unadjusted for IMF/BIS meetings and Christmas holidays.

3 MB highlights publication scheduled on 21 April 2011 (Thursday) was moved to 20 April 2011 (Wednesday). 21 April 2011 (Maundy Thursday) was a regular holiday.
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**Overview**

Headline inflation decelerates with lower food inflation. Average inflation for Q3 2011 was 4.4 percent using the 2000-based CPI series, slightly lower than the quarter-ago rate of 4.5 percent but higher than the 3.9 percent rate registered in the same quarter a year ago. This brought the year-to-date average to 4.3 percent in the first nine months of the year, which remained within the Government's inflation target range of 3-5 percent for 2011. The slowdown in headline inflation was due mainly to lower inflation outturns for food. Meanwhile, non-food inflation rose on account of higher prices for fuel, and transportation and communication services. The official NSO core inflation measure, at the same time, remained at 3.6 percent from the previous quarter’s level as the increase in non-food core inflation offset the decrease in food core inflation. However, all three alternative measures of core inflation estimated by the BSP reflected a downtrend relative to the rates registered in the previous quarter. Nonetheless, the number and weight of CPI components showing inflation rates above the 5.0 percent threshold continued to edge higher, suggesting that potential price pressures continue to be a cause for concern.

Domestic demand remains intact. While real GDP growth slowed down in Q2 2011 due to weak external demand and government underspending, household consumption continued to expand robustly on the back of sustained overseas remittance flows, generally buoyant consumer confidence, and a benign inflation outlook. The double-digit growth in private construction along with the steady build-up of inventories likewise boosted GDP growth. Other demand indicators also pointed to the underlying strength of domestic demand, supported by upbeat business and consumer sentiments, improving employment conditions, and strong credit activity. Capacity utilization and production indices reflected the continued resilience of manufacturing activity. Energy sales picked up in August to record its highest growth in 2011 so far, while vehicle sales declined at a slower pace. Business confidence for the current quarter also recovered following two consecutive rounds of decline in confidence readings. The consumer outlook likewise improved on expectations of further income gains and better job prospects in the months ahead. Going forward, however, the balance of risks to domestic output conditions leans toward a slower pace of economic activity given strong and persistent global headwinds.

Global economic activity has slowed down and become more uneven. In its September 2011 World Economic Outlook, the IMF revised downward its global growth projections for 2011-2012 and noted that the balance of risks to growth has tilted firmly to the downside. The risks relate mainly to fragile balance sheets of sovereigns and banks (particularly in the euro area), weak policy responses from advanced economies (AEs), increasing signs of overheating in emerging economies, and renewed volatilities in commodity prices. Continued weaknesses in the US economy have also weighed down on the global expansion given its central role in global trade and asset pricing. AEs will likely continue to face the difficult task of pushing growth while containing fiscal risks that, if unchecked, may spill over to global financial markets. Meanwhile, emerging and developing (ED) economies continue to support global activity, but their growth could slacken as external demand eases. Meanwhile, the likelihood of a global economic slowdown presents a downside risk to commodity prices, tempering global inflation pressures. Supply-related concerns will continue to be key risk factors to commodity price trends, but weaker global growth prospects are expected to help stabilize global commodity prices going forward.

Domestic financial markets have been affected by the volatile global environment. Conditions in global financial markets have become highly unsettled as concerns over the strength of global economic activity and continuing fragility of sovereign and bank balance sheets in AEs contributed to lower risk appetites. Market confidence has been dampened further by the seeming lack of a credible political consensus in both the US and euro area on how to address long-term fiscal concerns in these economies. In the early part of the review quarter, local stock trading benefited from positive developments in the domestic front owing to the better-than-expected fiscal performance, moderate inflation outturns, and optimism about local

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1 The analyses in this report are based on information as of 30 September 2011.
2 IMF, World Economic Outlook, September 2011
corporate earnings in the second quarter, but turned bearish in September. Both the EMBI+ Philippine spread and the Philippine CDS spread likewise widened in Q3 2011 relative to their previous quarter levels, reflecting heightened global risk aversion. Meanwhile, the peso maintained its strength on sustained foreign exchange inflows from overseas Filipino (OF) remittances, portfolio inflows, and foreign direct investments (FDI). At the same time, auctions for government securities during the quarter were generally oversubscribed while the yield curve shifted downward on the back of ample market liquidity. The growth in domestic liquidity remained strong, reflecting in part increased credit activity, which in turn, was supported by ample funds in the system and the low interest rate environment. This is in line with results of the Q3 2011 BSP Senior Bank Loan Officers’ Survey indicating an overall net increase in demand for loans from enterprises and households.

**Inflation expectations continue to be within target range.** Based on the results of the BSP’s survey of private economists,\(^4\) the mean inflation forecast for 2011 eased to 4.5 percent in Q3 2011 but remained at 4.3 percent for 2012. Analysts noted that the recent easing of global commodity prices as well as expectations of slower global economic growth could dampen inflation expectations going forward. Likewise, the Asia Pacific consensus forecasts\(^5\) for Philippine inflation were also lower and within the announced target range for 2011.

**The BSP keeps policy interest rates steady during the quarter.** During its 28 July and 8 September monetary policy meetings, the Monetary Board (MB) decided to keep policy rates steady as latest baseline projections indicated a within-target inflation outlook, supported by firmly anchored inflation expectations. The MB was of the view that the abating price pressures provide monetary authorities sufficient room to keep policy rates on hold in the face of heightened output uncertainty and financial volatility in AEs.

**Meanwhile, the reserve requirement (RR) ratio is raised.** At its 28 July 2011 policy meeting, the MB decided to increase anew the RR on deposits and deposit substitutes of all banks and non-banks with quasi-banking functions by one percentage point (ppt) effective 5 August 2011 as a preemptive move to better manage liquidity. The MB believed that sustained foreign exchange inflows, driven by upbeat market sentiment over the brighter prospects for the Philippine economy, could fuel a further acceleration of domestic liquidity growth, which could pose risks to future inflation.

**Current monetary policy settings remain appropriate.** The sum of new information points to the appropriateness of current policy settings, with the latest baseline inflation projections at a lower path than that of the previous Inflation Report. Upside risks to the inflation outlook are also expected to recede on renewed uncertainty over the strength and pace of the global economic recovery. Likewise, inflation expectations remain well-contained, supported by easing commodity prices. Thus, the MB was of the view that there is scope for the BSP to pause and assess further the outlook for inflation and growth as new information becomes available on the domestic and international fronts. Given the manageable inflation environment, the current settings of monetary policy are considered to be well placed to respond to evolving global and domestic economic conditions. Nonetheless, the MB continues to be mindful of any remaining upside risks to inflation, including potential increases in liquidity due to sustained capital inflows, which could fuel credit demand beyond the economy’s absorptive capacity and lead to a build-up of destabilizing asset price bubbles. Growth in monetary aggregates and bank lending continues to be firm, confirming the ample liquidity circulating in the financial system. Upside risks to the inflation outlook could also emanate from pending petitions for electricity rate adjustments and possible higher global rice prices. The BSP, therefore, remains watchful over evolving price and output conditions, both on the global and domestic fronts, and will ensure that monetary policy settings remain appropriate.

[On 20 October 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. Similarly, the reserve requirement ratios were kept unchanged.]

\(^4\) Based on the September 2011 survey
\(^5\) Refer to forecasts for the period July-September 2011
I. INFLATION AND REAL SECTOR DEVELOPMENTS

Prices

Inflation decelerates.

Headline inflation declines on account of lower food inflation.

Official core inflation remains steady.

The year-on-year (y-o-y) headline inflation was 4.4 percent in Q3 2011, slightly lower than the quarter-ago rate of 4.5 percent but higher than the 3.9 percent rate registered a year ago 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 lower headline inflation for Q3 2011 at 4.8 percent from 5.0 percent in Q2 2011. On a year-to-date (y-t-d) basis, the average inflation of 4.3 percent using the 2000-based basket and 4.8 percent using the 2006-based basket are both within the Government’s inflation target range of 3-5 percent for 2011.

Based on the 2000-based CPI series, the slowdown in headline inflation was due mainly to lower food inflation, particularly for miscellaneous food.

Meanwhile, core inflation, which excludes some food and energy items to measure generalized price pressures, was unchanged at 3.6 percent in Q3 2011 from the previous quarter’s level.

Headline and Core Inflation

The decline in headline inflation during the review quarter was due to lower inflation outturns for food. Food inflation, in turn, went down due to lower prices of sugar. Meanwhile, non-food inflation rose on account of increased prices of fuel, and transportation and communication services.

The official NSO core inflation measure remained steady in Q3 2011 as the decrease in food core inflation was offset by the increase in non-food core inflation. Nonetheless, the Q3 2011 core inflation was lower compared to the 4.0 percent recorded in the same quarter a year ago.

Meanwhile, all three alternative measures of core inflation estimated by the BSP reflected a downtrend in Q3 2011 relative to the rates registered in the previous quarter. The trimmed mean, weighted median and net of volatile items measures slowed down to 3.4 percent, 2.5 percent, and 4.8 percent from the previous quarter’s 3.7 percent, 2.6 percent, and 5.0 percent, respectively.
Core inflation contributed 3.1 percentage points (ppt) to headline inflation in Q3 2011, lower than the 3.3-ppt contribution in the previous quarter and the 3.4-ppt contribution in the same quarter a year ago. Meanwhile, non-core CPI items contributed 1.3 ppts to headline inflation during the period, higher than the contribution of 1.2 ppts in the previous quarter and 0.5 ppt 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 Q3 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) edged up to 35 from 29 in the previous quarter and 16 in Q3 2010. Accordingly, these items accounted for a greater proportion of the CPI basket at 19.2 percent compared to 16.7 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 28 food items with inflation rates above the threshold from 27 in the previous quarter. Meanwhile, there were 11 non-food items with inflation rates higher than the threshold in Q3 2011 compared to the previous quarter’s 9 items.

Food inflation

Food, beverage, and tobacco inflation declined to 3.8 percent during the review quarter from 4.2 percent in the previous quarter, but was higher than the 3.3 percent posted a year ago. Reflecting tight supply conditions triggered by weather disturbances, prices picked up for most food products, including fish, and fruits and vegetables. Meanwhile, lower prices of sugar due to ample domestic supply tempered the increase in food inflation.

Non-food inflation

Non-food inflation inched up to 5.0 percent in Q3 2011 from 4.9 percent a quarter ago and 4.4 percent a year ago. Higher inflation for fuel, and transportation and communication services accounted for the rise in non-food inflation during the review period. In particular, from 9.8 percent in Q2 2011, transportation and communication services inflation rose to 9.9 percent in Q3 2011, reflecting the surge in global oil prices. Fuel inflation likewise climbed to 16.7 percent from 15.3 percent due to higher prices of gas and LPG.
Energy Prices

The international price of Dubai crude oil eased by 3.3 percent quarter-on-quarter (q-o-q) in Q3 2011 on expectations of slower global economic growth due to the euro zone’s continuing debt crisis and the weak US economy.

In July, oil prices recovered on optimism that the US would be able to increase its debt ceiling and euro zone leaders would succeed in convincing investors that plans to contain the region’s debt crisis would be adequate. However, oil prices dipped in August following Standard & Poor’s (S&P’s) downgrade of the US credit rating, which fueled concerns of a further slowdown of the US economy, thereby cutting fuel demand in the world’s largest energy consumer.

Oil prices recovered slightly in September after the European Central Bank (ECB) announced that it would provide loans to banks in the euro area to help contain the region’s debt crisis. Towards the end of the month, however, oil prices dropped following the US Federal Reserve’s (US Fed) announcement to buy US$400 billion worth of long-term US government bonds to counter significant downside risks to the US economy. Oil prices also went down as the pledge of G-20 economies to help contain Europe’s debt crisis failed to ease fears of a possible global recession.

Global energy authorities have revised downward their 2011 forecasts for global oil demand as of September relative to their June projections. Revisions were triggered by the expected slowdown in industrial activity in most major economies along with lower global economic growth projections. The International Energy Agency (IEA), the Organization of the Petroleum Exporting Countries (OPEC), and the Energy Information Agency (EIA) projected global demand for 2011 to increase by 1.0 million barrels per day (mmbd) [from 1.3 mmbd], 1.1 mmbd.
Local gasoline pump prices decrease.

Domestic Retail Pump Prices (peso/liter)*
End-quarter prices

<table>
<thead>
<tr>
<th>Quarter</th>
<th>Gasoline**</th>
<th>Kerosene</th>
<th>Diesel</th>
<th>LPG</th>
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<tr>
<td>2010</td>
<td></td>
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<tr>
<td>Q1</td>
<td>44.25</td>
<td>41.37</td>
<td>33.75</td>
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<td>Q2</td>
<td>44.00</td>
<td>42.12</td>
<td>34.75</td>
<td>31.72</td>
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<tr>
<td>Q3</td>
<td>41.50</td>
<td>40.12</td>
<td>33.00</td>
<td>31.41</td>
</tr>
<tr>
<td>Q4</td>
<td>48.50</td>
<td>45.62</td>
<td>38.00</td>
<td>38.92</td>
</tr>
<tr>
<td>2011</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Q1</td>
<td>54.60</td>
<td>53.11</td>
<td>47.10</td>
<td>37.27</td>
</tr>
<tr>
<td>Q2</td>
<td>54.65</td>
<td>49.77</td>
<td>44.20</td>
<td>39.22</td>
</tr>
<tr>
<td>Q3</td>
<td>56.45</td>
<td>49.51</td>
<td>44.05</td>
<td>38.46</td>
</tr>
<tr>
<td>Q-o-Q</td>
<td>1.80</td>
<td>-0.26</td>
<td>-0.15</td>
<td>-0.76</td>
</tr>
<tr>
<td>Y-o-Y</td>
<td>14.95</td>
<td>9.39</td>
<td>11.05</td>
<td>7.05</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)

Power rates increase on higher generation costs coming from independent power producers (IPP).

Power

Retail electricity rates rose by 5.3 percent on a y-o-y basis in Q3 2011 due to increased generation costs. Higher cost of electricity purchased from IPPs accounted for the increase in generation charges.

Meanwhile, the Energy Regulatory Commission (ERC) has approved Meralco’s petition to raise distribution, metering, and supply charges in 2012 under the Performance-Based Rate (PBR) mechanism. The proposed rate adjustment was intended to allow Meralco to implement its capital expenditure program and pay for its operating and maintenance requirements. The approved increase, however, was lower than the adjustment sought by Meralco.

The ERC has also approved provisionally the NPC-Small Power Utilities Group’s (NPC-SPUG) petition to recover through the Universal Charge (UC) the shortfalls in the Missionary Electrification (ME) subsidy for calendar years 2003 to 2009. The ERC directed all distribution utilities and the National Grid Corporation of the Philippines (NGCP) to collect UC-ME charges in the amount of ₱0.0709/kwh per month starting in August 2011.

There remain potential sources of upside pressures on electricity charges stemming from pending petitions with the ERC. These include: (1) the Power...
Aggregate Demand and Supply

GDP growth decelerates due to weak external demand and government underspending.

Gross domestic product (GDP) grew at an annual rate of 3.4 percent in Q2 2011, slower than the 8.9 percent growth recorded in the same quarter in 2010 and the 4.6 percent increase in Q1 2011 based on the national accounts data using constant 2000 prices. On the expenditure side, the expansion was led by household consumption, which contributed 3.6 percentage points to GDP growth. Meanwhile, on the production side, services sector was the major contributor to GDP growth at 2.8 percentage points.

Likewise, gross national income (GNI) increased at a moderated pace of 1.9 percent in Q2 2011 from 3.3 percent in Q1 2011 and 9.2 percent in the same period last year. The slowdown in GNI growth was due to the contraction in the net primary income (NPI) on account of the ongoing political crisis in the Middle East and North Africa (MENA) as well as the economic uncertainty in AEs.

Meanwhile, the seasonally-adjusted estimate of GDP showed a 0.6 percent quarter-on-quarter growth in Q2 2011 from 1.9 percent in Q1 2011.

Aggregate Demand

Household consumption, accounting for 68.6 percent of GDP, continued to boost GDP growth with a sustained 5.4 percent expansion in Q2 2011. All major expenditure items posted increases, particularly food, miscellaneous goods and services, as well as furnishings, household equipment, and routine household maintenance.

Government consumption increased by 4.5 percent in Q2 2011 following three consecutive quarters of decline, with the release of allotments to different agencies to facilitate the implementation of their respective programs and projects.
Economic Performance
At constant 2000 prices
Growth rate (in percent)

<table>
<thead>
<tr>
<th>Sector</th>
<th>2010 Q2</th>
<th>2011 Q1</th>
<th>2011 Q2</th>
</tr>
</thead>
<tbody>
<tr>
<td>By expenditure item</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Household consumption</td>
<td>1.9</td>
<td>5.3</td>
<td>5.4</td>
</tr>
<tr>
<td>Government consumption</td>
<td>7.4</td>
<td>-17.2</td>
<td>4.5</td>
</tr>
<tr>
<td>Capital formation</td>
<td>38.0</td>
<td>42.3</td>
<td>0.9</td>
</tr>
<tr>
<td>Fixed capital formation</td>
<td>26.6</td>
<td>12.7</td>
<td>-5.7</td>
</tr>
<tr>
<td>Exports</td>
<td>24.0</td>
<td>2.0</td>
<td>-0.3</td>
</tr>
<tr>
<td>Imports</td>
<td>22.1</td>
<td>11.3</td>
<td>4.1</td>
</tr>
</tbody>
</table>

Source: NSCB

Meanwhile, capital formation growth weakened to 0.9 percent, from its quarter- and year-ago growth rates of 42.3 percent and 38.0 percent, respectively. The slump in construction activities due, in turn, to the decline in public construction, led to a 5.7 percent contraction in fixed capital formation. Nonetheless, the slower growth in capital formation was supported by the build-up of inventories which amounted to ₱7.2 billion in Q2 2011 against a drawdown of ₱12.5 billion in Q2 2010.

Total exports decreased by 0.3 percent in Q2 2011 due to the slower growth in exports of goods combined with a decline in exports of non-factor services. In particular, growth in merchandise exports slowed down to 0.1 percent from 7.0 percent in Q1 2011 and 28.6 percent in Q2 2010, due mainly to the decline in exports of electronic components, which accounted for 53.8 percent of total merchandise exports. Meanwhile, exports of non-factor services declined for the second consecutive quarter by 2.2 percent.

Other Demand Indicators
Leading indicators showed that domestic demand conditions remained firm, supported by upbeat business and consumer sentiments, improving employment conditions, and strong credit activity. Average capacity utilization and production indices reflected the continued resilience of manufacturing activity. Energy sales picked up to record its highest growth in 2011 so far, while vehicle sales declined, but at a slower pace. Business confidence for the current quarter also recovered following two consecutive rounds of decline in confidence readings. The consumer outlook likewise improved on expectations of further income gains and better job prospects in the months ahead.

Property Prices

Land Values

Data from Colliers International indicated that implied land values in the Makati CBD and Ortigas Center increased in Q2 2011 from the quarter- and year-ago levels. Implied land values in the Makati CBD reached ₱268,928/sq.m. in Q2 2011, higher by 0.3 percent and 1.3 percent relative to the levels

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5 In the absence of reported closed transactions, implied land values based on trends are used by Colliers International to monitor prices.
recorded in Q1 2011 and Q2 2010, respectively. Similarly, implied land values in the Ortigas Center rose by 1.0 percent q-o-q and 4.3 percent y-o-y to ₱125,169/sq.m. For the second half of 2011, Colliers expects land values to rise by more than 3.0 percent given the continued high interest in Makati properties. Land values are presently at about 63-65 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 increase q-o-q but are lower than year-ago levels.**

The monthly office vacancy rate in the Makati CBD increased to 4.2 percent in Q2 2011 from 3.7 percent in the previous quarter. This was due largely to the higher grade A office vacancy, driven by the relocation of Mitsubishi Heavy Industries from BPI Buendia to Robinsons Cybergate Plaza, as well as the downsizing of Pfizer Inc. in Ayala Life FGU and the closure of Atkins Philippines in 6750 Ayala Avenue. Meanwhile, the Q2 monthly vacancy rate is lower compared to the year-ago rate of 7.0 percent.

**Overall residential vacancy rates rise with more supply introduced in the market.**

The residential vacancy rate at 9.5 percent during the quarter was higher compared with both the Q2 2010 and Q1 2011 levels. Vacancy rates in the residential sector continued to rise as more supply is introduced in the market. On the other hand, occupancy rates for luxury residential units increase. Colliers expects the overall vacancy rate to increase to as high as 12.0 percent by mid-2012, driven by the continued surge in supply.

**Rental Values**

**Office rental values increase amid limited office space.**

Meanwhile, monthly office rents in the Makati CBD reached ₱661/sq.m. in Q2 2011, higher by 1.5 percent and 7.6 percent than the quarter- and year-ago levels. According to Colliers, the Makati CBD continued to be a preferred location (followed by Bonifacio Global City) despite the increase in rents amid limited office space. Meanwhile, in alternative business locations, Colliers noted that Manila and Pasay are starting to pick up as sought-after locations, notably by off-shoring and outsourcing (O&O) companies. Office rental values in Q2 2011 remained

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6 Actual rentals for housing comprise 13.8 percent of the 2006-based CPI basket. The NSO presently surveys rentals only ranging from around ₱200-₱10,000/month to compute rent inflation. However, the rental values discussed in this section pertain to high-end rented properties, which may be considered as indicators of wealth and demand.

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

Monthly rents for 3-bedroom condominium units in the Makati CBD rose to ₱569/sq.m. in Q2 2011, representing a 1.6 percent and 5.5 percent growth from the quarter- and year-ago levels. Given the notable rise in occupancy rates with the limited availability of these unit types, rents for the luxury 3-bedroom units are expected to increase further. Residential rental values were above their 1997 levels in nominal terms but were only about 57.4 percent of their 1997 levels in real terms.

Jones Lang LaSalle\(^8\) estimated average office rentals in the Makati CBD at ₱8,441/sq.m. per annum in Q2 2011, higher by 3.5 percent compared to the previous quarter and by 13.1 percent compared to the same quarter in the previous year. Office rental values continued to rise on the back of strong demand from the O&O sector. Despite the substantial volume of new supply projected to be completed over the next quarters, Jones Lang LaSalle still expects moderate growth in office rental values in the coming quarters as a result of the sustained increase in demand from the O&O industry.

Capital Values

Similarly, capital values\(^9\) 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 Q2 2011, Grade A office capital values in the Makati CBD rose to ₱80,010/sq.m., higher by 1.8 percent and by 6.7 percent compared to the quarter- and year-ago levels, respectively. Office capital values in Q2 2011 were higher than the 1997 levels for grade A offices in nominal terms. However, in real terms, office capital values were about 48.3 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. Average prices for residential condominium units increased by 2.7 percent q-o-q and 5.9 percent y-o-y in Q2 2011. Residential capital

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\(^8\)Jones Lang La Salle is one of the world’s leading real estate services and money management firms, with approximately 160 offices worldwide. It has over 45 years of experience in Asia Pacific, with over 12,500 employees operating in more than 60 offices in 13 countries across the region.

\(^9\)Probable price that the property would have fetched if sold on the date of the valuation. The valuation includes imputed land and building value.
values for luxury residential buildings were above their 1997 levels in nominal terms. In real terms, residential capital values were about 52.2 percent of the comparable levels in 1997.

**Vehicle Sales**

Domestic vehicle sales continued to decline in Q3 2011, albeit less negative than the 10.3 percent contraction in the previous quarter. Based on the preliminary data from the Chamber of Automotive Manufacturers of the Philippines, Inc. (CAMPI), vehicle sales decreased by 7.1 percent due to limited supply of models as industry production was disrupted in the aftermath of the twin disasters in Japan.

- Y-o-y, passenger car sales recovered in Q3 2011 at 1.7 percent, a turnaround from the quarter-ago contraction of 17.3 percent.

- Meanwhile, sales of commercial vehicles\(^{11}\) dropped further to 11.0 percent from the 6.5 percent contraction recorded in the previous quarter.

**Energy Sales**

Y-o-y power sales of Meralco picked up in Q3 2011 to 3.0 percent from the 2.1 percent contraction in the previous quarter. Energy sales grew by 5.9 percent in the same period a year ago. The improvement in energy sales can be traced to higher consumption from both commercial and industrial sectors, which was sufficient to offset the weak performance from the residential sector. Energy sales from the commercial sector were driven mainly by the communications and real estate sub-sectors, which, in turn, were propped up by the O&O industry in the country. Meanwhile, energy sales to the Cavite Economic Zone contributed to the increased consumption of the industrial sector.

\(^{10}\) Vehicle sales starting 2011 were adjusted to exclude the sales of four (4) members which left CAMPI, namely, Hyundai, Volvo, Chevrolet, and Chana.

\(^{11}\) Commercial vehicles include Asian utility vehicles (AUVs), sports utility vehicles (SUVs), light commercial vehicles (LCVs), light trucks, heavy-duty trucks, and buses.
Capacity utilization in manufacturing remains above 80 percent.

![Graph showing monthly average capacity utilization for manufacturing](image)

**Monthly Average Capacity Utilization for Manufacturing**

- **Aug 2011**: 83.3%
- Source: NSO

Volume and Value of Production

Industrial production continued to grow in August 2011, albeit at a slightly slower pace of 2.6 percent for the value of production index (VAPI) and 2.1 percent for the volume of production index (VOPI) from 4.6 percent (revised) in July 2011. The deceleration in the VAPI growth could be attributed to lower production values of basic metals, while the moderation in production output of the footwear and wearing apparel industry pulled down the VOPI growth.

Business Expectations Survey (BES)

Results of the Q3 2011 Business Expectations Survey showed an improvement in business sentiment for the period Q3 to Q4 2011 after slipping in the previous quarter. Business sentiment turned more optimistic in Q3 2011 as the overall confidence index (CI) rose by 2.3 index points to 34.1 percent from 31.8 percent in the previous quarter. The next quarter outlook was also more upbeat with a CI of 53.9 percent compared to 33.0 percent in the previous quarter.

Respondents attributed the bullish business outlook for the quarter ahead to general expectations of continued economic growth due to strong domestic demand, fuelled partly by the inflow of overseas Filipinos (OF) remittances, and brisker business during Christmas and harvest seasons. This prevailing sentiment mirrored the more optimistic views of businesses in Thailand, Singapore and New Zealand, in contrast to the weaker outlook in the United States, Canada and Germany.

Respondents cited the following factors for their more buoyant outlook: (a) expectations of more robust demand, (b) implementation of government projects, including the Public-Private Partnership (PPP) program, (c) sound macroeconomic fundamentals, (d) business expansion arising from steady investment inflows, (e) recovery of markets in Japan, (f) introduction of new and enhanced business strategies, and (g) strong confidence in the government. Their responses suggest that the challenges posed by the recent US credit rating downgrade and by sovereign debt crisis issues in some parts of Europe could be countered by stronger domestic demand, higher fiscal spending, and continued growth in the private sector.

---

12 Respondents cited the following factors for their more buoyant outlook: (a) expectations of more robust demand, (b) implementation of government projects, including the Public-Private Partnership (PPP) program, (c) sound macroeconomic fundamentals, (d) business expansion arising from steady investment inflows, (e) recovery of markets in Japan, (f) introduction of new and enhanced business strategies, and (g) strong confidence in the government. Their responses suggest that the challenges posed by the recent US credit rating downgrade and by sovereign debt crisis issues in some parts of Europe could be countered by stronger domestic demand, higher fiscal spending, and continued growth in the private sector.
Likewise, expectations of better employment conditions and income gains lift consumer sentiments.

### Consumer Expectations Survey

<table>
<thead>
<tr>
<th>Index</th>
<th>2010 Q3</th>
<th>2010 Q1</th>
<th>2010 Q2</th>
<th>2011 Q3</th>
<th>2011 Q1</th>
<th>2011 Q2</th>
<th>2011 Q3</th>
</tr>
</thead>
<tbody>
<tr>
<td>Next 3 months</td>
<td>15.3</td>
<td>-6.2</td>
<td>-7.8</td>
<td>1.5</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Next 12 months</td>
<td>33.4</td>
<td>1.2</td>
<td>4.4</td>
<td>11.7</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Source: BSP

Overall consumer CI edged higher but remained in negative territory in Q3 2011 at -18.7 percent from -24.1 percent in Q2 2011.\(^{13}\) The negative CI implied that consumers with an optimistic outlook remained outnumbered by those with opposite views. Expectations of more job opportunities and income gains, along with news of the implementation of the government’s Pantawid Pamilyang Pilipino Program lifted consumer sentiments. Furthermore, survey results suggested that positive economic developments\(^ {14}\) are expected to boost domestic demand for the quarter. Improving consumer confidence was also noted in the US, France, New Zealand, Thailand and Japan for Q3 2011.

Looking ahead, consumers were more optimistic for the quarter- and year-ahead periods due to favorable job and income prospects combined with stable prices of goods and services. This was reflected in the positive CI index for the quarter ahead at 1.5 percent (from -7.8 percent a quarter ago), which shifted to positive territory after posting negative CIs since the start of 2011. Likewise, the year ahead CI increased to 11.7 percent (from 4.4 percent a quarter ago).

### External Demand

#### Exports

Y-o-y merchandise exports in Q2 2011 grew modestly by 1.0 percent, significantly lower than the quarter- and year-ago rates of 8.1 percent and 34.5 percent, respectively. Exports were pulled down mainly by manufactures as the majority of electronic product sales was affected in the aftermath of the twin disasters that struck Japan earlier this year—consistent with the slight drop in the book-to-bill ratio. Meanwhile, the expansion could be traced to mineral products, driven mainly by copper metal exports, which grew by 120.5 percent in Q2 2011 due to increased sales of cathodes and refined copper. Another contributing factor are the petroleum product exports, which can be attributed to higher shipments of naptha and reformates as well as other fuel oils.

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\(^{13}\) The survey was conducted during the period 1-14 July 2011.

\(^{14}\) These developments include an expansion in the domestic labor market, local industries and fiscal spending.
Imports of Goods (BOP data)

<table>
<thead>
<tr>
<th>Commodity Group</th>
<th>2010 Q2</th>
<th>2010 Q1</th>
<th>2011 Q2</th>
</tr>
</thead>
<tbody>
<tr>
<td>Capital Goods</td>
<td>30.0</td>
<td>-1.1</td>
<td>-3.5</td>
</tr>
<tr>
<td>Raw Materials &amp; Intermediate Goods</td>
<td>33.2</td>
<td>24.4</td>
<td>0.0</td>
</tr>
<tr>
<td>Mineral Fuels &amp; Lubricants</td>
<td>36.8</td>
<td>31.7</td>
<td>18.6</td>
</tr>
<tr>
<td>Consumer Goods</td>
<td>15.2</td>
<td>-20.7</td>
<td>-2.9</td>
</tr>
<tr>
<td>Special Transactions</td>
<td>56.1</td>
<td>5.5</td>
<td>-8.4</td>
</tr>
<tr>
<td>Total Imports1/</td>
<td>31.1</td>
<td>14.9</td>
<td>2.2</td>
</tr>
<tr>
<td>Conceptual and coverage adjustments</td>
<td>-210.0</td>
<td>-47.3</td>
<td>61.8</td>
</tr>
<tr>
<td><strong>Total Imports, BPM5</strong></td>
<td>32.1</td>
<td>13.3</td>
<td>2.4</td>
</tr>
</tbody>
</table>

1/ Include valuation adjustments to NSO data
Source: BSP

Similarly, imports of goods slowed down to 2.4 percent in Q2 2011 from 13.3 percent in the previous quarter, owing to softening demand for foreign goods amidst increasing world prices coupled with a fragile global growth outlook. Nevertheless, merchandise imports expanded due mainly to higher imports of mineral fuels and lubricants with elevated prices of petroleum crude imports. This, in turn, was due to lingering supply concerns that the conflict in the MENA region might curb oil shipments. Meanwhile, inward shipments of capital goods declined for the second consecutive quarter by 3.5 percent due to reduced shipments of office and electronic data processing machines. Consumer goods also pulled down imports during the review quarter.

Aggregate Supply

Output growth on the production side was supported by the services sector, which expanded by 5.0 percent in Q2 2011, and comprising 57.0 percent of GDP. The Q2 2011 growth was faster than in the previous quarter but was lower than the expansion recorded in Q2 2010. The growth in services was driven by the acceleration in the financial intermediation sub-sector as well as the sustained growth in real estate, renting and other business activities, and other services sub-sectors.

The Q2 2011 economic growth was likewise boosted by the agriculture sector, which contributed 0.7 percentage point to GDP growth. Agriculture, which accounted for 10.6 percent of total GDP, grew at a faster pace of 7.1 percent y-o-y in Q2 2011 compared to the 4.3 percent recorded in Q1 2011. This was also a turnaround from the 2.0 percent contraction recorded in the previous year. The expansion of the agriculture sector was bolstered by the recovery of sugarcane, palay, and corn production.

Meanwhile, the industry sector contracted by 0.6 percent from a growth of 7.3 percent and 15.7 percent in Q1 2011 and Q2 2010, respectively. Industrial output was pulled down by the contraction in construction and electricity, gas, and water supply industries, coupled with slower growth in manufacturing and mining and quarrying industries.
Labor Market Conditions

Unemployment rate dips slightly.

Based on the preliminary results of the July Labor Force Survey (LFS), the unemployment rate in July 2011 was estimated at 7.1 percent, slightly lower than the 7.2 percent posted in April 2011 but higher than the 7.0 percent registered in July 2010. Similarly, the proportion of underemployed to total employed persons was lower at 19.1 percent in July 2011 relative to the April 2011 level of 19.4 percent, but represented an increase compared to the 17.9 percent posted in July 2010.\(^\text{15}\)

Employment increased by 2.4 percent y-o-y in July 2011 to 37.1 million, driven largely by the growth in the services sector. This was higher by about 0.9 million compared to the level registered in the same period a year ago. The services sector accounted for 52.2 percent of the total employed persons, while the agriculture and industry sectors employed 32.6 percent and 15.2 percent, respectively.

In terms of major occupation groups, the y-o-y increase in the employment level could be traced to the higher growth of laborers, officials of government and special interest organizations, service workers, clerks, professionals, technicians, and special occupations workers. However, the decline in the employment of farmers and workers in trades and plants pulled down employment growth during the period.

\(^{15}\) 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.
II. MONETARY AND FINANCIAL MARKET CONDITIONS

Domestic Liquidity and Credit Conditions

*Domestic liquidity continues to grow, although at a slower pace as NFA expands further....*

M3 continued to grow in August 2011, although at a slightly slower pace of 9.4 percent from the end-Q2 2011 expansion of 11.4 percent. The growth of domestic liquidity was fueled by the accelerated expansion in net foreign assets (NFA), particularly in the BSP’s NFA position, as foreign exchange inflows from OF remittances, as well as portfolio and direct investments, continued to increase. Meanwhile, the NFA of banks decreased further, owing to the sustained increase in foreign liabilities coupled with a decline in foreign assets. On the one hand, banks’ foreign liabilities rose with the increase in placements made by foreign banks, including that of the head offices/other branches of foreign banks, with resident banks. 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, net domestic assets (NDA) decreased further by 10.6 percent 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). Nonetheless, net domestic credits expanded by 8.9 percent with the sustained increase in credits extended to the private sector, consistent with the sustained pick-up of bank lending to businesses and households. Meanwhile, credits extended to the public sector declined anew as credits extended to the National Government (NG) continued to fall owing to its favorable cash position as reflected in the steady increase in NG deposits with the BSP and other banks.

*Bank lending growth accelerates further.*

The expansion in bank lending was sustained during the quarter, supported by the view that underlying domestic demand remains robust, boosted, in turn, by positive economic outlook of both businesses and consumers. As of August 2011, bank lending growth, net of banks’ reverse repurchase (RRP) placements with the BSP, rose to 19.8 percent y-o-y from a growth of 18.8 percent at end-Q2 2011 and 9.8 percent at end-Q3 2010. The faster growth of bank lending was driven largely by lending to the following productive sectors: electricity, gas and water; wholesale and retail trade; manufacturing; financial intermediation; transportation, storage and communication; real estate, renting and business services; construction; and manufacturing. By contrast, the growth in household consumer loans
Meanwhile, overall credit standards remain generally unchanged.

### General Credit Standards to Enterprises (Overall)

<table>
<thead>
<tr>
<th></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>
<th>Q3 2011</th>
</tr>
</thead>
<tbody>
<tr>
<td>Tightened considerably</td>
<td>5.3</td>
<td>0.0</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>
<td>7.1</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>
<td>92.9</td>
</tr>
<tr>
<td>Eased somewhat</td>
<td>0.0</td>
<td>0.0</td>
<td>0.0</td>
<td>0.0</td>
<td>0.0</td>
<td>0.0</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>0.0</td>
<td>0.0</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>
<td>100.0</td>
</tr>
<tr>
<td>Diffusion Index</td>
<td>15.8</td>
<td>4.5</td>
<td>9.5</td>
<td>15.0</td>
<td>0.0</td>
<td>5.6</td>
<td>7.1</td>
</tr>
<tr>
<td>Weighted Diffusion Index</td>
<td>10.1</td>
<td>2.3</td>
<td>4.8</td>
<td>10.0</td>
<td>0.0</td>
<td>7.6</td>
<td>8.6</td>
</tr>
<tr>
<td>Mean</td>
<td>2.8</td>
<td>3.0</td>
<td>2.9</td>
<td>2.9</td>
<td>3.0</td>
<td>2.9</td>
<td>2.9</td>
</tr>
<tr>
<td>Number of banks responding</td>
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<td>21.0</td>
<td>20.0</td>
<td>19.0</td>
<td>18.0</td>
<td>14.0</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”).

The overall net tightening of credit standards for loans to enterprises reflected the banks’ less optimistic outlook on the general economy and certain industries amid uncertainties brought about by adverse external developments during the quarter. The net tightening of credit standards for enterprises in Q3 2011 was also attributed by respondent banks to financial system regulations and banks’ reduced tolerance for risk, as well as the degree of competition from other banks and non-bank lenders.

With regard to firm size, survey results indicated a net tightening of credit standards for top corporations, consistent with the overall net tightening of credit standards. Meanwhile, all of the respondent banks reported unchanged credit standards for large middle-market, small and medium, and micro enterprises.

In terms of specific credit standards, loan maturities appeared to have shortened across firm sizes, except micro enterprises, reflecting more subdued economic prospects. However, banks reported narrower loan margins and increased credit lines, particularly for top corporations and large middle-market enterprises in...
Survey results have been showing a net narrowing of loan margins since Q4 2010 on the back of a generally stable interest rate environment while the size of credit lines has been increasing since Q2 2010. Banks’ standards on collateral requirements and loan covenants were unchanged for all firm sizes.

### Lending to Households

The survey results indicated a slight net easing of credit standards for loans to households,\(^{22}\) reflecting the net easing of credit standards for housing loans.\(^{23}\) Meanwhile, all respondent banks reported unchanged credit standards for credit card, auto, and personal/salary loans. The steady view of respondent banks on the financial system regulations and access to market financing contributed to the unchanged credit standards for credit card, auto, and personal/salary loans during the quarter.

In terms of specific credit standards, survey responses, however, indicated easing loan margins, particularly for housing and auto loans. Banks’ responses also show increased credit lines and longer loan maturities for housing loans.

### Loan demand

The survey results also pointed to a sustained positive net change in demand\(^{24}\) for loans from enterprises (except micro enterprises) and households. The net increase in demand for loans from both enterprises and households could be traced to upbeat expectations of borrower firms about the general economic activity, the favorable interest rate environment, higher cash flow requirements, and lack of other sources of financing. The favorable terms of financing offered by respondent banks also contributed to the increased demand for loans from households during the review quarter.

The overall positive net change in demand for corporate and household loans was consistent with the strong bank lending growth during the first two months of Q3 2011 for which data are available.

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\(^{22}\) Loans extended to households include: (1) housing loans; (2) credit card loans; (3) auto loans; and (4) personal/salary loans.

\(^{23}\) One bank reported easing of credit standards for housing loans.

\(^{24}\) “Net change in demand” refers to the percentage difference between banks reporting an increase in loan demand and banks reporting a decrease. A positive net change in demand indicates that more banks reported an increase in loan demand compared to those stating the opposite, whereas a negative net change in demand implies that more banks reported a decrease in loan demand compared to those reporting an increase.
Special questions on commercial real estate loans

As in the previous quarter, the Q3 2011 survey round included specific questions on commercial real estate loans for the BSP to have a better sense of banks’ views on the property sector. All respondent banks reported unchanged credit standards (except loan margins which showed net widening) for commercial real estate loans in Q3 2011 relative to Q2 2011. Similarly, banks’ loan-to-value ratios were steady during the quarter. Banks also reported unchanged demand for commercial real estate loans in the third quarter.

Interest Rates

*T-bill rates remain at low levels.*

Yield curve shifts down.

Primary Interest Rates

During Q3 2011, the average 91-day T-bill rate was broadly steady at 1.49 percent from 1.46 percent in Q2 2011. The same period saw the average 182-day T-bill rate rising slightly to 1.8 percent from 1.1 percent while the 364-day T-bill rate continued to decline to 1.9 percent from 2.4 percent. Nonetheless, compared to the previous year, T-bill rates have been generally declining due to strong demand, as investors sought safe-haven instruments amid concerns of a double-dip recession in the US and a worsening euro area debt problem. The confluence of factors, including ample liquidity, moderate inflation, favorable government fiscal position and the possibility that the country’s credit rating could soon be upgraded to investment grade is expected to further bring down T-bill rates.

Yield Curve

Secondary market yields declined generally across tenors (except for the 4-year and 5-year instruments) as of end-September 2011 relative to the end June-2011 levels, largely on the back of ample market liquidity and upbeat confidence in the domestic economy, which, in turn, is boosted by the BSP’s decision to keep its policy rates steady to support economic growth given within-target inflation outlook. Debt paper yields were lower by a range of 33.2 basis points (bps) (10-year GS) to 155.7 bps (1-year GS) compared to end-June 2011 levels. Relative to the 30 September 2010 levels, yields were likewise lower across all tenors except for the 5-year tenor, with the shorter-dated tenors decreasing by a larger magnitude.
Interest rate differentials narrow.

The average positive differentials between domestic and US interest rates, net of tax, narrowed in Q3 2011 relative to the previous quarter, following the decline in the average RP 91-day T-bill rate to 1.44 percent in Q3 2011 from 1.52 percent in Q2 2011 and the fall in the average US 90-day T-bill rate to 0.03 percent from 0.10 percent. Meanwhile, the rise in the average US 90-day LIBOR was offset by the fall in Philippine T-bill rates.

The positive differential between the BSP’s policy interest rate (overnight borrowing or RRP rate) and the US federal funds target rate remained unchanged at 425 bps in Q3 2011. Adjusted for the risk premium, the average spread between the BSP’s policy rate and the US federal funds target rate fell to 253 bps from 293 bps in Q2 2011. This development, reflecting higher risk aversion, could be traced to the 48-bp rise in the risk premium as the 10-year US yield declined more than the 10-year RP yield.

The real lending rate—measured as the difference between the average bank lending rate and inflation—declined to 2.0 percent as of September 2011 from 2.5 percent in June as a result of the drop in the average nominal bank lending rate to 6.6 percent in September 2011 from 7.1 percent in June while the inflation rate remained steady at 4.6 percent as of September 2011 (2000-based CPI series).

Using the 2006-based CPI inflation series, the real lending rate likewise declined to 1.8 percent in September 2011 from 1.9 percent in June, as the inflation rate went down to 4.8 percent in September from 5.2 percent in June.

Based on the 2000-based CPI series, the real lending rate of the Philippines at 2.0 percent in September 2011 remained the fourth highest in a sample of 10 Asian countries, with Indonesia recording the highest real lending rate at 7.8 percent. Based on the 2006-CPI series, the Philippines’ real lending rate ranked the fifth highest in September for the same sample.

25 Adjusted risk premium which is measured as the differential between the 10-year ROP note and the 10-year US Treasury note
Financial Market Conditions

Domestic financial markets are not immune to adverse external developments.

Conditions in global financial markets have become highly unsettled as concerns over the strength of global economic activity and continuing fragility of sovereign and bank balance sheets in AEs contributed to lower risk appetites. Market confidence has been further dampened by the lack of a credible political consensus in both the US and euro area on how to address long-term fiscal concerns in these economies. In the early part of the review quarter, investor sentiments benefited from positive developments in the domestic front but turned bearish as the quarter closed. As a result, the PSEi averaged at 4,194.4 index points in September, lower compared to both its July and August averages. Both the EMBI+ Philippine spread and the Philippine CDS spread likewise widened in Q3 2011 relative to their previous quarter levels, reflecting heightened global risk aversion. Meanwhile, the peso kept its strength on sustained foreign exchange inflows from OF remittances, portfolio inflows, and FDI.

Stock Market

Despite occasional episodes of heightened risk aversion and volatility, the Philippine Stock Exchange index (PSEi) drifted upwards during the quarter, boosted by a stable domestic inflation, the Philippines’ ratings upgrades in June, and increased investor demand for domestic mining stocks. The composite index went up by 1.9 percent to average 4,334.4 index points in Q3 2011 from the 4,253.1 index points posted in Q3 2011. Relative to the average posted a year ago, this quarter’s level accelerated sharply by 19.5 percent.

Trading in the local bourse was bullish at the start of the period-in-review, breaching the 4,500 benchmark several times before turning bearish as the quarter closed. Moody’s and Fitch Ratings’ upgrades of the country’s sovereign credit ratings, a better-than-expected fiscal performance, optimism about local corporate earnings in the second quarter and higher investor demand for mining stocks as gold prices rose following the shift to safer haven assets helped lift the PSEi to close at 4,503.6 index points end-July.

However, trading sentiments were dampened in early August through September by worries about the impact on the rest of the world of the S&P downgrade of the US credit rating on 5 August and a similar S&P downgrade for Italy on 16 September. Concerns
Foreign investors turn net sellers.

As concerns about the lack of a credible solution to Europe’s deepening debt troubles and fears of world GDP growth slowing down as China’s manufacturing sector contracted for the third straight month in September and Germany’s retail sales fell sharply, also helped push global and local stocks lower during the period.

Amidst generally bearish sentiments, foreign investors withdrew from the local bourse to post net sales amounting to ₱5.6 billion during the quarter-in-review, a sharp reversal of the ₱19.7 billion net purchases recorded in the second quarter of 2011. Stock market capitalization similarly declined by 8.0 percent (q-o-q) to ₱8.2 trillion at the close of the third quarter of 2011.

Government Securities

The prevailing ample market liquidity, manageable inflation, strong peso, and the NG’s solid fiscal performance, coupled with the BSP’s decision to keep policy rates steady, encouraged investors to park their excess funds on short-term GS. T-bill auctions during the review period were generally oversubscribed, amounting to ₱123 billion compared to ₱73 billion in the previous quarter.

For five consecutive auctions, the Auction Committee awarded either the full programmed amount or higher for the 91-day and 182-day T-bills. Awards exceeded programmed levels, where the Bureau of the Treasury (BTr) accepted double the programmed amount in auctions for non-competitive bids. Bids for the 364-day and 182-day T-bills in the 25 July and 19 September auctions, respectively, were rejected, as bid rates were deemed unreasonably high. With the comfortable level of cash balances in the third quarter, the NG was able to grant partial awards and reject bids on a number of occasions.

Sovereign Bond and CDS Spreads

Debt spreads widened significantly in the third quarter. The EMBI+ Philippine spreads, or the extra yield investors demand to hold Philippine debt securities over US Treasuries, averaged 208 bps during the review period, wider than the second quarter’s average of 181 bps. Similarly, the credit default swap (CDS) spread, or the cost of insuring the

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26 The government can exercise this prerogative if initially programmed amount is less than 25 percent of the total tenders. In particular, awards for the non-competitive bids on all tenors were doubled in the 5 September auction.
country’s 5-year sovereign bonds against default, rose to 163 bps from 133 bps in Q2 2011. Against neighboring economies, the Philippine CDS traded narrower than Indonesia’s 170 bps but wider than Malaysia’s 119 bps and Thailand’s 145 bps.

Threats of contagion from the turbulence in global financial markets contributed largely to the widening trend of the country’s debt spreads. The sovereign credit rating downgrades of US and Japan in August, combined with persistent worries over the global economic slowdown and the solvency of euro area governments and financial institutions, spurred flight from riskier emerging market assets, including ROPs. The series of disappointing economic data releases from AEs likewise contributed to the widening of debt spreads. Market fears also escalated on concerns over the ability of political parties in the US and Europe to agree on sensible strategies that will both encourage employment and reduce indebtedness. Credit spreads peaked on 26 September, the widest since June 2009, as financial markets priced in Italy’s downgrade alongside worries of a possible default by Greece.

Although episodes of narrowing occurred in the latter part of August and September on positive expectations that the US Fed will intervene to spur economic growth and on renewed hopes following the progress made by European leaders in resolving the region’s debt crisis, debt spreads remained at peak levels as uncertainties lingered with the absence of concrete actions from policymakers to stem AEs’ sovereign debt and growth problems.

The Philippine banking system sustained its sound footing during the quarter in review, supported by solid asset growth and robust credit expansion. Moreover, credit quality continued to improve, posting lower non-performing loans (NPL), which were closer to their pre-Asian crisis levels, and higher loan-loss provisioning ratios. The system’s capital adequacy ratio of over 15 percent remained comfortably above the BSP’s and the Bank for International Settlements’ (BIS) minimum requirements.

Banking System

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

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27 On 5 August, the S&P downgraded the US long-term credit rating to AA+. During the same day, Moody’s and Fitch maintained the triple “A” US credit rating. However, in Moody’s 15 July 2011 report, the rating agency noted a possible downgrade unless progress towards a budget that includes a long-term deficit reduction program is achieved.

28 On 24 August, Moody’s downgraded Japan’s sovereign credit rating by one step to Aa3 with a stable outlook.

29 On 21 September, S&P lowered Italy’s credit rating to A from A+ with a negative outlook on concerns that weakening economic growth and a “fragile” government could mean that the nation will struggle to reduce its debt burden.
Saving Mobilization

Savings and time deposits remained the primary sources of funds for banks. Banks’ total deposits\(^3\) as of end-August 2011 amounted to P3.8 trillion, 11.8 percent higher than the year-ago level of P3.4 trillion. The continued growth in deposits reflected depositors’ sustained confidence in the banking system. Savings deposits registered an 18.8 percent growth and continued to account for nearly half of the funding base. Demand deposits expanded by 12.5 percent y-o-y while time deposits were largely unchanged from its level posted a year ago.

Institutional Developments

The total resources of the banking system rose by 11.8 percent to P7.4 trillion as of end-August. 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 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, denoting 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 in Q1 2010, due mainly to the increase in the branches/agencies of U/KBs and RBs.

The banking system’s asset quality as measured by the NPL ratio sustained its downtrend path, easing to 3.2 percent as of end-August 2011 from the 4.0 percent registered a year ago. Banks’ initiatives to improve asset quality along with prudent lending regulations helped bring back the NPL ratio to pre-Asian crisis levels. The low NPL ratio reflected the 7.3 percent decline in the level of NPLs combined with the 15.2 percent expansion in the industry’s total loan portfolio (TLP). The NPL level dropped to P113.5 billion at end-August 2011 from P122.5 billion during the same period in 2010, while TLP expanded to P3.5 trillion from P3.1 trillion during the same period last year.

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\(^3\) Total peso-denominated deposits.
Meanwhile, the NPL ratio of U/KBs declined further to 2.5 percent as of end-August 2011 from the 3.2 percent posted in the same period in 2010, but was generally unchanged relative to the ratio posted at end-June 2011.

Nonetheless, the Philippine banking system’s NPL ratio of 3.2 percent was higher compared to some of its neighbors like Indonesia’s 2.8 percent, Malaysia’s 2.0 percent, South Korea’s 1.1 percent and Thailand’s 3.0 percent. The lower NPL ratios of Malaysia and South 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 99.3 percent as of end-August 2011 from 94.9 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.

Similarly, the capital adequacy ratios (CARs) of the Philippine banking system continued to reflect the stability of the industry. The banking system’s average CARs of 16.0 percent on solo basis and 17.0 percent on consolidated basis as of end-December 2010 was largely unchanged relative to the previous quarter’s ratios as qualifying capital grew at generally the same pace with risk-weighted assets. The industry’s CAR continued to exceed both the statutory level set by the BSP at 10.0 percent and the Bank for International Settlements (BIS) international standard at 8.0 percent.

The Philippine banking system’s CAR continued to be slightly higher than those of Malaysia (14.3 percent), South Korea (14.7 percent) and Thailand (16.1 percent). Indonesia posted the highest CAR in the region at 17.2 percent.

Meanwhile, placements in the special deposit account (SDA) facility of the BSP increased by about

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31 Sources: Various central bank websites and financial stability reports, Indonesia (commercial banks, July 2011); Malaysia (banking system, July 2011); Thailand (commercial banks, June 2011); and Korea (banking system, December 2010).
32 CAR solo basis includes head office and branches/other offices while consolidated basis includes parent bank and financial allied subsidiaries excluding subsidiary insurance companies.
33 Sources: Various central bank websites and financial stability reports, Malaysia (banking system, July 2011); Korea (commercial banks, December 2010); Thailand (average full branch, June 2011) and Indonesia (commercial banks, July 2011).
77.8 percent y-o-y to reach P1,620.4 billion as of end-September 2011 from the P911.4 billion posted during the same period a year ago. Meanwhile, placements under the BSP RRP window declined to P241.7 billion from P245.1 billion and P295.1 billion posted a year earlier and a quarter ago, respectively.

**Exchange Rate**

*Peso appreciates on sustained forex inflows.*

![Quarterly Peso-Dollar Rate]

**Changes in Selected Dollar Rates**

<table>
<thead>
<tr>
<th></th>
<th>Year-to-date</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Appr./(Depr.), in percent</td>
<td></td>
</tr>
<tr>
<td></td>
<td>30 Jun*</td>
<td>30 Sep**</td>
</tr>
<tr>
<td>Philippine peso</td>
<td>1.2</td>
<td>0.3</td>
</tr>
<tr>
<td>Thai baht (onshore)</td>
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<td>-3.5</td>
</tr>
<tr>
<td>Chinese yuan</td>
<td>2.2</td>
<td>3.5</td>
</tr>
<tr>
<td>Malaysian ringgit</td>
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<td>-3.9</td>
</tr>
<tr>
<td>South Korean won</td>
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<td>-4.6</td>
</tr>
<tr>
<td>Singaporean dollar</td>
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<tr>
<td>New Taiwan dollar</td>
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<td>-4.4</td>
</tr>
<tr>
<td>Indonesian rupiah</td>
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<tr>
<td>Japanese yen</td>
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<td>5.8</td>
</tr>
<tr>
<td>Indian Rupee</td>
<td>-0.0</td>
<td>-8.6</td>
</tr>
</tbody>
</table>

*Source: Bloomberg, Reuters and PDEX*

* As of 4:00 p.m., 30 June 2011
** As of 4:00 p.m., 30 September 2011

The peso continues to show resilience despite heightened global risk aversion stemming from the mounting concerns over the euro area debt crisis and the slowing global economic recovery. In Q3 2011, the peso averaged P42.75/US$1, appreciating by 1.2 percent from the P43.25/US$1 average in the previous quarter. On a y-o-y basis, the peso appreciated by 5.9 percent from the P45.27/US$1 average posted in the third quarter of 2010. The peso’s strength was underpinned by the sustained inflow of OF remittances, net portfolio investments, and foreign direct investments (FDI).

The peso generally appreciated in the first two months of the review quarter as positive sentiment towards emerging Asian economies supported the continued inflow of foreign exchange into the country. In particular, the country was a recipient of strong inflow of portfolio investments stemming from investors’ renewed interest on PSE-listed securities and fixed income investments in July-August 2011. The peso also benefited from the long position of hedge funds in emerging Asian currencies on Asia’s brighter prospects. However, the peso depreciated slightly in the last month of the quarter due to the weakness in Asian equities and apprehensions over the debt crisis in Europe, which dampened risk appetite. Such developments spurred dollar short-covering as investors sought safe-haven assets amid heightened risk aversion.

On a year-to-date basis, the peso appreciated against the US dollar by 0.3 percent on 30 September 2011 as it closed at P43.72/US$1, moving in tandem with the Japanese yen, Chinese yuan, and Indonesian rupiah. Meanwhile, the rest of the Asian currencies including the Indian rupee, New Taiwan dollar, Korean won,
Thai baht, Malaysian ringgit, and Singapore dollar depreciated vis-à-vis the US dollar.\textsuperscript{36}

Volatility, as measured by the coefficient of variation of the daily average exchange rates declined to 0.01 percent in Q3 2011 compared with 0.46 percent in Q2 2011.

On a real, trade-weighted basis, the peso lost its external price competitiveness against the baskets of currencies of major trading partners (MTPs) and competitor countries in both the broad and narrow series in Q3 2011.\textsuperscript{37} This reflected mainly the combined effect of the nominal appreciation of the peso and the widening inflation differential relative to those of the major, broad, and narrow competitor countries, which led to the increase in the real effective exchange rate (REER) index of the peso by 2.3 percent, 1.8 percent, and 2.0 percent, respectively.\textsuperscript{38}

On a y-o-y basis, the peso lost international competitiveness against the baskets of currencies of MTPs and competitor countries in the narrow series as the peso appreciated in real terms by 2.6 percent and 5.1 percent, respectively. This developed due to the widening inflation differential along with the nominal appreciation 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 nominal depreciation of the peso against this basket of currencies led to a decrease in the peso’s REER index by 2.5 percent.

\textsuperscript{36} Based on the last done deal in the afternoon.

\textsuperscript{37} 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.

\textsuperscript{38} The REER index represents the Nominal Effective Exchange Rate (NEER) index of the peso, adjusted for inflation rate differentials with countries whose currencies comprise the NEER index basket. A decrease in the REER index indicates some gain in the external price competitiveness of the peso, while a significant increase indicates the opposite. The NEER index, meanwhile, represents the weighted average exchange rate of the peso vis-à-vis a basket of foreign currencies.
III. Fiscal Developments

Fiscal balance continues to improve.

<table>
<thead>
<tr>
<th>National Government Fiscal Performance</th>
<th>January-August</th>
<th>Growth</th>
<th>% to Q1-Q2 2011</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>2010</td>
<td>2011</td>
<td>Program</td>
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<tr>
<td>Surplus/(Deficit)</td>
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<td>-34.5</td>
<td>6.3</td>
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<tr>
<td>Revenues</td>
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<td>912.8</td>
<td>14.7</td>
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<tr>
<td>Expenditures</td>
<td>1,030.9</td>
<td>947.2</td>
<td>0.7</td>
</tr>
</tbody>
</table>

*Totals may not add up due to rounding

Source: BTR

The fiscal deficit in January to August 2011 reached ₱34.5 billion, 84.9 percent lower than the ₱228.1 billion deficit incurred during the same period last year. This represented 14.7 percent of the ₱234.4 billion programmed deficit for Q1-Q3 2011.

Revenue collections increased by 13.7 percent to ₱912.8 billion in Jan-August 2011 compared to the year-ago level, and accounted for 87.7 percent of the programmed level of ₱1,040.8 billion for Q1-Q3 2011. The BIR and the Bureau of Customs (BOC) contributed ₱619.7 billion and ₱172.0 billion, respectively, to total revenues, or an increase of 13.4 percent and 0.7 percent compared to their contributions in the same period last year. The collections by the BTr likewise rose to ₱62.1 billion in Q3 2011 from ₱39.1 billion in the same period in 2010. Revenues from other offices also increased by 26.4 percent to ₱58.9 billion.

Expenditures during the period January-August 2011 amounted to ₱947.2 billion, 8.1 percent lower than the disbursements in the same period in 2010, representing 74.3 percent of the Q1-Q3 2011 programmed amount. Excluding interest payments, total disbursements declined by 8.3 percent to ₱750.6 billion. Interest payments also went down by 7.6 percent to ₱196.6 billion.
IV. EXTERNAL DEVELOPMENTS

Global economic expansion weakens, with the balance of risks to growth now firmly tilted to the downside.

The global economy weakened in the second quarter of the year amid falling market confidence and growing downside risks. The JP Morgan global composite index fell further to 51.5 in August from 52.5 in July, as manufacturing and services moderated. Purchasing managers index (PMI) indicators also indicated a continuing slowdown in the pace of global trade, with the index for global new export orders slipping to 50.8 in August from 51.1 in the previous month.39

Inflation pressures remained elevated in emerging and developing economies amid increasing capacity constraints, while tightening policies had yet to gain significant traction. Renewed concerns over the weakening US economy and the unraveling debt crises in the euro area, meanwhile, continued to temper commodity prices, which had started to ease as early as the latter part of the second quarter of 2011. On the whole, headline inflation is seen to recede as food, energy, and commodity prices moderate. However, some upward risks remain, especially in emerging economies where demand pressures are high.

The US economy remains on a sluggish growth trajectory.

US real GDP grew at an annualized rate of 1.0 percent in Q2 2011 from 0.4 percent in the previous quarter, according to the second estimate released by the Bureau of Economic Analysis. A slowdown in imports growth as well as upturns in nonresidential fixed investment and federal government spending underpinned the higher output growth. However, slower growth in exports and personal consumption were also noted. Going forward, manufacturing is expected to expand at a slower rate as new orders continue to decline. The manufacturing PMI declined to 50.6 in August from 50.9 in July and 55.3 in end-Q2 2011.

Latest indicators showed a sharp erosion in consumer confidence in the US during the quarter. From 57.6 in June, the Conference Board Consumer Confidence Index fell to 45.4 in September.40 Likewise, the Thomson Reuters/University of Michigan preliminary index of consumer sentiment declined to 59.4 in September from 71.5 in June. Consumer sentiment took a severe hit in the third quarter as

Mounting concerns on the ongoing debt problem weigh down on euro area growth prospects.

unemployment remained high while wages stagnated. The drawn-out political debate over the US debt ceiling, as well as renewed fears that the economy could again fall back into recession, also dampened consumer sentiment.

As regards price developments, y-o-y inflation rose to 3.8 percent in August (after holding at 3.6 percent since May), a result of sustained, albeit slower increases, in the energy and food indices. On a quarterly basis, the average inflation rate rose to 3.7 percent in the period July to August from 3.4 percent in April to May.

Eurostat’s second estimates showed that real GDP in the euro area grew by 0.2 percent on a quarterly basis in Q2 2011, slower than the 0.8 percent increase recorded in the previous quarter. Output growth decelerated on account of the ongoing debt crises in the region, which prompted governments to cut back on their spending.41

Other indicators pointed to an increasingly pessimistic outlook on retail sales and overall economic activity for Q4 2011. The Eurozone retail PMI fell below 50.0 for the fifth consecutive month at 49.6, indicating continued decline in sales. The European Commission’s Economic Sentiment Indicator also continued to decrease, dropping from 103.0 in July to 98.3 in August.

Meanwhile, inflation in the euro area was at 2.5 percent in August, the same as in July. Fuels for transport, heating oil, and electricity had the biggest upward effects on the headline rate.42

The Japanese economy continues to contract.

After contracting by 0.9 percent q-o-q in Q1 2011, Japan’s real GDP shrank anew by 0.3 percent in Q2. Weak capital investments in the wake of the earthquake and tsunami in March as well as delays in the government’s rebuilding programs contributed to the decline. The IMF and the Bank of Japan (BOJ), however, reported that supply constraints have started to ease and that activity has started to rebound, with the IMF expecting Japan to contract by a lower magnitude of ½ percent this year.43

The seasonally-adjusted manufacturing PMI fell below the neutral 50 threshold to 49.3 in September, down from 51.9 in August and 52.1 in July. This signaled a

41 Eurostat news release 127/2011 dated 06 September 2011.
43 IMF. World Economic Outlook September 2011.
marginal contraction in manufacturing production owing to a decline in new export orders. Survey respondents in August noted that the recovery of the automobiles sector supported the improvement earlier in the quarter, while manufacturing and exports had been more subdued in September because of a stronger yen and weaker external demand, especially from China.

Headline inflation in August was unchanged from July at 0.2 percent. In a September 2011 statement, the BOJ noted that the rate of change in the CPI was expected to remain at around the same rate, but inflation could rise if commodity prices were to increase.

China’s real GDP grew by 9.5 percent y-o-y in Q2 2011, slightly down from 9.7 percent in Q1 2011. Investment remained the major source of growth, while the contribution of consumption declined somewhat compared with the previous quarter.

From 49.3 in July, the seasonally-adjusted manufacturing PMI for China held generally steady at 49.9 in August and September. Despite a slight deterioration in operating conditions, manufacturing output continued to grow in September, albeit at a marginal rate due to the subdued intake of new business and export orders. This would also suggest that recent credit tightening measures in light of heightened inflation pressures had started to dampen industrial activity.

Headline inflation eased to 6.2 percent in August from 6.5 percent in July. Inflationary pressures remained, given persistent increases in the prices of housing and property and food (including meat, poultry, and grains).

Domestic liquidity growth continued to decelerate in response to the further tightening of monetary policy. From 15.9 percent as of end-June and 17.6 percent in July 2010, M2 growth decelerated to 14.7 percent as of end-July 2011.

China tightened anew its policy stance in September 2011 by expanding the base used to calculate banks’ required reserves. Under the new rule, banks will have to include margin deposits (in addition to normal deposits) to comply with the requirement. The move followed the 25-bps hike in lending rates to 6.56 percent in July.

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Central banks continue to tighten policy settings amid rising upside risks to inflation.

Other central banks also tightened their monetary policy settings amid rising upside risks to inflation earlier in the quarter. In July, the ECB and the Bank of Thailand (BOT) raised their respective policy rates by 25 bps. BOT raised its policy rates by another 25 bps in August.

Similarly, after raising its policy rates by 50 bps in July, the Reserve Bank of India increased its repo and reverse repo rates in September by another 25 bps to 8.25 percent and 7.25 percent, respectively.
V. MONETARY POLICY DEVELOPMENTS

The Monetary Board decides to keep policy rates steady during the quarter.

BSP Policy Interest Rates
In percent

At the same time, the MB raises anew reserve requirements.

During its 28 July and 8 September monetary policy meetings, the MB decided to maintain policy interest rates at 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 the review quarter. The interest rates on term RRPs, RPs, and SDAs were also left unchanged.

The MB’s decision was based on its assessment that the inflation outlook remained favorable, indicating that policy settings during the quarter remained appropriate. Latest baseline forecasts showed inflation settling within the target range of 3-5 percent for 2011-2013 while inflation expectations remained firmly anchored, given easing commodity prices and manageable inflation outcomes. Domestic output growth also slowed down in the first half of 2011 as external demand weakened and public spending went below program.

Furthermore, the MB was of the view that risks to the inflation outlook may be receding, with global inflationary pressures expected to ease along with the slowdown in AEs. Food prices have also remained tame with favorable supply conditions in both domestic and international markets. The abating price pressures give monetary authorities sufficient room to keep policy rates on hold. A prudent pause in the policy stance would allow for a more careful assessment of inflation risks amid signs of sluggish global economic growth. Greater output uncertainty in the global economy implies weak external demand. The MB assessed that the current monetary policy settings in Q3 2011 remained in line with the need to safeguard price stability and support sustained economic growth.

At its 28 July 2011 policy meeting, the MB also kept policy rates steady, but decided to raise anew the reserve requirement on deposits and deposit substitute of all banks and non-banks with quasi-banking functions by one percentage point effective 5 August 2011. The MB’s decision to raise the reserve requirement was a preemptive move to better manage liquidity. The MB noted that bank lending, supported by the strong momentum of domestic economic activity and stable financial conditions, continued to grow at double-digit rates since January 2011. The MB also
believed that sustained foreign exchange inflows, driven by upbeat market sentiment over the brighter prospects for the Philippine economy, could fuel a further acceleration of domestic liquidity growth, which could pose risks to future inflation.
VI. INFLATION OUTLOOK

Private Sector Economists’ Inflation Forecasts

Mean inflation forecasts in the BSP’s survey of private economists exhibit mixed trends but remain within the target range.

Based on the results of the BSP’s survey of private economists for September 2011, inflation is expected to be within the 3-5 percent target range for both 2011 and 2012. The mean inflation forecast for 2011 eased to 4.5 percent in the third quarter compared to 4.7 percent in the previous quarter. Meanwhile, the mean inflation forecast for 2012 remained at 4.3 percent.45

Analysts noted that the recent easing of global commodity prices as well as expectations of slower global economic growth due to the euro zone’s continuing debt crisis and the weak US economy would dampen inflationary pressures going forward.

Based on the probability distribution on the forecasts provided by 10 out of 13 respondents, there is a 73.3 percent chance that average inflation for 2011 could settle 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 July-September 2011) for Philippine inflation were also lower and within the announced target range for 2011.

For Q4 2011 and Q1 2012, inflation is estimated to be at 4.5 percent and 4.0 percent, respectively.

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45 For Q4 2011 and Q1 2012, inflation is estimated to be at 4.5 percent and 4.0 percent, respectively.
Results of the BES for Q3 2011 show a smaller number of respondents anticipating inflation to increase in Q3-Q4 of 2011.

Likewise, results of the CES for Q3 2011 show that consumers expect a lower inflation over the next 12 months.

Relative to the previous survey, a smaller majority of respondents expect inflation to move up in the survey quarter (from a diffusion index of 38.7 percent to 32.1 percent) as well as in the next quarter (from 34.8 percent to 29.2 percent), reflecting in part the moderating global commodity prices.

Consumers also project inflation to decline over the next 12 months relative to the previous survey on expectations of more stable domestic prices. In particular, over the next 12 months, respondents anticipate inflation to drop to 8.5 percent from 10.4 percent in the previous survey round. Respondents expect lower inflation for the following items: transportation (from 17.6 percent to 14.0 percent); fuel (from 10.9 percent to 7.4 percent); education (from 11.5 percent to 8.6 percent); house rent (from 8.2 percent to 5.7 percent); and fruits and vegetables (from 15.2 percent to 12.8 percent). Using the diffusion index, the survey showed a smaller majority of respondents expecting increases in the prices of goods and services over the next 12 months: from 56.9 percent in Q2 2011 to 48.7 percent.
BSP Inflation Forecasts

Emerging baseline forecasts show that inflation could settle within the inflation target range over the policy horizon.

The emerging baseline forecasts point to average inflation settling within the government-announced target ranges for 2011-2013 of 4.0 percent ± 1.0 percentage point.\(^{46}\)

Compared to the previous quarter, the downward adjustment in the forecast path in Q3 2011 may be attributed to the lower-than-projected inflation outturns from June to September, easing of global oil prices, lower domestic output expansion and slower domestic liquidity growth. The slower money demand growth reflected the impact of recent policy actions by the BSP, including the 2 ppts increase in reserve requirements, to curb potential inflation pressures.

The risks to the inflation outlook appear slightly skewed to the downside. Concerns over the global economic recovery brought about by fiscal issues in the US and continuing distress in the euro area, represented key downside risks to inflation via its potential adverse impact on the pace of economic activity and commodity prices, particularly oil. At the same time, the peso strengthened further during the quarter, providing a stabilizing impact on costs of imported commodities.

Meanwhile, upside risks to inflation could come from the volatility of oil prices, large capital inflows, which can fuel excessive credit growth petitions for electricity rate adjustments, and the prospect of higher global rice prices.\(^{47}\)

Demand Conditions

The latest National Income Accounts (NIA) from the NSCB showed that the domestic economy continued to expand, albeit below expectations. 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 and spillovers from the slowdown in advanced economies.

Nonetheless, some bright spots remained in the domestic manufacturing sectors as capacity utilization remained above the 80 percent mark in August.

\(^{46}\) BSP models use the 2000-based CPI series to forecast inflation. Re-estimation of these models would commence once the historical series of the 2006-based CPI is released.

\(^{47}\) Thailand plans to raise the buying price of rice as part of the new administration’s plan to boost the government’s domestic support policy program.
Meanwhile, business and consumer confidence remained favorable as indicated by the BSP-conducted surveys. Responses from the business sector showed improved business sentiment in the current and upcoming quarter after slipping in Q2 2011. Strong domestic demand, owing to sustained inflow of OF remittances, and expectations of brisker business in the Christmas and harvest seasons are the reasons for the respondents’ bullish outlook in the second semester of year. On the other hand, household respondents remained upbeat based on the Q3 2011 survey but are more optimistic for the year ahead. Households’ brighter year-ahead outlook was boosted by expectations of stable prices, better employment opportunities, and increased salaries.

Supply Conditions

The agriculture sector registered a 7.1 percent growth in Q2 2011, reversing the 2.0 percent contraction recorded in the same quarter a year ago. The recovery of the sector was driven mainly by the strong growth of palay, corn and sugarcane, implying favorable supply conditions in the near term.

As of end-Q3 2011, the Food and Agriculture Organization (FAO) projected global cereal production in 2011 to reach 2.3 billion tons, 3.0 percent higher than its year-ago level. The expansion is due largely to expectations of improved wheat, rice and coarse grains productions. Despite the generally favorable outlook on grains production, the FAO warns that uncertainties on world food security may become more prevalent due to unpredictable weather conditions. Total cereal utilization is expected to increase in 2011/12 as food consumption is anticipated to keep pace with population growth. Meanwhile, cereal inventories are also forecasted to increase by close of seasons in 2012 due mainly to the projected build-up of world rice inventories.

In the energy market, oil prices have eased following the US credit rating downgrade in August. After reaching a high of US$116 per barrel in April, the price per barrel of oil fell to an average of US$106.3 in September. Looking ahead, world oil demand is expected to ease, broadly in line with the expected weakening of global economic activity. This could translate into lower demand-pull price pressure on oil prices. Nonetheless, supply-related factors continue to pose risks to oil prices. In particular, geopolitical uncertainties would continue to be a key risk factor in the global oil market given price-inelastic supply and
Output gap estimate narrows.

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 0.8 percent in Q2 2011, down from the 3.3 (revised) percent reported in the previous quarter. The lower output gap was due to the slower growth of actual output in Q2 2011 compared to the previous quarter, which also implied lower inflationary pressures over the short to medium term from domestic demand.

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 to 2013, which are consistent with the DBCC-approved estimates;
(b) BSP’s overnight RRP rate at 4.5 percent from June 2011 to December 2013;
(c) Dubai crude oil price assumptions, which are consistent with the futures prices of oil in the international market;
(d) Annual increase in nominal wage of 4.2 percent for 2012 and 4.1 percent for 2013;
(e) Real GDP growth, which is endogenously-determined in the BSP’s MEM; and
(f) 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 suggests that inflation could peak in the fourth quarter of 2011 before slowing down in 2012.

Slower global and domestic economic activity present downside risks to inflation while higher electricity rates and agricultural commodity prices remain as potential upside risks.

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 suggests that inflation could peak in the fourth quarter of 2011 before slowing down in 2012. Compared to the previous report, the latest fan chart presents a downward shift in 2011 and 2012 inflation. The lower 2011 and 2012 inflation path generated during the quarter incorporates the impact of lower-than-projected inflation outturns from June to September 2011. Moreover, the downward adjustment in the 2011 to 2012 inflation path could be traced primarily to slower global output growth and its corresponding impact on oil prices and domestic economic activity.

Similarly, initial forecasts for 2013 show that the central inflation projection could settle slightly above the low-end of the medium-term target range of 4.0 percent ± 1.0 percentage point.

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 the current price environment and risks to future inflation suggests that the balance of risks to the inflation outlook appears slightly skewed to the downside. This is reflected in the latest fan chart by the wider bands below the central projection than those above it. The downside risks to future inflation have intensified due to concerns over the strength of the global economy and its potential impact on domestic economic activity and the demand for petroleum products.

- The downside risks to global economic expansion have intensified. The IMF has identified the worsening of the debt crisis in the euro area and the downscaling of medium-term growth prospects in the US as primary perils that could have severe repercussions to the global economic environment. Consequently, slower growth in the world economy presents downside pressures on commodity prices. In particular, oil prices have already somewhat stabilized because of lower global demand. However, supply constraints and
geopolitical uncertainties continue to be key risk factors in the oil market.

- Demand-side price pressures could weaken as developments in the external sector dampen domestic economic activity.

- Despite recent episodes of volatility in the global currency markets, the country’s strong macroeconomic fundamentals together with sustained remittances could help stabilize the peso over the medium-term. In turn, the stable domestic currency represents downside risks to inflation as it helps reduce the cost of imported goods and services.

Meanwhile, there are also upside risks to the inflation outlook. Additional petitions for electricity rate adjustments pose additional risks to inflation. Finally, supply shocks in key agricultural commodities due to weather-related disruptions could trigger potential spikes in commodity prices.

- Additional petitions for power rate adjustments for the recovery of stranded contract cost and debts, recovery of transmission line repairs resulting from typhoons and theft, an increase in the universal charges for missionary electrification, and recovery of fuel and foreign exchange costs represent additional risks to future inflation as these are not yet included in the baseline forecasts.

- Food prices remain as upside risk on inflation with no signs of moderation in demand from emerging economies and no significant additions to global inventory buffers. Supply shocks in key agricultural commodities, both in the domestic and global fronts, are sources of uncertainty on food prices. The damages from the weather-related disturbances in the Philippines and other Southeast Asian nations could constrain supply and put transitory upward pressure on rice prices in the near-term.
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. Lastly, the lightest band covers the lower and upper 90 percent of the probability distribution. The bands widen (i.e., “fan out”) as the time frame is extended, indicating increasing uncertainty about outcomes. The band in wire mesh depicts the inflation profile as of Q2 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 sum of new information points to the appropriateness of current policy settings...

...with inflation pressures moderating.

Demand-based price pressures are also expected to moderate amid increasing downside risks to global recovery.

Nevertheless, domestic demand remains buoyant, indicating the need to maintain a prudent policy stance.

Meanwhile, risks to the inflation outlook have receded given the significantly more uncertain international growth outlook. Price pressures are expected to ease in the near term as global inflationary pressures are likely to be held back by a stalled global economic recovery. Conditions in global financial markets have also become highly unsettled given interlocking sovereign debt and banking concerns in Europe and the prospects of a delayed economic recovery in the US. As a result, demand-side factors driving global commodity prices have abated, easing constraints on monetary policy. Given downward pressures on oil prices, risks to domestic inflation have likewise declined. Imported inflationary pressures are also expected to be tempered by the relative stability of the peso.

Renewed uncertainty over the strength and pace of the global economic recovery could pose downside risk to the domestic economy. As a result, the expected moderation in external demand could reduce aggregate demand-side price pressures over the short term.

With demand-pull pressures expected to ease on prospects of slower output growth both globally and in the domestic economy, there is scope for the BSP to pause and assess further the outlook for inflation and growth as new information becomes available from the domestic and international fronts. Given manageable inflation environment, the current settings of monetary policy are considered to be well placed to respond to evolving global and domestic economic conditions.

Domestic demand appears to be intact as evident in the fairly strong expansion in bank lending activities as well as in private spending. While the near-term growth outlook is somewhat weaker, the medium-term outlook remains favorable, provided that the world economic outlook does not deteriorate further. Growth in monetary aggregates and bank lending also
continues to be firm, confirming the ample liquidity in the system. While initial assessment suggests that there should be no immediate concern for the recent uptrend in bank lending growth, such a condition requires the maintenance of a prudent monetary policy stance to contain any upward pressures on asset prices. Authorities are also mindful of the remaining upside risks to inflation, including the potential impact of strong net capital inflows on domestic liquidity, pending petitions for electricity rate adjustments, and possible higher global rice prices. The BSP, therefore, remains watchful over evolving price and output conditions both on the global and domestic fronts, to ensure that monetary policy settings remain appropriate.
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.

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