

THE BSP AND PRICE STABILITY

1. *What is inflation?*

Inflation refers to the rate of change in the average prices of goods and services typically purchased by consumers. If inflation is low and stable, then we say that there is price stability.

Inflation is typically defined as the annual percentage change in the Consumer Price Index (CPI). The CPI represents the average price of a standard basket of goods and services consumed by a typical Filipino family for a given period. This standard basket contains hundreds of consumption items (such as food products, clothing, water and electricity) whose price movements are monitored to determine the change in the CPI, or the level of inflation.

The National Statistics Office (NSO) calculates and announces the monthly CPI and the rate of inflation based on a nationwide monthly survey of prices for a given basket of commodities. The NSO also determines the composition of the CPI basket through surveys that are conducted periodically.

2. *Why do we want price stability?*

Studies based on the experience of many countries have shown that price stability supports growth because it allows households and businesses (including export enterprises) to plan ahead and arrive at better informed decisions relative to their consumption, investment, savings and production needs. In the case of export firms, price stability allows them to price their products competitively, reducing the risks related to the rising cost of raw materials.

Price stability also promotes income equality by protecting the purchasing power of the poor who do not have adequate assets (real or financial) that serve as a hedge against inflation.

The growing consensus in recent years among most economists and policymakers is that the primary objective of central banks should be to achieve price stability. As a result, in the past decade or so, a growing number of countries have granted institutional independence to their central banks and, by law, committed the latter's monetary policy to achieving price stability.

3. *Why is the BSP the main government agency responsible for promoting price stability?*

Among the various government bodies, the Bangko Sentral ng Pilipinas (BSP) is uniquely qualified to promote price stability because it has the sole ability to

influence the amount of money circulating in the economy. By controlling the supply of money, the BSP is able to exert some influence on the prices of goods and services.

In addition, as the Philippines' central monetary authority, the BSP is tasked to promote price stability conducive to balanced and sustainable economic growth. This is mandated by law under the provisions of Republic Act No. 7653, also known as the New Central Bank Act, which was passed into law on 10 June 1993. Achieving price stability is a universal goal shared by central banks and monetary authorities all over the world.

This does not mean, however, that the BSP pursues price stability to the exclusion of other objectives. Although the price stability objective is the BSP's main priority, other economic goals—such as promoting financial stability and achieving broad-based, sustainable economic growth—are given consideration in policy decision-making. Thus, the BSP coordinates with other government agencies to make sure that its policies are part of a consistent and coherent overall policy framework.

4. *What is the BSP's role in relation to inflation?*

The BSP controls inflation by influencing, through monetary policy, the supply of money circulating in the economy. The level of money supply affects the overall demand for goods and services in the economy. This, together with the aggregate supply of goods and services, determines the level of prices.

One of the main causes of inflation is excessive liquidity, or a situation when there is too much money supply relative to the supply of goods and services. Allowing more money to circulate induces people to increase their demand for goods and services. If this increased demand is not matched by higher production, prices are bid up. Conversely, too little money to support consumption and investment tends to reduce the demand for goods and services. Given the same level of supply, lower demand for goods and services causes prices to fall.¹

The BSP has the ability to influence money supply, thereby enabling it to influence the movement in the prices of goods and services. However, the BSP does not have absolute influence over inflation. There are other important factors affecting consumer prices apart from money supply. Some examples are weather disturbances that affect agricultural production, and movements in world oil prices.

¹ This relationship is based on the Quantity Theory of Money (QTM). The QTM states that the total amount received by sellers of output [as measured by the volume of goods and services produced (Q)] multiplied by the price (P) is equal to the total amount spent by purchasers of output [defined as the stock of money supply (M)] multiplied by the velocity of money or the number of times the stock of money is turned over during a given period to finance spending on final goods and services (V), i.e., $P \times Q = M \times V$. Assuming that the velocity of money and the level of production are stable, an increase in money supply would lead to an increase in prices.

These factors cannot be controlled by monetary policy and are, therefore, outside the influence of the BSP.

MONETARY POLICY AND ITS CURRENT FRAMEWORK

5. *What is monetary policy?*

Measures or actions taken by the central bank to regulate the supply of money in the economy constitute what is called monetary policy. Monetary policy actions of the BSP are aimed at influencing the timing, cost and availability of money and credit, as well as other financial factors, for the purpose of stabilizing the price level.

If the BSP believes that money supply is in excess of a desired level, then it can take action to reduce the money supply. This is referred to as contractionary monetary policy. On the other hand, if—based on the BSP’s assessment—the liquidity situation is tight and there is a need to increase money supply, it implements an expansionary monetary policy.

6. *How does the BSP implement monetary policy?*

The BSP implements monetary policy using various instruments to achieve the inflation target set by the National Government.

To contract or expand liquidity in the financial system, the BSP can do any or a combination of the following actions:

- raising/reducing the BSP's policy interest rates;
- increasing/decreasing the reserve requirement;
- encouraging/discouraging deposits in the special deposit account (SDA) facility by banks and trust entities of BSP-supervised financial institutions;
- increasing/decreasing the rediscount rate on loans extended by the BSP to banking institutions on a short-term basis against eligible collaterals of banks' borrowers; and
- outright sales/purchases of the BSP's holdings of government securities.

The BSP's primary monetary policy instruments are its overnight reverse repurchase (borrowing) rate and overnight repurchase (lending) rate.

7. *What is the basic approach to monetary policy in the Philippines?*

In the past, the BSP followed the monetary aggregate targeting approach to monetary policy. This approach is based on the assumption that there is a stable and predictable relationship between money on the one hand, and output and

inflation on the other hand. This means that changes in money supply (on the assumption that velocity is stable over time) are directly related to price changes or to inflation. Thus, it is assumed that the BSP is able to determine the level of money supply that is needed given the desired level of inflation that is consistent with the economy's growth objective. In effect, under the monetary targeting framework, the BSP controls inflation indirectly by targeting money supply.

This approach was modified beginning in the second semester of 1995 under the modified form of monetary targeting to put greater emphasis on price stability instead of rigidly observing the targets set for monetary aggregates. In addition, monetary authorities wanted to address one of the pitfalls of monetary targeting, i.e., it does not account for the long and variable time lag in the effects of monetary policy on the economy. Under the modified framework, the BSP can exceed the monetary targets as long as the actual inflation rate is kept within program levels. Under this modified approach, policymakers monitor a larger set of economic variables in making decisions regarding the appropriate stance of monetary policy. This includes movements in key interest rates, the exchange rate, domestic credit and equity prices, indicators of demand and supply, and external economic conditions, among other variables.

THE SHIFT TO INFLATION TARGETING

8. *What is inflation targeting?*

On 24 January 2000, the BSP's policy-making body, the Monetary Board, approved in principle the shift to inflation targeting as a framework for conducting monetary policy. Inflation targeting focuses mainly on achieving price stability as the ultimate objective of monetary policy. This approach involves the announcement of an explicit inflation target that the central bank promises to achieve over a given time period. The target inflation rate is set and announced jointly by the BSP and the government through an inter-agency body. Although the responsibility of achieving the target rests primarily with the BSP, this joint announcement reflects active government participation in achieving the goal of price stability and government ownership of the inflation target.

The BSP formally adopted inflation targeting as the framework for monetary policy in January 2002. The Philippines joined a long list of inflation targeters such as Australia, Canada, Finland, Sweden, New Zealand, the United Kingdom, Israel, Brazil, Chile and Thailand, which have moved from high inflation to low inflation following the successful implementation of inflation targeting in their countries.

9. *What are the features of inflation targeting?*

Over the past two decades, financial deregulation and liberalization resulted in the introduction of new products and changes in the structure of the financial system.

The said changes, however, appeared to have weakened the traditional relationship linking money supply to income and prices. This has prompted many central banks, including the BSP, to review their approach to monetary policy.

Like other central banks, the BSP recognized the important features of inflation targeting as follows:

- simple framework which can, therefore, be easily understood by the public;
- allows greater focus on the goal of price stability, which is the primary mandate of the BSP;
- forward-looking and recognizes that monetary policy actions affect inflation with a lag;
- reflects a comprehensive approach to policy by taking into consideration the widest set of available information about the economy;
- promotes transparency in the conduct of monetary policy through the announcement of targets and the reporting of measures that the BSP will adopt to attain these targets, as well as the outcomes of its policy decisions;
- increases the accountability of monetary authorities to the inflation objective since the announced inflation target serves as a yardstick for the performance of the BSP, and thus helps build its credibility; and
- does not depend on the assumption of a stable relationship between money, output and prices, and can still be implemented even when there are shocks that could weaken the relationship.

10. *What are the requirements for the successful adoption of inflation targeting?*

The success of implementing inflation targeting as the framework for monetary policy depends on the following preconditions that complement and reinforce each other:

- Firm commitment to price stability. The primary objective of the central bank is to maintain price stability that is conducive to a balanced and sustainable economic growth. As such, the central bank should not be bound by multiple objectives such as financing the government's deficit, keeping the exchange rate at a given level, or other policy agenda of the government unless these are necessary to achieve the goals of price stability.
- Central bank independence. The central bank must be able to conduct monetary policy without political interference. It must be able to use whatever monetary policy instrument is needed to achieve price stability. The central bank should also have fiscal independence, i.e., it must not be constrained by the need to finance the fiscal deficit.
- Good forecasting ability. The central bank should have a good statistical model for forecasting inflation.

- **Transparency.** The central bank should promote transparency by communicating clearly to the public its policy actions and the reasons behind them.
- **Accountability.** There should be accountability on the part of the central bank should actual inflation deviate from the target.
- **Sound financial system.** The financial system should be fundamentally sound to make monetary policy more effective in influencing output and prices. The financial system acts as the intermediary by which the BSP influences the supply of money and credit in the economy.

11. Does the Philippines satisfy all the requirements of inflation targeting?

As the table below suggests, the basic requirements for the successful adoption of inflation targeting are already in place in the Philippines.

Requirements for the Adoption of Inflation Targeting	Is it in place in the Philippines?
Central Bank independence	Yes, the law provides fiscal and administrative independence to the BSP as the central monetary authority.
Central Bank commitment	Yes, the law mandates that the BSP should be concerned primarily with maintaining price stability.
Good forecasting ability	Inflation forecasting models are continuously being improved; these are supplemented by judgment and discretion given available economic and financial indicators.
Transparency	In addition to existing reports and publications, the BSP also publishes the Inflation Report and the minutes of relevant Monetary Board discussions on monetary policy (with a lag).
Accountability	The BSP stands firmly behind the inflation target and, should there be any deviations, explains the reasons to the public and higher authorities.
Sound financial system	The financial system is constantly developing, partly in view of the measures implemented by supervisory authorities to strengthen it.

12. How is inflation targeting actually done?

Under inflation targeting, the central bank publicly announces a target for inflation and promises to achieve this over a specified time period. The central bank then compares actual headline inflation against its inflation forecasts. The central bank uses the various monetary policy instruments at its disposal to achieve the inflation target. In the case of the Philippines, this involves mainly adjustments in the key policy interest rates of the BSP. Other instruments are also used, which include rediscounting and reserve requirement. The central bank also provides regular reports explaining its policy decisions and containing its assessment of the inflation environment and outlook.

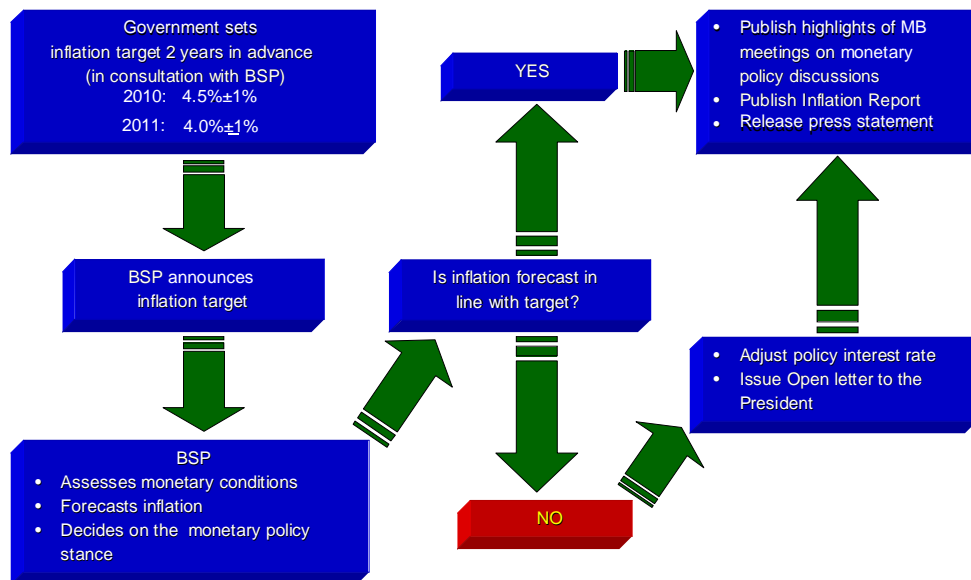
If the central bank fails to meet the inflation target, it is required to explain to the public why the target was not achieved and to come up with measures on how to steer inflation towards the target level.

MAKING INFLATION TARGETING OPERATIONAL IN THE PHILIPPINES

13. What is the process involved in making inflation targeting operational?

The BSP has been observing the following operational guidelines since its implementation of inflation targeting in 2002.

INFLATION TARGETING FRAMEWORK



- Setting of the inflation target. The target-setting process is largely based on the existing framework for coordination among government economic agencies under the Development Budget Coordinating Committee (DBCC), an inter-agency body responsible for setting the annual government targets for macroeconomic variables, particularly the Gross National Product (GNP) and Gross Domestic Product (GDP) growth rates and inflation, which are important inputs in the formulation of the revenue, expenditure and financing programs of the National Government. The National Government, through the DBCC, sets the inflation target two years ahead in consultation with the BSP. The public announcement of the inflation target is made by the BSP Governor, and it is the BSP's responsibility to conduct monetary policy in order to achieve the target.

When the BSP adopted the inflation targeting framework in 2002, the inflation target was defined in terms of a range (for example, the target range for 2006 was 4-5 percent). In 2006, the Government's inflation target was respecified from a range target to a point target with a tolerance interval of ± 1 percentage point starting in the target for 2008. The inflation target is 4.5 percent ± 1 percentage point (or a range equivalent to 3.5-5.5 percent) for 2010 and 4.0 percent ± 1 percentage point (or a range equivalent to 3-5 percent) for 2011. On 15 July 2010, the Monetary Board announced the BSP's shift to a fixed inflation target for the medium term of 4 ± 1 percent for 2012-2014. The shift to a fixed medium-term inflation target from a variable annual inflation target was approved by the DBCC on 9 July 2010 under DBCC Resolution No. 2010-3.

This shift from a range target to a point target with a tolerance interval effectively widens the BSP's target band. A broader target band is seen to provide added flexibility to monetary authorities in steering inflation. It helps ensure that the design of the inflation target is more consistent with the country's economic circumstances, and safeguards the credibility of the inflation targeting framework. It also helps align monetary policy practices in the Philippines with those in other inflation targeting countries.

Under the inflation targeting framework, there is a need to distinguish between the inflation target and the inflation forecast. The inflation target represents policymakers' desired inflation rate, which they commit to achieve over the policy horizon (which is two years in the Philippine case). Inflation targets, because of their institutional nature, tend to be less susceptible to revisions—although countries with a history of high inflation tend to set a decelerating path for inflation targets across a period of several years. The inflation forecast, meanwhile, represents the expectation or prediction of the inflation rate over the policy horizon, given information currently available. The inflation forecast changes over time, as important new information is incorporated in the assessment of future inflation. The forecast is a major factor considered by monetary authorities when deciding on whether monetary policy instruments should be adjusted to attain the inflation target.

- Measure of inflation. The BSP uses the rate of change in the CPI in expressing its target for monetary policy. Also known as the “headline” inflation rate, the rate of change in the CPI is a commonly used and widely known measure of inflation. It is also monitored by an independent statistical agency namely, the NSO, thereby ensuring data integrity, and is announced to the public with a relatively short time lag. The CPI itself represents the average price of a standard “basket” of goods and services consumed by a typical family. In the Philippines, this CPI is composed of various consumer items as determined by the nationwide Family Income and Expenditure Survey (FIES) conducted every six years by the NSO.

In conducting monetary policy, the BSP also monitors what is known as “core” inflation. A common observation with CPI inflation is that, historically, it tends to be affected by the transitory effects of volatile price movements of certain commodities found in the CPI. Temporary shocks or disturbances in certain areas of the economy, often due to factors outside the direct control of economic policy (e.g., oil price shocks), may cause fluctuations in the CPI inflation that may not necessarily require a monetary response. By eliminating the impact of such disturbances on price data, core or underlying inflation serves as a useful alternative indicator of the path of inflation. The NSO definition of core inflation is computed by excluding selected unprocessed food and energy-related items from the CPI.

- Models for inflation forecasting. The BSP uses quantitative models to forecast the monthly inflation rate up to a period of two years. Statistical tests indicate that these models track the actual inflation rate reasonably well. The BSP is in the process of refining its macroeconomic inflation forecasting model (using annual data) that is capable of projecting the inflation rate further into the future.
- Meetings on monetary policy. Starting in 2012, the Monetary Board will hold eight (8) monetary policy meetings a year to discuss and decide on the appropriate monetary policy stance of the BSP in order to keep inflation within the target. Based on the assessment of the macroeconomic environment and the price situation of commodities, the Monetary Board takes the necessary actions consistent with the chosen monetary policy stance. These actions consist of the various instruments discussed in Item No. 6. The decisions of the Monetary Board concerning monetary policy are determined by a majority vote. No attribution of votes to individual Board members is made in order to emphasize the collegial, consensus-based nature of the decision-making process.

To strengthen the decision-making process, the Monetary Board of the BSP receives recommendations from the Advisory Committee (AC), a technical body which meets regularly a few days prior to each MB monetary policy meeting. The Advisory Committee is composed of the following members: (1) the BSP Governor, who serves as Chairman; (2) the Deputy Governor for Monetary

Stability; (3) the Deputy Governor for Supervision and Examination; (4) the Assistant Governor of the Monetary Policy Sub-Sector; and (5) the Assistant Governor of the Treasury Department. The meetings of the AC are intended to serve as a forum for in-depth, comprehensive, broad-ranging and balanced assessment of monetary conditions, the economic outlook, inflationary expectations and the forecast inflation path. The AC members agree by majority vote on a set of recommendations that are then submitted to the Monetary Board.

- Transparency and accountability mechanism. The BSP has a number of disclosure and reporting mechanisms to help the public monitor better its commitment to achieving the inflation target. In addition to various reports and publications, the BSP publishes the Quarterly Inflation Report and the Highlights of the Meeting of the Monetary Board on Monetary Policy. The BSP also holds regular seminars and conferences involving the discussion of monetary developments and policy issues.

To ensure accountability in cases where the BSP fails to achieve the inflation target, the BSP Governor issues an Open Letter to the President outlining the reasons why actual inflation did not fall within the target, along with the steps that will be taken to bring inflation towards the target. Open Letters to the President have been issued on 16 January 2004, 18 January 2005, 25 January 2006, 19 January 2007, 14 January 2008, and 26 January 2009.

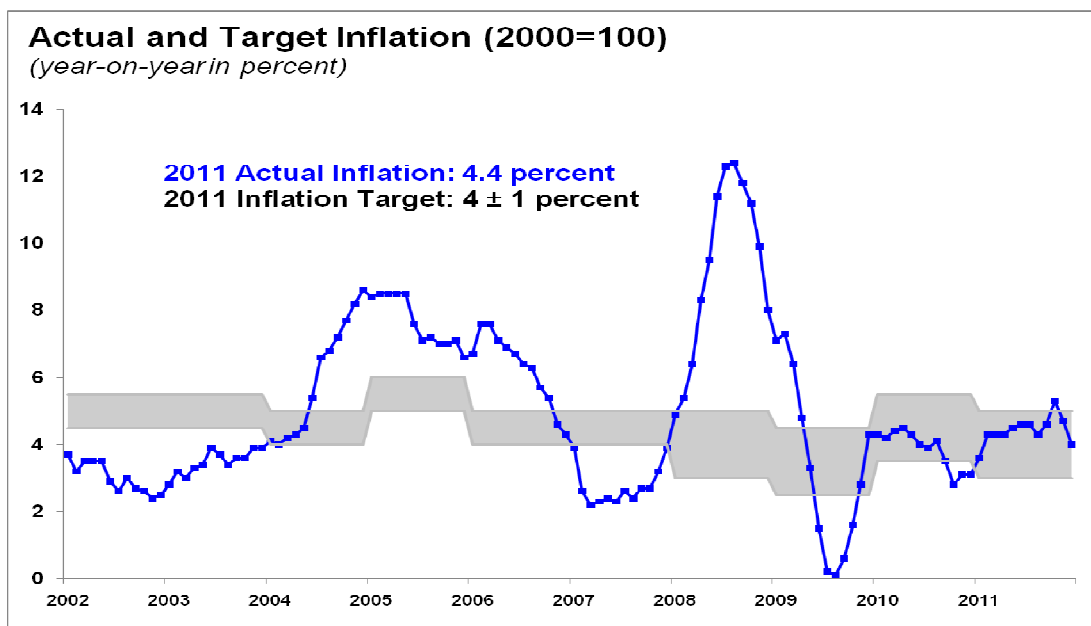
- Explanation clauses, or exemptions to the inflation target. Explanation clauses refer to the predefined set of acceptable circumstances under which an inflation-targeting central bank like the BSP may fail to achieve its inflation target. Such exemptions recognize the fact that there are limits to the effectiveness of monetary policy and that deviations from the inflation target may sometimes occur because of factors beyond the control of the central bank. Under the inflation-targeting framework of the BSP, these exemptions include price pressures arising from: (1) volatility in the prices of agricultural products; (2) natural calamities or events that affect a major part of the economy; (3) volatility in the prices of oil products; (4) significant government policy changes that directly affect prices such as changes in the tax structure, incentives and subsidies. In using explanation clauses, the BSP will have to explain carefully and clearly to the public how these factors resulted in the deviation of the inflation outcome from the target. It will also describe the actions to be taken and the length of time involved to achieve the inflation target.

14. *Since the BSP adopted inflation targeting, have the targets met actual inflation?*

In 2009, year-on-year headline inflation averaged 3.2 percent, well within the National Government's target range of 2.5-4.5 percent for the year. Likewise,

headline inflation in 2010 averaged at 3.8 percent, well within the target range of 3.5-5.5 percent for the year. In 2011, headline inflation [computed using the 2000-based Consumer Price Index (CPI) series] averaged at 4.4 percent, within the announced Government target of 3.0-5.0 percent. Meanwhile, the new 2006-based CPI series released by the NSO—which was derived using an updated consumer basket of goods and services—showed a higher 2011 average inflation of 4.8 percent but also remained within the Government's target range.

The matrix below summarizes the inflation developments since the BSP shifted to inflation targeting framework, indicating among others, the actual inflation compared to the target.



Inflation Developments, 2002 – 2010

Year	Actual Inflation (in percent)	Inflation Target (in percent)¹	Actual vs Target	Developments/Factors affecting inflation
2002	2.9	4.5-5.5	Lower	<ul style="list-style-type: none"> • Slowdown in food inflation and subdued demand-pull inflationary pressures
2003	3.0	4.5-5.5	Lower	<ul style="list-style-type: none"> • Absence of significant demand-driven pressures with the continued soft spots in overall demand, soft labor market conditions, and moderate capacity utilization in industries such as manufacturing • Easing cost-push inflationary pressures with the abatement of the El Niño phenomenon and the downtrend in international oil prices
2004	5.5	4.0-5.0	Higher	<ul style="list-style-type: none"> • Supply-side shocks including the increase in global oil prices (which led to higher domestic pump prices of petroleum products and hikes in transport fares) as well as the spate of typhoons and domestic supply constraints affecting the availability of certain food products • Higher meat prices linked to the recurrence of avian flu in other countries
2005	7.6	5.0-6.0	Higher	<ul style="list-style-type: none"> • Continued rise in consumer prices particularly those for food, energy, and transportation • Global increase in oil prices leading to higher domestic pump prices, adjustments in minimum wage throughout the country, as well as hikes in the transport fares and utility charges • Adverse effect of El Niño dry weather on agricultural output, especially on rice and corn production

2006	6.2	4.0-5.0	Higher	<ul style="list-style-type: none"> • Higher world oil prices, the two-percentage point increase in the VAT, and the removal of certain VAT exemptions in 2005
2007	2.8	4.0-5.0	Lower	<ul style="list-style-type: none"> • Generally stable prices for major food items, favorable supply conditions, particularly the sustained growth in agriculture, and the subsiding base effect of the RVAT on CPI • Firm peso tempering the impact on domestic prices of increasing global commodity prices, including food and oil, which rose during the latter part of the year
2008	9.3	4.0±1	Higher	<ul style="list-style-type: none"> • Confluence of global and supply-side factors beyond the direct control of the BSP such as the big surge in the international prices of oil and food commodities, resulting in higher domestic rice and pump prices of fuel • Supply shocks over a longer period, which contributed to second-round effects, affected wage and price-setting behavior of businesses and households; inflation expectations also rose
2009	3.2	3.5±1	Within	<ul style="list-style-type: none"> • Slowdown in inflationary pressures during the early until the middle part of the year owing to lower oil and other commodity prices due, in large part, to subdued demand conditions • Slight uptick in consumer prices towards the latter part of the year, particularly those for food and petroleum products, due to weather disturbances and lifting of price cap on petroleum products

2010	3.8	4.5±1	Within	<ul style="list-style-type: none"> • Food inflation was lower especially in the first half of the year as domestic supply recovered from the impact of the previous year's typhoons. It posted an uptick in the third quarter as prices of agricultural commodities went up; in particular, sugar prices increased as El Niño affected the harvest and delayed the milling season. • This was more than offset by higher non-food inflation which can be traced to the surge in the prices of electricity and petroleum products.
2011	4.4	4.0±1	Within	<ul style="list-style-type: none"> • Food inflation was generally stable as ample supply in the aftermath of typhoons tempered the price increases, despite supply shocks triggered by weather-related factors which resulted in production disruptions and agricultural damages thus initially pushing food inflation higher. • Meanwhile, non-food inflation trended upwards during the year as domestic prices of petroleum crude tracked the movement in the international market. Adjustments in electricity and water rates also contributed to the increase.
<p>* For 2002-2004, actual inflation figures used 1994 as the base year whereas inflation data for 2005-2011 used 2000 as the base year.</p> <p>¹ Annual targets</p> <p>^r revised</p>				