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## **Economic Focus**

### **December inflation accelerates on fuel prices**

#### **Eight-month high**

Headline consumer inflation picked up to 4.4% Y/Y in December after rising to 2.8% in November. The sharp increase was due primarily to the upsurge in world fuel prices that was reflected in domestic retail prices. As a result, inflation in fuel, light and water shot up to 7.6% having come from deflation of 1.1% the previous month. The increase in services inflation to 3.5% from 0.2% was due to the same cause. As for food inflation, which had been responsible for headline inflation accelerating in recent months, it rose to 5.2% from 4.8%. Other details are seen in Figure 1.

#### **Higher global fuel prices, end of domestic price freeze cause surge**

Prices of various kinds of fuel were adjusted in response to rising world prices, including gasoline, diesel, kerosene and LPG. Kerosene and LPG are components of the fuel, light and water index while gasoline and diesel form part of the services index. In addition to higher world fuel prices, domestic prices were jacked up after lifting of a temporary price freeze imposed in response to several strong typhoons in September and October. Consequently, the two sub-indexes contributed bulk of the increase in headline inflation between November and December.

#### **Better supply flattening out food inflation**

Food inflation in comparison has started to flatten out, as illustrated in Figure 2. The increase in December to 5.2% from 4.8% in November is less than that from October to November. This is largely because damage to food supplies and supply chains from the strong typhoons in September and October is now being mitigated. It is especially visible in slowing inflation for fruits and vegetables, and to a lesser extent, rice, two items that contributed much to rising inflation in October and November.

#### **2010 inflation, interest rates will increase**

Different from last year's general trend of declining inflation, we expect inflation this year will accelerate. The drivers will be higher commodity prices as a result of a firmer global economic recovery and stronger domestic demand. However, we expect these inflationary pressures to be tempered by excess domestic capacity due to weak economic growth in 2009 and peso appreciation. From an average headline inflation rate of 3.3% in 2009, we expect inflation to increase to 4.2% this year. Higher inflation means the next move for the central bank is a tightening of monetary policy. But it is expected to be gradual and take place in 2H, when there are more signs the economy is strengthening. We believe the policy rate will increase 75 bps to 4.75% by yearend.

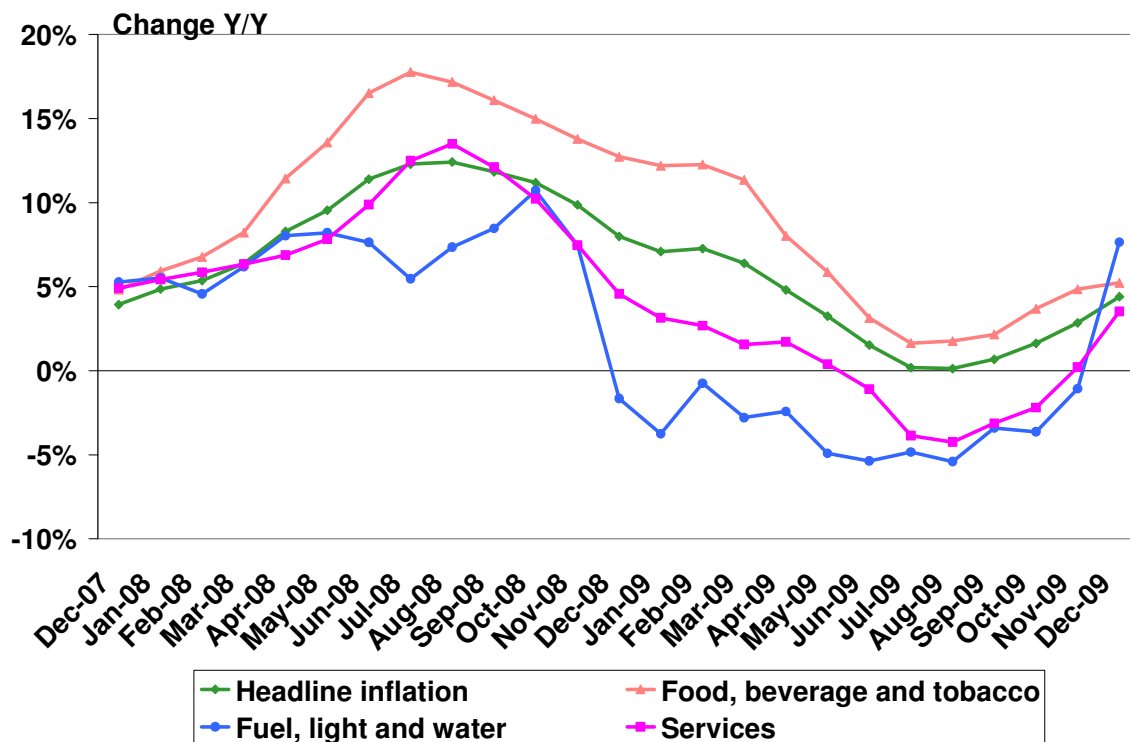
**SEE APPENDIX I FOR IMPORTANT DISCLOSURES AND ANALYST CERTIFICATIONS**

**Figure 1. Higher fuel prices drive up December inflation**

	%Y/Y (2000=100) not seasonally adjusted										Weight (%)
	4Q08	2008	1Q09	2Q09	3Q09	4Q09	Oct-09	Nov-09	Dec-09	2009	
Headline inflation	9.7	9.3	6.9	3.2	0.3	3.0	1.6	2.8	4.4	3.3	100.0
Food, beverage & tobacco	13.8	12.9	11.9	5.6	1.9	4.6	3.7	4.8	5.2	5.9	50.0
Clothing	5.0	4.2	3.5	2.6	2.2	2.0	2.0	2.1	2.0	2.6	3.0
Housing & repairs	5.3	4.3	4.1	3.0	2.2	2.1	2.1	2.1	2.1	2.8	16.8
Fuel, light & water	5.4	6.5	-2.4	-4.2	-4.5	0.8	-3.6	-1.1	7.6	-2.6	6.9
Services	7.4	8.6	2.5	0.3	-3.7	0.5	-2.2	0.2	3.5	-0.2	15.9
Miscellaneous	3.8	3.0	3.3	2.9	2.3	1.9	2.0	1.9	1.8	2.6	7.5
Core inflation	7.7	6.2	6.3	4.4	3.1	2.9	2.7	2.7	3.2	4.1	

Sources: National Statistics Office, CEIC and Kim Eng Securities

**Figure 2. Food inflation flattening out**



Sources: National Statistics Office, CEIC and Kim Eng Securities

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