HIGHLIGHTS OF THE MEETING OF THE MONETARY BOARD ON MONETARY POLICY ISSUES HELD ON 25 AUGUST 2005*

The Advisory Committee[1] submitted the following recommendations for the consideration of the Monetary Board:

1) Maintain the current monetary policy settings as follows:

   (a) Maintain the BSP's policy interest rates at 7.0 percent for the overnight RRP (borrowing) rate and 9.25 percent for the overnight RP (lending) rate; and

   (b) Maintain the current interest rates on term RRPs, RPs, and SDAs.

2) Maintain the current reserve requirement ratios;

3) Continue to articulate support for the intensified use of non-monetary measures to address supply-side risks, particularly those relating to food supply, by strengthening representation and coordination with various government agencies; and

4) Intensify the BSP's public information campaign with greater focus on the dynamics and sources of price pressures in order to help guide inflationary expectations.

I. Key Considerations in the Formulation of the Monetary Policy Stance

The Advisory Committee's recommendations were based on the following considerations:

- Headline inflation eased further in July 2005 to 7.1 percent from 7.6 percent in the previous month as most commodity groups registered slower price increases. Inflation for the first seven months of the year averaged 8.2 percent. Likewise, core inflation continued to decelerate in July.

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* The highlights of the discussions of the 25 August 2005 Monetary Board meeting were approved by the Monetary Board during its meeting held on 22 September 2005.

[1] The Advisory Committee is composed of the Governor of the BSP as Chairman and four members, namely: the Deputy Governor for the Monetary Stability Sector, the Deputy Governor for Supervision and Examination Sector, the Managing Director of the Treasury Department, and the Director of the Department of Economic Research.

- The ongoing pressures on consumer prices continue to be linked mainly to oil and energy-related prices. In terms of contribution to year-on-year inflation, food accounted for 2.7 percentage points of the 7.1 percent inflation in July; fuel, light and water, 1.3 percentage points; and services, 1.6 percentage points (of which transport and communication accounted for 1.1 percentage points).

- The continued deceleration in both headline and core inflation is in accord with the BSP's expectations of easing inflation pressures in the second half of the year. Nevertheless, there are risks to future inflation. Volatility in international oil prices and its feed-through impact on domestic prices of goods and services continue to be the dominant risk factor in the outlook for inflation.

- Selected indicators suggest a moderation in the pace of economic activity.

  - Average capacity utilization in manufacturing rose slightly to 80.1 percent in May 2005 from the revised rate of 80.0 percent in the previous month.

  - The value of production index (VAPI) for manufacturing rose by 12.9 percent year-on-year in May, lower than the revised April growth rate of 14.2 percent. However, year-on-year growth in volume of production index (VOPI) for manufacturing was 5.4 percent in May, up from the revised growth rate of 3.1 percent in April.

  - Preliminary data show that merchandise exports rose slightly by 1.0 percent year-on-year in June, marginally higher than the previous month's 0.9 percent. The weak export performance in June was due largely to the decline in electronics exports, which accounted for 64.8 percent of total export revenues.

  - The year-on-year growth in merchandise imports slowed down to 2.7 percent in May from 6.5 percent in the previous month.

  - The country's major corporations posted generally strong revenue growth in the first half of 2005. For some firms, however, growth in net income was capped by higher costs of financing, raw materials, distribution, and utilities.

  - The year-on-year growth in passenger car sales fell to 2.8 percent in July 2005 from 22.7 percent in the previous month, according to the Chamber of Automotive Manufacturers of the Philippines, Inc.

  - Energy sales by the Manila Electric Company grew at a faster pace of 5.2 percent year-on-year in June 2005 from 0.6 percent in the previous month. This was still lower than the 6.8 percent rise in June 2004.

- The unemployment rate declined to 12.9 percent in April 2005 from 13.7 percent a year ago, but rose from 11.3 percent in January 2005. Using the new definition of unemployment, it declined to 8.3 percent in April 2005 from an estimated 8.9 percent a year ago.[2]

- The third quarter 2005 BSP Business Expectations Survey showed that business optimism in the third quarter declined, but firms expect conditions to improve in the fourth quarter. The latest Consumer Expectations Survey showed weaker consumer outlook for the third and fourth quarters of 2005.

- The composite leading economic indicator of the National Statistical Coordination Board (NSCB) rose to 0.081 in the third quarter of 2005 from 0.072 in the second quarter.

• The volatility in global oil prices is expected to continue to exert a central influence on the inflation outlook.

- Agriculture output grew by 1.3 percent in the first half of 2005, lower than the 6.4 percent recorded a year ago as the El Niño-induced drought affected adversely the production of major crops such as rice and corn.

- World oil prices continued to rise in August 2005 as news of possible supply shortages arising from refinery outages in the US aggravated concerns of sustained tightness in the market. In addition, uncertainty over the severity and location of the expected hurricanes during the August-September storm season added pressures in the oil futures market. In the domestic market, retail oil prices continued to rise, reflecting the successive increases in world oil prices.

• In the financial sector, the growth in domestic liquidity accelerated while bank lending continued to expand at a moderate pace. Meanwhile, Treasury bill (T-bill) rates were generally higher during the 15 August 2005 compared to their levels in the previous month and the previous week.

- Based on preliminary data, the growth in domestic liquidity (M3) accelerated to 12.8 percent year-on-year in June 2005, based on

[2] Starting April 2005, the new Labor Force Survey (LFS) questionnaire was used to estimate the unemployed, which included all persons who were 15 years old and over as of their last birthday and were reported as without work, currently available for work, and seeking work or not seeking work due to valid reasons. The old definition of unemployment did not consider the availability criterion.

Depository Corporations Survey (DCS) from the 12.2 percent in the previous month.[3]

- Outstanding loans of commercial banks grew by 6.4 percent year-on-year to ₱1.593 trillion as of end-June 2005. This was slightly lower than the 6.9 year-on-year growth recorded in May 2005.

- Relative to the 18 July 2005 auction, the T-bill rate for the 91-day, 182-day and 364-day tenors increased during the 15 August 2005 auction. Relative to the 8 August 2005 auction, T-bill yield for the 91-day tenor, 182-day and 364-day tenors rose by 4.0 basis points, 13.7 basis points and 20.4 basis points respectively. Yields for short-term government securities rose as banks factored in uncertainties relating to the country's political situation as well as the status of the EVAT reform law.

- The peso appreciated against the US dollar in August on strong Asian currencies following the revaluation of the Chinese yuan and easing tensions on the domestic political front.

- The National Government (NG) recorded a ₱15.1 billion fiscal deficit in July 2005, 22 percent lower than the deficit in the same month in the previous year, as the increase in revenues outpaced the rise in expenditures. This brought the NG's budget deficit for the first seven months to ₱82.6 billion, 16.9 percent lower than the year-ago level and was equivalent to only 45.9 percent of the deficit target for the year.

- Global economic expansion remained broadly on track during the first half of 2005, led by the robust economic growth in the US and China. At the same time, the sustained recovery of the Japanese economy boosted further global growth. Inflation pressures at the global level appeared to be well-contained despite higher inflation outturns in recent months. Forward-looking global economic indicators appear consistent with a moderate but solid growth performance in the year ahead. However, the volatility in oil prices continues to be a major source of risk to the outlook.

II. Review of the Monetary Policy Stance

- The Monetary Board noted that the outlook for inflation remains unchanged. Current forecasts continue to reflect the dominant impact of high oil prices. A modest deceleration in inflation is expected in the second half of 2005, helped in part by the recent easing in food prices.

[3] M3 refers to the stock of broad money based on data on the Depository Corporations Survey (DCS). The DCS, which replaces the Monetary Survey (MS) as the basis for measuring domestic liquidity, features an expanded list of surveyed institutions that includes the BSP, commercial banks, thrift banks, rural banks, non-stock savings and loan associations and non-banks with quasi-banking functions.

Nevertheless, average inflation is still expected to exceed the target for both 2005 and 2006.

- The members of the Monetary Board also pointed out that there are downside risks to output growth at present. Continued pressures on prices may prompt a cutback in consumption spending, which remains the key driver of aggregate demand. The members of the Monetary Board believed that under such conditions, monetary authorities should also take account of the need to provide enough room for demand to continue to grow to cushion the contractionary impact of rising oil prices.

- At the same time, the members of the Monetary Board recognized the need for continued monitoring of the risk of higher inflation expectations, particularly given expectations of sustained increase in oil prices.

- The members of the Monetary Board also reiterated that it will continue to pay close attention to the liquidity conditions in the financial system because of their implications on activity in the foreign exchange market and consequently inflation.

- Some members of the Monetary Board pointed out the need to watch closely the narrowing of interest rate differentials between the domestic and foreign interest rates, which may affect the foreign exchange market and in turn inflation expectations.

- Noting the various risks to future inflation, the members of the Monetary Board underscored their readiness to act preemptively to curb any possible build-up in inflation expectations. They emphasized the need to further strengthen transparency and communication of policies and prospects of inflation in order to help manage inflation expectations. The members of the Monetary Board likewise expressed their continuing support for the use of direct non-monetary measures that would ensure greater availability and timely distribution of goods and services.

III. Monetary Policy Decision

- Upon assessment of the balance of risks to inflation and the evidence that has become available since its previous meeting on monetary policy, the Monetary Board approved unanimously the following measures:

  1) Maintain the current monetary policy settings as follows:

     (a) Maintain the BSP's policy interest rates at 7.0 percent for the overnight RRP (borrowing) rate and 9.25 percent for the overnight RP (lending) rate; and

(b) Maintain the current interest rates on term RRPs, RPs, and SDAs.

2) Maintain the current reserve requirement ratios;

3) Continue to articulate support for the use of non-monetary measures to address supply-side risks, particularly those relating to food supply, energy conservation, and the development of alternative energy sources, by strengthening representation and coordination with various government agencies; and

4) Intensify the BSP's public information campaign with greater focus on the dynamics and sources of price pressures in order to help guide inflationary expectations.

The next meeting of the Monetary Board to discuss the monetary policy setting is scheduled on 22 September 2005.