HIGHLIGHTS OF THE MEETING OF THE MONETARY BOARD ON MONETARY POLICY ISSUES HELD ON 28 JULY 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 to 7.6 percent year-on-year in June 2005 after holding steady at 8.5 percent in the past four months. The favorable movement in the overall consumer prices in June was traced mainly to a deceleration in inflation for all commodity groups (except for clothing)

* The highlights of the discussions of the 28 July 2005 Monetary Board meeting were approved by the Monetary Board during its meeting held on 25 August 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 Assistant Governor, Monetary Policy Sub-Sector and the Managing Director of the Treasury Department.

relative to year-ago levels. This brought the year-to-date inflation to 8.3 percent. Similarly, core inflation also continued to ease in July 2005.

- In terms of contribution to the year-on-year inflation, food and energy-related items remained the primary sources of inflationary pressures. Food, beverage and tobacco (FBT) accounted for 3.23 percentage points of the 7.6 percent inflation in June; transport and communication, 1.33 percentage points; and fuel, light and water (FLW), 1.32 percentage points.

- The slowdown in both headline and core inflation was consistent with earlier BSP forecasts of a mild deceleration in inflation beginning in the second half of 2005. Nevertheless, there are risks to future inflation. These include: (1) the impact of higher oil prices on other key goods and services, particularly transport prices; and (2) the impact on food prices of the recent El Niño dry spell. However, most of the foreseeable pressures on consumer prices are temporary episodes (e.g., the El Niño dry spell). Inflation, therefore, is likely to slow down further towards the second half of 2006 as the impact of current supply-side influences taper off.

- Meanwhile, the recent suspension of the EVAT reform law could ease pressure on consumer prices. However, a further delay in its implementation could have repercussions on future inflation. Market uncertainty over the fiscal position of the National Government could raise the risk premium. In turn, this can create volatility in the financial and foreign exchange markets, which could lead to higher inflation expectations.

- Selected indicators suggested sustained but slower growth in 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 2005, lower than the revised April growth rate of 14.2 percent. 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.

  - Merchandise exports grew by 1.1 percent year-on-year in May 2005, marking a sharp slowdown from April when it recovered from two consecutive months of decline to grow by 8.8 percent.

  - The year-on-year growth in merchandise imports slowed down to 2.7 percent in May 2005 from 6.5 percent in the previous month. This, however, was an improvement from the 1.7 percent contraction in the same month last year.

- Passenger car sales increased by 22.7 percent in June 2005, higher than the previous month's 15.9 percent but lower than the previous year's 44.3 percent.

- Energy sales by the Manila Electric Company grew marginally by 0.6 percent year-on-year in May 2005, following three consecutive months of decline. This was still lower than the 3.8 percent rise in the same month last year.

- 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 second quarter 2005 BSP Business Expectations Survey showed that business outlook was less optimistic than in the previous quarter but remained positive. The overall business outlook diffusion index (DI) for the second quarter of 2005 was recorded at 12.9 percent, lower than 17.6 percent in the previous survey. The latest Consumer Expectations Survey likewise showed weaker consumer outlook for the second and third quarters of 2005.

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

- Agricultural production grew by a slight 0.6 percent year-on-year in the first quarter of 2005, as gains from poultry and fishery production offset the decline in crop production caused by the El Niño-induced drought.

- World oil prices continued to rise in July 2005 as the market became more sensitive to any indication of tightness in supply accompanied by the sustained growth in world oil consumption. The higher demand for motor gasoline in the US this summer as well as the advent of storms near the Gulf of Mexico in early July exerted pressures on oil prices. In the domestic market, retail oil prices were raised twice in July reflecting mainly the successive increases in imported petroleum products as well as those of world crudeoil prices.

[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.

- In the financial sector, the growth in domestic liquidity accelerated. Bank lending likewise showed an improvement but remained modest. Meanwhile, Treasury bill (T-bill) rates were generally lower during the 18 July 2005 auction compared to their levels on 11 July 2005.

  - Based on preliminary data, the growth in domestic liquidity (M3) accelerated to 12.2 percent year-on-year in May 2005, based on Depository Corporations Survey (DCS) from the 12.0 percent rise in the previous month.[3]

  - Outstanding loans of commercial bank (KB) grew by 6.9 percent year-on-year to ₱1.590 trillion as of end-May 2005. This was higher than the 4.3 year-on-year growth recorded in April 2005.

- Relative to the 11 July 2005 auction, T-bill yields for the 91-day and 182-day tenors eased by 72.1 basis points and 10.9 basis points, respectively, during the 18 July 2005 auction. Meanwhile, moving more in line with the secondary market yields, the 364-day T-bill rate rose by 50 basis points from its level on 6 June 2005 when bids for the same tenor were last accepted. The general decline in T-bill rates reflected optimism that the government will be able to achieve its fiscal target for 2005, following reports of a budget surplus in June 2005.

- The peso depreciated against the US dollar in July on heightened political tension following the resignation of several Cabinet members and mounting calls for President Arroyo to resign; revisions of the country's debt rating outlook from stable to negative by Fitch Ratings, Standard and Poor's, and Moody's Investors Service; and the Supreme Court's decision to suspend the implementation of the VAT reform law. Exchange market pressure remained a risk to the inflation environment due to the possibility of further narrowing of interest rate differentials with the prospects of further increase in US interest rates combined with easing domestic interest rates.

- The National Government (NG) recorded a ₱0.2 billion fiscal surplus in June, a turnaround from the ₱2.7 billion deficit in the same month in the previous year. This brought the NG's budget deficit for the first semester to ₱67.5 billion, 15.7 percent lower than the year-ago level and was equivalent to only 68.5 percent of the first semester deficit target of ₱98.5 billion.

[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.

- The pace of global economic activity moderated but remained robust in the second quarter of 2005, led by the strong growth of the US and Chinese economies. Manufacturing activity eased in a number of countries reflecting the impact of higher world oil prices and some inventory adjustments. Consumer spending and exports growth slowed down in most economies while labor market conditions remained generally favorable. The inflation outlook in major economies continued to be well-within expectations despite the relatively high current inflation. Forward-looking global economic indicators continued to be consistent with a moderate but solid growth performance in the year ahead. However, the volatility in oil prices continued to be a major source of risk to the outlook.

II. Review of the Monetary Policy Stance

- The members of the Monetary Board noted that inflation continued to be caused mainly by rising oil prices as well as the recent adjustments in transport fares and wages. Meanwhile, demand conditions are characterized by moderate economic growth due to a slowdown in consumer spending in the first quarter.

- The members of the Monetary Board also noted that latest forecasts indicate that average inflation will exceed the targets for 2005 and 2006, and most of the foreseeable pressures on consumer prices remain linked to the behavior of oil prices. In addition, such pressures are expected to produce a primarily short-term negative impact on inflation.

- The members of the Monetary Board were of the view that the greater risk to the economy at present may be to output, as continued pressures on prices would dampen consumption spending, which remains the sole lynchpin of aggregate demand. The members of the Monetary Board believed that under such conditions, the monetary policy stance should provide enough room to allow demand to continue to grow in order to help cushion the expected contractionary impact of rising oil prices.

- At the same time, the members of the Monetary Board recognized that there is a greater risk of higher inflation expectations given the sustained increase in oil prices.

- The members of the Monetary Board noted further the need to continuously monitor the growth in liquidity, which could affect activity in the foreign exchange market and lead to inflationary pressure. The 7 July 2005 increase in reserve requirements has helped keep liquidity in check. Continued monitoring will help guide monetary authorities in undertaking the necessary preemptive action against further pressure on consumer prices.

? The members of the Monetary Board also pointed out the need to watch closely the movement of interest rate differentials between the domestic and foreign interest rates, which continued to narrow with the sustained rise in the US federal funds rate target. While such narrowing of differentials can be taken as a reflection of lower risk premium, it could potentially have an effect on foreign exchange flows, exchange rate and ultimately, on future inflation.

? The members of the Monetary Board stressed, however, that monetary policy shall be used only to address persistent volatility of the peso to the extent that this will have an adverse impact on future inflation.

? Given these considerations, the members of the Monetary Board concluded that raising policy rates does not appear to be warranted, as this would reduce demand but does not address directly the key influence behind rising consumer prices, namely oil prices.

? Keeping in mind the various risks to the inflation outlook, the members of the Monetary Board underscored their readiness to act preemptively to curb any possible build-up in inflation expectations. They also reiterated the need to further strengthen efforts to communicate publicly the assessment for future inflation along with the overall policy message. 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 basic food products to cushion pressures on consumer prices.

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:

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

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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 25 August 2005.