



**HIGHLIGHTS OF THE MEETING OF THE MONETARY BOARD ON
MONETARY POLICY ISSUES HELD ON 7 APRIL 2005***

The Advisory Committee¹ submitted the following recommendations for the consideration of the Monetary Board:

1. Change the current monetary policy settings as follows:
 - a) Increase the BSP's policy interest rates by 25 basis points to 7.0 percent for the overnight RRP (borrowing) rate and 9.25 percent for the overnight RP (lending) rate; and
 - b) Adjust the current interest rates on term RRPs, RPs, and SDAs.
2. Maintain the current reserve requirement ratios; and
3. Continue to articulate support for the 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.

A measured increase in policy rates would provide a signal to the public of the BSP's commitment to fighting inflation by preventing inflation expectations from spiraling away from the inflation target.

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

The above recommendations were based on the following considerations:

- 2 Headline inflation remained steady at 8.5 percent in March 2005, the same rate as in the previous month. Clothing, housing and repairs, and services posted higher year-on-year inflation in March. Services inflation rose, owing mainly to the increase in inflation for transportation and communication due to higher prices of gasoline and oil products.

* The highlights of the discussions of the 7 April 2005 Monetary Board meeting were approved by the Monetary Board during its meeting held on 12 May 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 Acting Managing Director of the Treasury Department.



However, inflation for food, beverage and tobacco as well as fuel, light and water was slower in March compared to the previous month.

- ? Core inflation—defined as headline inflation after excluding volatile food and energy items such as rice, corn, fruits and vegetables, liquefied petroleum gas (LPG), kerosene and gasoline—slowed down to 8.0 percent year-on-year in March 2005 from 8.1 percent a month ago.
- ? The outlook for inflation continued to show a decelerating path. For 2005, inflation would likely exceed the target of 5.0-6.0 percent as the full impact of supply-side pressures sets in. In the absence of further adverse shocks, the average inflation for 2006 could fall to the target range of 4.0-5.0 percent.
- ? Supply- or cost-side factors are expected to remain the central influence on the future path of inflation. The continuing presence of slack in the economy—evidenced by less than maximum capacity utilization, relatively high unemployment, and modest credit demand—is not likely to cause an upsurge of demand-related pressures in the near term.
- ? Spot and futures prices of crude oil continued to rise. The expected volatility in world oil prices are related to concerns over the ability of oil producers to widen output capacity.
 - ✍ The robust expansion of economic activity in many countries, led by the US, China, and India, has fueled the rise in oil consumption and in part, reduced the margin of excess production capacities of oil exporters.
 - ✍ Threats of increased terrorist attacks in major oil producing countries continued to pose risks to supply in the world market.
 - ✍ Indications of speculative activity by hedge funds in the oil futures market contributed in part to the pressures on oil prices.
- ? In the domestic market, pump prices of petroleum products were raised by local oil companies thrice in March, reflecting the rise in world crude prices.
- ? Nominal wage adjustments in the form of increases in the cost of living allowance or an increase in the minimum daily wage were issued in all 17 regions over the past year, with the latest increase granted on 29 March 2005. Despite nominal adjustments, real wages declined over the past year due to the uptrend in inflation.



- ? In the transport sector, there are pending petitions for transport fare adjustments before the Land Transportation Fare Regulatory Board (LTFRB).
- ? Some evidence suggest that cost-side influences may have already been feeding into the public's inflation expectations, such as those shown by private sector's inflation forecasts, consumer and business expectations surveys, and term spread movements. In turn, these developments could increase the risk that expectations may become disanchored.
 - ✍ Mean inflation forecasts for both 2005 and 2006 of private analysts polled by the staff have been rising.
 - ✍ Results of the latest January 2005 Consumer Expectations Survey (CES) by the BSP showed that households anticipated higher inflation in the second quarter for selected group of commodities relative to the previous quarter. The highest price increases were expected to come from electric bills, transportation, water bills, fish and seafood, fruits and vegetables, meat, and rice.
 - ✍ The results of the consumer surveys conducted by the Social Weather Station (SWS) and the Pulse Asia in March 2005 showed growing concerns among Filipinos over the urgent need to control the rising prices of basic goods.
 - ✍ Relative to the year-ago levels, the spreads between long-term and short-term interest rates in the secondary market have widened, suggesting higher inflation expectations.
- ? Imported inflation has been tempered in part, by the peso's nominal appreciation against the US dollar due mainly to the sustained inflows of remittances from overseas Filipino workers, participation of foreign investors in the initial public offerings of two companies, stronger regional currencies, exporter dollar sales and the favorable reaction to the passage of modifications to the value added tax.
- ? Selected indicators of demand exhibited positive trends such as solid revenue growth of the country's major corporations, recovery in export growth, and improving business optimism.
 - ✍ Total merchandise exports increased by 15.4 percent year-on-year to reach US\$3.28 billion in January 2005. This was an acceleration from growth of 2.9 percent in the previous month and 4.1 percent in January 2004.
 - ✍ The value of production index (VAPI) for manufacturing increased by 15.7 percent year-on-year in January 2005. This was, however,



lower than the 17.9 percent growth posted in December 2004. On a month-on-month basis, VAPI declined for the third straight month (2.9 percent in January). Year-on-year growth in the volume of production index (VOPI) for manufacturing was slightly lower at 5.5 percent in January compared to 5.9 percent in the previous month. Meanwhile, the month-on-month decline in VOPI was higher at 3.1 percent in January from the 0.9 percent drop a month ago.

- ✍ The country's major corporations posted strong revenue growth in 2004. Robust domestic and international sales volume of beer boosted San Miguel Corporation's revenues, while heightened expansion drove sales of fastfood leader Jollibee Foods Corporation. Ayala Corporation also reported strong revenue growth, owing to the solid performance of its key operating subsidiaries and affiliates including Globe Telecom. Globe and its competitor, PLDT, posted revenue growth of over ten percent as the subscriber base for their wireless business continued to expand.
- ✍ The first quarter 2005 Business Expectations Survey showed business optimism maintaining a relatively steady and positive outlook in the current quarter and improving significantly in the second quarter of the year.
- ? However, the sizeable unemployment rate and spare capacity in manufacturing continued to show some slack in resource use. Moreover, merchandise imports, car sales and energy sales declined.
- ✍ Average capacity utilization in manufacturing declined slightly to 79.8 percent in January 2005 from 80.0 percent in the previous month. Compared to the utilization rate in January 2004, this was higher by 1.7 percentage points.
- ✍ Merchandise imports declined further by 2.1 percent year-on-year to reach US\$3.11 billion in January 2005. This was a further downturn from the 8.9 percent expansion in the same month last year.
- ✍ The Chamber of Automotive Manufacturers of the Philippines, Inc. (CAMPI) reported a larger annual decline in passenger car sales of 7.1 percent in February 2005 compared to 0.1 percent drop registered in the previous month. Similarly, sales of trucks and buses fell further by 42.4 percent year-on-year in February from 31.1 percent in January.
- ✍ Energy sales by the Manila Electric Company declined by 2.5 percent year-on-year in February 2005 as against the 7.2 percent increase in the previous month.



- ✍ The latest Labor Force Survey conducted by the National Statistics Office (NSO) showed that unemployment rate rose to 11.3 percent in January 2005 from 11.0 percent a year ago. This was also higher than the 10.9 percent unemployment rate in October 2004.
- ? Agricultural production accelerated in 2004 despite damages caused by typhoons in the last quarter of the year. The outlook for agricultural production in 2005 could improve given indications of exit of the El Nino phenomenon as well as the expected favorable impact of government programs to enhance the productivity of the sector and mitigate the impact of the dry spell. This highlighted the importance of sustained implementation of government intervention measures to ensure adequate food supply.
- ? In the financial sector, the benchmark 91-day T-bill rate continued to ease due to ample liquidity in the system. The increase in liquidity arising from external inflows remained below levels warranted by the economy's growth and inflation path.
- ✍ Based on latest data, the growth of domestic liquidity (M3) accelerated to 11.0 percent year-on-year in January 2005, based on Depository Corporation Survey (DCS) from the 9.1 percent increase in the previous month.²
- ✍ Outstanding loans of commercial bank loans grew by 4.0 percent year-on-year to ₱1.512 trillion as of end-January 2005. This was higher than the 2.6 year-on-year growth recorded in December 2004 but remained modest.
- ✍ Relative to the 28 February 2005 auction, T-bill rates eased across all tenors during the 14 March 2005 auction. This could be traced to the presence of ample liquidity in the system.
- ? Exchange market pressure remained a risk to the inflation environment due to the likelihood of further declines in interest rate differentials and the potential adverse market sentiment shifts due to delays in needed tax measures.
- ? The recent fiscal performance of the National Government (NG) indicated that the government is clearly on track to meet the first quarter target. The NG budget deficit in February 2005 reached ₱23.5 billion, bringing

² 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 actual deficit for the first two months to ₱40.1 billion, and about 51.5 percent of the ₱77.8 billion first quarter fiscal program.

- ? Global economic growth was robust in 2004 due to sustained gains in investment, steady improvements in labor market conditions, and recovery of business and consumer confidence in the major economies. Industrial production and export gains, however, appeared to have slowed down in most economies, reflecting both a return to more sustainable pace of expansion and the adverse impact of higher oil prices.
- ? Forward-looking indicators appeared consistent with a moderate, yet continued solid growth performance in 2005. Meanwhile, inflation expectations appeared to be well anchored. However, the widening global imbalances alongside continued volatility in world oil prices and weakening of the US dollar continued to pose risks to the outlook.
- ✍ In the US, the brisk pick-up in consumer spending and private domestic investment boosted the overall performance in 2004. Recent indicators suggested that the US economy has started the year 2005 strongly at a moderating pace. Labor market conditions continued to improve while business and consumer confidence remain robust. The mounting budget and current account deficits could also dampen prospects for sustained economic growth.
- ✍ The pace of economic activity in the euro area was weaker in the second half of 2004 as domestic demand remained subdued while export growth weakened further due to the strengthening of the euro and the modest slowdown in global growth. Investments, however, remained strong. The moderate economic growth and weak labor markets contained the rise in wages.
- ✍ The UK economy's strong growth momentum continued in the last quarter of 2004, propelled by the robust output performance of the services sector, the modest recovery of manufacturing, and accompanied by solid growth in investment and public consumption. Household spending, grew weaker during the quarter, alongside the observed slowdown in retail sales and housing market activity.
- ✍ The Japanese economy remained on a gradual recovery trend despite ongoing adjustments stemming from the slowdown in the global IT market. Industrial production and export growth could improve gradually as the impact of adjustments in IT-related sectors wanes. The uptrend in business investment could be maintained as corporate profits continue to improve steadily.
- ✍ Prompted by the brisk pace of output expansion in the US, the US Fed decided to raise its policy rates by 25 basis points during its most



recent policy meeting. By contrast, monetary authorities in Japan, in Euro area, and in UK kept their monetary policy settings unchanged.

II. Review of the Monetary Policy Stance

- ? The members of the Monetary Board noted that the prevailing conditions and outlook indicated that price pressures continued to be dominated by supply side risks and that demand side impulses remained generally moderate and limited despite some improvements.
- ? The members of the Monetary Board also noted that the sources of expected price pressures over the two-year policy horizon continued to be linked to supply side factors, notably price fluctuations in the world oil market and weather-induced pressures on agricultural food prices.
- ? The members of the Monetary Board recognized that the upside risks to the inflation outlook increased given recent movements in international oil prices. This implied renewed cost-push pressures on energy and transport prices over the policy horizon.
- ? The members of the Monetary Board pointed out that the prospect of continued pressures from oil and transport prices could also raise the likelihood of second-round effects in the form of nominal wage increases. These risks may lead to an upward shift in the forecast inflation path.
- ? The members of the Monetary Board noted that the public's expectations of future inflation may be disanchored as cost-side influences may already be feeding into it. Inflation expectations appeared to be on the rise, based on survey of the inflation forecasts of the private analysts; anticipation of higher inflation for selected commodities over the next 12 months in the Consumer Expectations Survey by the BSP; and growing public concerns over rising inflation as shown in the survey results of the Social Weather Station and Pulse Asia in March 2005. Moreover, an increase in the differentials between long-term and short-term interest rates in the secondary market was observed.
- ? Based on these considerations, the members of the Monetary Board agreed that a marginal increase in policy interest rates would be appropriate in providing a signal to the public of the BSP's commitment to fighting inflation and preventing inflation expectations from spiraling away further from the inflation target.



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. Change the current monetary policy settings as follows:
 - a) Increase the BSP's policy interest rates by 25 basis points to 7.0 percent for the overnight RRP (borrowing) rate and 9.25 percent for the overnight RP (lending) rate; and
 - b) Adjust the current interest rates on term RRP, RPs, and SDAs.
2. Maintain the current reserve requirement ratios; and
3. Continue to articulate support for the 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.

The next meeting of the Monetary Board to discuss the monetary policy setting is scheduled on 5 May 2005.

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