Bangko Sentral ng Pilipinas

HIGHLIGHTS OF THE MEETING OF THE MONETARY BOARD ON MONETARY POLICY ISSUES HELD ON 31 MAY 2007*

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

- Maintain the current monetary policy settings as follows:

a. Maintain the BSP's policy interest rates at 7.5 percent for the overnight RRP (borrowing) rate and 9.75 percent for the overnight RP (lending) rate;

b. Maintain the tiering scheme;

c. Maintain the current interest rates on term RRPs, RPs, and SDAs; and

d. Maintain the current reserve requirement ratios.

The Monetary Board then proceeded to review the recent developments and the key considerations in the formulation of the BSP's monetary policy stance.

I. Review of Recent Developments

A. Domestic price conditions

- Headline inflation rose marginally to 2.3 percent in April from 2.2 percent in March. The modest uptick in price pressures was due largely to the faster increases in the indices for food, beverage and tobacco; fuel, light and water; and services.

- Excluding selected food and energy products, underlying inflation was steady in April. The official core inflation measure published by the National Statistics Office (NSO) was unchanged at 2.6 percent. On a

* The discussion presented herein reflects the assessment made by the Monetary Board based on the information available at the time of the policy meeting. The highlights of the discussions of the 31 May 2007 meeting were approved by the Monetary Board during its regular meeting held on 21 June 2007.

[1] The Advisory Committee is composed of the Governor of the BSP as Chairman and five 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, the Managing Director of the Monetary Policy Sub-sector, and the Acting Director of the Department of Economic Research.

month-on-month basis, the official core inflation rate was steady at 0.1 percent.

- The latest Business Expectations Survey (BES) for Q2 2007 indicated that respondents anticipate inflation to move up in Q3 2007, consistent with the BSP's forecast that inflation has already bottomed out.

B. Supply side indicators

Developments in Agriculture

- The agriculture sector registered a 3.6 percent growth in Q1 2007, down from 3.9 percent posted in the same period last year. The major contributions to output growth came from the *palay*, fishery, livestock and poultry sub-sectors.

- Normal weather conditions support the outlook of stable food prices. The Philippine Atmospheric, Geophysical and Astronomical Services Administration (PAGASA) forecasted normal weather conditions until the end of May. Current conditions in the equatorial Pacific point to a 20 percent chance of a La Niña developing in 2007, and in particular over the coming two to three months.

Oil price developments

- International spot and futures prices of oil were higher in May due to continued geopolitical tensions in Nigeria and seasonal maintenance and unexpected shutdowns in US oil refineries. Meanwhile, domestic pump prices were raised twice in May.

Developments in the utilities sector

- NPC power rates are set to decrease further after the NPC filed an application before the ERC for another power rate reduction under the new GRAM and ICERA. Meanwhile, Manila Water is currently implementing a reduction in water rates in Metro Manila's east zone.

C. Demand conditions

- Q1 2007 GDP posted the highest growth in 17 years at 6.9 percent. The high GDP growth was backed by the strong performances of Trade, Manufacturing, Agriculture, Fishery and Forestry (AFF), Transportation, Communication and Storage (TCS), Finance and Private Services. On the expenditure side, the main growth drivers were higher household spending, exports of goods and services, and government consumption.

- Selected indicators of demand indicated a broad upward trend.

  - Land values in Q1 2007 were stable relative to end-2006 levels but are expected to rise over the next 12 months based on estimates from Colliers International Research. Year-on-year, the estimated land value index in the Makati Central Business District (CBD) was largely unchanged while that in Ortigas was 6.5 percent higher. Meanwhile, office and residential vacancy rates in the Makati CBD continued to decline to 3.7 percent and 9.3 percent, respectively, and are expected to ease further.

  - The year-on-year growth in passenger car sales accelerated to 34.9 percent in March from 25.6 percent in February. The Chamber of Automotive Manufacturers of the Philippines, Inc. (CAMPI) attributed strong sales to the introduction of new models, dealer incentives and promotions. Sales of trucks and buses rose at a robust albeit slower pace of 45.8 percent year-on-year in March compared to 66.0 percent in February.

  - Energy sales by Meralco rose at a slower pace of 1.1 percent year-on-year in February compared to 5.0 percent in January. This can be traced mainly to the decline in residential power consumption and lower growth in electricity demand by the commercial sector.

  - Appliance sales slid slightly by 0.7 percent year-on-year in February after declining by 12.0 percent in January. Similarly, year-to-date sales declined at a slower pace of 6.6 percent compared to 21.2 percent in the first two months of 2006.

  - Average capacity utilization in manufacturing was slightly higher in March at 80.0 percent compared to a revised rate of 79.3 percent in February based on the NSO's Monthly Integrated Survey of Selected Industries (MISSI).

  - MISSI data also showed weak manufacturing activity in March. The value of production index (VAPI) declined for the seventh consecutive month by 5.2 percent year-on-year in March. Similarly, the volume of production index (VOPI) continued to fall by 7.6 percent year-on-year during the same month.

- Latest merchandise trade data show double-digit growth in both exports and imports.

  - Growth in merchandise exports accelerated to 10.6 percent year-on-year in March from 7.8 percent in February. This can be traced mainly to higher growth in manufactures and mineral products.

- Growth in merchandise import payments accelerated to 10.4 percent year-on-year in March from 9.9 percent in February. This can be attributed to the recovery in imports of capital goods and the continued strong growth in imports of raw materials and intermediate goods.

- Business sentiment continues to be bullish in Q2 2007 based on the latest BES. The overall business confidence index (CI) remained above the 40 percent level for the third consecutive quarter, after rising to a record high of 49.4 percent in Q4 2006. The Q2 2007 CI remained strong at 46.4 percent, higher relative to comparable levels year-on-year and quarter-on-quarter.

D. Monetary conditions

Interest rate developments

- Relative to the 30 April 2007 auction, T-bill rates during the 21 May 2007 auction generally increased.

- Relative to their 30 April levels, secondary market yields of GS increased on 23 May except for the longer-term tenors (i.e., 7 years and up) which registered declines.

Domestic liquidity and credit conditions

- Domestic liquidity or M3 continued to post strong growth at 26.3 percent year-on-year in April, from the 24.6 percent increase registered in the previous month. The sustained expansion in domestic liquidity continued to be driven by the increase in the net foreign asset (NFA) position of depository corporations (DCS), following the steady rise in overseas Filipinos' (OF) remittances, export earnings, as well as foreign direct and portfolio investment inflows. Net domestic credit growth also contributed to the expansion of domestic liquidity.

- Consumer credit rose by 21.1 percent year-on-year in Q4 2006. This was marginally lower than last year's 22.0 percent growth. Auto loans, credit card receivables and residential real estate loans expanded by 17.9 percent, 20.3 percent, and 24.5 percent, respectively.

Financial market developments

- In May, the stock market sustained its upbeat mood. The continued deceleration in inflation, the strengthening of the peso, bright economic prospects and strong corporate profits helped sustain investors' interest in local stocks.

E. Exchange rate developments

- The peso continues to strengthen on strong dollar inflows and positive market outlook. On 22 May, the peso broke the ₱46/US$1 level, rallying to an almost 7-year intra-day trading high of ₱45.87/US$1 due to continued strong inflows from OF remittances, foreign direct and portfolio investments, and export earnings. Despite recent concerns about the country's ability to meet its fiscal deficit target, market sentiment remained positive due to sustained economic growth, lower inflation, and favorable external payments position.

F. Fiscal developments

- The NG incurred a fiscal surplus in April of ₱12.0 billion, lower than the April 2006 surplus of ₱17.6 billion. The surplus, however, was a reversal of the ₱33.4 billion deficit in March.

G. External developments

- Global economic conditions, although growing at a moderate pace, continued to be favorable in Q1 2007, with a gradual rebalancing in the composition of global growth. Growth in Japan remains fairly stable, and recent evidence suggests a continuation of solid growth in emerging Asia and the Euro Area, where growth from the latter has become more broad-based. However, the US economy experienced moderate expansion, as the slowdown in the housing market exerted a drag on economic growth.

- Domestic demand, investment, exports, buoyant labor market conditions and benign financial conditions were the key growth drivers in the global economy. However, a number of risks remain, notably the expected slower growth trajectory of the US economy, a disorderly unwinding of global imbalances, and a potential increase in financial market volatility.

- Global inflation appears to have generally moderated since mid-2006 due mainly to falling oil prices. Thus, the near-term outlook for inflation would still be shaped mainly by developments in energy prices.

- In May, major central banks decided to maintain their policy rates on concerns about inflation risks and downside prospects on growth in the near term.

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

- The Monetary Board assessed that the outlook for inflation over the policy horizon continues to be benign, due mainly to easing supply-side pressures, moderate demand pressures and well-contained inflation expectations. Ample supply of major food items, the subsiding base effect of the RVAT on the CPI, and the strengthening of the peso have contributed to the continued downtrend in inflation.

- However, sustained growth in domestic liquidity remains a key policy concern. Domestic liquidity expansion has remained strong in the past several months and although current inflation has continued to decelerate, a prolonged surge in liquidity could eventually pose risks to future inflation. In addition, volatility in oil prices remains a risk to the inflation outlook, given the limited production capacity and the threat of possible geopolitical disruptions. The possibility of additional wage adjustments also provides some upside risks.

- The Monetary Board believed that the implementation of the new monetary measures beginning 10 May 2007 will help siphon off additional liquidity in the system and thereby exert a mitigating impact on future inflation. While the initial results have been encouraging, the recent policy moves need to be given more time to fully work their way through the financial system and achieve their objective of keeping domestic liquidity growth down to a more modest pace. This will also allow further assessment of the liquidity impact of the continued strong foreign exchange inflows into the economy.

- The Monetary Board underscored the need to keep a close monitoring of the impact of the new measures on monetary conditions for the next several months, which will serve as basis for subsequent monetary policy actions to ensure that the benign inflation environment is maintained over the policy horizon.

III. Monetary Policy Decision

- After considering the risks to inflation and the evidence that has become available since its previous meeting on monetary policy, the Monetary Board approved the recommendations of the Advisory Committee.

The next meeting of the Monetary Board on the monetary policy stance is scheduled on 12 July 2007.