HIGHLIGHTS OF THE MEETING OF THE MONETARY BOARD ON MONETARY POLICY ISSUES HELD ON 21 SEPTEMBER 2006*

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 7.5 percent for the overnight RRP (borrowing) rate and 9.75 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 at 10 percent for regular reserves on the deposit liabilities of universal banks (UBs) and commercial banks (KBs), and 11 percent for liquidity reserves on the deposit liabilities of UBs and KBs; and

3) Continue to articulate the BSP's support for the Government's use of non-monetary measures to address supply-side risks to basic commodity prices and continue representation and coordination with concerned government agencies for this purpose.

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

Inflation

- Headline inflation continued to moderate in August, falling to 6.3 percent from 6.4 percent in July. This was due to slower price increases for fuel, light and water (FLW), as well as services and miscellaneous items.

* 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 21 September 2006 meeting were approved by the Monetary Board during its regular meeting held on 12 October 2006.

[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 Officer-In-Charge of the Department of Economic Research.

Similarly, core inflation—defined as headline inflation after excluding volatile food and energy items—decelerated to 5.3 percent from 5.4 percent in July.

- International spot and futures prices of crude oil eased in August on higher US gasoline inventories and easing geopolitical tension over Iran's nuclear program. Similarly, domestic pump prices of gasoline and kerosene were reduced during the month.

Demand

- Data continued to generally point to moderate demand conditions.

  - Gross Domestic Product (GDP) rose by 5.5 percent in the second quarter of 2006. This was higher than the year-ago growth rate of 5.4 percent but lower than the first quarter's 5.7 percent. Gross National Product (GNP) expanded by 6.6 percent, boosted by the double-digit growth in Net Factor Income from Abroad (NFIA).

  - Based on the results of the Monthly Integrated Survey of Selected Industries (MISSI), which covers 509 manufacturing establishments, average capacity utilization rose to 80.3 percent in June from a revised rate of 80.2 percent in May.

  - Growth in merchandise export earnings decelerated to 12.9 percent in July. This can be traced to the slowdown in manufactured exports which comprised 85.7 percent of total.

  - Growth in merchandise imports slowed to 7.7 percent in June due to lower growth in imports of capital goods and mineral fuels, lubricants and related materials.

  - Based on the new National Statistics Office (NSO) definition of unemployment, the jobless rate declined to 8.0 percent in July 2006 from 8.2 percent in the previous quarter, but remained higher relative to the year-ago rate of 7.7 percent. The same trend was observed for the jobless rate using the old NSO definition of unemployment.[2]

  - Passenger car sales increased by 15.1 percent year-on-year in July, higher than the previous month's 6.6 percent. Sales of trucks and

[2] Beginning in April 2005, the NSO released a new definition of unemployment, which covers all persons 15 years old and over and are reported as: (1) without work and currently available for work and seeking work; or (2) without work and currently available for work but not seeking work for the following reasons: (a) tired/believed no work available; (b) awaiting results of previous job application; (c) temporary illness/disability; (d) bad weather; and (e) waiting for rehire/job recall. The old definition of unemployment did not consider the availability criterion.

buses surged by 56.9 percent year-on-year in July, reversing the 29.8 percent decline in the previous month.

- Appliance sales continued to decline, with total units sold falling by 20 percent year-on-year in July.

- Total energy sales by the Manila Electric Company (Meralco) declined for a second month, falling by 2.0 percent year-on-year in June. This was due to reduced energy consumption by all sectors except the industrial sector.

- Based on data from Colliers International Research, property values in Metro Manila were unchanged in the second quarter relative to the previous quarter but were higher on a year-on-year basis. Meanwhile, the average office and residential vacancy rates in the Makati Central Business District continued to ease.

- Results of the third quarter 2006 Business Expectations Survey (BES) showed that firms expect business activity to be robust in the fourth quarter in line with the seasonal increase in demand. Meanwhile, the third quarter 2006 Consumer Expectations Survey (CES) indicated a more cautious consumer outlook for the fourth quarter and the next 12 months.

Domestic Liquidity

- Domestic liquidity, as measured by M3, rose by 13.2 percent year-on-year in July based on preliminary data from the BSP's Depository Corporations Survey (DCS).[3] This was a slight deceleration from the 13.4 percent growth registered in June. Liquidity expansion continued to be driven by sustained inflows from overseas Filipino workers' remittances and portfolio investments.

- Outstanding loans of commercial banks (KBs) rose by 4.3 percent year-on-year in July, from a marginal decline of 0.6 percent in the previous month. The improvement was driven mainly by the growth in loans to the financial institutions, real estate and business services (FIREBS) sector and the community, social and personal services sector.

Other Domestic Developments

- The Bureau of Agricultural Statistics (BAS) reported a 5.1 percent increase in agricultural production for the first semester of 2006. This was

[3] The DCS, which replaced 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.

higher than the 1.4 percent growth recorded in the same period in 2005. Higher output growth was traced to the recovery of the crops subsector and increased fishery and livestock production.

- Treasury bill (T-bill) auction rates eased across all tenors on 11 September 2006 relative to 31 July 2006 due to continued strong demand for government securities amid ample market liquidity.

- Positive market sentiment generated by sustained economic expansion and better-than-expected fiscal position for the first seven months resulted in the strengthening of the peso against the US dollar. Stronger regional currencies due partly to market expectations of a pause in the US tightening cycle, and sustained inflows from OFW remittances, export earnings and foreign investments likewise contributed to the peso's appreciation.

- The National Government (NG) generated a ₱14.3 billion fiscal surplus in August, which brought down the year-to-date fiscal deficit to ₱34.2 billion, 57.7 percent lower than the deficit for the comparable period in 2005. The eight-month fiscal deficit is equivalent to less than a third of the full-year target of ₱125.0 billion.

External Developments

- Global economic activity was strong in the second quarter of 2006 on renewed strength of domestic consumption, continued growth in services, and steady improvements in corporate profits. Nonetheless, recent developments continued to indicate a rebalancing in the composition of global demand. A number of risks also remain, notably the volatility in international oil prices, disorderly unwinding of global imbalances, and unexpected tightening of financial markets. Risks to the outlook for prices remain on the upside, with inflationary pressures appearing to have increased in countries where sustained high rates of growth have absorbed spare capacity.

- Major central banks maintained their policy rates at current levels despite indications of inflation pressures in their respective economies. The US Federal Open Market Committee (FOMC) kept the federal funds target rate steady at 5.25 percent in September as US economic growth moderated earlier this year. However, the FOMC maintained that further policy rate increases may be needed going forward to address existing inflation risks depending on the evolution of the outlook for inflation and output. The European Central Bank (ECB) Governing Council maintained key interest rates in August but remained of the view that a progressive withdrawal of monetary accommodation is warranted to help anchor medium to longer-term inflation expectations. Similarly, the Bank of England's Monetary Policy Committee kept its official bank rate steady at 4.75 percent in September. The Bank of Japan decided in the same month to maintain current policy settings at it encouraged the uncollateralized overnight call rate to remain at around 0.25 percent.

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

- The Monetary Board was of the view that current monetary policy settings remained appropriate to prevailing demand and supply-side conditions. Forecasts continued to show a generally declining path for inflation, with average inflation for 2007 expected to settle within the 4-5 percent target in the absence of further adverse shocks. The stronger peso should help keep down the domestic prices of imported commodities, particularly crude oil, while the favorable outlook for agriculture should help ensure stable food prices.

- Meanwhile, the continued easing of core inflation suggested minimal demand-based inflation pressures. Aggregate demand, to date, has been driven largely by consumer spending.

- However, the Monetary Board also recognized that the inflation outlook remained at risk from energy-related cost-side pressures. These pressures stem mainly from the vulnerability of world oil prices to supply constraints and geopolitical disruptions. Potential shifts in the public's inflation expectations will thus continue to require monitoring. The possibility of such shifts does not appear to be a pressing concern at the moment, but could become a risk in the future if cost pressures escalate more sharply than expected. This assessment applies equally to potential second-round pressures linked to wage-setting behavior. Liquidity conditions will also continue to be closely monitored in view of their potential impact on inflation.

- With this assessment, the Monetary Board reiterated its strong commitment to achieving the inflation targets for the medium term and its readiness to act against emerging risks to the outlook for inflation and to inflation expectations.

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 unanimously approved the recommendations of the Advisory Committee.

The next meeting of the Monetary Board to discuss the monetary policy setting is scheduled on 2 November 2006.