HIGHLIGHTS OF THE MEETING OF THE MONETARY BOARD ON MONETARY POLICY ISSUES HELD ON 17 JULY 2008[1]

I. Monetary Policy Decision

After considering the inflation outlook and the balance of risks to the inflation outlook as well as the evidence that has become available since its previous meeting on monetary policy, the Monetary Board decided to adjust the current monetary policy settings as follows:

a) Raise the BSP's policy interest rates by 50 basis points to 5.75 percent for the overnight RRP (borrowing) rate and 7.75 percent for the overnight RP (lending) rate;

b) Adjust accordingly the current interest rates on term RRPs, RPs and SDAs; and

c) Maintain the current reserve requirement ratios.

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

The decision to further tighten monetary policy settings was based on the following assessment of conditions:

a) Supply shocks have proven to be more persistent. Concurrent and interrelated shocks to the economy—such as the persistent surge in oil prices, and spikes in commodity prices—have contributed to elevated inflation readings.

b) Second-round effects have set in more strongly, as evident in the rise in core inflation, including the pricing of services and the earlier-than-expected wage adjustments. While there is no evidence of a wage-price spiral yet, the expected protracted nature of the commodity price spikes could feed into wage and price-setting behavior.

[1] 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 sets of economic information were provided by the technical secretariat of the Advisory Committee (AC). 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 Managing Director of the Monetary Policy Sub-sector. The highlights of the discussions of the 17 July 2008 meeting were approved by the Monetary Board during its regular meeting held on 7 August 2008. The next meeting of the Monetary Board is scheduled on 26 August 2008.

c) Inflation expectations are rising, as evident in consumer and business expectations surveys as well as in the uptrend in the yield curve and the term spreads of government securities.

d) Real interest rates are in negative territory, so a higher policy rate increase could help provide greater impact in stabilizing the inflation risk premium.

e) The BSP's baseline forecasts show the greater risk of inflation exceeding the inflation targets for 2008 and 2009 as supported by the following: 1) price pressures have increased even as they are projected to ease starting late 2008; 2) the pass through from global prices is not yet over and the global non-oil commodity price hikes appear prolonged and are expected to take longer to unwind; and 3) base effects continue to be unfavorable given low readings last year.

f) The buoyancy of demand conditions adds latitude to the conduct of monetary policy and suggests room for a measured policy response.

g) For these reasons, the Monetary Board believed that a more decisive monetary action was necessary. Inflation control is the foremost priority of the BSP. Sustained high inflation can unseat inflation expectations and potentially create a repeating cycle of lingering inflation and wage pressures that could prove costly to the economy. The Monetary Board believed the 50-basis point policy adjustment has a stronger impact than a 25-basis point hike in countering an incipient rise in inflation expectations and in serving as a signal of the inflation-fighting resolve of the BSP.

h) In the view of the Monetary Board, a prompt and a more decisive response to the upside risks to inflation is expected to more effectively calm elevated inflation expectations and reduce the long-term cost to output growth from prolonged high inflation.

III. Recent Developments in Economic Indicators

The Monetary Board's decision took into account the recent developments in various economic indicators:

A. Domestic price conditions

- Headline inflation hit 11.4 percent year-on-year in June—the highest in more than 14 years—from 9.5 percent (revised) in May. Most major commodity groups, led by food, beverages and tobacco, posted higher inflation rates relative to their levels in the previous month.

- Core inflation, which measures the underlying trend in inflation by excluding specific food and energy items, was similarly higher in June. The official core inflation measure published by the National Statistics Office (NSO) increased to 6.6 percent in June from 6.2 percent in May.

B. Inflation Expectations

- Recent surveys show more respondents expect inflation to move up:

  - Latest BES survey results for Q2 2008 indicated that the number of respondents who anticipate inflation to move up in Q2 2008 and Q3 2008 has increased.

  - Similarly, results of the latest CES for Q2 2008 showed that households nationwide expect an increase in the prices of goods and services over the next 12 months.

  - The BSP's Q2 2008 survey of private sector economists/analysts showed higher inflation forecasts for both 2008 and 2009.

  - The yield curve has shifted upward, and the term spreads between longer-term and short-term T-bills generally increased from their end-2006 levels.

C. Demand conditions

Favorable conditions arising from respectable domestic output growth imply that the economy can withstand a measured tightening:

- GDP grew at a slower rate of 5.2 percent in Q1 2008 compared to the growth posted in the previous quarter and the comparable period last year. GDP was boosted by household spending and capital investments on the expenditure side, and by the services sector from the production side.

- Monthly data from the NSO showed an 11.8 percent growth in merchandise imports in April 2008 from 12.1 percent in March. However, exports decelerated in May 2008 to 2.3 percent from 4.9 percent in April.

- Selected demand indicators suggest a slight moderation in demand conditions.

  - Makati Central Business District (CBD) Q1 2008 data from Jones Lang La Salle showed a year-on-year increase in office and residential rents of around 18.2 percent and 10.9 percent (in peso terms), respectively.

  - Passenger car sales declined by 0.5 percent year-on-year in May 2008, a reversal of the 6.1 percent growth registered in the same period last year and the 25.0 percent growth in April. Year-to-date sales slowed down to 8.8 percent in the first five months of 2008 from 10.0 percent in the comparable period last year.

  - Year-on-year commercial vehicle sales increased by 20.6 percent in May, higher than the 19.6 percent posted a year ago, but lower than the 29.2 percent registered in the previous month. On a year-to-date basis, commercial vehicle sales slowed down to 17.5 percent from 21.7 percent in the comparable period last year.

  - Year-on-year sales of trucks and buses decelerated to 14.3 percent in May compared to its year- and month-ago levels of 16.0 percent and 57.1 percent, respectively. Year-to-date sales were recorded at 12.5 percent, significantly lower than the 44.0 percent growth posted in the same period last year.

  - Year-on-year energy sales of Meralco declined by 0.1 percent in May, a reversal of the year- and month-ago expansion of 5.8 percent and 6.4 percent, respectively. Year-to-date energy sales grew at a slower rate of 2.5 percent in May, compared to the 3.9 percent in the same period last year.

  - Appliance sales were up by 13.1 percent year-on-year in May, although lower than the 15.9 percent posted a year ago and the 31.2 percent growth in the previous month. However, on a year-to-date basis, appliance sales increased at a higher rate of 16.0 percent compared to the previous year’s 11.3 percent.

- Average capacity utilization in manufacturing at 80.7 percent in April 2008 represented a modest increase over the 80.4 percent (revised) registered in March. This development reflected a gradual uptrend starting January this year, based on the rates presented in the NSO's Monthly Integrated Survey of Selected Industries (MISSI).

- The value of production index (VAPI) recovered to 7.3 percent year-on-year in April 2008 after registering a decline of 5.0 percent (revised) in March 2008. The volume of production index (VOPI) likewise rebounded year-on-year in April 2008 to 5.2 percent, after the 6.1 percent (revised) decline in March 2008.

- Q2 Business Expectations Survey (BES) results show business sentiment has remained positive but has turned more cautious. The index was lower by 17.3 index points and 33.8 index points compared to the levels in the previous quarter and in 2007, respectively.

- The Consumer Expectations Survey (CES) results showed a decline in consumer confidence in Q2 2008. The nationwide overall consumer outlook index (CI) for Q2 2008 decreased to -43.8 percent, down by 11.7 index points quarter-on-quarter and by 17.8 index points year-on-year.

- Based on the results of the April 2008 Labor Force Survey (LFS), the unemployment rate reached 8.0 percent in April 2008, higher than the 7.4 percent rate recorded in April 2007.

- The National Wages and Productivity Commission (NWPC) approved minimum wage and COLA adjustments in thirteen (13) out of seventeen (17) regions effective this month. The salaries of government employees were also increased by 10 percent in July.

D. Supply-side indicators

<u>Developments in Agriculture</u>

- Agriculture slowed to 3.0 percent in Q1 2008 relative to the year- and quarter-ago growth rates of 5.7 percent and 4.0 percent, respectively.

- Retail prices of commercial rice continued to increase in June. Meanwhile, prices of beef, pork, and poultry products in June were generally unchanged.

- International rice prices weakened while maize and wheat prices rose in June 2008. The turnaround of prices was due to bumper crops in some major exporting countries (Cambodia, Thailand, and Vietnam) and even major importing countries such as Bangladesh.

Oil Price Developments

- The average price of oil products was higher in June following the depreciation of the dollar against the euro, tension between Israel and Iran, and the Morgan Stanley forecast that crude oil prices could reach $150 per barrel in July with falling US stockpiles. Meanwhile, the import tariff on specific crude and refined petroleum products remained at zero in July 2008. Domestic pump prices of diesel and LPG were raised on 12 July 2008, while gasoline prices were reduced by ₱1.00 per liter on 10 July.

- In the transport sector, the Land Transportation Franchising and Regulatory Board (LTFRB) announced on 9 July 2008 another round of increases in jeepney and bus fares.

Developments in the Utilities Sector

- Electricity rates in NCR were still slightly higher in May compared to the same month in the previous year despite the month-on-month decline in generation and system loss charges.

- The Metropolitan Waterworks and Sewerage System-Regulatory Office (MWSS-RO) approved a lower discount under the foreign currency differential adjustments (FCDA) for Q3 2008. This translated to a slight increase in water rates for both Manila Water and Maynilad customers.

E. Financial Market Developments

- Inflation concerns, risk aversion, and economic uncertainty in the US continued to dictate financial market sentiments.

Market Interest Rates

- The after-tax differentials between the 91-day RP T-bill rate and the comparable foreign rates in the US widened by 159.6 basis points to 168.1 basis points during the period 1-7 July 2008, following the steep increase (by 203 basis points) in the 91-day RP T-bill rate.

- The secondary market yields for government securities (GS) and the term spread (secondary market yields for GS over the BSP policy rate) generally increased.

Stock Market

- Stock market trading continued to weaken during the first semester of 2008, as investors stayed cautious amid unfavorable developments, including: the global credit crises; fears of a prolonged US recession; increase in the price of world crude oil; and uptick in domestic inflation.

Foreign Exchange

- On a month-on-month basis, the peso depreciated by 3.1 percent in June 2008 to average ₱44.33/US$1. Inflation worries continued to drag the peso lower as prices of oil and food remained elevated. Investor risk aversion towards emerging markets likewise contributed to the weakening of the currency.

- On a year-to-date basis, the peso depreciated by 9.4 percent to close at ₱45.57/US$1 on 10 July 2008. The depreciation of the peso was in line with the movements of the Korean won and Indian rupee, which depreciated by 6.6 percent and 8.5 percent, respectively, vis-à-vis the US dollar relative to their end-2007 closing levels.

Global Bond and Credit Default Spreads

- As of 8 July, debt spreads have widened significantly since mid-June. The escalating debt spreads was due to a specter of inflation concerns brought about by the unabated rise in fuel and food prices. Oil prices hovered near all-time highs (over US$140 per barrel) amid tensions in the Middle East.

- The EMBI+ Philippine spreads reached 320 basis points on 8 July, its highest level in 2008. During the same period, Philippine credit default swap (CDS) spreads, or insurance-like contracts that protect investors against default or restructuring, tracked the same trend as it widened to 282 basis points from 262 basis points as of end-June.

F. Balance of Payments

- The balance of payments (BOP) for Q1 2008 yielded a surplus of US$1.7 billion, 20.8 percent higher than the US$1.4 billion surplus registered in the same quarter a year ago, as both the current and the capital and financial accounts continued to post surpluses.

G. Domestic Liquidity and Credit Conditions

- Based on data generated from the new system of bank reports, domestic liquidity or M3 increased in March. The expansion in domestic liquidity continued to be driven by the increase in the net foreign assets (NFA), particularly those of the BSP, as banks registered a reduction in their NFA.

- Based on preliminary data from the new system of bank reporting, outstanding loans of commercial banks (including reverse repurchase agreements or RRPs) rose further in March.

- Capital-raising activities in the PSE were weak in the period January-June 2008. Net intercompany borrowings by local subsidiaries were likewise lower due to repayments to foreign/parent companies. Meanwhile, corporate bond issuances rose during the first semester of 2008 relative to the comparable period in the previous year.

H. Fiscal developments

- The National Government (NG) registered a fiscal surplus in May amounting to ₱7.0 billion, a turnaround from the ₱1.7 billion deficit in the comparable period last year. Cumulatively, the fiscal deficit reached ₱18.8 billion for the period January-May, less than half of last year's deficit for the same period. This also represented 45.9 percent of the programmed deficit for the first semester of 2008.
- The public sector external debt-to-GDP ratio in Q1 2008 was 26.1 percent of GDP, lower by 5.3 percentage points compared to the 31.4 percent in the comparable period last year.

I. External developments

- Higher prices have resulted in an "income crunch" across the world. The recent run-up in commodity prices comes in the face of heightened weakness in US economic activity, which is already causing the global expansion to lose speed. Growth in the emerging and developing economies is set to slow, although still expected to remain above long-term trends in all regions.

- The central banks of Taiwan, Indonesia, Russia and the Euro region hiked rates. The Bank of Canada canceled a previously telegraphed rate cut. Meanwhile, the Fed and the Bank of England have started to adopt a hawkish tone, but analysts believe that the Fed will not hike rates given the rise in the unemployment rate.