HIGHLIGHTS OF THE MEETING OF THE MONETARY BOARD ON MONETARY POLICY ISSUES HELD ON 22 SEPTEMBER 2005*

The Advisory Committee[1] 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 7.25 percent for the overnight RRP (borrowing) rate and 9.5 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;

3) Continue to articulate support for the use of non-monetary measures to address supply-side risks, particularly those related to food supply and oil, by strengthening representation and coordination with various government agencies;

4) Encourage public support for energy conservation and efficiency measures; and

5) Support exploration/use of alternative sources of energy.

The Advisory Committee expressed the view that it was important for the BSP to undertake monetary action now to protect its inflation targets and help avoid the need for drastic tightening measures later.

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

The Advisory Committee's recommendations were based on the following considerations:

* The highlights of the discussions of the 22 September 2005 Monetary Board meeting were approved by the Monetary Board during its meeting held on 20 October 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 Managing Director of the Treasury Department, and the Director of the Department of Economic Research.

- Headline inflation rose slightly in August 2005 to 7.2 percent from 7.1 percent in the previous month, due mainly to higher inflation for housing and repairs as well as for services. Average inflation for the period January-August was 8.1 percent. Meanwhile, core inflation continued to decelerate in August.

- In terms of contribution to year-on-year headline inflation, food accounted for 2.7 percentage points; fuel, light and water, 1.3 percentage points; and transport and communication, 1.2 percentage points.

- There continue to be risks to future inflation. Volatility in international oil prices and its feed-through impact on domestic prices continue to be the dominant risk factor in the outlook for inflation.

- Selected indicators continue to suggest sustained but slower growth in economic activity.

  - Economic growth slowed down in the second quarter, reflecting the impact of higher prices of oil and other commodities and sluggish external trade, as well as the lingering effects of the El Niño dry spell. Growth in gross domestic product (GDP) declined to 4.8 percent in the second quarter of 2005 from 6.5 percent in the previous year, bringing the first semester growth to 4.7 percent.

  - Average capacity utilization in manufacturing in June 2005 was steady at 80.1 percent relative to the previous month.

  - The value of production index (VAPI) for manufacturing rose by 7.2 percent year-on-year in June, lower than the revised May growth rate of 13.6 percent. The volume of production index (VOPI) for manufacturing fell marginally by 0.1 percent year-on-year in June from growth of 6.1 percent in May.

  - Preliminary data show that growth in merchandise exports accelerated to 11.4 percent year-on-year in July from 1.2 percent in June. This was traced to the robust performance of electronic products, which accounted for 66.2 percent of total export revenue.

  - Merchandise imports rose by 6.0 percent year-on-year in June from nil in May, due largely to higher import bill on fuel.

  - The country's major corporations posted generally strong revenue growth in the first half of 2005. For some firms, however, growth in net income was capped by higher costs of financing, raw materials, distribution and utilities.

  - Property values rose while vacancy rates declined during the second quarter, based on estimates of Colliers International Research.

- The year-on-year growth in passenger car sales slowed down to 2.8 percent in July from 22.7 percent in the previous month, according to data from the Chamber of Automotive Manufacturers of the Philippines, Inc.

- Energy sales by the Manila Electric Company grew at a slower pace of 1.6 percent year-on-year in July from 5.2 percent in June, as energy consumption of the residential and commercial sectors slowed down while that of the industrial sector continued to decline.

- Appliance sales declined for the seventh straight month, falling by 17.2 percent year-on-year in June. This was slightly higher than the previous month's 17.1 percent and was a reversal of the previous year's 5.1 percent expansion.

- The unemployment rate declined to 10.9 percent in July 2005 from 11.7 percent a year ago and 12.7 percent in April 2005, using the old definition of unemployment. Based on the new definition of unemployment, the jobless rate declined to 7.7 percent in July from 8.3 percent in April.[2]

- The third quarter 2005 BSP Business Expectations Survey showed that business optimism in the third quarter declined, but firms expect conditions to improve in the fourth quarter. The latest Consumer Expectations Survey showed weaker consumer outlook for the third and fourth quarters of 2005.

- The composite leading economic indicator of the National Statistical Coordination Board (NSCB) rose to 0.081 in the third quarter of 2005 from 0.072 in the second quarter.

- Agriculture output grew by 1.3 percent in the first half of 2005, lower than the 6.4 percent recorded a year ago as the El Niño-induced drought affected adversely the production of major crops such as rice and corn.

- World oil prices continued to rise in September as Hurricane Katrina affected US crude oil production facilities, refinery facilities and pipelines, adding to the tightness of oil supply and capacity in the market. However, the announcement of International Energy Agency (IEA) member countries to release emergency stockpiles helped ease world oil prices. In the domestic market, retail oil prices continued to rise since June 2005, reflecting the successive increases in world oil prices. In response, the

[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.

Philippine government is implementing several measures to help cushion the impact of high oil prices.

- In the financial sector, the growth in domestic liquidity accelerated, while bank lending continued to expand at a moderate pace. Meanwhile, Treasury bill (T-bill) rates were generally higher during the 12 September 2005 auction compared to their levels in the previous month and the previous week.

  - Based on preliminary Depository Corporations Survey (DCS) data, the growth in domestic liquidity (M3) accelerated to 13.6 percent year-on-year in July 2005 from 12.8 percent in the previous month.[3]

  - Outstanding loans of commercial banks grew by 4.0 percent year-on-year to ₱1.546 trillion as of end-July 2005. This was slightly lower than the 6.4 year-on-year growth recorded in June.

  - Relative to the previous auction on 22 August 2005, the T-bill rate for the 91-day, 182-day and 364-day tenors increased during the 12 September 2005 auction. This was due to the combined impact of lingering political concerns and lower demand for government securities following the successful issuance of retail treasury bonds on 31 August 2005.

- The peso was weaker against the US dollar in early September due to market jitters relating to the uncertainty on the domestic political front. Increased corporate dollar demand prompted by rising crude prices also weighed down on the local currency.

- The National Government (NG) posted its third monthly fiscal surplus in five months in August, as revenues exceeded expenditures by ₱1.8 billion. Revenue collections rose by 33.6 percent while expenditures grew by 9.2 percent, reflecting intensified revenue collection efforts and prudent spending. This brought the NG's budget deficit for the first eight months to ₱80.8 billion, which is 27.3 percent lower than the year-ago level and equivalent to only 44.9 percent of the deficit target for the entire year.

- Global economic expansion remained broadly on track during the first half of 2005, led mainly by robust economic growth in the US and China. Inflation pressures at the global level appeared to be well-contained despite higher inflation. Forward-looking global economic indicators appear consistent with a moderate but solid growth performance in the

[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.

year ahead. However, the continued rise in oil prices continues to be a major source of risk to the outlook for the rest of the year.

II. Review of the Monetary Policy Stance

- Members of the Monetary Board agreed that given prevailing conditions and the outlook for inflation and output, there may be a stronger case for monetary action against inflation pressures. Firstly, supply-side inflation pressures are expected to build up over the policy horizon given the likelihood of continued high crude oil prices for the foreseeable future. Such an outlook not only increases the risk of second-round effects from supply shocks but also poses a threat to inflation expectations, as the public may begin to expect inflation to remain indefinitely at high levels.

- An added concern was that the recent growth in the money supply may not necessarily be funding consumption and investment spending, as growth in bank lending has remained moderate and aggregate demand appears to be slowing down. This situation raises the risk that the excess liquidity could merely fuel inflation through exchange market pressure rather than promote growth through bank lending and real sector activity.

- It was also noted that the trend of rising foreign interest rates due to monetary tightening by other central banks could lead to further declines in interest rate differentials. Declining interest differentials may encourage investors to buy more dollar-denominated assets. Combined with excess liquidity in the financial system, a shift toward dollar assets could lead to volatility in the peso-dollar exchange rate, which in turn could raise inflation and inflation expectations.

- Given that the projected risks from cost-side pressures have intensified and the risk of higher inflation expectations has increased, the Monetary Board believed that it was important for the BSP to undertake monetary action now to protect its inflation targets and help avoid the need for drastic tightening measures later.

- The Monetary Board also agreed that moving forward, the BSP should continue to closely monitor the evolving conditions for consumer prices, aggregate demand, domestic liquidity and other factors in order to determine the appropriate stance of monetary policy. The Monetary Board reiterated its commitment to fighting inflation and is prepared to undertake all necessary actions to safeguard future inflation and inflation expectations.

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 unanimously approved 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 7.25 percent for the overnight RRP (borrowing) rate and 9.5 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;

  3) Continue to articulate support for the use of non-monetary measures to address supply-side risks, particularly those relating to food supply, energy conservation, and the development of alternative energy sources, 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.

The next meeting of the Monetary Board to discuss the monetary policy setting is scheduled on 20 October 2005.