



**HIGHLIGHTS OF THE MEETING OF THE MONETARY BOARD ON
MONETARY POLICY ISSUES HELD ON 5 JUNE 2008***

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

- Adjust the current monetary policy settings as follows:
 - (a) Raise the BSP's policy interest rates by 25 basis points to 5.25 percent for the overnight RRP (borrowing) rate and 7.25 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.

The recommendation to tighten monetary policy settings was based on the following assessments:

- (a) Tighter monetary policy would help anchor inflation expectations (including wage demands) and stop higher commodity prices from spreading into the wider economy;
- (b) Indications of second-round effects and higher inflation expectations also support the need for a measured increase in policy rates; and
- (c) The buoyancy of domestic demand suggests that there is some room for a measured policy response to second-round effects.

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

* 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 5 June 2008 meeting were approved by the Monetary Board during its regular meeting held on 17 June 2008.

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 Managing Director of the Monetary Policy Sub-sector.



Review of Recent Developments

A. Domestic price conditions

- Headline inflation rose to 8.3 percent year-on-year in April from 6.4 percent in March, bringing the year-to-date average to 6.2 percent. [Headline inflation rose to 9.6 percent year-on-year in May—the highest in more than nine years—from 8.3 percent in April and 2.4 percent a year ago, bringing the year-to-date average to 6.9 percent].
- Core inflation, which measures the underlying trend in inflation by excluding specific food and energy items, was similarly higher in April. The official core inflation measure published by the National Statistics Office (NSO) increased to 5.9 percent in April from 4.8 percent in March. [Core inflation accelerated to 6.2 percent year-on-year in May from 5.9 percent in April].

B. Demand conditions

- Gross Domestic Product (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 growth was boosted by household spending and capital investments on the expenditure side, and by the services sector from the production side.
- For Q1 2008, the business cycle path remained broadly steady, indicating a continuing expansion phase.
- Monthly National Statistics Office (NSO) data reflected a 12.2 percent growth in merchandise imports for March 2008. Meanwhile, exports declined by 6.8 percent year-on-year in March.
- Selected demand indicators of demand indicated a broad strengthening trend.
 - Land values in the Makati Central Business District (CBD) and Ortigas Center rose in Q4 2007 and reached about 70 percent of the 1997 levels. In real terms however, land values only increased slightly in Q4 2007 and remained at about 30-40 percent of the peak levels in 1996.
 - Passenger car sales declined by 6.5 percent year-on-year in March, compared to the 34.9 percent growth registered in the same period last year and 11.4 percent in February. Year-to-date sales growth decelerated to 7.8 percent in the first quarter of 2008 from the 9.9 percent growth in the comparable period last year.



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- Meanwhile, commercial vehicle sales continued to grow although at a slower rate of 11.4 percent year-on-year in March, compared to the year-ago level of 14.9 percent and the month-ago level of 11.9 percent. Likewise, on a year-to-date basis, the growth of commercial vehicle sales slowed down to 12.2 percent, lower than the 23.4 percent registered in the comparable period last year.
- On a year-on-year basis, sales of trucks and buses increased by 12.9 percent in February 2008, lower than the 66.0 percent recorded in February 2007 but a reversal of the 21.7 percent contraction in January 2008. Year-to-date sales growth decelerated to 7.8 percent in the first quarter of 2008 from the 9.9 percent growth in the comparable period last year.
- Year-on-year energy sales of Meralco contracted by 3.7 percent in March, a reversal of the year- and month-ago growth of 5.1 percent and 6.0 percent, respectively. As a result, year-to-date energy sales grew at a slower rate of 2.1 percent in March, compared to the 3.7 percent growth registered in the same period last year.
- Based on revised data, appliance sales continued to grow although at a slower rate of 11.5 percent year-on-year in March, compared to the year-ago growth of 24.3 percent. However, this was higher than the 8.3 percent growth registered a month ago. Meanwhile, year-to-date appliance sales increased by 12.0 percent, but at a lower pace compared to the 13.5 percent increase recorded in the same period last year.
- Average capacity utilization in manufacturing was relatively steady for the eighth consecutive month at 80.2 percent in March 2008, based on the rates reported in NSO's Monthly Integrated Survey of Selected Industries (MISSI).
- The value of production index (VAPI) decreased by 5.0 percent year-on-year in March 2008, reversing the 7.4 percent (revised) increase in the previous month. The volume of production index (VOPI) also dropped by 5.9 percent year-on-year in March, reversing the 6.3 percent (revised) increase in February.
- Q2 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 a year ago, respectively.
- Preliminary Q2 2008 CES results showed a decline in consumer confidence. The nationwide overall consumer outlook index (CI) for



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the second quarter of 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 preliminary results of the January 2008 Labor Force Survey (LFS), the unemployment rate declined to 7.4 percent in January 2008 from 7.8 percent in January 2007.
- The salaries of government employees will increase by 10 percent effective July 2008. The National Wages and Productivity Commission (NWPC) recently approved minimum wage and COLA adjustments in NCR, Region IV-A, Region VIII, and Region X. Meanwhile, the proposal for the ₱125 daily wage hike for private sector employees and the Salary Standardization Law (SSL) III for government workers remain pending in Congress.

C. Supply-side indicators

Developments in Agriculture

- Agriculture expanded in Q1 2008 buoyed by production increases in the crops, poultry, and fishery subsectors.
- Retail prices of commercial rice in Metro Manila were steady while price increases were slower during May in areas outside Metro Manila.
- Data from NFA as of 16 May indicate that the country's total rice inventory stood at 2.2 MMT, higher than the previous month's and previous year's level of 1.9 MMT. In terms of rice sufficiency, the latest inventory level is sufficient to last 68 days based on the average daily rice requirement of 33 thousand MT.
- Meanwhile, prices of beef products were generally unchanged and the prices of poultry products sustained their downward trend in April given sufficient supply in the market.
- International prices for rice and maize continued their rise in April, largely driven by persistent supply tightness and the imposition of new export restrictions. Rice prices sustained increases in May.

Oil Price Developments

- International spot and futures prices of oil were higher in May due to OPEC's reluctance to increase its production and supply disruptions. In the domestic scene, the oil import tariff will be reduced to zero in June. Meanwhile, pump prices of most petroleum products increased anew on 31 May.



- In the transport sector, provisional increases for jeepney and bus fares were implemented on 21 May. The minimum fare for jeepneys nationwide increased by ₱0.50 and the fare for regular and air-conditioned buses in Metro Manila by ₱1.00 and ₱1.50, respectively. For provincial buses, there will be an increase of ₱0.50 in the minimum fare for regular buses and an additional of ₱0.10 for every succeeding kilometer while air-conditioned buses were allowed to charge ₱0.25 more for every kilometer.

Developments in the Utilities Sector

- Electricity rates in Metro Manila were raised anew in April as Meralco adjusted its generation, transmission, and system-loss charges.
- The Metropolitan Waterworks and Sewerage System-Regulatory Office (MWSS-RO) earlier approved the reduction in water rates through the foreign currency differential adjustments (FCDA) for Q2 2008.

D. Financial Market Developments

- Inflation fears, risk aversion, and economic uncertainty in the US and global economies continued to drive stock market sentiments, while the peso depreciated in April relative to the previous month.

Interest Rates

- During the 26 May 2008 auction, the Auction Committee made a ₱1.62 billion partial award of 364-day T-bills at an average rate of 6.846 percent, 6.9 basis points lower than the rate at the previous auction (12 May).
- Relative to their 30 April levels, terms spreads (secondary market yields of GS net of reverse repurchase or RRP) generally increased across all tenors on 27 May. The spread of the yield curve shifted upward as investors remained cautious on continued concerns over global and domestic inflationary pressures.

Stock Market

- The uptick in domestic inflation, economic uncertainty in the US and global economies, and lack of positive news continued to dampen market sentiments that resulted in four consecutive months of decline in the PSEi from 3,266.0 index points in January to a new low of 2,749.8 index points in April. In May, trading started weak as investors stayed cautious. In the second week of May, the market gained momentum as the PSEi showed a sustained uptrend from 2,727.70 index points on 6 May to 2,896.15 index points on 20 May.



Foreign Exchange

- The peso depreciated by 1.2 percent to average ₱41.84/US\$1 in April relative to the previous month. Risk aversion continued in April as investors avoided assets in emerging markets in anticipation of further global financial turbulence amid widening losses triggered by the property downturn in the US.
- On a year-to-date basis, the peso depreciated by 5.6 percent to close at ₱43.82/US\$1 on 30 May 2008. The depreciation of the peso was in line with the movements of the Indian rupee, Thai baht, and Korean won which depreciated by 7.3 percent, 7.5 percent and 9.1 percent, respectively, vis-à-vis the US dollar relative to their end-2007 closing levels.

Global Bond and Credit Default Spreads

- Debt spreads eased in May as global oil prices retreated from their peak of over US\$135 a barrel on 22 May. Emerging debt spreads over US Treasury notes [Emerging Market Bond Index (EMBI)+ Global] tightened to 255 basis points on 27 May from 264 basis points posted in end-April. During the same period, EMBI+ Philippine spreads tracked the same trend as it slightly eased to 224 basis points from 228 basis points.
- On the domestic front, Philippine credit default swap (CDS) spreads widened to 223 basis points on 27 May from end-April's 195 basis points.

E. Domestic Liquidity and Credit Conditions

- Based on data generated from the new system of bank reporting, domestic liquidity or M3 grew by 9.6 percent year-on-year in March, up from 6.6 percent in February. The expansion in domestic liquidity continued to be driven by the increase in 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 RRP) rose further in March, posting a growth of 10.6 percent year-on-year. This was higher than the 5.7 percent growth posted in February. Bank lending—net of banks' RRP placements with the BSP—increased by 15.7 percent year-on-year in March.
- Consumer credit increased by 15.9 percent year-on-year in Q4 2007 but this was lower than the 21.1 percent growth recorded in Q4 2006 and the 20.9 percent growth registered in Q3 2007.



- Capital-raising activities in the PSE were weak in the period January-April 2008. Meanwhile, corporate bond issuances rose slightly during the first four months of 2008 relative to the comparable period in the previous year.

F. Fiscal developments

- The National Government (NG) registered a fiscal surplus in April amounting to ₱25.8 billion, more than twice the surplus in the comparable period last year. This brought the fiscal deficit for January-April to ₱25.8 billion, lower by one-third relative to last year's deficit for the same period. For the first four months, revenue collections grew by 11.0 percent to ₱375.5 billion compared to ₱338.5 billion for the same period last year.
- The full-year public sector external debt-to-GDP ratio in 2007 was 26.1 percent of GDP, lower by 5.4 percentage points compared to 31.5 percent in 2006. This can be attributed to the increase in GDP to US\$144.1 billion for 2007 from US\$117.6 billion in 2006. This offsets the increase in the stock of public sector external debt which rose to US\$37.7 billion from US\$37.1 billion in 2006.

G. External developments

- The weakness in US economic activity and the volatility in financial markets are causing global expansion to lose speed. Emerging market economies, however, have so far been less affected by the financial market turbulence and have continued to grow at a rapid pace—particularly China and India—although economic activity is beginning to moderate in other Asian economies.
- Meanwhile, headline inflation has increased around the world, reflecting the greater weight of energy and food in consumption baskets. The risks to the outlook for inflation have intensified and the concern is that persistent inflation in emerging economies may require tightening of monetary policies going forward.
- Against the background of financial market volatility and a possible protracted slowdown in the US economy, an extended period of slower growth is expected in the near term as the rest of the world may not be able to decouple from the US despite the strong fundamentals of emerging market economies.
- The Fed eased monetary policy settings while most central banks remained on hold. The Fed reduced its target for the federal funds rate by 25 basis points to 2.0 percent. Meanwhile, the central banks of the Euro area, Japan, and England maintained policy settings on growing concerns on rising inflation.



- In Asia and the Pacific, Indonesia, China, and Taiwan raised their policy rates during their latest policy meetings, whereas New Zealand, Australia, India, South Korea, Thailand, and Malaysia maintained their monetary policy stance.

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

- In its assessment, the Monetary Board noted that the inflation outlook calls for preemptive policy action against emerging second-round effects and rising inflation expectations.
- The emerging baseline forecasts, which reflect more recent data on inflation and output, indicate a likely breach of the inflation targets in 2008 and 2009, with the balance of risks tilted to the upside. The BSP forecasts 2008 average inflation to reach 7.0-9.0 percent. For 2009, average inflation is expected to decline to 4.0-6.0 percent.
- The upside risks to inflation include exchange rate volatility, continuing high world oil prices, possible increases in electricity rates, and petitions for transport fare increases (recent adjustments were only provisional), and possibility of higher-than-expected wage hikes in those regions where wage petitions have not yet been acted upon. Moreover, despite the signs of prices easing in some commodities such as wheat, food inflation is likely to remain elevated as world prices are unlikely to fall back to their pre-2007 levels.
- The Monetary Board also noted that there are already indications that supply-driven pressures are beginning to feed into demand. Core inflation as of May 2008 has reached its highest level since April 2006. Recent business and consumer confidence surveys also indicate an upward shift in inflation expectations, coinciding with increased term spreads on government securities and higher secondary market yields.
- Given the early evidence of second-round effects, the Monetary Board recognized the need to act promptly to rein in inflationary expectations. Since monetary policy affects economic variables with a time lag, policy measures undertaken now will help address risks to inflation in 2009. In addition, the buoyancy of domestic demand suggests some room for a measured policy response. Favorable conditions arising from a respectable and still solid domestic growth as well as a strong external payments situation imply that the economy can withstand a measured tightening.



III. 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 approved the recommendations of the Advisory Committee.

The next meeting of the Monetary Board on the monetary policy stance is scheduled on 17 July 2008.

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