HIGHLIGHTS OF THE MEETING OF THE MONETARY BOARD ON MONETARY POLICY ISSUES HELD ON 2 JUNE 2005*

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 7.0 percent for the overnight RRP (borrowing) rate and 9.25 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;

3) Continue to articulate support for the intensified use of non-monetary measures to address supply-side risks, particularly those relating to food supply, 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.

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

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

- Headline inflation was unchanged at 8.5 percent in April 2005 as slower food inflation offset the uptick in non-food inflation. This brought the year-to-date average inflation rate to 8.5 percent. On a month-to-month basis, inflation rose in April 2005 from the March 2005 rate.

* The highlights of the discussions of the 2 June 2005 Monetary Board meeting were approved by the Monetary Board during its meeting held on 7 July 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 Assistant Governor, Monetary Policy Sub-Sector and the Managing Director of the Treasury Department.

- The current inflationary process continues to be driven by the upsurge in oil prices. Of the 8.5 percent inflation for April 2005, 3.3 percentage points were attributed to food, beverage and tobacco, 1.7 percentage points to transportation and communication services and 1.4 percentage points to fuel, light and water.

- Meanwhile, core inflation continued to decelerate to 7.8 percent in April from 8.0 percent a month earlier.

- In the short-run, inflation is expected to trend higher owing to the emergence of new risks such as the implementation of the reforms in VAT, adjustments in transport fares and possible increase in wages over and above the equivalent of loss of purchasing power and ancillary adjustments. The ongoing impact of dry weather and the continued rise in world oil prices may also contribute to pressures on domestic prices.

- Most indicators of demand suggested sustained growth in economic activity, although at a slower pace.

  - Economic growth was slower in the first quarter of 2005 compared to a year ago and the previous quarter. This was due largely to the slowdown in consumption and external trade and the decline in mining and agricultural production.

  - Average capacity utilization in manufacturing rose slightly to 79.9 percent in March 2005 from 79.8 percent in the previous month.

  - The value of production index (VAPI) for manufacturing rose by 11.7 percent year-on-year in March 2005, higher than the revised February growth rate of 10.0 percent. Year-on-year growth in volume of production index (VOPI) for manufacturing was 2.8 percent in March from 1.6 percent in February.

  - The first quarter 2005 financial performance of the country's major corporations showed mixed trends.

  - Merchandise exports fell by 2.8 percent year-on-year in March 2005. This was a faster decline compared to the previous month's 0.6 percent and a reversal from year-ago growth of 7.1 percent.

  - Merchandise imports declined for the fourth straight month, dropping 4.0 percent year-on-year in March 2005. This was also a downturn from the 4.4 percent expansion in the same month last year.

  - Passenger car sales increased by 35.0 percent year-on-year in April 2005, higher than the previous month's 6.4 percent but slower than the 119.2 percent expansion a year ago.

- ✍ Energy sales by the Manila Electric Company declined further by 3.7 percent year-on-year in March 2005 from the 2.5 percent drop in the previous month.

- ✍ The unemployment rate rose to 11.3 percent in January 2005 from 11.0 percent a year ago. This was also higher than the 10.9 percent unemployment rate in October 2004.

- ✍ The second quarter 2005 BSP Business Expectations Survey showed that business outlook was less optimistic than in the previous quarter but remained positive. The overall business outlook diffusion index for the second quarter of 2005 was recorded at 12.9 percent. The latest Consumer Expectations Survey likewise showed weaker consumer outlook for the second and third quarters of 2005.

- ✍ The composite leading economic indicator (LEI) of the National Statistical Coordination Board (NSCB) continued to rise in the second quarter of 2005 to 0.272 from 0.245 in the first quarter.

✍ The volatility in global oil prices is expected to continue to exert a central influence on the inflation outlook.

- ✍ Agricultural production grew by a slight 0.6 percent year-on-year in the first quarter of 2005, as the gains from poultry and fishery production offset the decline in crop production caused by the El Niño-induced drought.

- ✍ World oil prices dropped in early May following the build-up in US inventory and a seasonal decline in energy consumption. However, prices rose again in the fourth week of May due to renewed supply concerns. In the domestic market, oil companies reduced retail pump prices of petroleum products to reflect the drop in world oil prices.

? Growth in liquidity continued to strengthen, supported by sustained investments in government securities. Bank lending generally remained modest despite continued improvement.

- ✍ The growth in domestic liquidity (M3) accelerated to 11.7 percent (revised) year-on-year in February 2005, based on Depository Corporations Survey (DCS) from the 11.0 percent rise in the previous month.[2]

[2] 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.

- ✍ Outstanding loans of commercial bank (KB) loans grew by 5.8 percent year-on-year in February 2005. This was higher than the 4.0 percent year-on-year growth recorded in the previous month.

- ✍ Relative to the 25 April and 23 May 2005 auctions, T-bill rates eased across all tenors during the 30 May 2005 auction. T-bill rates continued to decline on more positive fiscal picture following the passage of the expanded VAT reform bill, reports that the National Government (NG) posted a budget surplus for the first time in four years in April, and the sale of US$750 million worth of global bonds by the NG.

? The peso strengthened against the US dollar in May due mainly to sustained inflows from OFW remittances, balance of payment surplus for the first four months of the year, improvements in tax collection, the passage of the VAT reform bill, and strong regional currencies. Exchange market pressure remained a risk to the inflation environment due to the possibility of further narrowing of interest rate differentials.

? The NG posted a ₱3.3 billion fiscal surplus in April 2005, the first time in the last four years. This brought the NG's budget deficit for the first four months to ₱60.1 billion, 7.0 percent lower than the deficit level posted a year ago and equivalent to 61.0 percent of the ₱98.5 billion program deficit for the first semester.

? Global economic expansion appeared to have slowed down during the first quarter of 2005. Consumption spending and export growth moderated in most economies while labor market conditions remained generally favorable. On the whole, forward-looking global economic indicators appeared consistent with a moderate, yet continued solid growth performance in the year ahead.

II. Review of the Monetary Policy Stance

? The members of the Monetary Board noted that the prevailing and emerging risks to inflation were associated mainly with supply-side or cost push factors such as the VAT reform, oil prices and imminent adjustments in transport fares. These factors were expected to push the future inflation path upward in the short-term but are not likely to have a lasting impact on prices in the absence of further shocks.

? The members of the Monetary Board also pointed out that demand-side pressures on prices continued to be muted due to cyclical and structural conditions, particularly high unemployment and modest credit demand. There was thus a need to preserve the conditions for continued expansion in aggregate demand, given emerging indications of the contractionary impact of the oil shock and the expected impact of fiscal adjustment via VAT reform on growth in the short run.

? At the same time, the members of the Monetary Board recognized that continued price pressures might influence inflation expectations. Monetary authorities should try to mitigate cost-push inflation from feeding into higher wages and prices of other goods and services. The BSP, therefore, should stand ready to take action in order to guide inflation expectations and signal the BSP's commitment to fight inflation.

? The members of the Monetary Board also noted that the recent policy rate increase should also be given time to fully work its way into the economy and exert its impact on inflation expectations. The current level of policy rates, while divergent from market interest rates, remained appropriate to promote levels of liquidity consistent with the output path and the inflation outlook. The BSP was able to contain the expansion of liquidity stemming mainly from inflows of OFW remittances and portfolio investments. There was also no significant evidence of a shift in preference away from peso assets.

? At the same time, the Monetary Board members recognized the need to strengthen representation with other government agencies in support of non-monetary supply-side intervention measures to mitigate the impact of higher prices on consumers, such as measures to facilitate distribution of basic goods and services to final consumers.

? The members of the Monetary Board also agreed to further strengthen transparency and communication of policies and prospects of inflation in order to manage 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 approved unanimously the following measures:

1) Maintain the current monetary policy settings as follows:

   (a) Maintain the BSP's policy interest rates at 7.0 percent for the overnight RRP (borrowing) rate and 9.25 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;

3) Continue to articulate support for the use of non-monetary measures to address supply-side risks, particularly those relating to food supply, 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 30 June 2005.