Bangko Sentral ng Pilipinas

HIGHLIGHTS OF THE MEETING OF THE MONETARY BOARD ON MONETARY POLICY ISSUES HELD ON 6 OCTOBER 2008[1]

I. Monetary Policy Decision

On the basis of its discussions on the balance of risks to the inflation outlook and given the ongoing global financial market turbulence, the Monetary Board decided to maintain the current monetary policy settings as follows:

a) Maintain the BSP's policy rates at 6.00 percent for the overnight RRP (borrowing) rate and 8.00 percent for the overnight RP (lending) rate;

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

c) Maintain the current reserve requirement ratio.

The policy decision to keep interest rates steady was arrived at in the process of balancing the BSP's concern over price stability and its resolve to undertake policy actions that will ensure the soundness and stability of the financial system.

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

- The Monetary Board discussed extensively the current conditions in the global economy, including the stresses being experienced in the global financial markets. The Board paid particular attention to the ongoing talks on proposed liquidity provision measures of the central banks in advanced economies that are considered pivotal in restoring global financial stability and reviving the flow of credit to support global economic growth. The Monetary Board also assessed

[1] The discussions presented herein reflect 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 on the 6 October 2008 meeting were approved by the Monetary Board during its regular meeting on held 23 October 2008. The next meeting of the Monetary Board is scheduled on 20 November 2008.

the impact of the expected global economic slowdown on the domestic economy.

- The Monetary Board then discussed the following developments:

  - Food and energy prices may have peaked, and are expected to stabilize—and could even retreat– in the coming months. This development could lead to lower headline inflation, providing monetary authorities more room for flexibility.

  - However, commodity prices are expected to remain at elevated levels for the remainder of 2008, and will probably continue to be volatile, as the supply and demand balance remains tight.

  - While core inflation is rising, there is no additional evidence of second-round effects, with wage demands contained and further petitions for transport hikes deferred.

  - There are also early signs of improving inflation expectations:

    - The term structure of interest rates appears to have stabilized and the differentials between short and long-term tenors have narrowed;

    - Various forecasts suggest lower inflation for 2009; and

    - Inflation expectations have stabilized, with the recent abatement of oil and rice prices.

- The emerging outlook indicates that inflation will decelerate to single-digit levels by the first quarter of 2009. With the full effects of the earlier increases in policy rates yet to be felt, future headline inflation is expected to slow down towards the target-consistent path by 2010.

- On balance, the risks surrounding the inflation outlook over the policy horizon are tilted to the downside.

- However, there is a need to remain mindful of the following possible sources of upside risks:

  - Weaker peso
  - Volatility in oil prices
  - Increases in utility charges
  - Positive output gap

- In addition, a steady monetary policy will ensure the effective functioning of the transmission channels for monetary policy, which, in turn, will be helpful in preventing any credit crunch, and will reinforce confidence in the financial markets and the economy as whole.

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 climbed to 12.5 percent year-on-year in August, higher than the 12.3 percent (revised) posted in July.

- By geographical location, inflation went up both in the National Capital Region (NCR) and in areas outside the NCR.

- Core inflation rose to 7.0 percent in August from 6.3 percent in July.

B. Inflation Expectations

- The Board noted that recent Business and Consumer Expectations surveys showed more respondents expecting inflation to move up in Q3 with some improvement in Q4. The Asia Pacific Consensus Forecasts for the Philippines in September showed lower inflation expectations for 2009 compared to the previous month's forecast.

C. Demand conditions

Recent data confirm that economic activity is moderating as higher fuel and food costs have slowed down the demand for commodities and services.

- GDP grew at a slower rate of 4.6 percent in Q2 2008 compared to the growth posted in the previous quarter and the comparable period last year. GNP also decelerated to 5.5 percent.

- Monthly NSO data showed merchandise imports increasing by 16.0 percent in July 2008, compared to their month- and year-ago growth rates of 12.7 percent and 14.3 percent, respectively.

- Meanwhile, exports growth decelerated in July at 4.3 percent from the month-and year- ago growth of 8.8 percent and 5.8 percent, respectively.

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

  - Colliers International Research estimates showed that the increase in land and rental values have generally moderated compared to 2007.

  - Passenger car sales improved in August due to increased preference for cars with smaller engines. Meanwhile, commercial vehicle sales declined while sales growth of trucks and buses slowed down due to undelivered fleet orders.

  - Year-on-year energy sales of Meralco declined further by 1.3 percent in July after shrinking by 1.0 percent in the previous month. This was a reversal of the 6.7 percent growth recorded in the same period last year. Year-to-date sales registered a 1.4 percent growth, although lower than the 4.6 percent expansion recorded in the comparable period in 2007.

  - Appliance sales recovered, registering a 34.9 percent year-on-year growth in July, a turnaround from the 3.8 percent contraction in the same period last year and more than twice the 17.4 percent growth in June. Likewise, year-to-date appliance sales increased by 12.3 percent year-on-year compared to 8.9 percent in the comparable period last year.

  - Average capacity utilization in manufacturing increased to 81.6 percent in July 2008 from 81.1 percent (revised) in June as it continued its gradual but steady uptrend since January this year.

  - The value of production index (VAPI) posted two-digit growth at 13.9 percent year-on-year in July 2008 after increasing by 9.4 percent (revised) in June 2008. Likewise, the volume of production index (VOPI) was higher year-on-year in July 2008 at 8.1 percent from 5.0 percent (revised) in June.

- Based on the results of the July 2008 Labor Force Survey (LFS), the unemployment rate declined to 7.4 percent in July 2008 from 7.8 percent a year ago.

- The National Wage and Productivity Commission has completed its recent round of wage and COLA adjustments in all regions in 2008, increasing the daily compensation of workers by 5.8 percent nationwide.

D. Supply-side indicators

Developments in Agriculture

- Latest data from the National Income Accounts showed that the agriculture, fishery and forestry output grew by 4.9 percent in Q2 2008 from 4.2 percent in the same period last year.

- Average retail prices of commercial rice started to decline since the third week of July and up to September, but rice price levels remain elevated when compared to the 2007 levels.

Oil Price Developments

- Dubai crude oil prices were lower in September due to worries about weaker global demand. Meanwhile, the import tariff on specific crude and refined petroleum products remained at zero in September 2008. Oil companies reduced the domestic pump prices of petroleum products further, with the latest reduction implemented on 19 September.

- In the transport sector, a consumer group, the National Council for Commuters Protection, submitted a petition to the Land Transportation Franchising and Regulatory Board (on 19 September 2008) for a reduction in the minimum fare for Metro Manila jeepneys and buses.

Developments in the Utilities Sector

- The pending petitions before the Energy Regulatory Commission and the volatility in the Wholesale Electricity Spot Market will likely create upside pressures on electricity rates in the coming months. Meanwhile, water rates are expected to increase in the fourth quarter.

E. Financial Market Developments

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

Market Interest Rates

- Market interest rates generally rose in August, reflecting market participants' expectations of higher BSP policy rates. Consequently, interest rate differentials between domestic market interest rates and comparable foreign rates as well as the spread of lending rates over the Treasury bill rates widened. Meanwhile, real lending rates remained negative with the higher August inflation outturn.

Stock Market

- In September, the market generally succumbed to grave external pressures following the collapse of the Lehman Brothers, the sale of Merrill Lynch & Co. to Bank of America, and the US Fed's takeover of the American International Group, Inc. (AIG).

Foreign Exchange

- The peso continued to weaken in September as it depreciated by 3.8 percent (month-on-month) to average at ₱46.76/US$1 amid rising risk aversion on concerns of a slowing global economy, particularly in the Euro area, as well as the worsening financial turmoil caused by the U.S. subprime crisis.

- On a year-to-date basis, the peso depreciated against the US dollar by 12.3 percent on 30 September 2008, closing at ₱47.05/US$1, as investors shunned emerging markets' assets.

Global Bond and Credit Default Spreads

- As the Lehman collapse triggered a significant spike in risk aversion, particularly against emerging market assets, the risk of owning Philippine bonds increased.

- The EMBI+ Philippine spreads widened to 319 basis points on 16 September, a 52-basis points jump from the 12 September level of 267 basis points, reaching a new high of 323 basis points on 17 September. The cost of protecting the country's bonds against default likewise climbed significantly to its year's peak with the Philippine five-year credit default swap spread widening to 294 basis points on 16 September from the 12 September level of 239 basis points.

- The coordinated liquidity measures by major central banks provided market relief as spreads eased from their peak levels.

F. Balance of Payments

- The balance of payments yielded a surplus of US$221 million in Q2 2008 as both the current and capital and financial accounts registered net inflows.

G. Domestic Liquidity and Credit Conditions

- Based on the Depository Corporations Survey, domestic liquidity or M3 grew by 4.1 percent year-on-year in July 2008, slightly lower than the 5.1 percent growth in June. The expansion in domestic liquidity continued to be driven by net foreign assets coupled with a marginal increase in net domestic assets.

- Outstanding loans of universal and commercial banks including reverse repurchase agreements (RRPs) continued to register strong growth in July at 23.9 percent, a slight deceleration from the previous month's growth of 24.2 percent. Net of RRPs, loans outstanding continued to accelerate at 18.5 percent in July from 18.1 percent in June.

- The equity raised in the Philippine Stock Exchange for the first eight months of 2008 was only around a fifth of the level reached in the same period in 2007. Meanwhile, bond issuances by the corporate sector in January-August 2008 reached ₱84.0 billion, 57.0 percent higher relative to the comparable period last year. This suggests that local firms have been turning to the corporate bond market to raise funds.

H. Fiscal developments

- The National Government registered a fiscal surplus in August amounting to ₱1.7 billion, lower than the ₱13.9 billion surplus in the comparable period last year. Cumulatively, the fiscal deficit reached ₱31.7 billion for the period January-August, higher than last year's ₱25.5 billion deficit for the same period.

- The public sector external debt-to-GDP ratio in Q2 2008 was 23.9 percent of GDP, lower by 4.7 percentage points compared to 28.6 percent registered in Q2 2007.

I. External developments

- The global economy is facing its most difficult challenge in many years as it continues to be hit by the combination of an imminent economic slowdown, still high commodity and oil prices and global financial turmoil:

    1. Despite strong Q2 GDP growth, the US economy is on a gradual downslope. More recently, the US financial system has been shaken to its core, with the closure of two of the most prominent financial institutions in Wall Street.

2. In response to the financial turmoil, major central banks around the world acted as one to soothe tensions in the financial system by pumping liquidity in global credit markets.

3. Meanwhile, growth is falling sharply in the Euro area, while inflation also seems to have peaked.

4. The headwind from commodity prices seems to be receding in Japan, but the downside risks remain high.