HIGHLIGHTS OF THE MEETING OF THE MONETARY BOARD ON MONETARY POLICY ISSUES HELD ON 20 OCTOBER 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 7.5 percent for the overnight RRP (borrowing) rate and 9.75 percent for the overnight RP (lending) rate; and

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

2) Maintain the current reserve requirement ratios;

3) Intensify the monitoring and surveillance of banks' compliance with the BSP's reserve requirements; and

4) 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.

The Advisory Committee expressed the view that a marginal increase in policy interest rates was needed to help address the risks to inflation, and that such a policy move would help avoid the need to tighten drastically later on if price pressures escalate further.

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 20 October 2005 Monetary Board meeting were approved by the Monetary Board during its meeting held on 17 November 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 continued to ease in September, consistent with the BSP's expectation of a mild deceleration in inflation for the remainder of the year. The average inflation rate for the first 9 months is 7.9 percent. Likewise, core inflation continued its decelerating trend in September, indicating some easing of demand pressures on consumer prices.

- In terms of contribution to year-on-year inflation, food accounted for 2.6 percentage points; fuel, light and water (FLW), 1.2 percentage points; and transport and communication, 1.2 percentage points.

- The feed-through impact of oil prices on inflation and inflation expectations continues to be the main risk to the outlook for inflation. The implementation of the Reformed Value Added Tax (RVAT) law is also expected to exert a short-term but significant impact on prices. An additional risk to future inflation is the rapid growth in domestic liquidity.

- Selected indicators showed some improvements in demand, but evidence of resource slack remains.

  - Average capacity utilization in manufacturing rose slightly to 80.2 percent in July 2005 from 80.1 percent in the previous month.

  - The value of production index (VAPI) for manufacturing increased by 13.1 percent year-on-year in July, higher than the revised June growth rate of 8.5 percent. The volume of production index (VOPI) for manufacturing fell by 1.1 percent year-on-year in July from a decline of 5.1 percent in June.

  - Preliminary data show that growth in merchandise exports slowed to 0.8 percent year-on-year in August from 11.4 percent in July. This was traced mainly to the softening of foreign demand for electronics products, which increased by 1.2 percent and accounted for 66.4 percent of total export revenue.

  - Merchandise imports declined by 3.1 percent year-on-year in July, following a 6.0 percent expansion in June. The drop in imports was due mainly to a sharp fall in imports of electronic components.

  - The country's major corporations posted strong revenue growth for the first six months of 2005. Net income results were mixed, however, as some firms reported slower profit growth.

  - 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 accelerated to 22.0 percent in August from 3.2 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 fell slightly by 1.5 percent year-on-year in August, as energy consumption in the commercial sector slowed down while that of the residential and industrial sectors declined.

- Appliance sales declined for the ninth straight month since December 2004, falling by 17.9 percent year-on-year in August. This was higher than the previous month's 14.5 percent and was a reversal of the previous year's 10.7 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 eased in early October as supply concerns were abated with the resumption in operation of some refinery units in the Gulf Coast. However, the projected increase in the stockpiling of oil towards the end of the year raises expectations of a seasonal rise in prices ahead of the winter season. In the domestic market, retail oil prices rose, reflecting the previous increases in the costs of imported oil.

• In the financial sector, the growth in domestic liquidity accelerated, while bank lending continued to expand at a modest pace. Meanwhile,

[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.

Treasury bill (T-bill) rates eased during the 10 October 2005 auction relative to the previous week.

- Based on preliminary Depository Corporations Survey (DCS) data, the growth in domestic liquidity (M3) accelerated to 15.0 percent year-on-year in August from 13.6 percent in July.[3]

- Outstanding loans of commercial banks (KBs) grew by 3.3 percent year-on-year to ₱1.558 trillion as of end-August 2005. This was slightly lower than the 4.0 percent year-on-year growth in July.

- Relative to the auction on 12 September 2005, the T-bill rate for the 91-day and 364-day tenors increased while that for the 182-day tenor declined during the 10 October 2005 auction. Relative to the 3 October 2005 auction, the T-bill yield for all tenors eased, due to ample market liquidity amidst lower supply of government papers, as the National Government (NG) reduced its weekly offering and cancelled some auctions of debt papers.

- Uncertainty in the domestic political front and the deferment of the implementation of the RVAT law weighed down the peso in September. However, the peso strengthened in early October amid thin corporate demand for the US dollar and strong inflows of remittances from overseas Filipino workers (OFW).

- The 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. Inflation pressures at the global level appeared to be well contained despite the observed uptick in inflation during the recent months. Forward-looking global economic indicators also appear consistent with a moderate but solid growth performance in the 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.

[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.

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. Latest staff forecasts, which incorporate more recent data on inflation, output and other key variables, indicate a possible breach of the inflation target in 2007 due to possible second-round effects coming from supply-side pressures.

- Equally important, the possibility of a sustained deviation of the forecast from the target over the policy horizon poses a considerable risk to inflation expectations, in that the public may begin to expect inflation to remain persistently well above announced government targets. Because monetary action normally requires 15-21 months to take full effect on inflation, policy measures undertaken now will help address the risks to inflation and inflation expectations in the coming year and in 2007.

- An added concern was the continued rapid growth in domestic liquidity. Available data suggest that the financial system remains very liquid despite the recent increase in the policy rate and the reserve requirements, and that the additional liquidity in recent months has been fueled by both foreign exchange inflows and by the deposit generation activities of banks. Under these conditions, the Monetary Board recognized that interest rate action may be usefully complemented with administrative measures to better manage the flow of liquidity within the financial system.

- The Monetary Board agreed that the need for a timely response to expected pressures, the risk of a sustained breach of the inflation target and the continued presence of excess liquidity in the financial system, provide the impetus for monetary action. This will not only address the risks to inflation and inflation expectations but also clearly demonstrate the BSP's commitment to its price stability mandate.

- Moving forward, the BSP will 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 its readiness to take further action, depending on how the risks to inflation evolve in succeeding months.

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 7.5 percent for the overnight RRP (borrowing) rate and 9.75 percent for the overnight RP (lending) rate; and

     (b) Adjust accordingly 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 17 November 2005.

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