HIGHLIGHTS OF THE MEETING OF THE MONETARY BOARD ON MONETARY POLICY ISSUES HELD ON 9 JULY 2009[1]

I. Monetary Policy Decision

The Monetary Board decided to:

a) Reduce the BSP's policy rates by 25 basis points to 4.00 percent for the overnight RRP (borrowing) rate and 6.00 percent for the overnight RP (lending) rate;

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

c) Maintain the current reserve requirement ratios.

The recommendation to reduce policy rates took into consideration the BSP's resolve to provide support to economic activity to the extent that the inflation outlook would allow.

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

- The Monetary Board noted that there remained some scope to reduce policy rates further.

  - The latest baseline forecasts continued to reflect a lower inflation path over the policy horizon, with average inflation falling at around the middle of the target range for 2009 and at the lower bound of the target range for 2010.

  - Inflation expectations remained well anchored. The results of the BSP and private sector surveys reflected inflation expectations falling within the target ranges for both 2009 and 2010.

[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 of the Monetary Stability Sector, the Deputy Governor of the Supervision and Examination Sector, the Assistant Governor of the Monetary Policy Sub-Sector, and the Managing Director of the Treasury Department. The highlights of the discussions on the 9 July 2009 meeting were approved by the Monetary Board during its regular meeting held on 30 July 2009. The next meeting of the Monetary Board on monetary policy issues is scheduled on 20 August 2009.

- The downside pressures on prices continued to predominate and were due mainly to expectations of a marked weakening of global economic activity and still ample inventory levels. In addition, with economic recovery expected to be gradual as financial market conditions remain weak, a rapid rebound in commodity prices was seen as remote for the near term.

- However, the Board was mindful of upside pressures on prices over the long term and the possibility that global commodity prices could be reaching a trough.

- With inflation pressures subdued and domestic demand conditions weak, there could be some scope for monetary policy to balance any short-run trade-off between inflation variability and output variability.

- The Board recognized that a continued accommodative stance would lend support to the productive sectors of the economy. Bringing down policy rates further could induce banks to lower borrowing costs which, in turn, could help promote wider access to domestic sources of financing, encouraging investment growth and providing the needed working capital to sustain the efficient operation of businesses.

- The Board also noted that an accommodative stance would help support market confidence. While there have been tentative signs of stabilization, the world economy is expected to remain under a prolonged period of deleveraging. Confidence could be slow to return, and the rebalancing of global demand could take some time. Thus, monetary policy must continue to be on the accommodative side to reinforce confidence among banks, firms, and households.

- With considerable monetary stimulus already in place and the impact of fiscal action already in the pipeline, the Monetary Board believed that prevailing monetary settings were appropriately calibrated to the outlook for inflation and domestic demand.

- The Monetary Board agreed to continue to pay close attention to signs of global demand recovery as well as to possible build-up in commodity price pressures over the medium term, with a view to undertaking timely action towards a non-inflationary recovery in economic activity.

III. Recent Developments in Economic Indicators

The Monetary Board's decision took into account recent developments in various economic indicators:

A. Domestic price conditions

- Headline inflation continued to fall in June, dropping to 1.5 percent year-on-year from 3.3 percent in May, the lowest in more than 22 years. This brought the year-to-date average inflation down to 5.0 percent from 5.7 percent a month earlier.

- All major commodity groups registered lower or negative inflation rates in June. Lower food inflation accounted for the bulk of the decline in headline inflation, with lower rice and corn prices and slower price increases year-on-year in fruits and vegetables, fish, and miscellaneous food. In addition, fuel prices were lower in June along with rentals inflation. Services inflation turned negative as educational services inflation slowed down and as transportation and communication services inflation turned even more negative.

- On a month-on-month, seasonally-adjusted basis, headline inflation was zero in June from negative 0.1 percent in May.

- Core inflation, which excludes specific food and energy items to measure generalized price pressures, was lower at 3.9 percent year-on-year in June from 4.4 percent in May. Year-to-date core inflation also went down from 5.7 percent to 5.4 percent. Likewise, all alternative core inflation measures estimated by the BSP declined.

B. Inflation Expectations

- Recent surveys showed inflation expectations remained generally well-anchored:

  - Results of the BSP's survey of private sector economists/analysts for May 2009 showed within-target inflation expectations for both 2009 and 2010.

  - The latest Asia Pacific consensus forecasts as of June 2009 showed lower inflation expectations for both 2009 and 2010.

  - Meanwhile, the results of the Consumer Expectations Survey (CES) for Q2 2009 showed marginally higher inflation expectations for the next 12 months: from 8.6 percent in the previous survey to 8.7 percent.

C. Inflation Outlook

- Latest baseline forecasts showed a continued downward shift in the inflation path, with annual average inflation likely to settle at about the middle of the 3.5 percent ± 1.0 percentage point target range for 2009 and at the lower bound of the target range of 4.5 percent ± 1.0 percentage point for 2010.

- The risks around the central projection for world economic activity remained skewed towards the downside, suggesting some downside risks as well to global commodity prices.

D. Demand conditions

Economic activity weakened substantially in the first quarter, reflecting the overall drag caused by the sharp decline in global economic activity.

- GDP rose at an annual rate of 0.4 percent in Q1 2009 compared to 3.9 percent in the same quarter in the previous year and 2.9 percent in the previous quarter.

- Based on preliminary NSO data, merchandise exports contracted further by 35.2 percent year-on-year in April 2009. Likewise, merchandise imports declined more steeply by 37.4 percent year-on-year in April from a contraction of 36.2 percent in the previous month.

- Other demand indicators also moderated:

    - Average capacity utilization in April remained below last year's average level, although slightly higher than the previous month's figure.

    - Year-on-year total vehicle sales declined in May as sales of commercial vehicles and trucks and buses dipped. Meanwhile, passenger car sales expanded.

    - Q2 2009 CES results showed overall consumer confidence declining quarter-on-quarter but still an improvement, year-on-year.

    - Year-on-year energy sales of Meralco dropped in May by 0.7 percent after contracting by 1.4 percent in the previous month. Energy sales also declined by 0.1 percent year-on-year in the same period a year ago.

E. Supply-side indicators

Developments in Agriculture

- Latest data from the NSCB showed that the growth in agriculture, fishery and forestry (AFF) slowed down to 2.1 percent in Q1 2009 from 2.8 percent in the same period a year ago. Growth in AFF during the period, which accounted for about a fifth (19.7 percent) of total GDP, was driven by the *palay*, fishery, poultry, livestock, and banana subsectors. Contraction in the corn, sugarcane, and other crops subsectors pulled down agricultural growth in Q1 2009.

- *Palay* production for Q2 and Q3 2009 is expected to grow by 1.8 percent and 2.4 percent year-on-year, respectively. Meanwhile, corn production for Q2 2009 is forecast at 1.3 MMT, 1.0 percent lower than the Q2 2008 output, due to heavy rains and the early harvest in Q1. For Q3 2009, corn harvest is expected to rebound and increase by 2.3 percent relative to the same period in 2008.

- FAO's April 2009 Crop Prospects and Food Situation continued to suggest an overall decline in world cereal production in 2009 from the previous year's record output as farmers have been discouraged by poor expected returns on their crops due to the sharp decline in grain prices and high input costs.

Oil Price Developments

- The spot price of Dubai crude oil was higher in May and June amidst expectations that the economic slowdown may be bottoming out and reports of greater-than-expected decline in US crude and gasoline inventories due to improving demand. Given these developments in oil demand, the Organization of Petroleum Exporting Countries (OPEC) decided to maintain its current oil production level during its meeting on 28 May 2009.

- Meanwhile, prices in the futures market decreased. The price of Brent crude oil for August 2009 deliveries fell to US$64.05 per barrel on 6 July 2009, lower by US$5.01 per barrel relative to its month-ago level of US$69.06 per barrel. Futures prices eased on signs that US oil demand would be slow to recover after it was reported that US unemployment jumped to 9.5 percent in June, the highest in almost 26 years.

- In the domestic market, oil companies raised the price of gasoline (by ₱0.50 per liter) but reduced the prices of kerosene and diesel (by ₱0.39 per liter and ₱0.38 per liter, respectively) on 7 July. This brought the year-to-date net increase in the prices of gasoline products to ₱10.25 for unleaded gasoline, ₱1.18 for diesel, ₱0.37 for kerosene, and ₱5.45 for LPG.

Developments in the Utilities Sector

- Compared to the previous month, Meralco rates were lower in June by about 4.0 percent. Meralco passed on to its customers lower generation costs from the Wholesale Electricity Spot Market (WESM) and its suppliers. Meralco's suppliers had lower generation costs due to cheaper natural gas.

- The Metropolitan Waterworks and Sewerage System-Regulatory Office (MWSS-RO) had approved the reduction in water rates through the foreign currency differential adjustments (FCDA) for Q3 2009 by ₱0.01/m^3 and ₱0.09/m^3 for Manila Water and Maynilad, respectively.

F. Financial Market Developments

Government Securities Market

- Relative to their 29 May levels, the yields and term spreads (secondary market yields of GS net of overnight reverse repurchase or RRP rates) generally increased across all tenors on 6 July 2009. Yields increased with the decline in bond prices as banks tightened their positions and some traders opted to stand in the sidelines after the government announced it may boost bond sales on concerns over the widening budget deficit, especially given the lower-than-expected GDP growth performance for the first quarter.

Interest Rate and Interest Rate Differentials

- The differential between the BSP policy rate and the US federal funds rate continued to narrow in May, following the BSP's 25-basis-point policy rate cut on 29 May. Adjusted for the risk premium, the differential widened with the decline in the risk premium, potentially encouraging capital inflows.

- The cumulative 175-basis-point policy rate cut of the BSP from 18 December 2008 to 28 May 2009 appeared to have been passed on partially by depository corporations to their borrowers. Actual bank lending rates declined by 87 basis points during the period 22-26 June 2009 to reach 8.401 percent relative to 9.272 percent for the period 8-12 December 2008.

Stock Market

- Stock market activity remained upbeat, as the Philippine Stock Exchange Index (PSEi) rose in May 2009 and June 2009, sparked by the market's positive perception that the economic downturn is bottoming out. The index closed 32 percent higher year-to-date on 7 July as investor sentiments were boosted by higher revenue collections, S&P's decision to maintain the country's credit rating, and expectations of another rate cut.

Foreign Exchange

- Despite the lower-than-expected GDP growth in the first quarter, the peso continued to appreciate in the first week of June with sustained strong OF remittances and the continuing weakness of the dollar. However, from the second week until the end of June, the peso weakened due to market concerns on prospects of a wider fiscal deficit, weak economic growth, a possible credit rating downgrade, and the political noise created by the prospects of amendments to the Philippine constitution.

- On a year-to-date basis, the peso and most of the Asian currencies weakened against the US dollar on 30 June 2009.

Global Bond and Credit Default Swap Spreads

- In June, credit risk continued to fall as financial markets showed signs of stabilizing as aggressive policy measures adopted in advanced economies appeared to have gained traction. The EMBI+Global spread slightly narrowed on 29 June to 446 basis points (bps), lower than the 480 bps average in May. Similarly, the EMBI+ Philippine spread slightly declined to 324 bps on 29 June compared to the previous month's average of 330 bps. The cost of protecting the Philippine debt from default, as measured by the Philippine five-year CDS spread, likewise narrowed to 223 bps in the same period.

G. Domestic Liquidity and Credit Conditions

- The growth of domestic liquidity or M3 increased to 15.0 percent year-on-year in May, higher than the 13.7 percent recorded in the previous month. The robust expansion in net foreign assets (NFA) at 19.8 percent in May continued to drive liquidity growth. Net foreign assets rose as the BSP continued to build up its international reserves, while banks reduced their foreign liabilities possibly as they paid off maturing obligations.

- The outstanding loans of commercial banks including reverse repurchase agreements (RRPs) grew by 10.2 percent year-on-year in May, lower than the 13.4 percent increase registered in April. Net of RRP placements with the BSP, bank lending also grew at a slower pace of 17.3 percent in May from 19.0 percent in the previous month.

- Total capital raised in the PSE for the period January-May 2009 remained significantly lower at ₱5.3 billion compared to ₱15.8 billion during the same period in 2008. Meanwhile, corporate bond issuance during the first five months of 2009 at ₱180.5 billion was more than triple the level recorded in the comparable period in 2008 at ₱49.2 billion.

H. Fiscal developments

- The January-May fiscal deficit reached ₱123.2 billion in 2009, more than six times the ₱18.8 billion deficit level in the comparable period last year. Compared to the programmed level, this represented 79.4 percent of the program deficit (₱155.1 billion) for the first semester.

I. External developments

- The world economy continues to face a severe downturn. Governments, central banks, and investors alike continue to watch out for signs that will either confirm or negate expectations that the global economic decline is indeed showing signs of bottoming out.

- The most recent indicators from the JP Morgan's Global Purchasing Managers' Index (PMI) point to a deceleration in the pace of decline in economic activity. Nevertheless, the PMI indicator for manufacturing activity is still at a very low level by historical standards, and is well below the level that would be consistent with an outright recovery.

  Based on the PMI, the US manufacturing sector failed to grow in May for the 16^{th} consecutive month. Nonetheless, based on the latest report of the Institute for Supply Management, the overall economy grew for the first time following seven months of decline. Meanwhile, the EU's first quarter GDP declined at a rate lower than previously anticipated. In Japan, although economic conditions continued to deteriorate, there are signs that the pace of decline may have begun to decelerate.

- Global inflationary pressures have been diminishing rapidly, owing to base effects stemming from lower commodity prices, weaker labor market conditions, and greater global economic slack.

- As governments worldwide have opted to spend their way out of recession, many countries are recording higher fiscal deficits, and are faced with the possibility that they may need to pay higher interest on rapidly expanding debt going forward. A commitment to long-term fiscal consolidation will help address concerns over fiscal sustainability.