

***INFLATION REPORT***  
***Third Quarter 2004***



**Bangko Sentral ng Pilipinas**





## **FOREWORD**

**T**he primary objective of monetary policy is to promote a low and stable rate of inflation conducive to balanced and sustainable economic growth. The adoption in January 2002 of the inflation targeting framework for monetary policy was aimed at helping fulfill this objective.

One of the key features of inflation targeting is greater transparency, which means greater disclosure and communication by the BSP of its policy actions and decisions. This Inflation Report is published by the BSP as part of its transparency mechanisms under inflation targeting. The objectives of this Inflation Report are: (i) to convey to the public the overall thinking and analysis behind the BSP's decisions on monetary policy, so that monetary policy is easier to follow and understand, and (ii) to enable the public to better monitor the BSP's commitment to the inflation target, thus helping anchor inflation expectations. The government's targets for annual headline inflation under the inflation targeting framework have been set at 4-5 percent for 2004 and 2005.

The report is published on a quarterly basis, presenting a survey of the various factors affecting inflation. These include recent price and cost developments, prospects for aggregate demand and output, monetary and financial market conditions, labor market conditions, fiscal developments, and the international environment. A section is devoted to the BSP's view of the inflation outlook during the policy horizon. This is followed by a discussion of the implications of the assessment of inflation and economic conditions on the monetary policy settings of the BSP. This issue of the Inflation Report also features a box article on the features and mechanics of OMO instruments used and how the conduct of OMO relates to the achievement of the BSP's monetary policy objective.

The Monetary Board approved this Inflation Report at its meeting on 21 October 2004.

A handwritten signature in black ink, appearing to read 'Rafael B. Buenaventura', written over a thin horizontal line.

**RAFAEL B. BUENAVENTURA**

Governor

October 2004



## **THE MONETARY POLICY OF THE BANGKO SENTRAL NG PILIPINAS**

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### **The BSP Mandate**

The BSP's main responsibility is to formulate and implement policy in the areas of money, banking and credit, with the primary objective of maintaining stable prices conducive to balanced and sustainable economic growth in the Philippines. The BSP also aims to promote and preserve monetary stability and the convertibility of the national currency.

### **Monetary Policy Instrument**

The BSP uses the overnight repurchase rate (RP) and reverse repurchase rate (RRP) as the key policy rates to set the monetary policy stance.

### **Policy Targets**

The BSP uses the CPI or headline inflation rate (compiled and released to the public by the National Statistics Office) as its target for monetary policy. The policy target is expressed in the form of a range for a given year and is set by the government in coordination with the BSP. For 2004-2005, the government's target for annual headline inflation has been set at 4-5 percent.

### **BSP's Explanatory Notes**

These refer to the predefined set of acceptable circumstances under which an inflation-targeting central bank may fail to achieve its inflation target. Such exemptions recognize the fact that there are limits to the effectiveness of monetary policy and that deviations from the inflation target may sometimes occur because of factors beyond the control of the central bank. Under the inflation targeting framework of the BSP, these exemptions

include price pressures arising from: (a) volatility in the prices of agricultural products; (b) natural calamities or events that affect a major part of the economy; (c) volatility in the prices of oil products; (d) significant government policy changes that directly affect prices such as changes in the tax structure, incentives and subsidies.

### **The Monetary Board**

The powers and functions of the Bangko Sentral, such as the conduct of monetary policy and the supervision over the banking system, are exercised by its Monetary Board, which has seven members appointed by the President of the Philippines.\* The Monetary Board meets every four weeks to review and decide on the stance of monetary policy.

<b>Chairman</b>	Rafael B. Buenaventura
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<b>Members</b>	Juanita D. Amatong Juan Quintos, Jr. Melito S. Salazar, Jr Antonino L. Alindogan, Jr. Vicente B. Valdepeñas, Jr.
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\* The seventh member of the monetary board to replace former Monetary Board Member Fe Barin, who was recently appointed as SEC chairman, is yet to be appointed by the president.

### **The Advisory Committee**

The Advisory Committee was established as part of the institutional setting for inflation targeting. It is tasked to deliberate, discuss and make recommendations on monetary policy to the Monetary Board. The Committee meets regularly every four weeks but may also meet in between the regular meetings, whenever it is deemed necessary.

**Chairman**                      Rafael B. Buenaventura  
Governor

**Members**                      Amando M. Tetangco, Jr.  
Deputy Governor  
Banking Services Sector, Research  
and Treasury

Alberto V. Reyes  
Deputy Governor  
Supervision and Examination Sector

Diwa C. Guinigundo  
Assistant Governor  
In-Charge of Research

Ma. Ramona GDT Santiago  
Director  
Treasury Department



**SCHEDULE OF THE MEETINGS ON MONETARY POLICY  
AND PUBLICATION OF HIGHLIGHTS FOR 2004-2005**

<b>Mtg. No.</b>	<b>Advisory Committee <sup>1/</sup></b>	<b>Monetary Board <sup>2/</sup></b>	<b>Publication of MB Highlights <sup>3/</sup></b>
<b>2004</b>			
1	12 January, Monday	15 January, Thursday	26 February, Thursday
2	9 February, Monday	12 February, Thursday	25 March, Thursday
3	8 March, Monday	11 March, Thursday	22 April, Thursday
4	12 April, Monday	15 April, Thursday	27 May, Thursday
5	3 May, Monday	6 May, Thursday	17 June, Thursday
6	31 May, Monday	3 June, Thursday	15 July, Thursday
7	28 June, Monday	1 July, Thursday	12 August, Thursday
8	26 July, Monday	29 July, Thursday	9 September, Thursday
9	23 August, Monday	26 August, Thursday	7 October, Thursday
10	20 September, Monday	23 September, Thursday	4 November, Thursday
11	18 October, Monday	21 October, Thursday	2 December, Thursday
12	15 November, Monday	18 November, Thursday	29 December, Wednesday
13	13 December, Monday	16 December, Thursday	27 January 2005, Thursday
<b>2005</b>			
1	10 January, Monday	13 January, Thursday	24 February, Thursday
2	7 February, Monday	10 February, Thursday	24 March, Thursday
3	7 March, Monday	10 March, Thursday	21 April, Thursday
4	4 April, Monday	7 April, Thursday	19 May, Thursday
5	2 May, Monday	5 May, Thursday	16 June, Thursday
6	30 May, Monday	2 June, Thursday	14 July, Thursday
7	27 June, Monday	30 June, Thursday	11 August, Thursday
8	25 July, Monday	28 July, Thursday	8 September, Thursday
9	22 August, Monday	25 August, Thursday	6 October, Thursday
10	19 September, Monday	22 September, Thursday	3 November, Thursday
11	17 October, Monday	20 October, Thursday	1 December, Thursday
12	14 November, Monday	17 November, Thursday	29 December, Thursday
13	12 December, Monday	15 December, Thursday	27 January 2006, Thursday

Notes:

<sup>1/</sup> Held every four weeks

<sup>2/</sup> MB meetings on monetary policy are held on Thursday after the latest Advisory Committee meeting.

<sup>3/</sup> Six weeks after the Monetary Board meeting on monetary policy



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## OVERVIEW

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- ✍ **Price pressures on consumer prices remained evident in the third quarter of 2004, with average headline inflation reaching its highest level since the third quarter of 2001.** The uptrend in inflation continued to be driven by the rise in food inflation and in energy-related non-food inflation. Food prices, particularly those for meat, fish and corn remained high due largely to higher input costs. Similarly, higher inflation rates were noted for all major non-food CPI items except clothing as well as housing and repairs. The increase in non-food inflation appears to be mostly energy-related, a result of rising oil prices in the international market. Transport and communication along with fuel, light and water posted double-digit inflation rate and contributed about half of the total non-food inflation and little more than one-fifth of total headline inflation for the period.
- ✍ **Overall economic activity remained robust based on latest available GDP data for the second quarter.** Strong consumer spending as well as increased investments in both public and private construction and faster export growth from increased foreign demand continued to be the main drivers of growth. On the production side, all three major sectors—agriculture, industry, and services—exhibited stronger growth based on national accounts data for the second quarter of 2004 compared to the year-ago levels. Nevertheless, the still double digit level of unemployment rate as well as the lack of a broad-based upsurge in demand conditions as evidenced by the modest improvements in credit activity and investments argue for the presence of some resource use slack.
- ✍ **National Government's (NG) fiscal position for the first eight months of the year pointed to NG's firm commitment to fiscal discipline.** The cumulative deficit level for January-August was ₱111.0 billion, 3.1 percent lower than the level in the same period a year ago. Revenue collections during the first eight months registered a double-digit increase of 13.2 percent year-on-year to ₱462.4 billion while government spending rose by only 9.7 percent to ₱573.4 billion.
- ✍ **Domestic market interest rates were generally higher during the third quarter.** The rise in T-bill rates reflected market concerns over the government's fiscal position, rising inflation given developments in oil prices and expectations of

further hikes in the US federal funds target rate. Despite the rise in domestic market interest rates, measures of spreads between domestic and foreign interest rates narrowed slightly as a result of the uptrend in foreign market rates following the hikes in US federal funds rate. Nevertheless, current interest rate differentials continued to be sizeable.

- ✍ **The peso weakened slightly in the third quarter.** The depreciation of the peso against the US dollar was due mainly to seasonal factors, including the increased corporate dollar demand to cover import requirements and end-quarter debt obligations. The peso was also weighed down by concerns' over the country's fiscal situation and the surge in world oil prices, which fueled market fears of higher inflation and interest rates.
- ✍ **On the external front, the robust and broad-based global economic recovery remained largely intact despite some observed soft spots in the US and Japan.** On the price front, the outlook remains in line with price stability although stronger inflationary pressures may persist over the short term. However, global markets remain highly vulnerable to further hikes in oil prices given the low spare capacity in oil production as well as uncertainties brought about by political developments in major oil producing countries.
- ✍ **The BSP kept its policy interest rates unchanged during the quarter despite perceptions of a need to tighten monetary settings against a backdrop of rising inflation.** The Monetary Board's decision to stay its hand reflected its assessment that current monetary settings remained consistent with the outlook for inflation and output growth over the policy horizon.
- ✍ **Latest BSP forecasts show that in the absence of appropriate supply-side measures, average headline inflation will continue to rise over the next year or so.** Headline inflation will likely exceed the 4-5 percent target for 2004 and 2005 as the full impact of the supply factors is felt. However, average inflation is expected to revert to the 4-5 percent target by 2006.
- ✍ **Monetary authorities believe that ongoing pressures on inflation remain largely rooted in the impact of supply shocks on prices.** Supply-side factors will remain the primary source of risk to the inflation outlook. However, historical record showed that headline inflation has a tendency to quickly revert to trend following episodes of supply-side pressures. Moreover, at present, the BSP finds no preponderant evidence yet of demand-driven inflationary

pressures or second-order inflationary effects from ongoing supply shocks. Thus, the BSP finds no compelling reason at this time to modify present monetary policy settings.

- ✍ **Given the dominant role of supply-side developments in the inflation outlook, inflation can be best mitigated by appropriate supply-side (i.e., non-monetary) policy measures that would facilitate timely importation, distribution and delivery of certain commodities.** The BSP has continued to articulate its support for the use of such measures and accordingly has made representations with relevant government agencies on the matter.
- ✍ **Conducting monetary policy in the current climate of negative supply shocks is a considerable challenge for the BSP.** Nonetheless, the BSP remains committed to its primary objective of maintaining price stability conducive to a balanced and sustainable economic growth.
- ✍ **The BSP will continue to assess economic and financial developments for indications of potential threats to the inflation target and, if necessary, undertake a well-timed policy adjustment.**

## **I. Recent Developments in Inflation and Economic Conditions**

### **Price and Cost Developments**

*Price pressures remained evident in the third quarter, driven by food and energy inflation.*

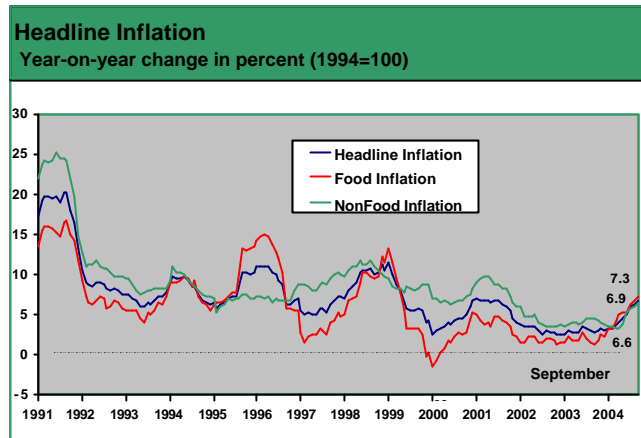
Inflationary pressures on consumer prices remained evident in the third quarter of 2004, with average headline inflation reaching its highest level since the third quarter of 2001. The uptrend in inflation continued to be driven by the rise in food inflation and in energy-related non-food inflation.

### **Headline and Core Inflation**

*Headline inflation trends upward due to higher food and non-food inflation.*

Headline inflation rose to 6.4 percent in the third quarter, based on the 1994 CPI series, from 4.6 percent in the previous quarter and 3.1 percent a year ago as inflation rates increased for nearly all major commodity groups. As in the previous two quarters, the increase was driven by higher prices for food and energy-related components of the CPI.

Rising foreign prices of imported oil products led to higher inflation rates for domestic oil prices and utilities (which are classified as Fuel, Light and Water or FLW in the CPI) as well as services, particularly transport. Average headline inflation for the first three quarters of 2004 stood at 4.8 percent, near the upper-end of the Government-announced target of 4.0-5.0 percent for the year.



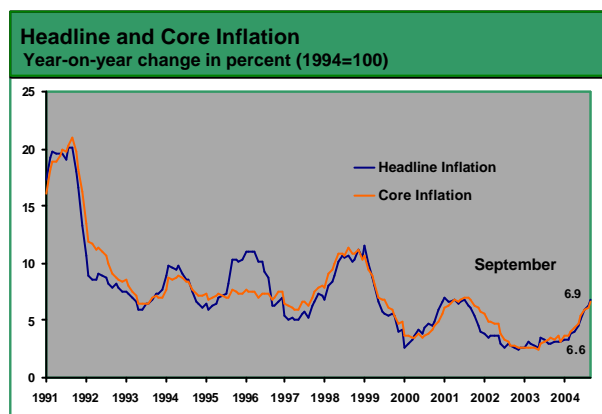
Figures using the 2000-based CPI series showed similar outcomes. Selected food items, along with fuel and transportation services pushed up the average third-quarter headline inflation rate to 6.9 percent, 2.2 percentage points higher than the previous quarter and 3.3 percentage points more than in the same period in 2003. Inflation figures from the 2000-based CPI series were generally higher compared to those from the 1994-based series.

<b>Headline and Core Inflation</b>				
<i>Year-on-year change, in percent</i>				
	Headline Inflation		Core Inflation	
	1994-Based	2000-Based	1994-Based	2000-Based
3 <sup>rd</sup> Quarter 2003	3.1	3.6	3.3	3.7
3 <sup>rd</sup> Quarter 2004	6.4	6.9	6.3	6.4
2004 YTD Average	4.8	5.2	4.9	5.1

*Core inflation was likewise higher during the third quarter.*

Similarly, core inflation, or the rate of CPI inflation after filtering out the effects of temporary disturbances or shocks to prices, was higher in the third quarter, suggesting moderate broad-based pressures on consumer prices. The National Statistics Office (NSO) core inflation rate, which is

simply the headline rate after excluding certain food and energy-related items, averaged 6.3 percent in the third quarter (1994 base-year CPI), higher than the recorded average of 3.3 percent for the same period a year earlier and the 4.8 percent posted in the previous quarter.<sup>1</sup> The year-to-date average core inflation was 4.9 percent, slightly higher than the headline inflation of 4.8 percent. The 2000-based third-quarter core inflation rate was 6.4 percent, likewise higher than the 3.7 percent average for the same period a year earlier and the 4.8 percent in the second quarter. The average core inflation for the first three quarters of the year was 5.1 percent, 0.1 percentage point lower than the headline inflation.



The BSP estimates of alternative measures of core inflation (e.g., trimmed mean, weighted median and trimmed mean) registered increases during the third quarter compared to those posted in the previous quarter as well as to recorded rates in the same quarter a year ago.<sup>2</sup> Trimmed mean,

<sup>1</sup> The NSO began releasing official core inflation data in February 2004 alongside headline inflation. As with headline inflation, core inflation is presently computed using both the 1994- and the 2000-based CPI series. A primer on core inflation is available in electronic format on the BSP website at <http://www.bsp.gov.ph/downloads/Primer%20Core%20Inflation.pdf>.

<sup>2</sup> A description of the BSP's methodology for computing alternative measures of core inflation may be found in the box article entitled "Estimating Core Inflation," which appeared in the Fourth Quarter 2001 issue of the BSP Inflation Report.

weighted median and net of volatile items measures of core inflation averaged at 5.0 percent, 4.0 percent and 5.7 percent, respectively during the quarter in review. These were higher compared to the previous quarter's averages of 3.6 percent, 3.3 percent and 3.9 percent, respectively. Moreover, the third quarter 2004 alternative core measures were also almost twice as high as estimates in the same quarter a year ago. The trimmed mean, weighted median and net volatile items measures averaged 2.6 percent, 2.5 percent and 2.4 percent, respectively in the third quarter of 2003. In the 2000-based CPI series, alternative measures of core inflation estimated by the BSP were likewise higher in the third quarter compared to the previous quarter a year earlier. Estimates of the trimmed mean, weighted median and net of volatile items measure of core inflation in the third quarter averaged at 5.7 percent, 4.2 percent and 5.4 percent, respectively.

## Food Prices

*Food inflation remains high due largely to higher input costs.*

Food inflation, which accounted for about 51 percent of the 1994-based CPI basket, rose further to 6.8 percent in the third quarter, 1.7 percentage points higher than the previous quarter and 5.1 percentage points above the figure recorded a year ago. This was traced mainly to high prices for meat, corn, fish, and dairy products. These items together accounted for almost two-thirds (63 percent) of the total food inflation for the quarter and about a third (2.2 percentage points) of the 6.4-percent headline inflation rate for the period. Meat prices, in particular, were a major cause of higher food inflation. The index for meat in the CPI showed double-digit increases of 15.4 percent year-on-year in the third quarter and 15.2 percent in the second, owing largely to the higher cost of livestock feed, particularly corn, in both the local and international market. Corn inflation rose to 11.5 percent in the third quarter from 9.5 percent in the previous quarter. Prices of fresh water

fish were also affected by the high cost of feedstuffs. Higher meat prices have also been linked to the recurrence of avian flu virus in other Asian countries, which led to increased demand for pork and fish among local consumers in lieu of poultry.

Meanwhile, rice inflation remained generally low at 2.8 percent in the third quarter, slightly higher than the 1.5 percent seen a quarter earlier. Robust farm output in the first semester of the year helped cushion supply during the lean production months from June to August. Price of fruits and vegetables meanwhile rose slightly due to distribution bottlenecks caused by typhoons during the third quarter.

### **Non-Food Prices**

*Non-food inflation increase except those for clothing and housing and repairs.*

Non-food inflation using the 1994-CPI series rose to 6.2 percent in the third quarter compared to 4.1 percent in the previous quarter and 4.5 percent in the same period a year ago. Although higher inflation rates were noted for all major non-food CPI items except clothing as well as housing and repairs, the increase appears to be mostly energy-related, a result of rising oil prices in the international market. Double-digit inflation rates were noted for transportation and communication (20 percent in the third quarter from only about 6.6 percent in the previous quarter). Under the FLW category, fuel inflation rose to 15.7 percent in the third quarter from 7.4 percent in the previous quarter. Transport/communication and fuel combined contributed about half (47.5 percent) to the total non-food inflation for the third quarter, or 20.6 percent of the total headline inflation during the period.

Meanwhile, inflation rates for clothing and miscellaneous items were generally stable while housing and repairs inflation showed a mild slowdown during the third quarter of 2004 compared to the previous quarter.

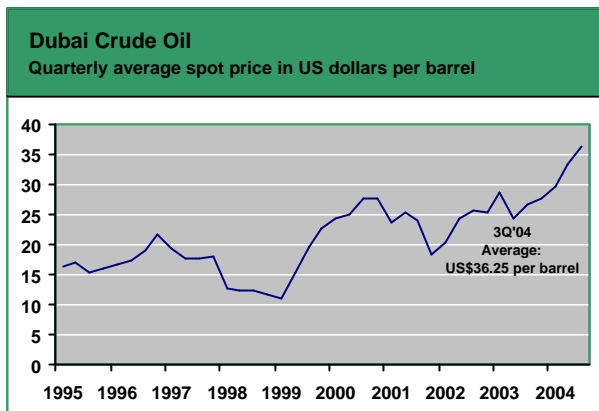
#### *Energy Prices*

***Global oil prices surge in the third quarter due to demand and supply factors.***

International oil prices continued to surge in the third quarter, with the average price per barrel of Dubai crude reaching US\$36.25, about 36.4 percent higher compared to a year ago and 8.9 percent up compared to the previous quarter. The uptrend in global oil prices has been traced to a combination of demand and supply concerns, namely the market uncertainty generated by geopolitical events, declining spare capacity, and political concerns in major oil-producing countries such as Iraq, Nigeria, Venezuela, and the financial difficulties of Yukos—a major oil producer in Russia—along with the sustained growth in the demand for oil by the world's rapidly growing economies have contributed to the upsurge in international oil prices in August.<sup>3</sup> According to the Energy Information Administration (EIA) of the US Department of Energy, global oil prices in the near term are likely to remain volatile and sensitive to news relating to possible reductions in worldwide production given an outlook of rising demand against relatively narrow global surplus production capacity. The EIA views that crude oil prices are not likely to drop significantly in 2005 because world oil demand is expected to continue to strengthen which could keep inventories tight. As of end-September 2004, the price of Dubai crude oil stood at US\$37.50 per barrel.

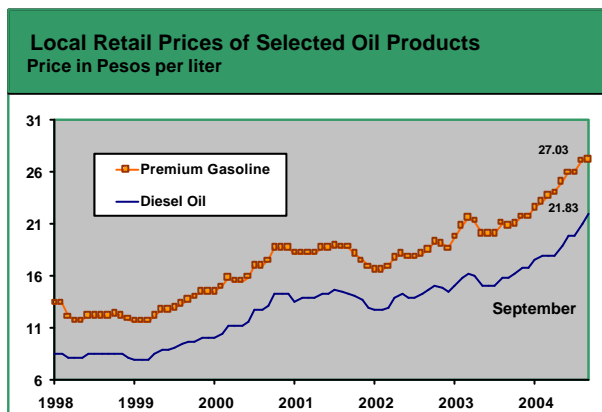
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<sup>3</sup> Short-Term Energy Outlook August 2004, available at <http://www.eia.doe.gov>



*Local pump prices reflect uptrend of prices in the world oil market.*

In response to the uptrend in the world market, domestic retail oil prices rose three times in August and twice in early September. Since end-June 2004, domestic pump prices of gasoline have risen by a cumulative ₱1.20 per liter, and those of kerosene and diesel by ₱1.90 per liter and ₱2.10 per liter, respectively. Meanwhile, the price of liquefied petroleum gas (LPG) rose by an average of ₱1.10 per liter during the period.



Industry Average: Retail/Pump Price of Petroleum Products										
Prevailing Prices (in peso per liter)										
Year	Month/Day/s	Premium Gasoline	Unleaded Gasoline	Regular Gasoline	AVTurb	Kerosene	Diesel	O. Fuel Oil	LPG	Average
2003	Dec	21.63	21.03	20.04	21.45	16.96	16.73	13.39	13.04	16.34
2004	Jan 2 to 5-Jan-04	21.63	21.03	20.04	21.45	16.96	17.03	13.39	13.04	16.45
	Jan 10 to 13-Jan-04	22.43	21.83	20.84	21.94	17.46	17.53	13.39	13.55	16.85
	Feb 3 to 4-Feb-04	23.03	22.43	21.44	21.94	17.76	17.83	13.39	13.97	17.13
	Mar 2, 8 to 10-Mar-04	23.03	22.43	21.44	21.94	17.76	17.83	13.39	13.13	17.15
	Mar 20, 22-Mar-04	23.63	23.03	22.04	21.94	18.16	17.83	13.69	13.13	17.29
	Apr 5, 19-Apr-04	23.93	23.33	22.34	22.23	18.46	17.83	13.69	13.85	17.43
	May 15-May to 2 Jun-04	24.93	24.33	23.34	23.20	19.46	18.83	14.19	14.97	18.28
	Jun 4 to 6, 18-Jun-04	25.83	25.23	24.24	24.08	20.36	19.73	14.69	15.54	19.03
	July 2-Jul-04	25.83	25.23	24.24	24.08	20.36	19.73	14.69	15.20	19.00
	Aug 2 to 8-Aug-04	26.33	25.73	24.74	24.56	20.86	20.23	14.69	15.20	19.30
	Aug 15 to 19-Aug-04	26.63	26.03	25.04	24.56	21.16	20.53	14.69	15.20	19.48
	Aug 21 to 29-Aug-04	26.98	26.38	25.39	24.56	21.51	20.88	14.69	15.44	19.71
	Sep 1 to 3, 15, 16-Sep-04	27.28	26.68	25.69	24.56	21.96	21.33	14.69	16.41	20.03
	Sep 25 to 27-Sep-04, 1-Oct-04	27.03	26.43	25.44	24.56	22.26	21.83	14.69	16.64	20.11

*Mass transport fares are unchanged during the quarter.*

Despite the increases in the domestic oil prices, minimum public mass transport fares for jeepneys and buses have remained unchanged since last government-approved increase in June. Transport groups have for the time being set aside plans to file petitions before the Land Transportation Franchising and Regulatory Board (LTFRB) for an additional ₱1 increase in the minimum jeepney fare (currently ₱5.50 for the first four kilometers) pending discussions with oil companies on possible discounts on fuel purchases.

*Utility Charges*

***Power rates increase in the third quarter.***

On 3 September, the Energy Regulatory Commission (ERC) gave provisional authority to the National Power Corporation (NPC) to adjust its generation rates by an average of ₱0.9798 per kwh effective 26 September.<sup>4</sup> NPC originally applied for a ₱1.87 per kwh adjustment in its rates. The approved adjustments in generation rate per grid are as follows:

<b>Grids</b>	<b>Approved Rate Increase (in ₱ per kwh)</b>
Luzon	1.2318
Visayas	0.2202
Mindanao	0.2665
Average	0.9798
Source: NPC	

Accordingly, distribution utilities that source power solely from NPC can automatically adjust their own generation charges and pass on the new rates to end-users. However, distribution utilities with suppliers apart from NPC (i.e., Meralco) would need to obtain ERC approval under the Generation Rate Adjustment Mechanism (GRAM) before using the new NPC rates.

On the other hand, the ERC has also allowed Meralco to adjust rates, based on an earlier petition for an increase. In an order issued on 20 August 2004, Meralco was given authority by ERC to raise its generation cost by ₱0.1737 per kwh effective September 2004. This adjustment was the

<sup>4</sup> ERC, “ERC grants provisional average rate increase of only 98 centavos per kwh”, 4 September 2004, available online at <http://www.erc.gov.ph>

third GRAM adjustment for Meralco and covers the test period February to May 2004.<sup>5</sup>

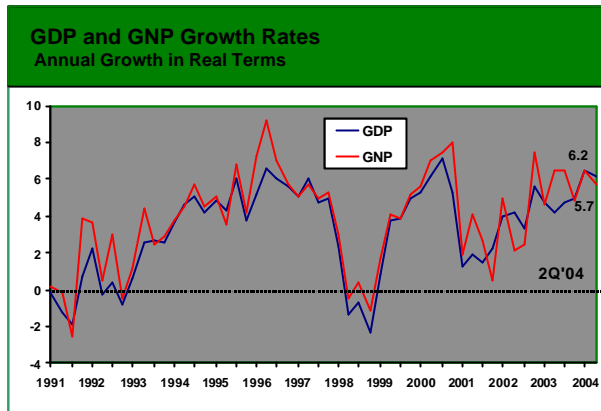
## **Aggregate Demand and Supply**

*Overall economic activity remains robust based on latest available GDP data for the second quarter.*

Overall, economic activity continued to be fairly brisk, with real gross domestic product (GDP) expanding by 6.2 percent in the second quarter amid political uncertainty linked to the national elections in May, the uptrend in international oil prices, and investor concerns over the widening public sector deficit. The rise was slightly lower than the 6.5 percent rise in the previous quarter but comparatively higher than the 4.2 percent growth a year earlier. Aggregate demand continued to be fueled by strong private consumer spending, along with increased activity in exports and investments, notably in construction. On the supply side, the sustained expansion in the services and industry sectors cushioned the slower growth in the agriculture, fishery and forestry sector. Nevertheless, the lower growth in factor earnings and higher interest payments contributed to the slowdown in the growth of the real gross national product (GNP) during the quarter to 5.7 percent from the 6.5 percent growth recorded both in the preceding quarter and in the second quarter of 2003. In particular, net factor income from abroad (NFIA) grew by a slower 0.3 percent in the second quarter compared to 6.7 percent in the previous quarter and 40.9 percent in the second quarter of 2003.

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<sup>5</sup> ERC, "Meralco has new generation rate", 25 August 2004, available online at <http://www.erc.gov.ph>



<b>Economic Performance as of the Second Quarter of 2004</b>				
<i>in percent</i>				
Sector	Share to total GDP	2004		2003 Q2
		Q2	Q1	
GNP		5.7	6.5	6.5
GDP	100.0	6.2	6.5	4.2
<i>By industrial origin</i>				
Agriculture, Fishery and Forestry	18.0	4.3	8.1	1.6
Industry	33.8	5.6	5.6	3.6
Services	48.2	7.3	6.4	5.7
<i>By expenditure item</i>				
Personal consumption expenditure	80.2	6.0	5.7	5.3
Government consumption	7.0	0.1	0.9	-5.4
Capital formation	19.6	8.5	10.1	-0.8
Export	45.5	14.9	11.1	1.2
Less: Imports	57.6	7.0	4.3	7.0
Source: National Statistical Coordination Board (NSCB)				

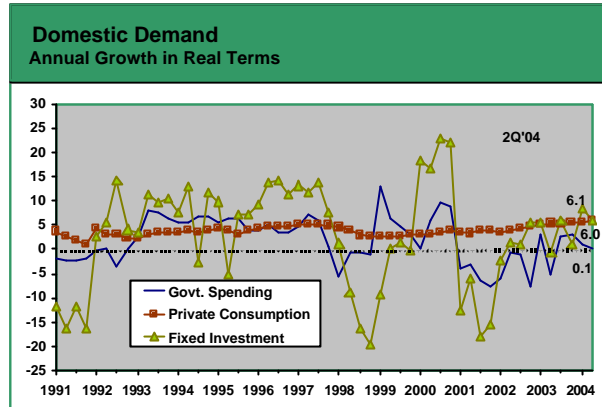
### ***Aggregate Demand***

***Robust private consumer spending continued to provide a boost to domestic demand.***

Growth in aggregate demand continued to be driven by robust consumer spending as well as increased investments in both public and private construction and faster export growth from increased foreign demand.

Personal consumption expenditures (PCE) posted a record growth rate of 6.0 percent during the second quarter, mainly on account of increased spending on utilities (fuel, light, and water) as more communities were connected to water and electricity services. The record increase in PCE was also partly attributed to election-related spending on food and services. On the other hand, growth in government spending remained firmly in check at 0.1 percent in real terms following a 0.9 percent rise in the first quarter as fiscal authorities kept spending in line with fiscal targets for the year.

Meanwhile, total fixed investments slowed compared to the previous quarter despite a notable increase in construction activity, particularly for public works and road maintenance projects. Public construction growth rose significantly to 14.9 percent in the second quarter, almost twice as fast as the rise in the previous quarter and a reversal from the contraction seen a year ago. Nevertheless, investments in durable equipment were generally slower, with reduced spending on road vehicles and equipment for railway transport, mining, air-conditioning and refrigeration. However, increases were noted for specialized industrial machineries, telecommunication, sound recording and reporting, and pumps and compressors. Investments in livestock, poultry and orchard development meanwhile grew at a slower pace of 0.4 percent in the second quarter of 2004 compared to the 3.5 percent growth in 2003 due to less spending on breeding stocks and orchard development.



Imports of goods and services posted a 7.0 percent growth in the second quarter, higher than the 4.3 percent growth in the previous quarter. This also matched the growth recorded in the second quarter of 2003. Goods imports grew by 6.9 percent, slightly higher than the 6.8 percent growth a year ago. Major imports included electrical and other machinery, textile fibers, feeding stuff and textile yarns. Meanwhile, growth in non-factor services imports rose slightly to 10.8 percent in the second quarter from 10.5 percent during the same period last year due mainly to growth in travel services.

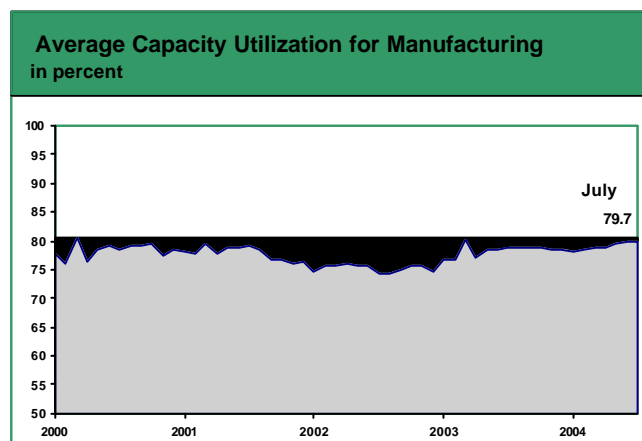
Latest data from NSO showed that total merchandise imports showed an increase of 8.9 percent year-on-year in August, up from 5.6 percent in July. The January-August 2004 imports rose by 7.2 percent year-on-year. Raw materials and intermediate goods, which comprised about 36.7 percent of total imports grew by 6.6 percent year-on-year in August. By contrast, capital goods, which accounted for another 36.7 percent of the total imports, dropped by 1.3 percent year-on-year.

*Other Demand Indicators*

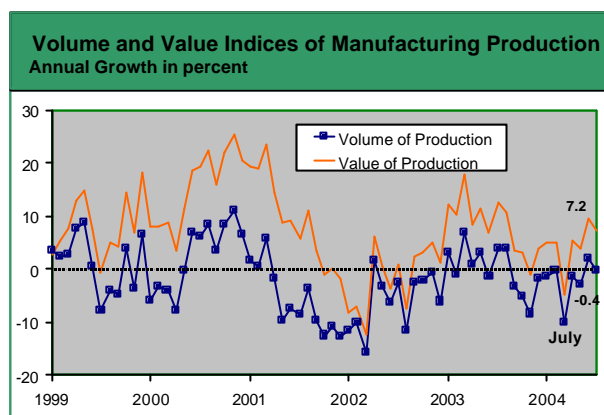
***Other economic indicators show mixed trends.***

Other indicators of domestic demand also displayed positive trends accompanied by a reduction in the excess capacity of the manufacturing sector. Car sales and energy consumption posted continued growth during the quarter. Moreover, the BSP's Business Expectations Survey (BES) provided evidence of relatively upbeat business outlook and the Consumer Expectations Survey (CES) indicated improvement in consumer expectations in the next quarter.

- ? Average capacity utilization in manufacturing hovered at close to 80 percent in recent months, suggesting an improvement in resource use. Data for July showed average capacity utilization remained relatively steady at 79.7 percent compared to the June level of 79.8 percent but higher than the average capacity utilization registered a year ago at 78.7 percent. Majority (51.7 percent) of the manufacturing firms in the sample were operating at 70-89 percent capacity in July, while 15.1 percent reported full or near-full capacity operation (90-100 percent), and the remaining third (33.2 percent) reported capacity utilization of below 70 percent.



? The value of production index (VAPI) for manufacturing increased by 7.2 percent year-on-year in July following a 9.7 percent annual growth in June. On a monthly basis, VAPI declined by 0.9 percent in July. Meanwhile, the volume of production index (VOPI) for manufacturing dipped slightly by 0.4 percent in July after a 2.0 percent rise in June. On a monthly basis, VOPI fell by 2.2 percent in July 2004.

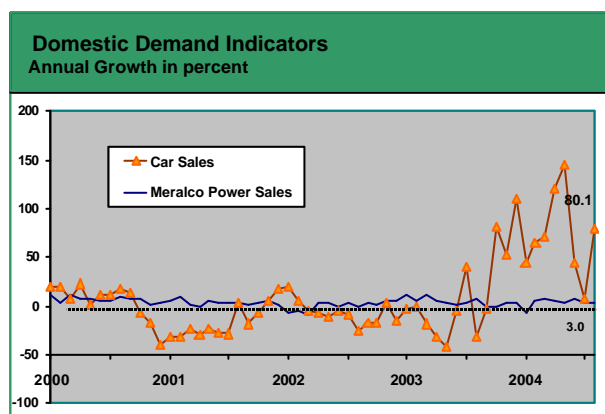


? The Chamber of Automotive Manufacturers of the Philippines, Inc. (CAMPI) reported growth in passenger car sales of 80.1 percent year-on-year in August—faster than the 8.2 percent sales growth in the previous month and a marked turnaround from the 30.7 percent contraction in August 2003. The year-to-date growth in passenger car sales was registered at 60.3 percent, a reversal of the 10.3 percent contraction seen in the same period a year ago. Meanwhile, truck sales continued to decline by 11.3 percent year-on-year in August following a larger 55.7 percent contraction in July. The January-August sales of trucks was 17.8 percent lower than the volume of truck and bus sales for the same period a year ago. The large jump year-on-year in car sales may be due to a shift in the consumption from AUV

hi-end models to sedans as excise tax makes AUV's more expensive. This may explain the 55.7 percent year-on-year drop in commercial vehicles, of which AUV's are classified under.

- ? Energy sales by the Manila Electric Company (Meralco) increased by 3.0 percent year-on-year in August, almost unchanged from 2.9 percent growth in July but lower than the 6.7 percent rise in August of last year. Relative to the previous month, the slight acceleration in the growth of Meralco's energy sales in August could be traced mainly to the increase in sales to commercial and industrial sectors.

Sector	Year-on-Year Growth Rate August 2004	Percentage Share in Total Sales	Percent Contribution to Growth
Total	3.0	100.0	3.0
Residential	0.9	34.5	0.3
Commercial	4.5	35.9	1.6
Industrial	3.6	29.0	1.1
Others	3.6	0.5	0.02



- ? Results of the Business Expectations Survey (BES) conducted by the BSP from 1 July to 9 August 2004 indicated a positive business outlook for the third and fourth quarters of 2004, with business confidence reaching record highs. The overall outlook diffusion index for third quarter of 2004 rose to 30.5 percent from 19.9 percent in the second quarter.<sup>6</sup> For the fourth quarter of 2004, the overall business outlook diffusion index likewise increased to 48.7 percent from the 32.4 percent recorded in the previous quarter. Respondents cited the stable political environment, the generally steady exchange rate and the rising demand for Philippine goods and services in local and external markets as the reasons for their improved optimism.
  
- ? Meanwhile, results of the first Consumer Expectations Survey (CES) conducted by the BSP during the period 1-7 July 2004 indicated that consumers expect higher income in the near term but this will be accompanied by higher prices. The survey showed that respondents expected unemployment and interest rates to rise and the peso to weaken over the next 12 months. Prices of basic commodities were also expected to increase, albeit only moderately, over the same period. The survey results indicated that the highest price increases are expected for food items such as meat, fish and other seafood, as well as electric utility bills and school expenses. However, respondents also indicated that they believe their family income will rise over the next 12 months, and that most of their income will be spent on food and electricity bills. Such an outlook of

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<sup>6</sup> The diffusion index (DI) is computed as the percentage share of households that answered in the affirmative less percentage share of households that answered in the negative in a given indicator; a positive DI indicates a favorable view except for unemployment, interest rate for borrowing money and inflation rate where a positive DI indicates the opposite.

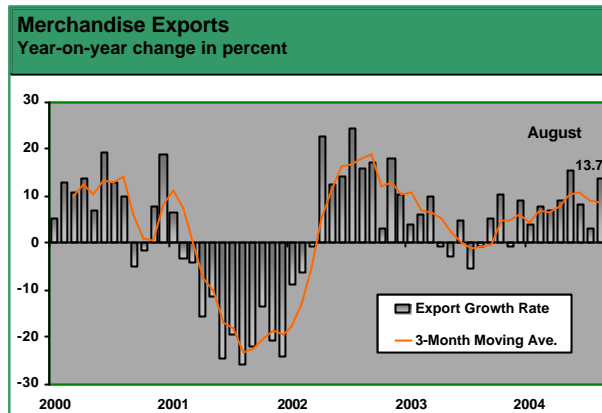
higher income coupled with higher prices and unemployment may indicate expectations of possible cost-of-living adjustments in salaries and wages.

*External Demand*

***Foreign demand for Philippine products remains buoyant.***

Data from NSO showed that the demand for Philippine exports continued to improve as total exports of goods and services posted double-digit growth of 14.9 percent in the second quarter from a 10.2 percent increase in the first quarter and 1.2 percent for the same quarter in 2003. Merchandise exports, which accounted for more than four-fifths (86.9 percent) of total exports, rose by 13.1 percent at the back of demand from the US and from Asia, notably Japan and China. The main contributors to growth were exports of bars, rods of copper, iron conglomerates, transmission apparatus, and other products manufactured. Meanwhile, exports of non-factor services advanced further with a 28.1 percent growth in the second quarter of this year owing to robust increases in travel receipts and miscellaneous income.

More recent merchandise export data published by the NSO showed a 13.7 percent year-on-year rise in August from 3.2 percent in July, bringing the cumulative growth for January-August to 8.5 percent. Electronics exports, which comprised almost two-thirds of the total, grew by 15.7 percent in August following a 0.8 percent growth in the previous month.



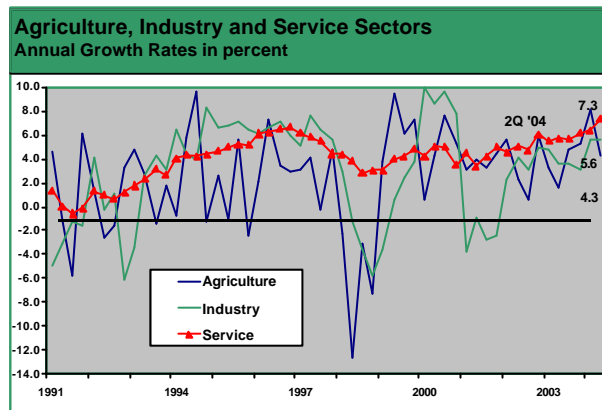
***Aggregate Supply***

*Major production sectors of the economy exhibit higher growth rates based on 2Q'04 data.*

On the production side, all three major sectors—agriculture, industry, and services—reported stronger growth based on national accounts data for the second quarter of 2004. The services sector, in particular, continued to be the main driver of economic activity, accounting for almost half or 48.2 percent of total output. With a growth rate of 7.3 percent, the services sector surpassed its second quarter 2003 growth performance of 5.7 percent and contributed 3.5 percentage points to the 6.2 percent rise in real GDP.

The strong performance of the services sector was a reflection of the favorable performance of its subsectors, notably transportation, communication and storage, which rose by 13.5 percent in the second quarter of 2004 from the 8.4 percent posted in the same period of last year. Enhancements in mobile phone services and expansion of road and railway transport services were the main contributors to its upswing of the services sector. Buoyed by brisk consumer sales, the wholesale-retail trade services subsector likewise posted laudable gains, as it expanded at a faster rate of 6.1 percent in the second quarter of 2004 from a 5.4 percent growth in the comparable period in 2003. Financial services rose by 8.8 percent in the second quarter

from 8.6 percent in 2003 as banks, non-banks and insurance companies continued to post positive growth rates during the period. With the real estate sector gradually improving, output growth in the ownership of dwellings and real estate rose to 4.5 percent from 4.1 percent growth last year. Private services also displayed an impressive performance during the second quarter, rising by 6.8 percent in 2004 from the 4.9 percent growth posted during the previous year's comparable quarter. Meanwhile, in view of the efforts to contain the burgeoning budget deficit, government services grew modestly by 2.7 percent in the second quarter from 2.2 percent in 2003.



The industry sector also made a strong showing in the second quarter, rising by 5.6 percent from 3.6 percent last year and contributing 1.9 percentage points to the 6.2 percent rise in real GDP. The sustained performance of manufacturing and the upturn in construction provided the impetus for the sector's growth. The 4.6 percent growth in the manufacturing subsector during the quarter was largely supported by activity in food manufactures, electrical machinery, chemical products and metal industries. Construction, on the other hand, demonstrated a remarkable growth of 13.7 percent for the period, which was a significant recovery from the contraction of 8.5

percent it experienced in 2003. Electricity, gas and water subsector was also a gainer as it posted a higher rate of growth of 4.1 percent in the second quarter of 2004 compared to the 3.2 percent growth last year as electric generation increased and water services expanded. In the manufacturing subsectors, mining and quarrying exhibited a significant slowdown in output to 2.5 percent compared to the previous year's double-digit growth of 26.7 percent. The reduction in growth was primarily a result of the slowdown in most of its subcomponents including chromite mining, crude oil, and other non-metallic mining, as well as the decline in gold and copper production.

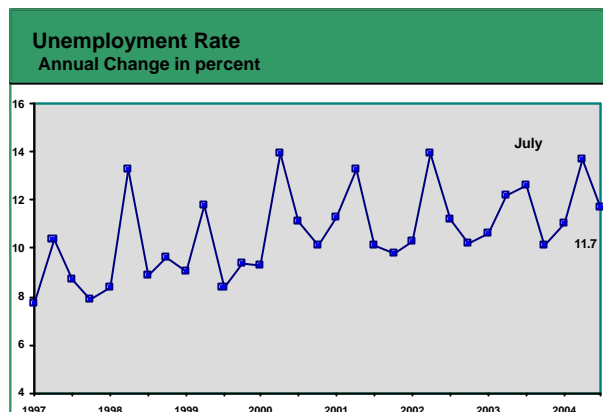
Favorable weather conditions allowed the combined agriculture, fishery and forestry sector to grow 4.3 percent for the second quarter from a modest 1.6 percent a year earlier. The sector contributed 0.8 percentage point to the recorded growth in real GDP. Increases in *palay*, sugarcane, and corn production provided the boost in agricultural output, while upgrades in seaweed processing and plantation sustained the growth in fishery production. Forestry showed the biggest increase as it posted a 110.4 percent growth for the period, a considerable climb from last year's decline of 30.1 percent. However, the livestock and poultry sectors posted modest growth rates.

## Employment Conditions and Wages

*Jobless rate eases but overall labor market conditions remain soft.*

Employment conditions remained generally soft in the third quarter despite a decline in the unemployment rate. The latest Labor Force Survey (LFS) published by the National Statistics Office (NSO) indicated that the unemployment rate declined to 11.7 percent in July from 13.7 percent in April 2004 and 12.6 percent for the same period last year. This was accompanied by the 0.1 percent improvement in the labor force participation rate from last

year. More jobs were reported in the agriculture subsector, as well as in retail trade, education and the transport, storage and communication subsector.



Employment in the agriculture sector, which comprised about 36.2 percent of total employment, grew by 5.7 percent year-on-year, due largely to the 6.1 percent (581,000) increase in jobs in the agriculture, hunting and forestry subsector.

The services sector, which comprised nearly half (48.2 percent) of total employment generated 598,000 jobs in July 2004, mainly from wholesale-retail trade, repair of motor vehicles, motorcycles and personal and household goods (393,000 at 7.1 percent) and transport, storage and communication (110,000, 4.7 percent), and education (90,000, 10.2 percent).

Meanwhile, the number of jobs in industry, which represents 15.6 percent of total employment, declined by 0.7 percent year-on-year (36,000 jobs), pulled down by the contraction in the number of jobs in construction (58,000 or 3.4 percent) from the previous year's 7.2 percent increase; and lower increase in the number of jobs in manufacturing

(12,000 or 0.4 percent) from last year's growth of 5.4 percent.

*Wage increases were granted and took effect in 13 regions including Metro Manila during the quarter.*

As of end-September 2004, wage adjustments in the form of increase in cost of living allowance (COLA) or increases in the minimum daily wage were granted and took effect in 13 regions (including Metro Manila). These include Region XI, where the increase was granted in December 2003 but became effective only on 1 January 2004. Of the 13 regions, 11 had issued and effected their increases during the third quarter. Similar increases are expected to become effective in the fourth quarter for the three other regions. Regions IX and XI had already implemented wage increases in the first semester. The increases, ranging from ₱15 to ₱20, were granted for two main reasons: (1) to restore workers' purchasing power eroded by increases in transportation fares and prices of basic commodities and services during recent months; and (2) to allow workers a an equitable share in economic gains.<sup>7</sup>

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<sup>7</sup> Press Releases of the Department of Labor and Employment-Regional Tripartite Wages and Productivity Board (DOLE-RTWPB), available online at <http://www.dole.gov.ph>

Region	Increase in Minimum Daily Wages/ ECOLA/COLA *	Date of Effectivity <sup>a/</sup>
National Capital Region (NCR)	₱20.00 (ECOLA)	10 July 2004
Cordillera Autonomous Region (CAR)	₱15.00 (COLA)	17 July 2004
Ilocos (Region I)	₱2 to ₱10; and ₱5 (COLA)	(Issued) 29 Sept 2004
Cagayan Valley (Region II)	₱8.00 (ECOLA)	8 August 2004
Central Luzon (Region III)	₱15.00 (COLA)	3 August 2004
Southern Tagalog (Region IV)	₱5.00 to ₱18.00	1 November 2004 <sup>b/</sup>
Bicol Region (Region V)	₱12.00	23 August 2004
Western Visayas (Region VI)	₱15.00 (for retail and cottage) ₱10.00 (other categories)	16 August 2004
Central Visayas (Region VII)	₱8.00	8 August 2004
Eastern Visayas (Region VIII)	₱7.00 (COLA) and ₱4.00	29 August 2004
Western Mindanao (Region IX)	₱5.00	8 May 2004
Northern Mindanao (Region X)	₱3.00 to ₱10.00 ₱12.00 (COLA integration)	12 August 2004
Southern Mindanao (Region XI)	₱25.00 (COLA integration)**	1 January 2004
SOCSARGEN (Region XII)	₱20.00 and ₱10.00 for non-agri and agri ₱10.00 (COLA integration)	1 September 2004
Caraga (Region XIII)	₱10.00	23 July 2004
Autonomous Region of Muslim Mindanao (ARMM)	₱5 to ₱60 in Basilan, and ₱20 ATB in other provinces <sup>c/</sup>	

\* COLA refers to the cost of living allowance while ECOLA means emergency COLA.  
 \*\* Integrated the daily COLA of ₱10.00 under Wage Order (WO) No. 6 granted in January 1998 and ₱15.00 under WO No. 9 granted in October 2000 into the minimum daily wage rate.  
 a/ After approval/issue of the pertinent wage order, the increase is effected only after publication in a newspaper  
 b/ Wage increase was issued in 3<sup>rd</sup> quarter  
 c/ ATB = across-the-board; issued 23 September 2004, but effectivity expected in 4<sup>th</sup> quarter

## Fiscal Developments

*NG Fiscal position for the first eight months of the year point to strong commitment to fiscal discipline.*

The National Government (NG) deficit for August fell by 35.7 percent to ₱11.7 billion from ₱18.2 billion in August 2003 and ₱19.3 billion in July 2004 due mainly to the 17-percent growth in revenue collections and moderate growth in spending of 3.0 percent during the month. This brought the cumulative deficit level for January-August to ₱111.1 billion, 3.0 percent lower than the deficit for the same period in 2003. Revenue collections in the first eight months registered a double-digit increase of 13.2 percent year-on-year to ₱462.4 billion while government spending rose by only 9.7 percent to ₱573.5 billion.

<b>National Government Fiscal Position</b>								
August 2004 (In billion pesos)								
Particulars	August		Actual		Growth		2004 Program	Percent of Program
	2004	2003	Growth (%)	January-August	2004	2003		
Surplus/(Deficit)	-11.7	-18.2	-35.7	-111.1	-114.5	-3.0	-197.8	56.2
Revenues	59.8	51.1	17.0	462.4	408.4	13.2	674.4	68.6
Expenditures	71.4	69.3	3.0	573.5	522.9	9.7	872.2	65.8

Source : Bureau of the Treasury (BTr)/Bloomberg News

### Financial Market Conditions

*Activities in the domestic financial markets improve in the third quarter.*

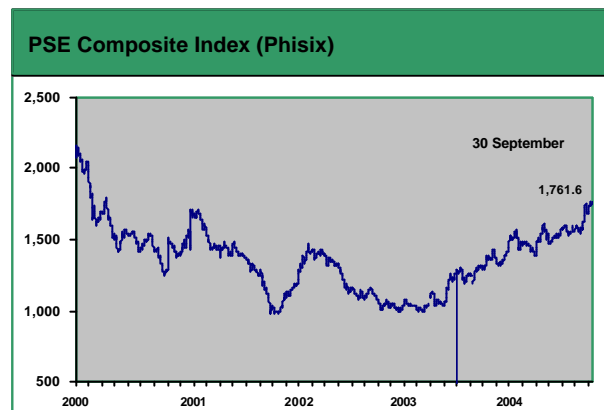
Trading in the domestic financial markets improved in the third quarter, characterized by stronger demand for both local equities and government debt papers. Optimism in the stock market has been helped by positive macroeconomic and corporate developments during the period, including the prospects of strong economic growth for 2004. Ample liquidity in the financial system has also fueled investor appetite for government securities. Bids tendered during the regular Treasury bill auctions were generally in excess of the offered amount, as banks invested their excess funds in secured investments.

*Stock Market*

*Philippine share prices advance further.*

Philippine share prices extended gains in July 2004 and continued to strengthen well into the third quarter of 2004, with the Philippine composite index (PHISIX) staying consistently above the 1,500-level during the period, and reaching three-year highs in the latter part of the quarter.

The PHISIX advanced by 36.1 index points to 1,584.7 index points in end-July from an average of 1,548.6 index points in the previous quarter prompted by market optimism following the inauguration of the new administration. It climbed further to 1,579.8 index points in end-August with the impressive first semester corporate earnings reports, particularly by major telecommunications companies, and the economy's sustained growth in the second quarter. The PHISIX settled at 1,761.6 index points in end-September due mainly to the upbeat economic projections as the government upgraded the country's growth forecasts for 2004.

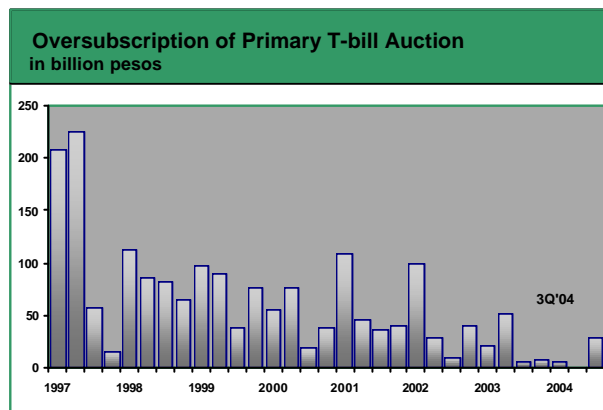


The market is expected to stay resilient during the last quarter of the year, with confidence boosted by positive macroeconomic and corporate outlook. However, worries over the buildup in inflationary pressures stemming from the recent oil price hikes as well as the country's weak fiscal position could limit gains in the PHISIX.

*Government Securities*

***Ample liquidity continues to fuel appetite for government debt papers.***

Liquidity in the financial system continued to help pump investible funds into the government securities market as the primary market continued to attract an excess of bids in the third quarter of 2004. Total oversubscriptions for the quarter amounted to around ₱28.7 billion, significantly larger than the ₱660 million posted in the previous quarter. This resulted as the seven regular T-bill auctions in the quarter drew a total of ₱105.7 billion tenders as against the ₱77.0 billion total offering. The third quarter average oversubscription level of ₱4.1 billion was also higher than that of the six auctions in the previous quarter of ₱110 million. Meanwhile, the Auction Committee tried to moderate increases in T-bill rates by exercising its option to reject excessively high bids. Total rejections for the period reached ₱48.2 billion. This was ₱22.1 billion higher than the ₱26.1 billion rejection in the second quarter.

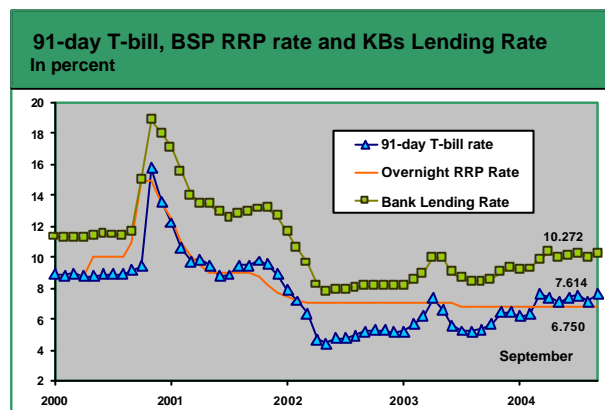


## II. Recent Monetary Conditions

### Interest Rates

*Market interest rates are generally higher during the third quarter.*

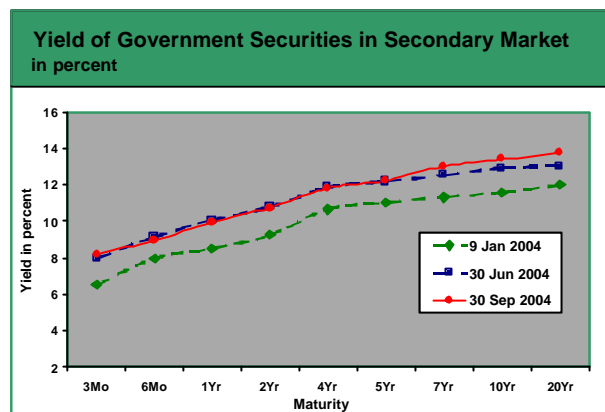
Domestic interest rates were generally higher during the third quarter. The weighted average benchmark 91-day T-bill rate rose to 7.5 percent in the third quarter from 7.3 percent in the second quarter. The 91-day T-bill rate rose slightly in July, eased briefly in August before edging up anew in September to 7.6 percent. The rise in T-bill rates reflected market concerns over the Government's fiscal position, rising inflation given developments in oil prices and expectations of further hikes in the US federal funds rates. Interest rates charged on bank loans followed the same trend during the quarter. From a range of 10.1-12.1 percent in June, average bank lending rates rose to 10.3-12.4 percent in July, eased slightly to 10.0-12.0 percent in August and rose anew to 10.3-12.4 percent in September.



*Yield Curve*

*Secondary market yield curve is flatter except in the longer end.*

The yield curve for government securities in the secondary market as of 30 September 2004 was generally flatter relative to the 30 June 2004 except for the longer end of the curve which exhibited a slight upward shift.



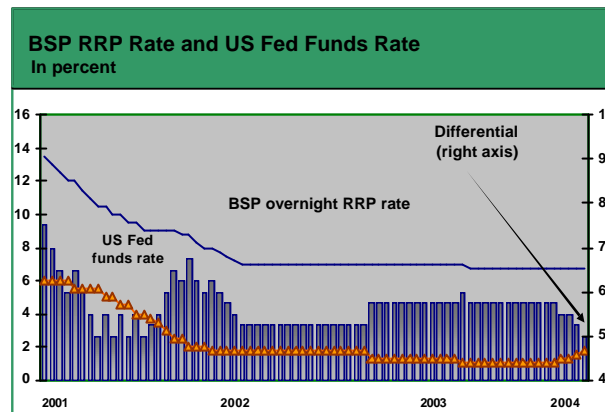
*Interest Rate Differentials*

*Spreads between RP and US interest rates narrows but remain sizeable .*

Philippine interest rate differentials with those of the US have generally tightened compared to the second quarter. Differentials between the RP 91-day T-bill rate (net of RP withholding tax) and the 90-day LIBOR and 90-day US T-bill declined from 441.4 basis points and 468.8 basis points, as of end-June respectively, to 418.7 basis points and 436.0 basis points as of end-September. Interest rate differentials narrowed as a result of the uptrend in foreign interest rates—following the upward adjustment in the US federal funds target rate in the third quarter—but remained sizeable.

The differential between the BSP’s policy interest rate (overnight borrowing or RRP rate) and the US federal funds target rate settled at 500 basis points as the US Federal Open Market Committee (FOMC) decided to raise the

federal funds target rate by 25 basis points on 10 August to 1.5 percent and by another 25 basis points to 1.75 percent on 21 September. Meanwhile, the Monetary Board of the BSP opted to keep policy rates unchanged during the review quarter.



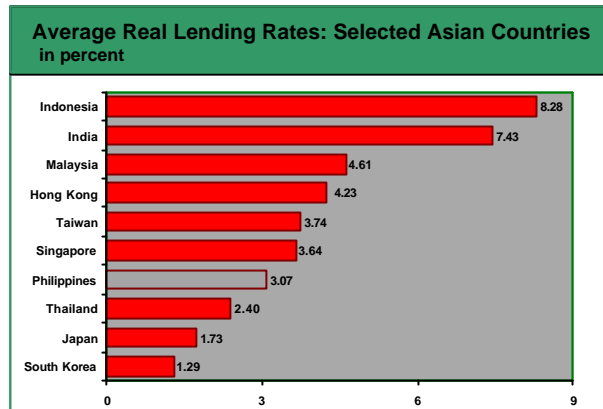
Adjusted for the risk premium—as measured by the differential between the 10-year ROP note and the 10-year US Treasury note—the differential between the BSP’s policy rate and the US federal funds target rate narrowed in the third quarter. The risk-adjusted differential narrowed to 111 basis points as of 30 September 2004 from 153 basis points registered on 30 June 2004, a result mainly of the upward adjustment in the US federal funds target rate in September 2004.

*Real Lending Rate*

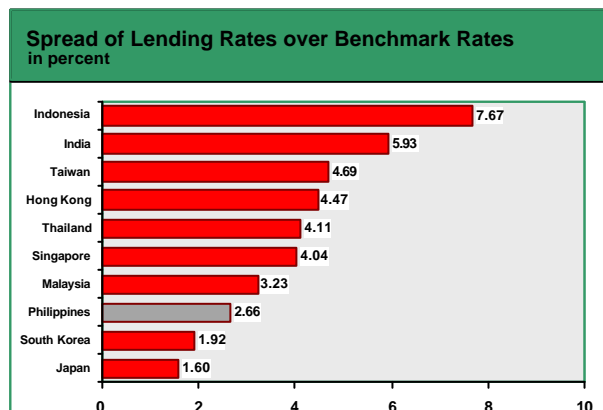
***Real lending rate eases in the third quarter.***

The real lending rate in the Philippines edged lower during the third quarter, declining from 3.7 percent in July to 3.2 percent in August and further to 3.1 percent in September due to the rise in inflation to average 3.3 percent for the third quarter. This level was 210 basis points lower than the previous quarter’s average of 5.4 percent. The Philippines’ real lending rate for September at 3.1 percent ranked the

fourth lowest in a sample of 10 Asian countries with real lending rates ranging from 1.3-8.3 percent during the same period.



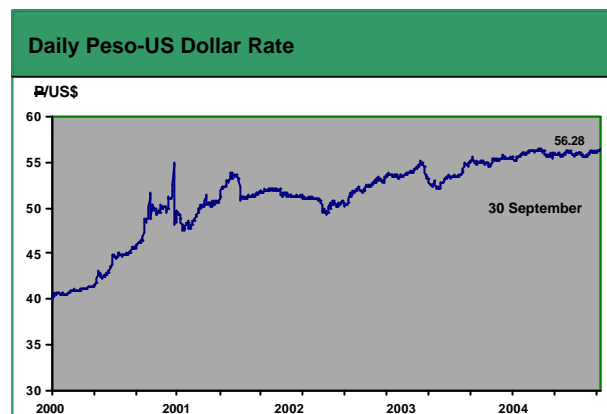
Meanwhile, the spread between the Philippine lending rate and the benchmark 91-day T-bill rate narrowed slightly to 266 basis points in September 2004, compared to 268 basis points in June 2004, due mainly to the increase in the average RP 91-day T-bill rate. Among the 10 Asian countries surveyed, the Philippines ranked the third lowest in terms of the spread between lending rates and benchmark interest rates.



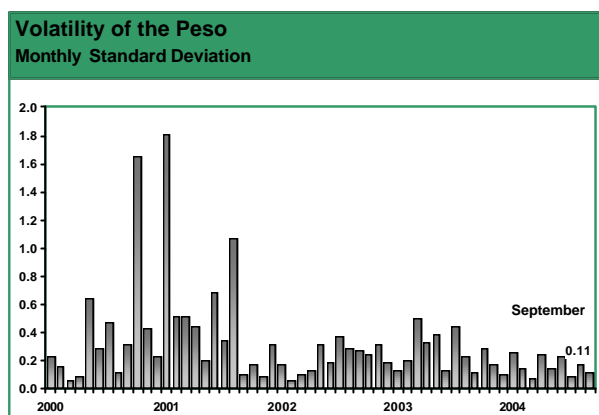
**Exchange Rate**

*The peso weakens slightly due mainly to seasonal factors.*

The third quarter of 2004 saw the peso depreciating slightly in nominal terms against the US dollar to ₱56.3/US\$1 as of end-September 2004 from ₱56.2/US\$1 at end-June 2004. The depreciation was due mainly to seasonal factors, including the increased corporate dollar demand to cover for import requirements and end-quarter debt service payments. The peso was also weighed down by unfavorable developments on both the external and domestic fronts, particularly the persistent concerns over the country's fiscal situation and the surge in world oil prices, which fueled market fears of higher inflation and increase in interest rates. The peso was also influenced by the general weakness in Asian currencies.



The peso, however, was less volatile, with the standard deviation of the daily exchange rates falling to ₱0.11 in September from ₱0.23 in June.



Compared to its level at end-December 2003, the peso-dollar rate as of 30 September 2004 depreciated by 1.4 percent, along with some currencies in the region, particularly the Japanese yen, Thailand baht and Indonesian rupiah. The same period saw the South Korean won, New Taiwan dollar and the Singaporean dollar appreciating vis-a-vis the US dollar.

<b>CHANGES IN SELECTED DOLLAR RATES</b> As of 30 September 2004	
Currencies	Appr/Depr(-) from 30 December 2003
South Korean won	3.95
Singapore dollar	0.66
New Taiwan dollar	0.15
Philippine Peso	(1.39)
Japanese yen	(3.53)
Thailand baht	(4.51)
Indonesian rupiah	(7.43)

*External competitiveness improves on a real, trade weighted basis.*

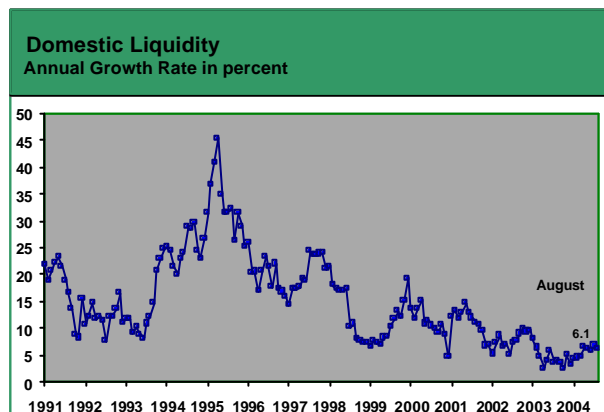
On a real, trade-weighted basis, the peso gained external competitiveness during the period July-September 2004 from its level in the previous quarter as indicated by the 1.8 percent depreciation of the real effective exchange rate (REER) index of the peso. The peso likewise posted real

depreciations over the same period vis-à-vis two baskets of currencies of the Philippines' competitor countries. The REER for the broad and narrow baskets of competitor currencies declined by 4.1 percent and 4.5 percent, respectively. The continued gain in competitiveness against the three baskets of currencies was brought about mainly by the nominal depreciation of the peso.

**Monetary Aggregates**

*Money demand rises steadily.*

Domestic liquidity (M3) rose by 6.4 percent year-on-year in July-August 2004 from 6.1 percent average growth rate posted in the second quarter. Credits to both the public and private sector continued to post positive growth rates. The strong demand for government securities has been the main driver of credit growth to the public sector. Meanwhile, the growth in the NFA—particularly in August—was due mainly to revaluation adjustments in the BSP's foreign currency denominated assets as a result of the weaker peso.



Growth in other monetary aggregates exhibited a similar trend. Year-on-year growth in reserve money (a narrower definition of money supply defined as the sum of currency issue net of cash in vaults of the Bureau of the Treasury (BTr) and banks' reserve balances with the BSP) accelerated

to 12.3 percent for July-August from the 11.0 percent for second quarter.

## Banking System

*Banking system remains generally stable as the asset base expands and NPLs declined.*

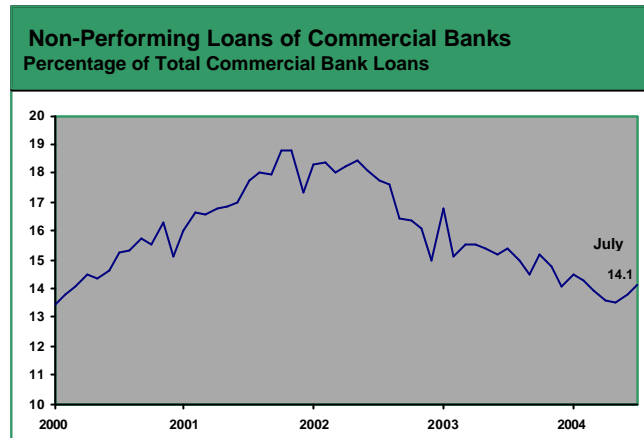
The banking system continued to expand as the system's aggregate resources grew by 2.2 percent quarter-on-quarter and 10.0 percent year-on-year to ₱4.04 billion as of June 2004. The expansion was attributed to the rise in commercial banks' asset base, which comprised more than 90 percent of the system's total assets.

### *Asset Quality*

*Asset quality improves.*

The banking system's asset quality improved as the ratio of its non-performing loans (NPLs) to total loans declined to 14.1 percent as of July from 15.6 percent in the same month a year ago. Compared to other Asian countries, the country's NPL ratio is comparable with Thailand's 12.4 percent but higher than Malaysia's 7.7 percent, Indonesia's 7.6 percent, and Korea's 2.6 percent.<sup>8</sup> Other Asian countries have been able to reduce their NPL ratios through publicly-owned asset management companies' (AMC) that purchased most of the banks' NPLs. Despite the improvements, the country's NPL ratio remains relatively high even as authorities continue to encourage banks to clean their balance sheets of non-performing assets (NPAs) through private special purpose vehicles (SPVs). Encouraging progress has been noted as of 30 September 2004, as the BSP has already issued 68 Certificates of Eligibility (COEs) to 18 banks involving a total amount of ₱4.5 billion worth of NPAs transferred under the SPV Act of 2002.

<sup>8</sup> Source: ARIC Financial Indicators, ADB website. Thailand (June 2004, commercial banks), Malaysia (June 2004, commercial banks); Korea (September 2003, commercial banks); and Indonesia (June 2004, financial system).



*Loan-loss Provisions*

***Banks' NPLs continue to be adequately covered.***

Commercial banks' loan exposure continued to be adequately covered as the NPL coverage ratio remained steady at 52.9 percent as of July from 53.4 percent recorded in June and 52.9 percent in end-2003. This reflects banks' compliance with the BSP's provisioning requirements to ensure that the banking system is sufficiently shielded against possible losses.

*Capital Adequacy*

***Capital adequacy is above statutory level.***

Using the new risk-based consolidated framework, commercial banks' capital adequacy ratio (CAR) strengthened to 17.8 percent<sup>9</sup> as of September 2003 from 17.7 percent in June 2003, exceeding the statutory level set by the BSP at 10.0 percent and the Bank for International Settlements' (BIS) standard of 8.0 percent.<sup>10</sup> The high CAR reflects the banking system's improved ability to cover risky assets.

<sup>9</sup> Consolidated banks

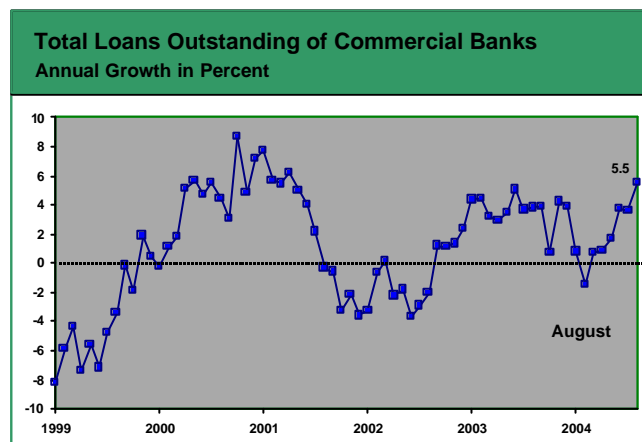
<sup>10</sup> BSP Circular No. 280, dated 29 March 2001, approved the guidelines for the adoption of the risk-based capital adequacy ratio along the criteria prescribed by the Bank for International Settlements (BIS).

The country's CAR is relatively higher compared to that of Malaysia (14.0 percent), Thailand (12.6 percent) and Korea (10.8 percent).<sup>11</sup> Indonesia posted the highest CAR in the region with 20.9 percent as of June 2004.

*Bank lending*

***Growth in bank lending picks up.***

Loans outstanding of commercial banks (KBs) grew by 5.5 percent year-on-year to reach ₱1.5 trillion as of end-August 2004. The August growth in KB lending represented an improvement from the 3.6 percent annual rise posted in the previous month and the 3.8 percent recorded in August 2003. It also marked the fastest increase in KB lending since April 2002. On a month-on-month basis, total KB loans rose by 1.4 percent during the period, a turnaround from the 0.7 percent contraction in July. Overall, the improvement in bank lending continues to be modest.

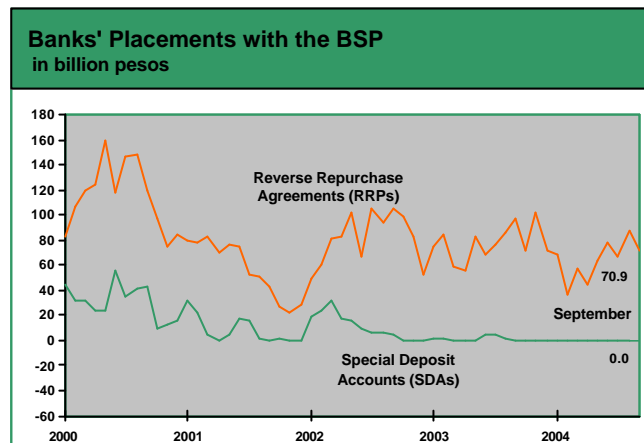


<sup>11</sup> Source: ARIC Financial Indicators, ADB website. Commercial banks CAR: Malaysia (June 2004); Thailand (June 2004); and Korea (March 2004).

*Banks' placements with the BSP*

***End-September volume of banks' RRP placements with the BSP settles lower than end-second quarter level.***

Banks' placements with the BSP under the RRP facility totaled at ₱70.9 billion as of end-September 2004, ₱6.9 billion lower than the end-June level. Banks' excess funds continued to be placed with the BSP under the RRP facility as the growth in bank lending remained relatively modest.



**Box: Features and Mechanics of Open Market Operations**

The BSP conducts monetary policy to influence the amount of liquidity or supply of money in the economy. Changes in liquidity affect interest rates, the allocation of resources between present and future needs, and the overall level of economic activity. The level of money supply affects the overall demand for goods and services in the economy, which, together with the aggregate supply of goods and services, determines the level of prices. Thus, the BSP employs various monetary instruments at its disposal to influence the money supply in support of the main policy objective of maintaining price stability conducive to a balanced and sustainable economic growth.

**Policy Instruments**

The central bank can work through the market by influencing the banks' holdings of excess reserves and thereby influence the level of liquidity in the market. Monetary policy instruments can be classified into two types: direct and indirect. Direct instruments enable the BSP to directly control certain items in banks' balance sheets which may be in the form of financial prices or quantities. Direct instruments have a strong coercive element as in the case of reserve requirements and directed lending requirements. Indirect instruments, on the other hand, work through the market to influence the behavior of financial institutions, usually through the pricing of central bank facilities. Indirect instruments include adjustments in short-term policy interest rates and the conduct of open market operations (OMO).

**Mechanics of OMO**

OMO is the monetary tool which involves the BSP publicly buying or selling government securities from banks and financial institutions in order to expand or contract the supply of money. When the BSP buys securities, it pays for them by directly crediting its counterparty's Demand Deposit Account that is being maintained with the BSP. Effectively, the transaction increases the buyer's level of reserves and on an aggregate level, expands the system's money supply. Conversely, when the BSP sells the securities, the buyer's payment (via direct debit against the buyer's Demand Deposit Account with the BSP) reduces his reserve account causing money supply to contract.

In conducting OMO, the BSP uses two instruments: (1) repurchase (repo) / reverse repurchase (reverse repo) agreements and (2) outright purchases and sales of securities.

For regular repos, the BSP purchases government securities from a bank with a commitment to sell it back at a specified future date at a predetermined rate. In effect, a repo transaction forms part of BSP's expansionary monetary policy as it increases the bank's level of reserves. Under a reverse repo, the BSP acts as the seller of government securities, thus, the bank's payment reduces its reserve account resulting in a contraction in the system's money supply. For both repos, the BSP can only affect the level of money supply temporarily, given that the parties involved commit to reverse the transaction at an agreed future date.

At present, the BSP enters into repo agreements with tenors of two weeks to one month and with the overnight contract being the shortest.

An outright contract, on the other hand, involves the direct purchase/sale of government security by the BSP from/to the market for the purpose of increasing/decreasing money supply on a more permanent basis. In such a transaction, the parties do not commit to reverse the transaction in the future creating a more permanent effect on the banking system's level of money supply.

### **Policy Rate Setting**

In the Philippines, the interest rates applied on overnight RP/RRP signals the stance of BSP's monetary policy. The BSP created the Advisory Committee which meets to deliberate, discuss and recommend to the Monetary Board the appropriate monetary policy stance that will enable the BSP to achieve the desired inflation target. The Committee is composed of the Governor, the Deputy Governor for the Banking Services Sector, Research and Treasury, the Deputy Governor for Supervision and Examination Sector, the Assistant Governor in-charge of Research, and the Director of Treasury Department. The Advisory Committee is assisted by a Technical Secretariat headed by the Director of the Department of Economic Research. The Committee meets every four weeks but also meets in between the regular meetings, whenever it is deemed necessary.

**Managing Risk**

In managing the credit risk inherent in OMO transactions, the BSP has adopted a valuation scheme for securities that are used in repos. Haircuts are applied, taking into consideration the remaining life of securities involved. Thus, eligible securities are valued based on their current market yields as well as the applicable haircut.

To avoid exposing the BSP to undue risks arising from purchases of securities, Section 91, Article V of RA 7653 (The New Central Bank Act) sets the type of securities that can be bought or sold by the BSP for its own domestic portfolio, as follows:

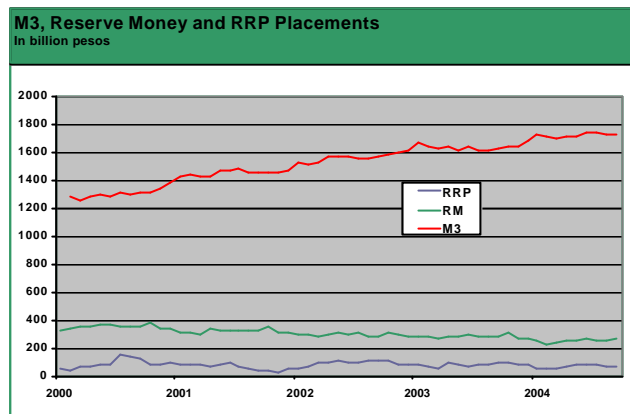
- (a) Evidences of indebtedness issued directly by the Government of the Philippines or by its political subdivisions; and
- (b) Evidences of indebtedness issued by government instrumentalities and fully guaranteed by the Government.

Section 92 of the same article also provides the BSP with effective instruments for OMO, that is, it may, subject to such rules and regulations as the Monetary Board may prescribe and in accordance with the principles stated in Section 90, issue, place, buy and sell freely negotiable evidences of indebtedness of the BSP, provided that such issuance shall be made only in cases of extraordinary movement in price levels. Said evidences of indebtedness may be issued directly against the international reserve of the BSP or against securities, which it has acquired under the provisions of Section 91 or may be issued without relation to specific types of assets of the BSP.

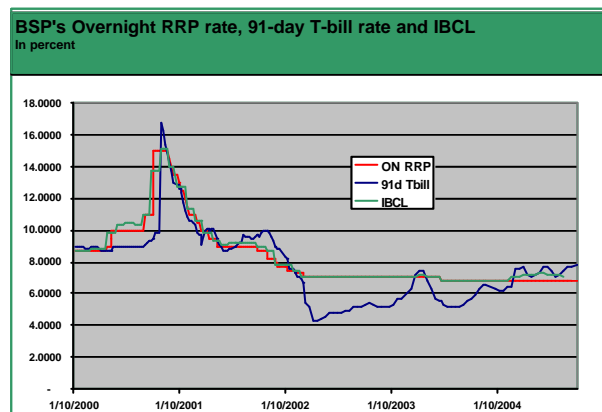
**Advantages of OMO**

The BSP may also use other monetary policy tools such as reserve requirements and rediscounting for more direct control. In addition, the BSP can also employ moral suasion as a last resort when existing market mechanisms cannot adequately and promptly ensure the attainment of specific monetary objectives. However, among the tools available to the BSP, OMO offers several advantages and continues to be the most practical tool for the following reasons:

First, it works within the BSP's initiative and control. Having the authority to steer market interest rates, the BSP can influence money supply by changing the monetary policy rates. Consequently, OMO gives the BSP greater flexibility in terms of the amount and timing of intervention.



Secondly, it is fast to implement and gives quick results. Any change in the policy rates is readily implemented, i.e., on the same day that the Monetary Board issues a resolution. Thus, any effect on the market is evident right after the overnight trading for the day.



### III. External Developments

*Broad-based global economic recovery remains largely intact.*

The robust and broad-based global economic recovery remained largely intact despite observed weak spots in the US and Japan. Growth in most regions has been underpinned by robust industrial production and rising corporate profitability, accompanied by steadily improving consumer demand. On the price front, the outlook remains in line with price stability although stronger inflationary pressures may persist over the short term. Overall, the prospects for sustaining the global economic growth remain generally positive. However, the global markets remain highly vulnerable to further hikes in oil prices given the low spare capacity in oil production as well as uncertainties brought about by political developments in major oil producing countries.

*US economic activity regains strength.*

Latest data suggest that US economic activity has regained strength recently after hitting a soft patch in the second quarter of 2004. Final estimates of the US Bureau of Economic Analysis (BEA) indicated that the US real GDP rose at an annual pace of 3.3 percent in the second quarter of 2004 from preliminary estimates of 2.8 percent. Consumer spending showed some positive movement on the back of sales growth of upscale chain stores. At the same time, business investment remains on an uptrend, supported by the generally solid performance of the manufacturing sector.<sup>12</sup> The US Federal Reserve expects the economy to show a stronger pace of expansion in the months ahead. However, the uncertain prospects for world oil prices could dampen consumer spending and raise the cost of production.

<sup>12</sup> US Federal Reserve, Testimony of Chairman Alan Greenspan on the economic outlook before the Committee on the Budget, U.S. House of Representatives, 8 September 2004, available online at <http://www.federalreserve.gov/boarddocs/press/monetary/2004>

***Strong export performance and improving domestic demand underpin economic recovery in the euro area.***

Economic recovery in the euro area held steady, underpinned by robust export performance and gradual improvements in domestic demand. GDP grew by 0.5 percent quarter-on-quarter in the Euro-zone and by 0.6 percent in the EU25 area during the second quarter, following a 0.6 percent growth in both areas in the previous quarter.<sup>13</sup> The recovery in private consumption is likely to proceed in line with increases in real disposable income and subsequent strengthening of employment conditions. Similarly, business investment is expected to continue to benefit from favorable financing conditions and improvements in corporate efficiency. On the price front, upward pressures on the general price level due mainly to oil price developments persist. However, the outlook remains consistent with price stability over the medium term.<sup>14</sup>

***Recovery of the Japanese economy continues, although at a slower pace***

Japan's economy continued to recover in the second quarter of 2004, albeit at a slower pace. Real GDP was revised downward to 0.3 percent quarter-on-quarter from advance estimates of 0.4 percent as the full impact of the steep world oil prices and reduced government spending is felt. This notwithstanding, the Cabinet Office is maintaining its assessment that Japan remains on the recovery track given the steady improvements in corporate profits, industrial production and employment conditions.<sup>15</sup> The ongoing global economic recovery should also provide the necessary boost to Japanese exports. However, deflationary pressures resumed in July as the annual CPI inflation for July was recorded at -0.1 percent from nil in the previous month.

<sup>13</sup> The euro-zone or euro area covers the following 12 countries: Austria, Belgium, Finland, France, Germany, Greece, Italy, Ireland, Luxembourg, the Netherlands, Portugal and Spain. The EU-25 area covers the Euro area plus Denmark, United Kingdom, Sweden, the Czech Republic, Estonia, Cyprus, Latvia, Lithuania, Hungary, Malta, Poland, Slovenia, and Slovakia.

<sup>14</sup> European Central Bank, Introductory statement to the ECB Press Conference on 2 September 2004 by ECB President Jean-Claude Trichet, available online at <http://www.ecb.int>

<sup>15</sup> CBS Market Watch, "Japan April-June GDP Falls Short," 12 August 2004, available online at [CBS.Market.Watch.com](http://CBS.Market.Watch.com)

The BOJ expects consumer prices to continue falling slightly on a year-on-year basis, as supply and demand conditions remain relatively soft.<sup>16</sup>

***UK economy  
continues to grow  
above trend.***

UK output growth remained above trend in the second quarter of 2004 as real GDP rose by 0.9 percent, the strongest quarterly expansion in almost five years (since Q3 1999), following a 0.7 percent revised growth in the previous quarter. Output from production industries increased by 0.9 percent, a reversal from the 0.5 contraction in the first quarter, while the services sector maintained the 0.9 percent growth recorded in the previous quarter.<sup>17</sup> However, the surge in consumption appeared to be moderating as retail spending tapered off and housing prices fell in August. Labor market conditions, meanwhile, continue to tighten with gradual improvement in average earnings, job vacancies, and employment benefit claims. Going forward, the UK economy is poised for continued output expansion, despite the slight deceleration of consumption in August. Inflation is likely to decline in the near term even though underlying cost pressures have increased due mainly to world oil prices.<sup>18</sup>

***Prospects for  
economic  
recovery in  
emerging  
markets remain.***

The buoyant economic recovery in emerging market economies and major developing countries in Asia continued in the second quarter of 2004, underpinned by the vigorous economic growth in China, strong domestic and external demand, and generally supportive macroeconomic policies. China's real GDP grew by 9.6 percent in the second quarter from 9.8 percent in the previous quarter. Consumption demand in China gained

<sup>16</sup> Bank of Japan, Monthly Report of Recent Economic and Financial Developments August 2004 (The Bank's Views), 10 August 2004, available online at [http://www.boj.or.jp/en/seisaku/04/seisak\\_f.htm](http://www.boj.or.jp/en/seisaku/04/seisak_f.htm)

<sup>17</sup> UK National Statistics Office, "GDP Growth : Economy up by 0.9% in Q2 2004," 27 August 2004, available online at <http://www.statistics.gov.uk/cci/nugget>

<sup>18</sup> Bank of England, Inflation Report August 2004, available online at <http://www.bankofengland.co.uk/Links/setframe.html>

strength further while the growth of investment and production in some overheated sectors moderated in response to the various macro control measures put in place. Grain production, likewise, recovered this quarter reversing the decline in grain output experienced in the past four years.<sup>19</sup> Consequently, consumer prices in China continued to accelerate as the average inflation rate in the second quarter jumped to 3.7 percent from 2.3 percent in the previous quarter.

*US Fed raises policy rate while monetary settings in other major central banks are unchanged.*

The US Fed decided to raise its policy rates by 25 basis points during its latest policy meeting while monetary authorities in Japan, the Euro area and the Bank of England (BOE) kept monetary policy settings unchanged.

In its meeting on 21 September 2004, the US Federal Open Market Committee (FOMC) decided to raise its target for the federal funds rate by 25 basis points to 1.75 percent. The Fed, however, maintained its view that the stance of the monetary policy remains accommodative, and that with robust underlying growth in productivity, it will continue to provide support to economic activity. The FOMC noted further that the balance of risks to the attainment of sustainable growth and price stability is roughly equal. With underlying inflation still expected to be relatively low, the Committee believes that “policy accommodation can be removed at a pace that is likely to be measured”.<sup>20</sup>

On 2 September 2004, the Governing Council of the European Central Bank (ECB) decided to maintain the minimum bid rate on the main refinancing operations and the interest rates on the marginal lending facility and the

<sup>19</sup> People’s Bank of China, China Monetary Policy Report Quarter Two, 2004, available online at <http://www.pbc.gov.cn/english/detail.asp>

<sup>20</sup> Federal Reserve, FOMC Statement dated 21 September 2004, available online at <http://www.federalreserve.gov/boarddocs/press/monetary/2004>

deposit facility steady at 2.0 percent, 3.0 percent, and 1.0 percent, respectively.

On 9 September 2004, the Bank of England's (BOE) Monetary Policy Committee voted to maintain the BOE's key repo rate at 4.75 percent.<sup>21</sup>

At its monetary policy meeting held on 8-9 September, the nine-member policy board of the Bank of Japan decided to leave monetary settings unchanged, keeping the target balance of current accounts held at the Bank at the current level of "around 30 to 35 trillion yen". The Bank, however, will provide more liquidity irrespective of the above target should there be a risk to the stability of the financial market.<sup>22</sup>

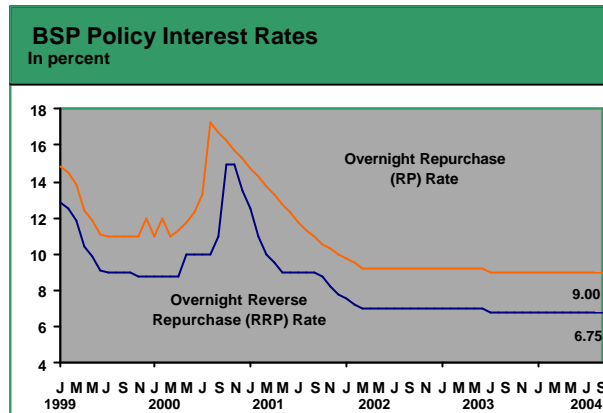
#### IV. Monetary Policy Developments

*BSP monetary policy settings were unchanged in the third quarter.*

The BSP kept its policy interest rates unchanged during the quarter despite perceptions of the need to tighten monetary settings against a backdrop of rising inflation. The Monetary Board of the BSP met four times during the quarter to discuss the monetary policy stance and had decided unanimously at each meeting to maintain the Bank's policy interest rates. The Monetary Board's decision to stay its hand reflected its assessment that current monetary settings remained consistent with the outlook for inflation as well as output. The BSP's policy rates were unchanged at 6.75 percent for the overnight RRP and 9.0 percent for the overnight RP. These key interest rates were last changed on 2 July 2003.

<sup>21</sup> Bank of England, *Monetary Policy Decision*, 10 August 2004, available online at <http://www.bankofengland.co.uk>

<sup>22</sup> Bank of Japan, *Statement of Monetary Policy* dated 9 September 2004 available online at <http://www.boj.or.jp/en/seisaku/seisaku>



*Monetary tightening may not be the appropriate response to supply-side pressures on prices.*

The Monetary Board noted that the factors driving the inflation uptrend in recent months were supply-side and transitory in nature. These supply-side factors include the rise in both global and domestic oil prices as well as some domestic supply constraints that led to higher prices of specific food items. As the risks to inflation are cost-push in nature, the Monetary Board believed that monetary policy might not be the appropriate tool to address the possibility of actual inflation exceeding the targets set for 2004-2005. Monetary tightening reduces inflation mainly by lowering private demand for goods and services, while supply-side factors (such as increases in world oil prices) affect mainly the cost of producing goods and services rather than private demand for these items.

*The forecasted inflation path is hump-shaped.*

The Monetary Board also gave primary consideration to the staff's inflation projections during its monetary policy meetings. Staff's baseline inflation forecasts indicated that average inflation might exceed the 4-5 percent target for 2004 and 2005. Nonetheless, inflation is expected to ease as early as mid-2005 and average headline inflation is expected to revert to 4-5 percent in 2006 in the absence of any further negative shocks. This hump-shaped form of the

forecasted inflation path supported the view that the inflation spiral is likely to be transitory.

In the event of a breach of the inflation target, the Monetary Board noted that they would have to issue an Open Letter addressed to the President of the Philippines, informing Her Excellency of the inflation developments, the reasons behind the inflation uptrend and measures undertaken by the BSP and other Government agencies to mitigate the impact on consumer prices. Consistent with the international best practices, the BSP has also predefined a set of reasons under which the inflation target could be breached. The BSP's explanatory notes<sup>23</sup> relate to price pressures stemming from: (a) movements in prices of agricultural products, (b) natural calamities; (c) movements in international oil prices, and (d) changes in government administrative measures.

The Monetary Board also discussed during its regular review of monetary policy stance the probable impact of the increase in the US federal funds rate. Members were of the view that the increases in the US federal funds rate have already been priced in by the market and were not expected to unduly affect the domestic inflation path, whether through the exchange rate or other channels. The Monetary Board considered the emerging differential between the domestic and foreign interest rates to be still comfortable.

The Monetary Board also reiterated its firm commitment of promoting price stability. The members were in agreement on the need to continue to monitor and assess the developments of second round effects emanating from supply-side pressures, which may require a measured monetary policy response in the future. This is consistent with the need to exercise caution so as to guard against

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<sup>23</sup> In other inflation targeting countries, this is the equivalent of an escape clause or explanatory clause.

possible persistence of inflationary pressures while maintaining the flexibility to promote economic growth.

***The Monetary Board supports the use of non-monetary measures to address supply-side price pressures.***

Given that the risk to inflation are predominantly emanating from the supply-side, the members of the Monetary Board indicated that it would continue to articulate its support for the use of non-monetary measures to address supply-side risks, particularly those relating to food supply. This will be undertaken by the BSP through representation and coordination with various government agencies.

In particular, the supply-side measures undertaken by the other government agencies to mitigate supply-side risks include the National Price Coordinating Council's initiatives on price monitoring and enforcement of the Price Act and Price Tag Law and efforts on supply chain intervention such as the conversion of privately-owned ports to commercial ports to complement the administration's RORO routes and reduce transportation costs by 40 percent. In addition, the DA and the Metro Manila Development Authority (MMDA) has also agreed to exempt vehicles transporting perishable goods from the truck ban to minimize spoilage. Currently, studies on the viability of using aluminum or plastic packaging or generic packaging for sardines and processed meat have also been undertaken to avert possible price hikes in canned goods as a result of a rise in the price of tin plates. Moreover, there have been moves to reduce the tariff on pork and as well as to allow the duty free importation of feeds.

## V. Inflation Outlook

### Inflation Forecasts

*Inflation may continue its uptrend over the next year or so.*

Headline inflation has continued its uptrend, accelerating from an average of 4.6 percent in the second quarter to 6.4 percent in the third quarter of 2004, and bringing the headline inflation for the first nine months of 2004 to 4.8 percent (1994=100). The balance of supply and demand conditions suggests that such an uptrend will persist in the near term. On the supply side, thin global oil capacity amid robust world demand has spurred further increases in oil prices. Furthermore, specific food products such as meat, fish, corn and dairy products have recorded higher prices due to higher input costs. In addition, weather disturbances have also constrained supply of some agricultural products.

On the demand side, the higher-than-expected first semester economic growth paints an improving demand picture. Nevertheless, weak spots persist in the areas of credit and investment. Moreover, while unemployment eased, it remains at double-digit levels, which suggests some slack in labor resource use. On the whole, demand-side indicators do not indicate strong signs of overheating in the domestic economy.

*The BSP expects headline inflation to exceed the 4-5 percent target for 2004-2005 as the impact of supply-side factors is felt but should revert back to 4-5 percent by 2006.*

The BSP is forecasting average headline inflation is likely to exceed the 4-5 percent target for 2004-2005 due to the recent rounds of oil price hikes. However, annual projections also show that it will eventually taper off to 4-5 percent by 2006. The BSP's forecasts are based on the following assumptions:

- a. Real GDP growth is consistent with the National Government's (NG) targets of 4.9-5.8 percent for 2004, 5.3-6.3 percent for 2005, and 6.3-7.3 percent for 2006;

- b. NG deficit levels will amount to ₱197.8 billion for 2004, ₱184.4 billion for 2005, and ₱161.8 billion for 2006.
- c. The overnight RRP rate was assumed constant at 6.75 percent from October 2004 to December 2006;
- d. The 91-day Treasury bill rates assumed an increasing trend with an average of 8.0 percent for 2004 and 2005 and 7.5 percent for 2006;
- e. International crude oil prices consistent with the latest DER projections (as of 8 October 2004, based on futures prices) of US\$35.33/bbl for 2004, US\$39.56/bbl for 2005, and US\$35.25/bbl for 2006;
- f. Increase in the daily minimum wage rate (measured by the non-agricultural wage rate for NCR) by 4 percent in July 2005 and July 2006.

### **Risks to the Inflation Outlook**

*Sustained increases in oil prices, uptrend in food prices as well as volatile movements in the foreign exchange market constitute the risks to the inflation outlook.*

The fan chart depicts the BSP's current assessment of inflation over the policy horizon, including judgments on the major risks to the outlook. As world oil prices continue to reach record-high levels, the BSP is projecting a higher inflation profile compared to that presented in the Second Quarter Inflation Report. Due to continued oil price increases, actual inflation outturn exceeded projections in the Second Quarter Inflation Report, thereby pushing the central projection (darkest band in latest inflation profile) upwards. As pressures on oil supply build up, inflation is expected to pick up steadily in the near-term, reaching the peak of around 7.7 percent in the first quarter of 2005. It may be worthy to note that such peak is around two percentage points higher than that depicted in the previous quarter's inflation profile. To account for the risks posed

by further rise in oil prices, depreciation of the peso and the possible uptrend in food prices, the upward skew of the fan chart (i.e., the difference between the width of the bands above the central projection compared to the corresponding bands below) has likewise been adjusted upwards. Nevertheless, as in the previous quarter's Inflation Report, inflation is expected to recede from its peak levels in the second quarter of 2005 so that the inflation profile stabilizes within the 4-5 percent target in the first quarter of 2006.

The main risks around the central projection relate to sustained increases in oil prices, movements of the peso-dollar exchange rate, and prospects on food price.

#### *Sustained Oil Price Increases*

The rise in international oil prices continues to pose a major risk to the inflation outlook over the policy horizon. The political instability and financial difficulties in oil-producing regions, coupled with the onset of the winter season, are expected to add pressure to the already tight world oil supply. With global oil prices still at high levels, the Government has urged oil firms to continue implementing smaller and staggered adjustments in prices to enable the public to cope with the price increases. In addition, the Government has also unveiled an energy independence and savings reform package that aims to achieve 60 percent self-sufficiency by 2010, and to shield the country from the adverse effects of importing oil. The energy independence and savings reform package involve developing renewable energy, increasing the use of alternative fuels, and forging strategic alliances with other countries.

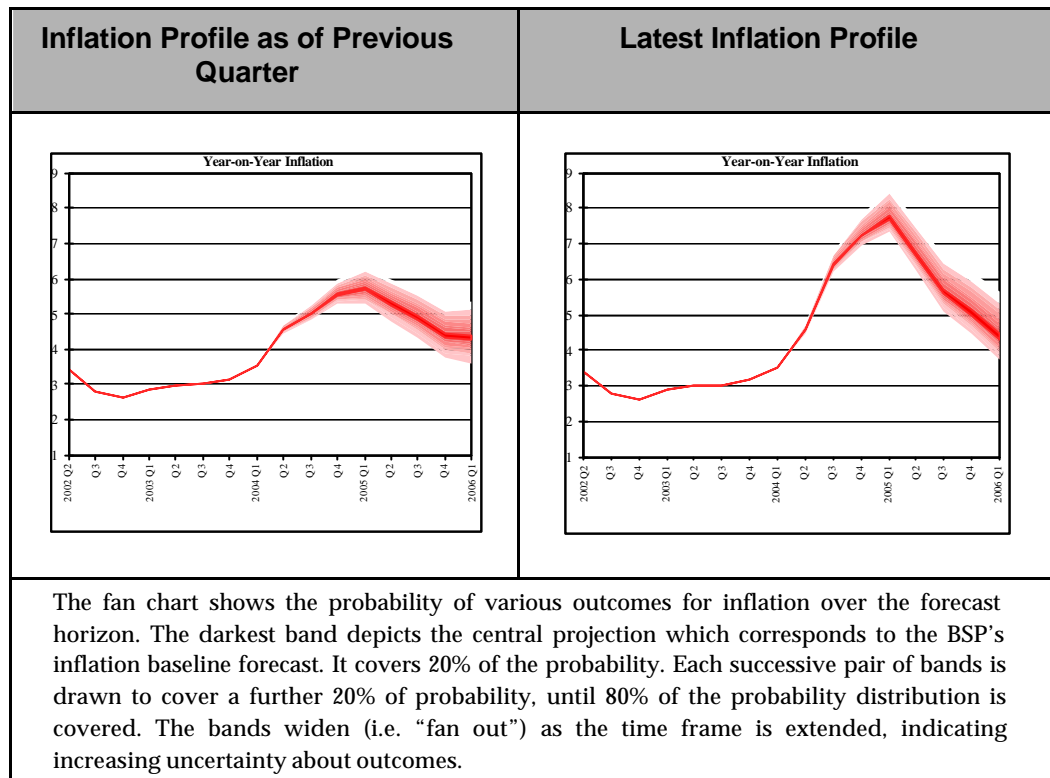
*Movements in the peso-dollar exchange rate*

Market concerns over the country's fiscal situation as well as further increases in the US federal funds target rate could weigh down on the local currency. However, there are indications that the peso may recover and stabilize in the fourth quarter of 2004. The peso's positive outlook during the remainder of the year hinges in part on the uptrend in remittance inflows from overseas Filipino workers (OFWs) and export receipts which are projected to grow by 6.0 percent and 10.0 percent in 2004, respectively. Moreover, the continued strength in the country's economic fundamentals, particularly the stronger-than-expected growth rate in the first half, is seen to support the peso. In fact, the country continues to enjoy net inflows of portfolio investments despite the concerns on the national elections early this year and the recent difficulties in the fiscal situation.

*Prospects on Food Prices*

Possible weather disturbances, increased prices of raw materials and production inputs (such as electricity and fuel), coupled with higher demand (due to the recurrence of the Avian flu in neighboring Asian countries), are expected to exert upward pressure on food prices. To help stabilize food prices, the Government aims to ensure a fluid and efficient supply chain, from the production to the end market. For instance, the Department of Agriculture launched a program, dubbed as "Pagkaing Sagana at Abot Kaya, Handog ng Agrikultura", that will directly link producers to retailers such as the National Market Vendors Association (Namvesco) in an effort to minimize price increases by middlemen. In addition, the Department of Trade and Industry (DTI), has instituted the "Generic Packaging Program" for commodities such as coffee, canned meat, sardines, dried fish, condiments, powdered

milk, and instant noodles, to help manufacturers cut down on the costs of labeling which will result in significant reduction in the retail prices of basic goods.



### **Private Sector Economists' Inflation Forecasts**

*Private analysts expect continued uptrend in inflation.*

BSP's expectations of a further uptrend in the inflation rate in 2004 and 2005 were echoed by the independent forecasts of private sector analysts. Results from an informal poll of various private institutions show that private analysts expect inflation to continue to rise in 2004 and 2005 and exceed the National Government's target of 4-5 percent. The mean forecast of the annual average inflation in 2004 was 5.3 percent, higher than the average forecast in the previous quarter of 4.5 percent.

For 2005, private forecasters see the average annual inflation to rise to 6.1 percent. Analysts expect further hikes in international oil prices, which will likely raise the cost of doing business, as well as the imminent increases in the US Fed funds target rate to put pressure on consumer prices in the near term. Some analysts also noted possible risks from second-order effects of supply-side pressures on the long term path of inflation.

On the outlook for economic growth, the survey indicated that the average annual growth in real GDP is expected to accelerate to 5.4 percent in 2004, from an average forecast of 4.9 percent in the previous quarter. The bullish growth prospect for the rest of the year is anchored on expectations of steady improvements in the agriculture sector given forecasts of favorable weather conditions and ongoing recovery of exports on the back of the strong global demand for semiconductors. Private analysts also expect strong growth in the IT sectors as well as new jobs created in BPO and call centers. At the same time, the robust consumer spending is expected to continue propelled by the steady inflows of OFW remittance.

As the full impact of higher world oil prices is felt, the average annual growth in real GDP is expected to moderate to a mean forecast of 4.7 percent in 2005, from an expected growth rate of 5.4 percent in 2004. This view stems from apprehensions over the impact of a possible monetary tightening both domestically and abroad as well as the various planned fiscal reforms (i.e. new taxes, austerity measures). In addition, exports are anticipated to slow down in 2005 as the global semiconductor industry consolidates in line with conditions in key export markets.

Private Forecasts for GDP and Inflation for 2004 and 2005						
	<u>Real GDP Growth (in %)</u>			<u>Inflation (1994=100)</u>		
	2004	2005	2006	2004	2005	2006
Equitable-PCI	5.6 (5.3-5.8)	5.2 (5.0-5.3)		5.8 (5.5-6.0)	6.4 (6.1-6.7)	
Banco de Oro	4.5	4.75		4.0	4.5	
BPI	5.5	5.0		5.3 (5.1-5.4)	6.5	
Credit Lyonnais SA	5.5	3.0		7.2	7.5	
Deutsche Bank	5.6	4.2		5.5	6.5	
Citibank	4.8	4.0		5.5	8.5	
Wallace Business Forum	5.6	5.0	5.4	5.4	5.0	4.7
Multinational Investment	6.1 (6.0-6.2)	6.6 (6.5-6.7)		4.9 (4.8-5.0)	5.8 (5.5-6.0)	
Makati Business Club	4.9 (4.8-5.0)			5.1 (4.9-5.2)	5.3	
Nomura Securities	5.3	4.3		4.9	4.8	
Cemex	5.8	4.4				
Metrobank	5.7 (5.6-5.8)	5.5 (5.2-5.7)		5.5 (5.4-5.5)	6.4 (6.0-6.8)	
Land Bank	5.0	5.0		5.0	6.0	
Median Forecast	5.4	4.9		5.6	6.5	
<b>Mean Forecast</b>	<b>5.4</b>	<b>4.7</b>		<b>5.3</b>	<b>6.1</b>	
High	6.2	6.7		7.2	8.5	
Low	4.5	3.0		4.0	4.5	
Number of observations	13	12		12	12	
Memo Item: Government Assumption/Target	4.9-5.8	5.3-6.3		4.0-5.0	4.0-5.0	

## VI. Implications for the Monetary Policy Stance

*Given the time lag in monetary policy, prospective decision should be geared toward the 2006 inflation target.*

In determining the appropriate monetary policy stance, it is important to recognize that monetary policy decisions normally require a time lag (currently estimated at 15-21 months) to take full effect. Because of this transmission lag, monetary actions undertaken at this point will primarily affect inflation in 2006 and have only a minimal impact on 2004-2005 inflation. Prospective decisions should therefore be oriented toward safeguarding the attainability of the 2006 inflation target.

*Historical record show that headline inflation has a tendency to revert to trend following episodes of supply-side pressures.*

In essence, the prevailing assessment of conditions for output and inflation over the policy horizon continue to argue for maintaining BSP policy interest rates at their current levels. The path of headline inflation over the near term is likely to be hump-shaped, with average inflation expected to ease back toward the government inflation target of 4-5 percent by 2006. This is wholly in accordance with past experience concerning episodes of food- or oil-driven supply-side inflation, during which headline inflation tended to quickly revert to manageable levels after a brief upsurge. At the same time, the supply-side pressures driving the projected uptrend cannot be appropriately addressed by monetary policy, which restrains inflation pressures mainly by curbing demand for goods and services. The direct impact of ongoing supply shocks on consumer goods is, for the moment, confined to higher production costs.

Given the lack of preponderance of demand-side effects of supply shocks or mounting demand-side inflationary pressures, there appears to be no compelling reason to change the present settings for monetary policy. The presence of relatively high unemployment and moderate credit activity in the economy supports the argument that the current inflation uptrend originates mainly from the supply side rather than the demand side. Given the dominant role of supply-side developments in the inflation outlook, inflation can be best mitigated by appropriate supply-side (i.e., non-monetary) policy measures that would facilitate timely importation, distribution and delivery of certain commodities. The BSP has continued to articulate its support for the use of such measures and accordingly has made representations with relevant government agencies on the matter.

*If necessary, monetary authorities will undertake monetary policy actions in order to address potential second order inflationary effects and guard against persistent inflationary pressures.*

This does not mean, however, that monetary policy will not be used to deal with inflationary pressures in the near future. The BSP recognizes the risk of a sustained period of rising oil prices, which could lead to economic dislocations in the form of reductions in domestic demand and self-sustaining inflation pressures reinforced by public expectations of persistently high inflation. Monetary action will thus become necessary when the available evidence begins to point more strongly to inflation pressures that are over and above those generated by ongoing supply shocks, or to emerging demand-side pressures on prices. Authorities also recognize the risk of prolonged exchange market pressure caused by narrowing nominal interest differentials, ample liquidity among banks, and negative market sentiment that could feed into inflation and inflation expectations.

In particular, monetary action may be considered if first, the preponderance of indicators suggests demand-side pressures on inflation. Second, if inflation forecasts exceed the estimated adjusted inflation target, which is the sum of the inflation target and the inflation attributable to supply shocks such as higher oil and food prices. Third, monetary authorities can respond to exchange market pressures arising from negative market sentiment or narrowing interest rate differentials that could feed into inflation and inflationary expectations and thereby, threaten the inflation target.

Given these considerations, the BSP will continue to assess economic and financial developments for indications of potential threats to the inflation target and, if necessary, undertake a well-timed policy adjustment.

## VII. Concluding Remarks

*The continued rise in inflation presents a challenge to monetary authorities.*

Conducting monetary policy in the current climate of negative supply shocks is a considerable challenge for the BSP. The continued rise in inflation during the last few months has led to public concern over its likely effects not only on purchasing power but also on economic activity in general. In its various public statements on monetary policy, the BSP has been careful to emphasize that the inflation spiral over the past year has been driven mainly by cost-push factors arising in large part from a series of supply-side shocks to the economy. This view has led to the prevailing policy stance of accommodating the ongoing supply shocks and, in the event of a breach in the inflation target, issuing an explanation to the public through an open letter addressed to the President. In doing so, authorities implicitly chose the risk public censure for not using its monetary policy to counteract the effects of supply shocks over the risk of exacerbating the real sector impact of the oil price shock.

The monetary policy framework of inflation targeting allows sufficient flexibility for monetary authorities to deal with unforeseen developments or shocks to prices by providing for a clear definition of the acceptable circumstances under which an inflation-targeting central bank may fail to achieve its inflation target. In so doing, it also recognizes the limits of the effectiveness of monetary policy under such circumstances. The array of acceptable circumstances include: (a) movements in prices of agricultural products, (b) natural calamities; (c) movements in international oil prices, and (d) changes in government administrative measures. Once the breach of the 2004 and 2005 targets are confirmed by official NSO data (in January 2005 and January 2006, respectively), the BSP will issue an open letter to the public outlining the reasons behind the deviation of actual inflation from the target, what monetary

authorities did in response to the deviation, and why they chose to respond in such a fashion.

*The BSP remains committed to its primary objective of maintaining price stability conducive to a balanced and sustainable economic growth.*

It bears repeating that the Bangko Sentral shares the strong commitment of the Philippine government to reforming the economy and leading it further on to the path to long-term economic development. Monetary authorities are firmly committed on the BSP's mission to contribute to the balanced and sustainable growth of the Philippine economy by promoting and maintaining price stability.

## Chronology of Monetary Policy Decisions

### 2000

#### **24 January 2000**

The Monetary Board—the policymaking body of the BSP—adopted in principle the shift to inflation targeting as the BSP's framework for conducting monetary policy.

### 2001

#### **26 December 2001**

The BSP announced formally the adoption of inflation targeting as framework for monetary policy beginning January 2002. The BSP also announced the Government's annual average inflation targets of 5.0-6.0 percent for 2002 and 4.5-5.5 percent for 2003.

### 2002

#### **17 January 2002**

The Monetary Board decided to reduce the overnight reverse repurchase (RRP) and repurchase (RP) rates by 25 basis points each to 7.5 percent and 9.75 percent, respectively.

Consequently, the Monetary Board also adopted a change in the tiering structure

for banks' overnight RRP placements with the BSP as follows: 7.5 percent for the first ₱5 billion, 4.5 percent for the next ₱5 billion and 1.5 percent for placements in excess of ₱10 billion.

The Monetary Board also approved a two-percentage point reduction to 7.0 percent of the liquidity reserve requirements on deposits and deposit substitute liabilities, common trust funds and other trust and fiduciary liabilities of commercial banks and non-banks with quasi-banking functions.

These monetary policy measures took effect on 18 January 2003. Moreover, it could be noted that this decision marks the first action of the Monetary Board under the inflation-targeting framework.

#### **14 February 2002**

The Monetary Board opted to lower the BSP's policy rates further by 25 basis points each, bringing the overnight RRP rate to 7.25 percent and the overnight RP rate to 9.5 percent effective 15 February 2002.

The Monetary Board also approved an adjustment in tiering scheme for banks' overnight RRP placements with the BSP as follows: 7.25 percent for placements

of up to ₱5 billion, 4.25 percent for the next ₱5 billion and 1.25 percent for placements in excess of ₱10 billion. The tiering scheme also covered special deposit accounts (SDAs) and would be applied on a consolidated basis.

**14 March 2002**

The Monetary Board decided to reduce BSP's key policy rates by another 25 basis points. The overnight RRP rate was lowered to 7.0 percent while the overnight RP rate was reduced to 9.25 percent effective 15 March 2002.

Correspondingly, the interest rates on overnight RRP and SDA placements with the BSP under the tiering scheme were adjusted as follows: 7.0 percent for placements of up to ₱5 billion, 4.0 percent for the next ₱5 billion and 1.0 percent for placements in excess of ₱10 billion.

**11 April, 8 May, 6 June, 4 July,  
1 August, 29 August, 26 September, 23  
October, 21 November, 19 December  
2002**

During the monetary policy meetings held for the period April-December 2002, the Monetary Board decided to keep the overnight RRP and RP rates steady at 7.0 percent and 9.25 percent, respectively.

**2003****16 January 2003**

The Monetary Board voted to keep the BSP's policy rates unchanged at 7.0 percent for the overnight RRP rate and 9.25 percent for the overnight RP rate.

**7 February 2003**

The BSP announced the Government's official target for the average annual inflation for 2004 at 4-5 percent.

**12 February, 13 March 2003**

The Monetary Board kept the BSP's policy rates unchanged at 7.0 percent for the overnight RRP rate and 9.25 percent for the overnight RP rate.

**19 March 2003**

(Special Monetary Board Meeting)

The Monetary Board decided to lift the three-tiered scheme on banks' placements with the BSP. Thus, overnight placements under the RRP window would be accepted at a flat rate of 7.0 percent effective 20 March 2003.

The Monetary Board also raised the liquidity reserve requirement against peso demand, savings, time deposit and deposit liabilities of universal banks and commercial banks by one-percentage

point to 8.0 percent effective 21 March 2003.

**10 April, 8 May 2003**

The Monetary Board maintained the overnight RRP and RP rates steady at 7.0 percent and 9.25 percent, respectively.

**5 June 2003**

The Monetary Board decided to leave the overnight RRP and RP rates unchanged at 7.0 percent and 9.25 percent, respectively.

The Monetary Board also decided to restore the tiering scheme on banks' placements with the BSP under the RRP and SDA windows effective 5 June 2003. In particular, overnight RRP placements would be subject to the following interest rates: 7.0 percent for the first ₱5 billion, 4.0 percent for additional amounts in excess of ₱5 billion but below ₱10 billion and 1.0 percent for amounts in excess of ₱10 billion.

**2 July 2003**

The Monetary Board voted to reduce the BSP's key policy interest rates by 25 basis points each to 6.75 percent for the overnight RRP rate and 9.0 percent for the overnight RP rate effective 2 July 2003.

The interest rates on banks' placements under the tiered system were also adjusted as follows: 6.75 percent for the first ₱5 billion, 3.75 percent for amounts in excess of P5 billion up to ₱10 billion and 0.75 percent in excess of ₱10 billion.

**31 July 2003**

The Monetary Board left unchanged the overnight RRP and RP rates at 6.75 percent and 9.0 percent, respectively.

**28 August 2003**

The Monetary Board opted to keep the BSP's policy rates unchanged at 6.75 percent for the overnight RRP rate and 9.0 percent for the overnight RP rate. The Monetary Board also decided to lift the tiering scheme for banks' placements with the BSP. Thus, effective 28 August 2003, overnight RRP transactions with the BSP were accepted at a flat rate of 6.75 percent.

**2 October, 23 October,  
20 November, 18 December 2003**

The Monetary Board voted unanimously to leave the BSP's policy rates unchanged at 6.75 percent for the overnight RRP rate and 9.0 percent for the overnight RP rate.

**2004**

**15 January 2004**

The Monetary decided to keep monetary policy settings unchanged. The overnight RRP and RP rates were maintained at 6.75 percent and 9.0 percent, respectively.

**5 February 2004**

(Special Monetary Board Meeting)

The Monetary Board decided to increase the liquidity reserve requirement for universal banks and commercial banks by two percentage points to 10 percent effective 6 February 2004.

**12 February, 11 March, 15 April, 6 May,  
3 June, 1 July, 29 July, 26 August, 23  
September 2004, 21 October**

The Monetary Board opted to maintain the key rates steady at 6.75 percent and 9.0 percent for the overnight RRP rate and overnight RP rate, respectively.

The *BSP Inflation Report* is published every quarter by the Bangko Sentral ng Pilipinas. The report is available as a complete document in pdf format, together with other general information about inflation targeting and the monetary policy of the BSP, on the BSP's website:

[www.bsp.gov.ph/about\\_bsp/inflation/default.htm](http://www.bsp.gov.ph/about_bsp/inflation/default.htm).

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