

***INFLATION REPORT***  
***Fourth 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 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 two box articles. The first box article explores the specific items that have been responsible for the inflation pressures in 2004. Meanwhile the second box article discusses the impact of new revenue measures on inflation, particularly the increase in the excise tax rates on alcohol and cigarettes.

The Monetary Board approved this Inflation Report at its meeting on 20 January 2005.

  
**RAFAEL B. BUENAVENTURA**  
Governor

January 2005



## **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
<b>Members</b>	Juanita D. Amatong Juan Quintos, Jr. Melito S. Salazar, Jr Antonino L. Alindogan, Jr. Vicente B. Valdepeñas, Jr.

## **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

**Technical Staff**      Editha S. Alido  
(Head)                      Director  
Department of Economic Research

**SCHEDULE OF THE MEETINGS ON MONETARY POLICY  
AND PUBLICATION OF HIGHLIGHTS FOR 2005-2006**

<b>Mtg. No.</b>	<b>Advisory Committee <sup>1/</sup></b>	<b>Monetary Board <sup>2/</sup></b>	<b>Publication of Monetary Board Highlights <sup>3/</sup></b>
<b><u>2005</u></b>			
1	11 January, Tuesday <sup>u</sup>	13 January, Thursday	24 February, Thursday
2	7 February, Monday	10 February, Thursday	23 March, Wednesday <sup>u</sup>
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
<b><u>2006</u></b>			
1	9 January, Monday	12 January, Thursday	23 February, Thursday
2	6 February, Monday	9 February, Thursday	23 March, Thursday
3	6 March, Monday	9 March, Thursday	20 April, Thursday
4	3 April, Monday	6 April, Thursday	18 May, Thursday
5	TBA <sup>4/</sup>	4 May, Thursday	15 June, Thursday
6	29 May, Monday	1 June, Thursday	13 July, Thursday
7	26 June, Monday	29 June, Thursday	10 August, Thursday
8	24 July, Monday	27 July, Thursday	7 September, Thursday
9	21 August, Monday	24 August, Thursday	5 October, Thursday
10	18 September, Monday	21 September, Thursday	2 November, Thursday
11	16 October, Monday	19 October, Thursday	29 November, Wednesday <sup>u</sup>
12	13 November, Monday	16 November, Thursday	28 December, Thursday
13	11 December, Monday	14 December, Thursday	25 January 2007, Thursday
<p>Notes:</p> <p><sup>1/</sup> Held every four weeks</p> <p><sup>2/</sup> Monetary Board meetings on monetary policy are held on the Thursday after the latest Advisory Committee meeting</p> <p><sup>3/</sup> Six weeks after the Monetary Board meeting on monetary policy</p> <p><sup>4/</sup> The Advisory Committee meeting was moved a day later to give way for the BSP's Planning Conference.</p> <p><sup>u</sup> The minutes of the meeting will be published a day earlier since 24 March 2005 (the sixth week after the 10 February meeting) is a legal holiday.</p> <p><sup>u</sup> TBA- To be announced since 1 May 2006 (the fourth week after the 3 April AC meeting) is a legal holiday.</p> <p><sup>u</sup> The minutes of the meeting will be published a day earlier since 24 March 2005 (the sixth week after the 19 October meeting) is a legal holiday.</p>			

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## OVERVIEW

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- ✍ **Inflationary pressures continued to persist in the fourth quarter of 2004 owing mainly to supply-side factors.** The increase in the prices of food and energy-related CPI components accounted for the largest contribution to the increase in inflation. In addition, the seasonally stronger demand during the holiday season also contributed to the acceleration of inflation in the fourth quarter.
- ✍ **Average inflation for 2004, which was recorded at 5.5 percent, was in line with expectations.** This was comparably higher than the 3.0 percent average inflation in 2003. This outcome was consistent with earlier forecasts of the BSP, which were made public in its past reports. In essence, the inflation uptrend in 2004 may be characterized as a predominantly supply-side phenomenon, arising in large part from a series of supply-side shocks to the economy.
- ✍ **The domestic economy remained on a steady growth path.** On the demand-side, the economic expansion was fueled by the continued vigor in private consumption and the strong demand for the country's exports. On the production-side, the growth was broad-based as all sectors posted higher growth compared to year-ago levels. Despite such improvements, indications of slack in economic activity remained, notably the sizeable unemployment and moderate lending and investment activities. The outlook for economic activity is also dampened, in part, by evidence of reduced business and consumer optimism based on the results of the latest BSP's Business and Consumer Expectations Surveys.
- ✍ **The National Government's (NG) budget deficit in 2004 stood at ₱186.1 billion, 5.9 percent below the program of ₱197.8 billion and 6.9 percent lower than the ₱199.9 billion deficit level during the previous year.** This is the second consecutive year that the NG outperformed its fiscal deficit goal, affirming the fiscal authorities' steadfast resolve to achieve fiscal consolidation.
- ✍ **Domestic interest rates edged higher in the fourth quarter.** The rise in interest rates reflected concerns over rising inflation, fiscal sustainability and the status of the country's credit ratings. Despite the rise in local market rates, interest spreads between local and foreign interest rates narrowed as a result of the US-led increase in foreign rates. However, interest rate differentials remained at comfortable levels relative to the troughs reached in the previous years.

- ✎ **The peso weakened slightly in the fourth quarter.** The slight depreciation of the peso was due largely to higher dollar demand by corporate to service end-quarter and end-year obligations as well as to cover their import requirements. Market apprehensions of a possible sovereign credit rating downgrade and persistent concerns over the country's fiscal situation also exerted pressure on the peso. Moreover, external developments, particularly the volatility in world oil prices contributed to the depreciation of the peso. However, the peso's decline was tempered by the strong inflows from overseas Filipino workers' (OFWs) remittances, favorable export performance and sustained economic growth.
- ✎ **Global economic growth continues to show signs of moderation but overall economic activity remained robust.** Industrial production and private consumption appeared to have slowed down in most economies while export gains tapered off due mainly to the weakening of the US dollar. Stronger inflationary pressures are expected to persist over the short term owing to the volatility in world oil prices, but the medium-term outlook remains in line with price stability. The presence of global imbalances, such as the large fiscal and current account deficit of the US, alongside the continued volatility in world oil prices and the global transition towards higher interest rates present downside risks to the global economic outlook.
- ✎ **The BSP kept monetary policy settings unchanged during the quarter.** Despite the higher outturns for both headline and core inflation, the inflation dynamics remained the same. Supply factors continued to be the main driver of the inflationary process while demand-side influence on prices were still limited. To date, the BSP has not found any compelling reason yet to modify monetary policy settings but is prepared to undertake a well-timed and calibrated monetary policy response if the need arises.
- ✎ **Prospective decisions will be oriented mainly toward safeguarding the 2006 inflation target, since monetary actions undertaken at this point will primarily affect inflation in 2006 and have only a minimal impact on 2005 inflation.**
- ✎ **Although current inflation is rising, the latest evidence indicated that future inflation is on a downtrend.** Inflation is expected to follow a declining trend over the next few quarters, beginning as early as March, and is likely to settle around 5 percent by the fourth quarter of 2005. The 2005 inflation target is still likely to be exceeded, but average inflation in 2006 should fall within the range target.
- ✎ **However, the outlook for prices was not altogether risk-free.** Supply-side pressures from oil prices and other sources continue to loom over the policy horizon, and the risk of demand-side effects from these supply shocks could very well increase in the near term and spill over into wage- and price setting behavior.
- ✎ **The outlook for inflation supported keeping policy settings unchanged, but also argued for continued readiness by authorities to act quickly against potential spillover demand-side pressures.**

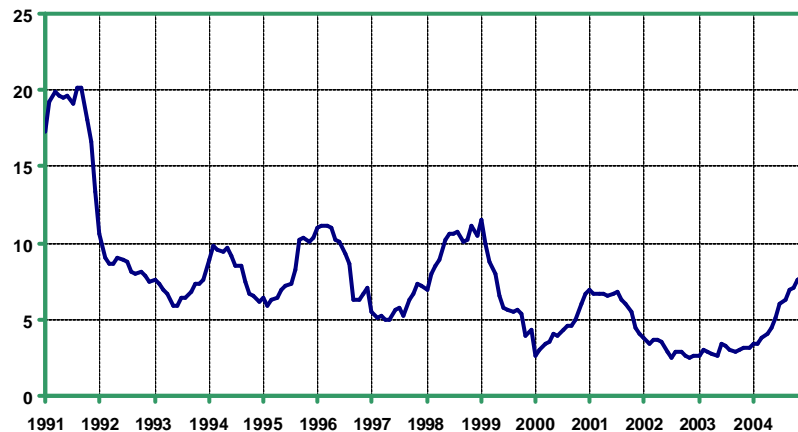
## **I. Recent Developments in Inflation and Economic Conditions**

### **Price and Cost Developments**

*Inflation rises further in the fourth quarter of 2004; full year average exceeds target.*

Inflationary pressures continued to persist in the fourth quarter of 2004. As in the previous quarters, supply-side factors continued to be the main driver of the uptrend in inflation. The increase in the prices of food and energy-related CPI components accounted for the largest contribution to the increase in inflation. In addition, the seasonally stronger demand during the holiday also contributed to the higher inflation in the fourth quarter. In line with expectations, average inflation for 2004 was recorded at 5.5 percent, exceeding the Government’s announced target of 4.0-5.0 percent. This was also comparably higher than the 3.0 percent average inflation in 2003. In essence, the inflation uptrend in 2004 may be characterized as a predominantly supply-side phenomenon, arising in large part from a series of supply-side shocks to the economy. These shocks included the increase in global oil prices, which translated into higher cost of transport services and other goods, as well as the spate of typhoons and domestic supply constraints that affected the availability of certain food products.

**Headline Inflation**  
Year-on-year change in percent (1994=100)



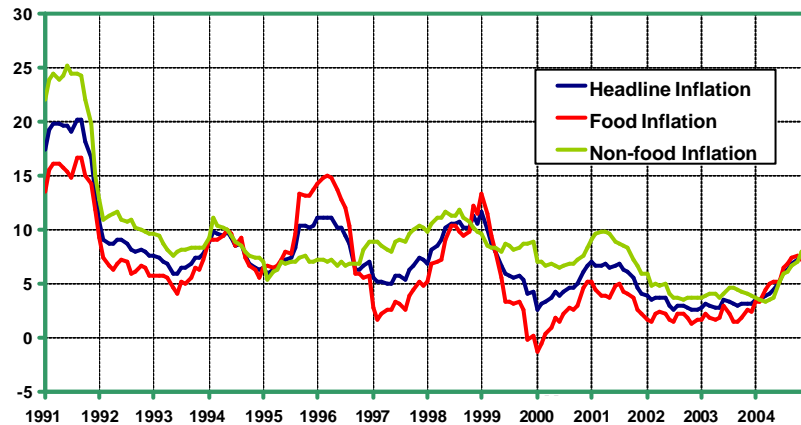
**Headline and Core Inflation**

*Most commodity items post higher prices during the review quarter.*

Average headline inflation rose to 7.5 percent in the fourth quarter, based on the 1994 CPI series, from 6.4 percent in the previous quarter and 3.1 percent a year ago as inflation increased for nearly all the major commodity groups. The 2004 average annual inflation reached 5.5 percent. Both food and non-food inflation rose. Inflation in the fourth quarter was also the highest quarterly average inflation since the first quarter of 1999. Pressures emanated largely from higher food prices caused by supply bottlenecks as well as the increases in the prices of energy-related components of the CPI and the stronger demand in line with the Christmas holiday. Food, oil and energy-related products (fuel, light, and transportation and communication) accounted for a combined share of 5.8 percentage points or 77 percent of the 7.5 percent average inflation in the fourth quarter.

**Headline, Food and Non-food Inflation**

Year-on-year change in percent (1994=100)



Likewise, the 2000-based headline inflation also tracked an upward trend in the fourth quarter of 2004. Headline inflation was 8.2 percent in the fourth quarter of 2004, higher than the 6.9 percent in the third quarter and the 3.8 percent a year ago. Full year average headline inflation was 6.0 percent, higher than the 3.5 percent average in 2003.

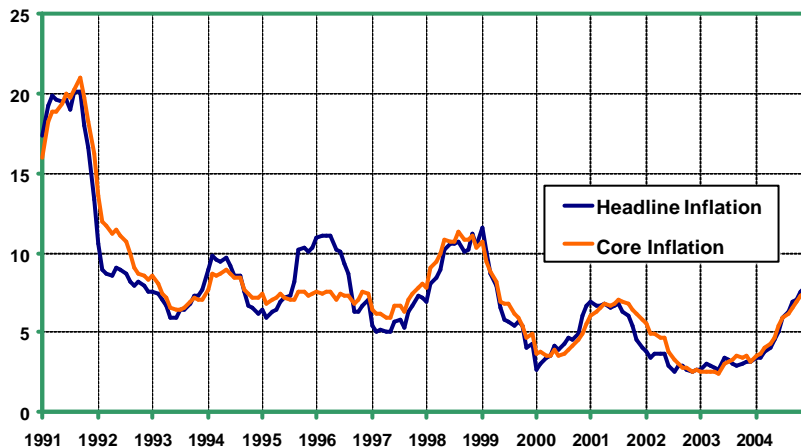
*Core inflation was likewise higher during the fourth quarter.*

Data on core inflation suggests moderately increasing pressures on consumer prices. The core inflation, as measured by the National Statistics Office (NSO), which is simply the headline inflation excluding certain food and energy-related items, averaged 7.3 percent in the fourth quarter (1994=100). This was higher than the recorded average of 3.4 percent for the same period a year earlier and the 6.3 percent posted in the previous quarter.<sup>1</sup> The full-year average core inflation settled at 5.5 percent.

A slightly higher core inflation of 7.4 percent in the fourth quarter was recorded using the 2000-based CPI series. This was also higher than the 3.8 percent average for the same period a year ago and the 6.4 percent in the previous quarter. The average full year core inflation for 2004 was 5.7 percent, 0.3 percentage point lower than the headline inflation.

**Headline and Core Inflation**

Year-on-year change in percent (1994=100)



<sup>1</sup> The NSO began releasing official core inflation data in February 2004 alongside headline inflation. 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>.

<b>Headline and Core Inflation</b> Quarterly averages of year-on-year change				
<b>Period</b>	<b>Headline Inflation</b>		<b>Core Inflation</b>	
	<u>1994=100</u>	<u>2000=100</u>	<u>1994=100<sup>a/</sup></u>	<u>2000=100<sup>b/</sup></u>
<b>2003</b>	<b>3.0</b>	<b>3.5</b>	<b>3.0</b>	<b>3.4</b>
First Quarter	2.8	3.0	2.6	2.7
Second Quarter	3.0	3.5	2.7	2.9
Third Quarter	3.1	3.6	3.3	3.7
Fourth Quarter	3.1	3.8	3.4	3.8
<b>2004</b>	<b>5.5</b>	<b>6.0</b>	<b>5.5</b>	<b>5.7</b>
First Quarter	3.5	4.1	3.8	4.2
Second Quarter	4.6	4.7	4.8	4.8
Third Quarter	6.4	6.9	6.3	6.4
Fourth Quarter	7.5	8.2	7.3	7.4

<sup>a/</sup> The 1994-based official core inflation definition excludes 20.2 percent of the CPI basket as follows: rice, corn, fruits and vegetables and fuel items (gas, LPG, kerosene, oil, gasoline and diesel).

<sup>b/</sup> The 2000-based official core inflation definition excludes 18.4 percent of the CPI basket as follows: rice, corn, fruits and vegetables, and fuel items (gas, LPG, kerosene, oil, gasoline and diesel).

Alternative measures of core inflation (e.g., trimmed mean, weighted median and net of volatile items) estimated by the BSP (1994=100) registered increases in the fourth quarter compared to those posted in the previous quarter and the same quarter a year ago. Trimmed mean, weighted median and net of volatile items measures of core inflation averaged at 6.0 percent, 5.0 percent and 6.9 percent, respectively during the quarter. These were higher than the previous quarter's averages of 5.0 percent, 4.0 percent and 5.7 percent, respectively. Moreover, the fourth quarter 2004 alternative core measures were more than twice as much as the estimates in the fourth quarter of 2003.

Similarly, estimates of the 2000-based alternative measures of core inflation were higher in the fourth quarter compared to the same quarter a year earlier. The trimmed mean, weighted median and net of volatile items measure of core inflation in the fourth quarter averaged at 6.7 percent, 5.0 percent and 6.5 percent, respectively, up from the previous quarter's levels of 5.7 percent, 4.3 percent and 5.4 percent, respectively.

**Alternative Core Inflation Measures**

*Quarterly averages of year-on-year change*

Year/Month	1994=100			2000=100		
	Trimmed Mean <sup>1/</sup>	Weighted Median <sup>2/</sup>	Net of Volatile Items <sup>3/</sup>	Trimmed Mean <sup>1/</sup>	Weighted Median <sup>2/</sup>	Net of Volatile Items <sup>3/</sup>
<b>2003</b>	<b>3.6</b>	<b>3.2</b>	<b>3.6</b>	<b>3.2</b>	<b>3.2</b>	<b>2.1</b>
First Quarter	2.5	2.5	1.8	2.8	3.2	1.8
Second Quarter	2.5	2.2	1.9	3.3	3.4	1.9
Third Quarter	2.6	2.5	2.4	3.2	3.1	2.2
Fourth Quarter	2.9	2.8	2.4	3.5	3.2	2.2
<b>2004</b>	<b>4.4</b>	<b>3.8</b>	<b>4.8</b>	<b>5.0</b>	<b>4.1</b>	<b>4.5</b>
First Quarter	2.9	2.9	2.8	3.7	3.9	2.7
Second Quarter	3.6	3.3	3.9	4.0	3.4	3.5
Third Quarter	5.0	4.0	5.7	5.7	4.3	5.4
Fourth Quarter	6.0	5.0	6.9	6.7	5.0	6.5

*1/ The trimmed mean represents the average inflation rate of the (weighted) middle 70 percent in a lowest-to-highest ranking of year-on-year inflation rates for all CPI components.*

*2/ The weighted median represents the middle inflation rate (corresponding to a cumulative CPI weight of 50 percent) in a lowest-to-highest ranking of year-on-year inflation rates.*

*3/ The net of volatile items method excludes the following items: educational services, fruits and vegetables, personal services, rentals, recreational services, rice, and corn.*

*Sources of Basic Data: NSO, BSP-DER*

**Box: Analyzing Inflation Pressures in 2004 Using Outlier Price Movements from a Trimmed Mean Core Inflation Rate**

The trimmed mean measure of core inflation is an alternative measure of core inflation that attempts to capture the central tendency of price movements within the CPI basket of goods and services.<sup>1</sup> It is calculated as the average inflation rate, in a given month, of the (weighted) middle 70 percent in a cross-section, lowest-to-highest ordering of year-on-year inflation rates for all CPI components. This means that two sets of items are excluded: those with the largest positive inflation rates representing a cumulative 15 percent of the CPI basket and those items with the lowest (or largest negative) inflation rates, likewise with a combined CPI weight of 15 percent. Because of its construction, calculations using the trimmed mean measure can reveal useful information on which items exhibited the most upward pressure during a particular period. This article examines the specific CPI items that were most often excluded by the trimmed mean measure. The intention is to show which specific commodities exhibited sustained extreme (positive) price movements in 2004 compared to the previous year's, and thereby gain information on the nature of recent inflation pressures.

**A Cross-Sectional Comparison**

Table 1 lists the items excluded from the trimmed mean core inflation rate in December 2003 and December 2004. A few things may be noted: (1) the upper bound of inflation rates was higher in December 2004 compared to the previous year; (2) the items in the upper 15 percent were mostly food and energy items such as meat, fuel and transport; and (3) these same items had much higher inflation rates in December 2004 compared to a year earlier.

When these items were removed in the various estimations of the monthly trimmed mean in 2004, the trimmed mean estimate tended to be lower relative to that of headline inflation. The gap between the headline inflation and the corresponding trimmed mean became evidently wider during the period. This indicated that during periods of higher inflation in 2004, these excluded items contributed largely to the observed rise in the headline inflation.

**Table 1. Inflation Rates of Basic CPI Items, December 2003 vs. December 2004**  
Ranked from lowest to highest, 2000=100, year-on-year change, in percent

December 2003		December 2004	
Headline Inflation	3.9	Headline Inflation	8.6
Core Inflation	3.8	Core Inflation	7.8
Trimmed Mean	3.6	Trimmed Mean	7.1
Educational	7.9	Fuel	24.7
Personal	7.5	Transp. & Communication	22.5
Water	7.0	Light	17.4
Medical	6.6	Meat	14.2
Light	6.6	Corn	12.8
Dairy Products	6.2	Dairy Products	10.4
Fuel	5.2	Fish	10.2
Rentals	5.0	Fruits & Vegetables	10.1
Fruits & Vegetables	4.9	Cereal Preparation	9.2
Footwear	4.4	Minor Repairs	9.1
Cereal Preparation	3.9	Educational	8.9
Meat	3.9	Eggs	6.7
Recreational	3.6	Medical	6.0
Corn	3.5	Misc. Food	5.3
Minor Repairs	3.0	Beverages	4.8
Personal Care & Effects	2.9	Personal	4.7
Transp. & Communication	2.8	Custom Clothes	4.3
Ready Made Apparel Excl. Footwear	2.6	Rice	4.0
Beverages	2.5	Household Operations	4.0
Misc. Food	2.4	Other services	3.8
Custom Clothes	2.3	Footwear	3.6
Other services	2.3	Personal Care & Effects	3.5
Tobacco	2.3	Rentals	3.2
Fish	2.0	Ready Made Apparel Excl. Footwear	3.2
Household Operations	1.9	Recreational	3.1
Household Furnishing & Equip.	1.9	Water	2.5
Eggs	1.9	Household Furnishing & Equip.	1.9
Rice	0.9	Tobacco	1.9
Other Miscellaneous Items	-0.1	Other Miscellaneous Items	0.1

n.b.) Items in shaded area represent those excluded in the trimmed mean.

<sup>1</sup> A description of the BSP's methodology for 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.

For example, after excluding both the upper and lower 15 percent in the distribution of CPI items in December 2004, the resulting trimmed mean was 7.1 percent (using the 2000-base year CPI series), lower than the 8.1 percent headline inflation for the same month. The trimmed items with the highest inflation, including meat, light, fuel, and transport and communication, had an average inflation rate of 19.7 percent.

**Analyzing 2004 Inflation**

**Table 2. Items Most Often Excluded From Trimmed Mean, 2000 = 100**

2003		2004	
	No. of Times Excluded		No. of Times Excluded
<b>Highest 15 %</b>		<b>Highest 15 %</b>	
1 Water	12	1 Meat	12
2 Educational Services	12	2 Corn	11
3 Medical Services	12	3 Fuel	9
4 Personal Services	12	4 Fish	6
5 Fuel	10	5 Transp. & Communication	6
6 Light	6	6 Educational Services	5
7 Dairy Products	2	7 Dairy Products	4
		8 Fruits & Vegetables	2
		9 Light	2
		10 Minor Repairs	1
		11 Personal Services	1
Average Inflation of Excluded Items	8.4%	Average Inflation of Excluded Items	12.4 %
<b>Lowest 15 %</b>		<b>Lowest 15 %</b>	
1 Other Miscellaneous Items	11	1 Other Miscellaneous Items	12
2 Minor Repairs	7	2 Tobacco	11
3 Eggs	6	3 Water	11
4 Light	5	4 Household Furnishing & Equipment	11
5 Rice	4	5 Ready Made Apparel Excl. Footwea	8
6 Fruits & Vegetables	4	6 Recreational Services	8
7 Meat	4	7 Other services	5
8 Other Services	3	8 Light	4
9 Household Furnishing & Equipment	3	9 Rice	3
10 Corn	2	10 Personal Care & Effects	3
11 Fish	2	11 Fruits & Vegetables	1
12 Ready Made Apparel Excl. Footwea	2	12 Footwear	1
13 Household Operations	2	13 Household Operations	1
13 Custom Clothes	1		
Average Inflation of Excluded Items	-0.1%	Average Inflation of Excluded Items	1.6 %

Table 2 shows the frequency or number of times each CPI item was removed from the computation of the trimmed mean in 2003 and 2004. In 2003, the upper-15 percent items most frequently excluded from the calculation of the trimmed mean measure were Water; Educational Services; Medical Services; Personal Services; and Fuel. This suggests that, apart from fuel, the price pressures during the year came mainly from services—although it was possible that the data simply reflected the impact of commodity-specific factors

In 2004, the items most frequently excluded in the trimmed mean on the upper end of the distribution were Meat, Corn, Fuel and Transport. This is consistent with the observation that most of the inflationary pressures in 2004 originated from sustained movements in food and energy prices associated with supply -side shocks.

It should be noted that average headline inflation was higher in 2004, as was core inflation based on the trimmed mean measure. This implies that the central tendency of the distribution of price changes in the CPI basket is on a rising path. Such a trend could point to persistent movements in prices and lead to adverse shifts in inflation expectations. This trend therefore bears closer monitoring in the near term.

### Food Prices

*Supply bottlenecks and seasonal increase in demand fuel increases in food prices.*

Food inflation increased to 7.6 percent in the fourth quarter, up from the 6.8 percent a quarter-ago and 2.3 percent in the comparable period a year ago. The full year food inflation was 5.8 percent, 3.8 percentage points higher than the average for 2003. High inflation rates were observed for meat (14.7 percent), corn (10.8 percent), dairy products (9.6 percent), fish (9.5 percent) and fruits and vegetables (8.0 percent). Meat alone contributed about 1.1 percentage points to inflation during the fourth quarter as production of poultry and livestock turned in lower growth in the first three quarters of 2004 due in part to the effect of high prices of feedstuffs such as corn. The next largest contribution came from fish at about 0.7 percentage point. The series of typhoons—which struck the country in late November to early December—partly disrupted the production and supply chain of crops in the Northern and Central Luzon as well as parts of Visayas. This drove up the prices of selected food items in the CPI basket including fish, fruits and vegetables. Moreover, the stronger demand for food products during the holiday season have also contributed to the uptick in food prices.

The robust agricultural production recorded for the first three quarters of 2004 provided some buffer to seasonal demand pressures as supply of some food items such as rice were adequate during the holiday season. Nonetheless, rice inflation showed a slight rise to 3.4 percent in the fourth quarter from 2.8 percent a quarter earlier.

### Non-food Prices

*Non-food inflation inch higher except for educational services.*

Non-food inflation using the 1994 CPI series accelerated to 7.8 percent in the fourth quarter of 2004 from 6.2 percent in the third quarter and 3.8 percent inflation a year ago. This brought the full year non-food inflation to 5.5 percent, 1.6 percentage points higher than the full year average in 2003. All non-food items, except for educational services registered higher inflation compared to their levels in the previous quarter. The uptrend in non-food inflation was likewise driven by the rise in oil prices and the corresponding increase in electricity rates along with the seasonally higher demand during the fourth quarter.

Among the non-food items, fuel, light and water registered the highest inflation at 15.2 percent, up from the 7.8 percent recorded in the third quarter bringing the full year average inflation to 7.4 percent. Fuel, alone, climbed to 21.5 percent in the fourth quarter, accelerating further from 15.7 percent a quarter ago. Light inflation showed a double-digit rate of 13 percent in the fourth quarter from only 2.2 percent previously, owing mainly to the recent power rate adjustment. Services continued to post double-digit inflation at 12.4 percent in the fourth quarter from 11.3 percent in the previous quarter, bringing the full year average to 8.7 percent. Of the services items, transportation and communication inflation accounted for the highest inflation at 22.9 percent from 20 percent in the previous quarter. This was due to the increases in the prices of gasoline products in October and November.

Similarly, inflation for the rest of the non-food items such as clothing, housing and repairs, and miscellaneous items accelerated although at relatively slower pace of 2.6 percent, 3.7 percent and 2.7 percent, respectively from their previous quarter's inflation of 2.1 percent, 3.2 percent and 2.3 percent. The full year inflation for clothing, housing and repairs and miscellaneous items averaged at 2.3 percent, 3.4 percent and 2.2 percent, respectively.

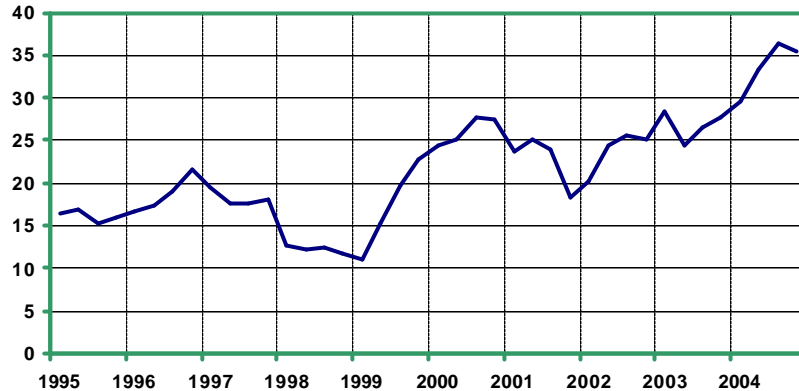
#### *Energy Prices*

*Global oil prices ease due to the build up in inventories and mild weather condition.*

International oil price was relatively calm at lower levels in the last two months of the fourth quarter of 2004, following its sustained rise starting in the first quarter of the year to reach its peak levels in August. International oil prices exhibited renewed uptick in October after a relative calm in September. However, the average price of Dubai crude oil settled at \$35.54 per barrel in the fourth quarter of 2004, 2.0 percent lower or cheaper by \$0.71 per barrel than the third quarter average of \$36.25 per barrel. Compared with the fourth quarter of 2003, international crude oil prices were higher by a huge \$7.86 per barrel, or by 28.4 percent.

**Dubai Crude Oil**

Quarterly average spot price in US dollars per barrel



Softening international oil prices in the fourth quarter were supported by reports of adequate stocks as the Organization of Petroleum Exporting Countries (OPEC) raised its output by 0.215 million barrels per day (mb/d) to 30.0 mb/d in October 2004.<sup>2</sup> The rise in US inventory following the recovery of US crude production in hurricane-hit Gulf of Mexico and some weakening of demand in the US helped ease the pressures on oil prices in the fourth quarter. In addition, mild winter across the Northern hemisphere (North America, Europe and China) also eased demand for heating fuel. However, the decline in world oil prices could be held back by the continued fears of terror attacks in the Middle East and the OPEC's decision to cut oil production by 1.0 mb/d effective 1 January 2004.

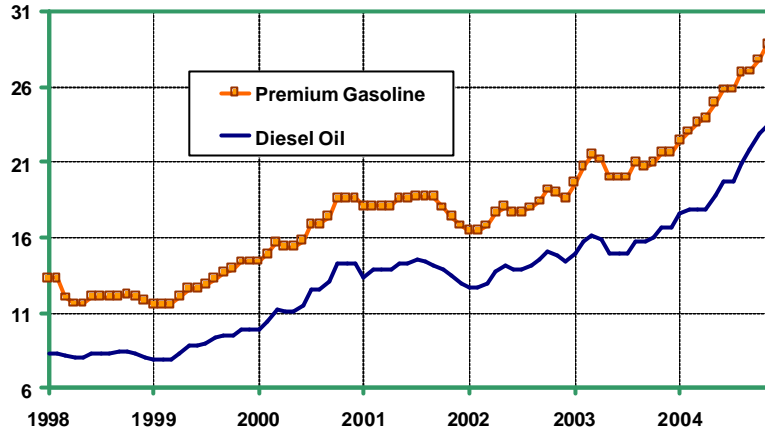
*Local oil companies implement price rollback in December.*

The uptrend in oil prices in the international market in earlier months led to the series of upward adjustments in the domestic oil prices in October to November. However, domestic oil prices fell slightly in December following the easing of international crude oil prices in November. Nonetheless, the end-December 2004 prices of domestic oil products per liter were generally higher than their end-September 2004 levels as follows: 27 centavos for liquefied petroleum gas (LPG), 64 centavos for fuel oil, ₱1.50 for gasoline products, ₱1.58 for diesel, ₱1.75 for kerosene and ₱2.09 for aviation turbo. Relative to their end-December 2003 levels, price increases per liter of the same oil products ranged higher from ₱3.87 for LPG to ₱7.05 for kerosene.

<sup>2</sup> IEA, Oil Market Report, 10 November 2004, available online at <http://www.eia.org>

**Local Retail Prices of Selected Oil Products**

Price in Pesos per liter



Industry Average: Retail/Pump Price of Petroleum Products									
Prevailing Prices (in peso per liter)									
Year	Month	Day/s	Premium Gasoline	Unleaded Gasoline	Regular Gasoline	AVTurbo	Kerosene	Diesel Oil	Fuel Oil LPG
2003	Dec		21.63	21.03	20.04	21.45	16.96	16.73	13.39
2004	Jan	2 to 5-Jan-04	21.63	21.03	20.04	21.45	16.96	17.03	13.39
	Jan	10 to 13-Jan-04	22.43	21.83	20.84	21.94	17.46	17.53	13.39
	Feb	3 to 4-Feb-04	23.03	22.43	21.44	21.94	17.76	17.83	13.39
	Mar	2, 8 to 10-Mar-04	23.03	22.43	21.44	21.94	17.76	17.83	13.39
	Mar	20, 22-Mar-04	23.63	23.03	22.04	21.94	18.16	17.83	13.69
	Apr	5, 19-Apr-04	23.93	23.33	22.34	22.23	18.46	17.83	13.69
	May	15-May to 2 Jun-04	24.93	24.33	23.34	23.20	19.46	18.83	14.19
	Jun	4 to 6, 18-Jun-04	25.83	25.23	24.24	24.08	20.36	19.73	14.69
	July	2-Jul-04	25.83	25.23	24.24	24.08	20.36	19.73	14.69
	Aug	2 to 8-Aug-04	26.33	25.73	24.74	24.56	20.86	20.23	14.69
	Aug	15 to 19-Aug-04	26.63	26.03	25.04	24.56	21.16	20.53	14.69
	Aug	21 to 29-Aug-04	26.98	26.38	25.39	24.56	21.51	20.88	14.69
	Sep	1 to 3, 15, 16-Sep-04	27.28	26.68	25.69	24.56	21.96	21.33	14.69
	Sep	25 to 27-Sep-04, 1-Oct-04	27.03	26.43	25.44	24.56	22.26	21.83	14.69
	Oct	3 to 6-Oct-04	27.03	26.43	25.44	24.56	22.61	21.98	14.69
	Oct	11 to 13, 16-Oct-04	27.38	26.78	25.79	24.90	23.03	22.40	14.69
	Oct	15, 18, 20-Oct-04	27.38	26.76	25.79	24.90	23.25	22.62	14.69
	Oct	30 to 31-Oct-04	27.83	27.23	26.24	25.68	23.51	22.91	15.03
	Nov	4 to 16-Nov 04	28.83	28.23	27.24	26.65	24.01	23.41	15.33
	Dec	8 to 10-Dec-04	28.83	28.23	27.24	26.65	24.01	23.41	15.33
	Dec	21 to 23-Dec-04	28.53	27.93	26.94	26.65	24.01	23.41	15.33
Last Change									
		23 Dec 04 - 10 Dec 04	(0.30)	(0.30)	(0.30)	0.00	0.00	0.00	(0.56)
Change from Previous Periods (End-of-Month and End-of-Quarter )									
		End-Dec 04 - End-Nov 04	(0.30)	(0.30)	(0.30)	0.00	0.00	0.00	(1.12)
		End-Dec 04 - End-Sep 04	1.50	1.50	1.50	2.09	1.75	1.58	0.64
		(in percent)	6.93	7.13	7.49	9.74	10.32	9.44	4.78
Cumulative Change									
		End-Dec 02 - End-Dec 01	1.75	1.75	1.74	0.97	1.83	1.48	2.65
		End-Dec 03 - End-Dec-02	3.09	3.09	3.09	2.55	2.63	2.33	0.99
		End-Dec 04 - End-Dec 03	6.90	6.90	6.90	5.20	7.05	6.68	1.94
		(in percent)	31.9	32.8	34.4	24.2	41.6	39.9	14.5

Source of Basic Data: Department of Energy

Meanwhile, the industry's oil inventory level reached an equivalent of 69 days of supply as of 6 December 2004. This includes an equivalent of 39 days of finished products, which is more than twice the Government's required minimum inventory level of 7 to 15 days. In addition, the inventory of crude in stock and crude in transit is equivalent to 10 days and 20 days, respectively. A comfortable level of oil supply would help cushion the impact of any possible sharp adjustments in world oil prices.

*Taxi fare increases in the fourth quarter.*

Despite the increases in the domestic oil prices in October and November, the minimum public mass transport fares for jeepneys and buses remained unchanged since the last government-approved increase on 9 June 2004. However, the minimum fare (flag-down) for taxis increased by ₱5.00 on 16 October 2004 or by 20 percent to ₱30.00 and from ₱2.00 to ₱2.50 for each succeeding 300 meters.

*Utility Charges*

*End-user power rates are adjusted upwards.*

Meralco raised its electricity rate by 18 percent in November, following the Energy Regulatory Commission's approval of a new cost recovery mechanism in the generation charge. The Commission also approved the first segment of the two-phased removal of inter-class cross-subsidies for Meralco customers.

The Energy Regulatory Commission (ERC) approved on 13 October 2004 a new method for cost recovery in the generation charge effective November 2004, called Automatic Adjustment of Generation Rate for Distribution Utilities. This scheme replaced the Generation Rate Adjustment Mechanism (GRAM).<sup>3</sup> Under this scheme, power rates shall be adjusted based on the prevailing rates of the given month as opposed to the GRAM's deferred or quarterly recovery scheme.<sup>4</sup>

Given the new system, Manila Electric Company (Meralco) increased its rate by ₱1.075 per kilowatt/hour (kwh) in November.

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<sup>3</sup> ERC, "ERC adopts new Guidelines to adjust Generation Rates", 14 October 2004, available online at <http://www.erc.gov.ph>

<sup>4</sup> ERC, "ERC Enlightens Public on New Meralco Rate", 26 November 2004, available online at <http://www.erc.gov.ph>

The ₱1.075 per kwh adjustment in Meralco's rate is equivalent to an 18 percent increase over Meralco's average selling rate of ₱5.9665 per kwh as of September 2004. This rate adjustment reflected mainly the ERC-approved average increase in the National Power Corporation's (NPC) generation charge of ₱1.23 per kwh in September 2004. Rising fuel and operations costs prompted the ERC to approve the said rate adjustment.

The ERC also approved starting November 2004, a separate ₱0.008 rate increase for the Meralco for 24 months.<sup>5</sup> The rate increase represents ₱366.8 million in advances made by Meralco for transmission line improvements charged to them by Quezon Power Philippines Limited (QPPL) from June 2000 to March 2004. This was apart from the ₱0.0127 rate increase granted by the ERC to Meralco for advances by Meralco to other charges by QPPL from June 2000 to September 2002. The ₱0.008 increase will be included in Meralco customers' bills from November 2004 to October 2006.

On 4 October 2004, the ERC approved the two-phase removal of inter-class cross-subsidies for Meralco customers which is mandated by the Electric Power Industry Reform Act (EPIRA), starting with the 40 percent removal effective October 2004 while the remaining 60 percent will be eliminated in October 2005.<sup>6</sup> This will result in higher electricity rate for residential and general service customers and lower rates for industrial consumers.

## **Aggregate Demand and Supply**

*The domestic economy remains on a steady growth path.*

The Philippine economy continued to grow in the third quarter of 2004. Real gross domestic product (GDP) grew by 6.3 percent in the third quarter, up from the 4.8 percent increase posted in the same period a year ago. This was, however, slightly slower than the 6.5 percent GDP growth in the previous quarter. The domestic economy remained generally resilient despite the risks posed by the fiscal position of the national government and rising international oil prices.

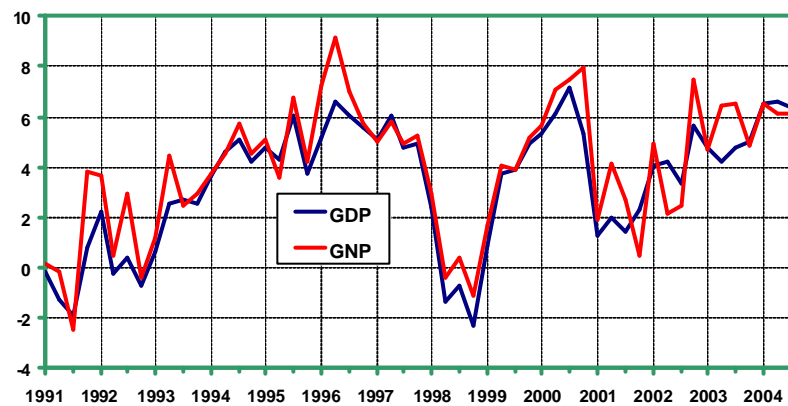
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<sup>5</sup> SEC Form 17-c, identification number PW 102, p. 1, 22 October 2004

<sup>6</sup> ERC, "ERC approves cross subsidy removal for Meralco customers", available online at <http://www.erc.gov.ph>

Stable consumer spending, increased investments in construction and sustained exports growth arising from improved foreign demand, drove the economic expansion. On the production side, the growth of the economy showed that all the three major sectors—services, industry, and agriculture—exhibited either stronger or sustained growth rates. Meanwhile, the modest increase in the net factor income from abroad (NFIA) contributed to the 6.1 percent growth in real gross national product (GNP) in the third quarter of 2004. This was the same rate of annual expansion in the previous quarter but slower than the pace in the previous year. The slowdown in the fourth quarter growth of the NFIA was attributed mainly to the increase in property expense and the ban on the deployment of Filipino workers to Iraq.

**GDP and GNP Growth Rates**  
Annual Growth in Real Terms



<b>Economic Performance as of the Third Quarter of 2004</b> <i>Real Annual Growth in percent</i>				
Sector	Share to total GDP	2004		2003
		Q3	Q2	Q3
GNP		6.1	6.1	6.5
GDP	100.0	6.3	6.6	4.8
<i>By industrial origin</i>				
Agriculture, Fishery and Forestry	18.0	7.9	3.8	4.7
Industry	34.7	4.5	5.6	3.7
Services	47.3	7.1	8.3	5.7
<i>By expenditure item</i>				
Personal consumption expenditure	79.4	5.6	6.3	5.2
Government consumption	6.5	(5.9)	(0.3)	2.5
Capital formation	18.2	16.2	8.0	(4.0)
Exports	54.9	16.5	14.8	2.8
Less: Imports	54.6	6.1	6.3	2.5
<i>Source: NSCB</i>				

### **Aggregate Demand**

***Strong private consumption continues to be the main driver of growth.***

Personal consumption expenditures (PCE) rose by 5.6 percent in the third quarter of 2004. This was slower than the 6.3 percent growth registered in the previous quarter but was faster than 5.2 percent rate of increase in the comparable quarter in 2003. The increase in consumption was attributed to better farm income due to robust growth of agriculture, higher remittances from the overseas Filipino workers, and wider and enhanced usage of mobile phone services. On the other hand, government consumption declined by 5.9 percent in the third quarter of the year as the government kept a tight rein on the budget deficit.

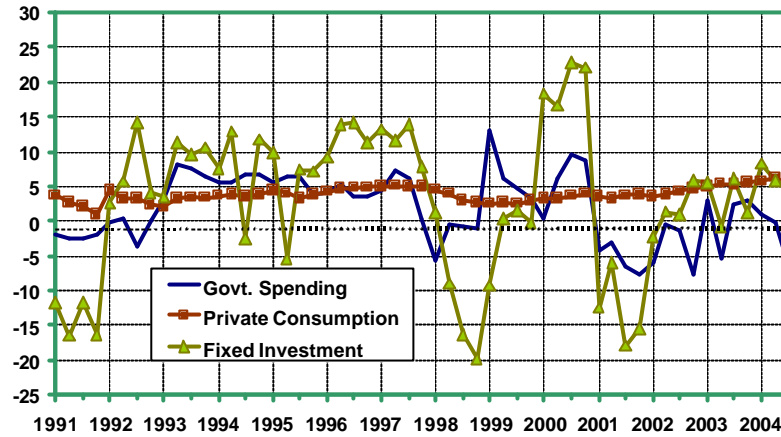
The growth of investments in fixed capital formation moderated to 5.4 percent in the third quarter of 2004 from 5.9 percent in the previous quarter and from 6.1 percent a year ago as investments in durable equipment slowed down and the withdrawal from stocks increased. Capital expenditures on durable equipment rose by 5.0 percent in the third quarter of 2004 from 3.1 percent in the second quarter. However, this was a marked deceleration from the 16.7 percent expansion in the same period in 2003. Changes in stock, which showed withdrawals from existing inventory, rose to 61.1 percent in the third quarter of 2004 from 23.0 percent in the

previous quarter. Investments in construction were favorable. Capital outlays for public infrastructure increased, particularly for the construction of flood-related infrastructures in Metro Manila including floodgates, lakeshore dikes and concrete bridges. Investments in breeding stocks and orchard development also increased by 5.2 percent in the third quarter of 2004 from the quarter-ago and from the year ago levels, as investments in poultry, orchard development and afforestation gathered positive momentum.

Total merchandise and non-merchandise services imports continued to gather strength at 6.1 percent growth in the third quarter of 2004, slightly slower than the 6.3 percent recorded in the second quarter of 2003 but higher than the 2.5 percent rise a year ago. Meanwhile, total merchandise imports surged to 6.6 percent during the third quarter of 2004 from 2.9 percent in the third quarter of 2003. The five major contributors to the growth in merchandise imports were electrical machinery, feeding stuff, textile yarns, cereals and machinery other than electrical.

Latest data from the NSO showed that year-on-year growth in merchandise imports increased to 16.3 percent in October from 14.8 percent in September and 8.9 percent in August. This was up significantly from the 7.0 percent growth in the previous year. This also brought imports for the first ten months of 2004 to \$33.9 billion, which is an 8.8 percent expansion from the year ago level. Imports of capital goods in October grew by 1.8 percent year-on-year to \$1.345 billion and accounted for 36.6 percent of total imports. This was, however, a deceleration from 3.9 percent growth in September. Raw materials and intermediate goods, comprising 37.3 percent of October imports, grew by 10.1 percent year-on-year.

**Domestic Demand**  
Annual Growth in Real Terms



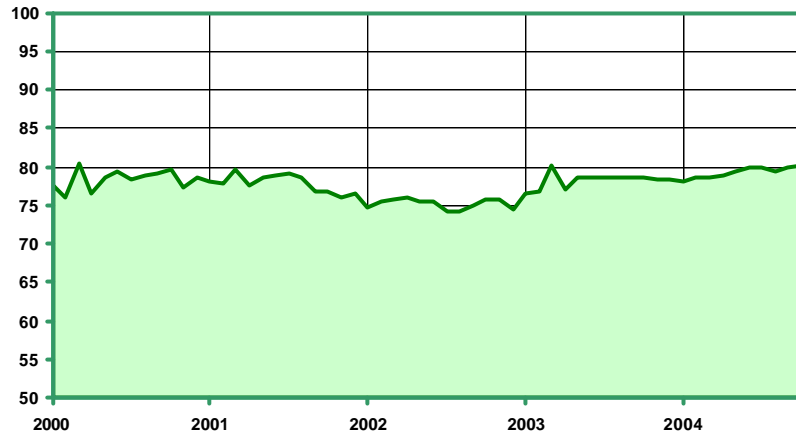
*Other Demand Indicators*

*Other demand indicators show mixed trends.*

Other indicators of domestic demand exhibited positive trends such as the higher production and continued improvements in average capacity utilization in the manufacturing sector as well as the encouraging revenue growth of major corporations. However, BSP-conducted surveys among firms and households reveal lower optimism, which could temper growth in production, employment, and consumption.

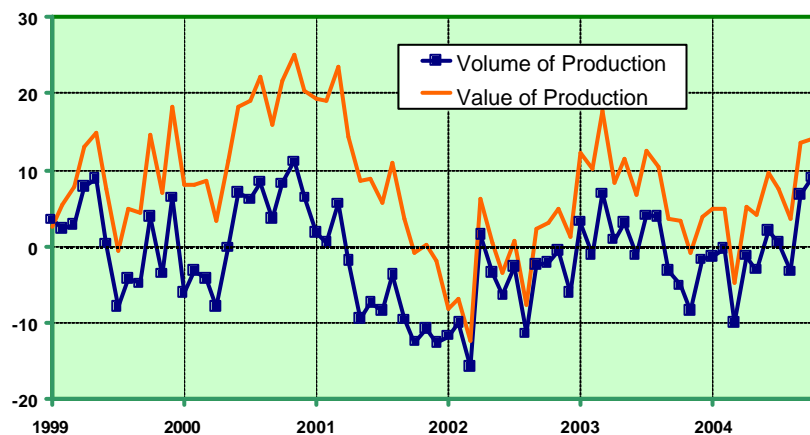
- ? Average capacity utilization in manufacturing rose slightly to 80.1 percent in October 2004 from 80.0 percent in September and from 79.2 percent in August. This was also higher than the capacity utilization of 78.7 percent posted in October 2003. More than half of the manufacturing firms in the sample (54.7 percent) were operating at 70-89 percent capacity in October, while 14.5 percent reported full or near-full capacity operation (90-100 percent), and the remaining third (31.4 percent) reported capacity utilization of below 70 percent.

**Average Capacity Utilization for Manufacturing**  
in percent



? The value of production index (VAPI) for manufacturing increased by 14.0 percent year-on-year in October, slightly higher than the 13.6 percent growth in September. On a monthly basis, VAPI rose by a modest 2.2 percent in October 2004 compared to 9.6 percent in the previous month. Likewise, the volume of production index (VOPI) for manufacturing rose by 9.0 percent year-on-year in October 2004, which was higher than the 6.8 percent growth in September. On a monthly basis, the growth in VOPI slowed down to 1.9 percent in October from 8.8 percent in the previous month.

**Volume and Value Indices of Manufacturing Production**  
Annual Growth in percent



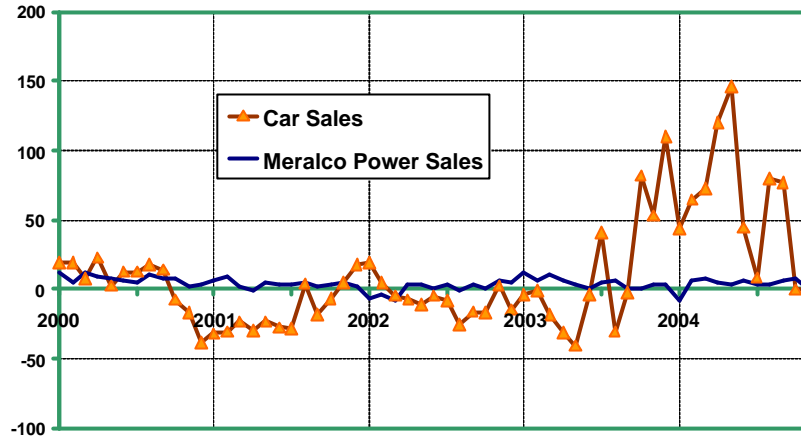
? The country's major corporations posted strong revenue and profit growth in the first nine months of 2004. For some firms though, the third quarter income growth was a marked slowdown from the previous two quarters. Food and beverage conglomerate San Miguel Corporation earned 13 percent more revenues in Jan-Sept 2004 relative to the previous year. Comparative figures for Jollibee Corporation and SM Prime Holdings were 24.6 percent and 16 percent, respectively. Telecommunications firms PLDT and Globe Telecom disclosed that net revenues grew by 19 percent and 14 percent, respectively, as the subscriber base for their cellular phone business continued to expand. Net profits during the third quarter moderated for some companies, particularly, Jollibee and San Miguel, as higher costs of raw materials, distribution and power capped the growth in their incomes.

<b>Financial Performance of Selected Companies</b> (in billion pesos)						
Company	Jan-Sept 2004	Jan-Sept 2003	Growth Rate (%)	2004 Q3	2003 Q3	Growth Rate (%)
Ayala Corp.						
Net Income	3.6	2.2	63	950	800	20
Globe Telecom						
Revenues	41.3	36.3	14	13.7	12.5	9
Net Income	9.0	7.5	20	2.1	3.1	(34)
Jollibee Corp.						
Revenues	19.3	15.5	25	6.6	5.1	29
Net Income	1.2	0.910	29	0.319	0.298	7
PLDT						
Revenues	87.5	73.5	19	29.0	25.4	14
Net Income	18.3	9.2	97	6.1	3.2	91
San Miguel Corp.						
Revenues	122.4	108.1	13	40.7	36.0	13
Net Income	5.6	4.8	15	1.6	1.8	(12)
SM Prime Holdings						
Revenues	7.4	6.4	16	2.5	2.1	20
Net Income	3.4	3.1	10	1.1	1.0	11
<i>Source: Company websites/Bloomberg</i>						

- ? The Chamber of Automotive Manufacturers of the Philippines, Inc. (CAMPI) reported a 0.8 percent decline in passenger car sales in November 2004, from flat growth in October and a 76.6 percent expansion in September. Similarly, sales of trucks and buses fell by 5.0 percent year-on-year in November, following an 8.6 percent expansion in the previous month. The decline in the November car sales was a significant downturn compared to the 53.2 percent annual growth in November 2003. However, the year-to-date growth in passenger car sales was 44.4 percent, up significantly from the January-November 2003 growth of 4.1 percent. On a month-on-month basis, car sales fell by 12.9 percent in November, a reversal from growth rates of 5.4 percent in October and 20.3 percent in September. Seasonally-adjusted car sales contracted by 6.9 percent in November, a larger decline compared to 0.1 percent in October. Meanwhile, year-to-date sales of trucks and buses were 12.8 percent lower than in the previous year.
  
- ? Energy sales by the Meralco declined by 0.2 percent year-on-year in November 2004, a reversal of the 8.0 percent increase in October and the 3.6 percent expansion in previous year. Sales to the residential and industrial sectors declined by 1.5 percent and 1.6 percent, respectively. On a seasonally-adjusted basis, energy sales fell by 3.2 percent month-on-month in November, from a 1.4 percent increase in the previous month.

Sector	Year-on-Year Growth Rate November 2004	Percentage Share in Total Sales
<i>Total</i>	-0.2	100.0
Residential	-1.5	34.5
Commercial	2.2	35.9
Industrial	-1.6	29.0
Others	4.5	0.6

**Domestic Demand Indicators**  
Annual Growth in percent



- ? Results of the fourth quarter 2004 Business Expectations Survey (BES) showed that business confidence in the economy declined but remained positive. The overall business outlook diffusion index (DI) for the fourth quarter of 2004 and the first quarter of 2005 are 18.6 percent and 21.3 percent, respectively.<sup>7</sup> These were both lower than the DIs of 21.3 percent and 27.4 percent, respectively based on the third quarter survey results. Respondents cited the fiscal deficit, rising oil prices, higher inflation and interest rates, and increasing cost of raw materials as the reasons for their less optimistic outlook. The anticipated increase in consumer demand during the Christmas holidays, higher income due to the harvest season, and the expected influx of dollar remittances and export earnings provided some support to business confidence.
- ? Meanwhile, results of the Consumer Expectations Survey (CES) conducted by the BSP on 1-7 October 2004 pointed to lower consumer expectations in the fourth quarter of 2004, first quarter of 2005 and fourth quarter of 2005. The overall CE diffusion index declined to -49.1 percent from -40.5 percent in the previous survey, as the number of households with “worse” expectations—about their current financial situation,

<sup>7</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.

their current level of income, and the country's economic condition—increased by 7.1 percentage points. This came alongside the 1.5 percentage point decrease in the number of families with “better” expectations. The decline in consumer expectations reflected concerns over high commodity prices, unemployment, and lower income. The first quarter 2005 DI also fell to -20.5 percent from -8.1 percent in the previous survey, as more households indicated increased pessimism over the family's financial situation and the country's economic conditions, even as net expectation on the level of family income remained positive. Given these concerns, the growth in personal consumption expenditures is likely to be modest in first quarter of 2005. The survey also revealed a growing cautiousness in consumer spending for assets, which could indicate a slowdown or even a possible decline in the volume of sales of appliances, cars and residential houses. Households expect unemployment and interest rates to increase and the peso to depreciate against the US in the next 12 months. Slightly lower inflation for the next twelve months was anticipated in the fourth quarter compared to the previous survey, with the highest price increases seen to come from electric bills, fish and seafood, meat and rice.

#### *External Demand*

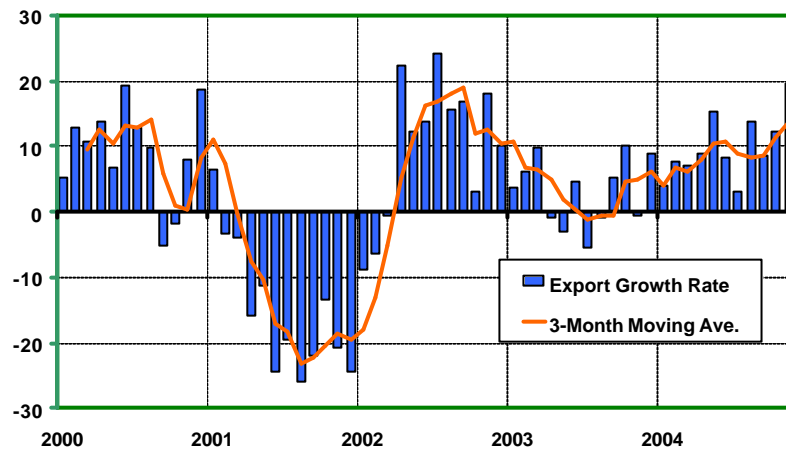
***Strong exports performance boosts growth of domestic economy.***

Total merchandise and non-merchandise exports grew robustly by 16.5 percent in the third quarter of 2004, the highest quarterly growth since the second quarter of 2003. Merchandise exports and exports of non-factor services recorded positive growth rates of 17.9 percent and 6.2 percent during the third quarter of 2004, respectively. The top five merchandise exports during the third quarter of the year included semiconductors, finished electrical, garments, crude coconut oil and bars and rods of copper. Meanwhile, the favorable performance of exports of non-factor services was on account of the robust expansion in insurance and travel services as tourism showed encouraging results during the period.

Meanwhile, based on the latest exports data from the NSO, total merchandise exports increased by 19.5 percent year-on-year to reach US\$3.69 billion in November 2004. This marked the fastest pace of exports since July 2002 when it registered at 24.2 percent. This also brought total merchandise exports for January-

November 2004 to US\$36.3 billion, a 9.9 percent rise from the same period a year ago. Exports of electronic products, which accounted for 67.6 percent of total export revenue in November, expanded by 16.1 percent, an acceleration from the 13.2 percent year-on-year growth in October. On a month-on-month basis, total merchandise exports declined by 1.7 percent in November, a downturn from the 3.1 percent expansion in October. Seasonally-adjusted exports increased by 2.5 percent in November 2004, following a 4.1 percent growth in the previous month.

**Merchandise Exports**  
Year-on-year change in percent



**Aggregate Supply**

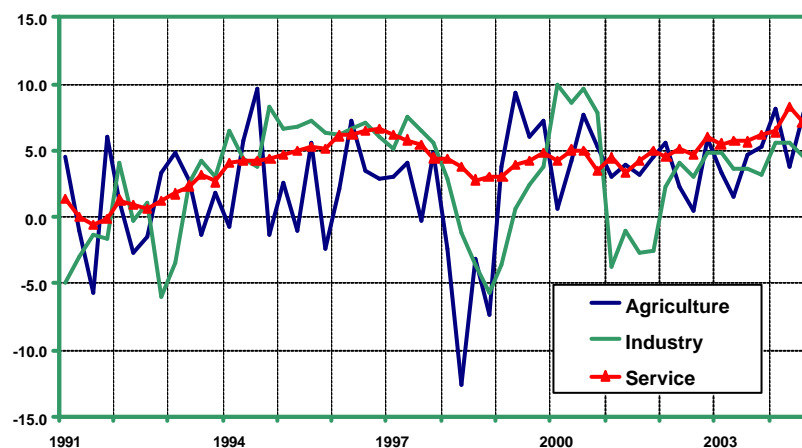
*On the supply-side, the economic expansion is broad based.*

On the production side, economic growth was broad-based as agriculture, services and industry performed well compared to what these sectors displayed a year ago as well as against the previous quarter's recorded growth rates except for the industry which exhibited a slow down.

In terms of contribution to the growth of the economy, the services sector led the growth as it contributed 3.4 percentage points to the 6.3 percent rise in GDP and accounted for the bulk of total GDP output with a 47.3 percent share. The services sector grew by 7.1 percent during the third quarter of 2004 as against that of 5.7 percent a year ago and the 8.3 percent in the previous quarter. Strong consumer demand fuelled largely this growth. Foremost among the sector's biggest contributors was transportation, communication and storage, which expanded by

8.5 percent in 2004 from 7.8 percent a year ago and from 14.6 percent in the second quarter of the year due to higher volume of passengers and the continued expansion of mobile phone service providers. Trade services likewise accelerated by 7.5 percent during the third quarter of 2004 from 7.1 percent a quarter ago and 5.3 percent in the previous year. This was driven mainly by increased sales of petroleum, pharmaceutical products, and passenger motor vehicles. Meanwhile, the vigorous performance of the banking, non-banking and insurance industries supported the upsurge in financial services from 6.7 percent in the third quarter of 2003 and from 9.6 percent in the previous quarter to 9.9 percent in the third quarter of 2004. The ownership of dwellings and real estate grew by 6.7 percent, surpassing the previous year's growth of 4.0 percent and the second quarter growth of 6.4 percent. Private services, which rose by 6.5 percent in the third quarter of 2004 from the quarter-ago increase of 6.9 percent and 5.2 percent a year ago. The impressive turnout by the hotel and restaurant, recreational, medical and health, and business services contributed to the expansion. Sustained efforts to contain the growing budget deficit limited the growth in government services. From a 4.8 percent rise in the third quarter of 2003 and from 4.8 percent in the previous quarter, government services slowed down to 2.4 percent in the third quarter of the year.

**Agriculture, Industry and Service Sectors**  
Annual Growth Rates in percent



Meanwhile, the industry sector accounted for 34.7 percent of total GDP output and contributed 1.6 percentage points to GDP growth. The industry sector rose by 4.5 percent during the third

quarter of 2004 from 3.7 percent in the same period in 2003, buoyed by the strong performance of the manufacturing and construction sub-sectors. This industrial expansion was however lower than the 5.6 percent recorded in the previous quarter. Manufacturing advanced at a faster pace of 4.7 percent in the third quarter of 2004 from 4.1 percent in the third quarter of 2003, while construction, which continued to show signs of recovery, improved markedly, posting an expansion of 8.6 percent during the review period from the contraction of 3.5 percent in the same period in 2003. Supporting the expansion in manufacturing are increases in food manufactures, electrical machinery, beverages, non-metallic minerals, chemical and chemical products, as well as furniture and fixtures. Meanwhile, the growth of the industry sector was tempered by the modest increase in electricity, gas and water at 2.0 percent during the third quarter of 2004 from 3.1 percent a year ago and 4.3 percent in the previous quarter. Moreover, mining and quarrying declined by 4.8 percent during the period in review in contrast to the 19.9 percent expansion in the third quarter of 2003 and the 2.7 percent rise in the previous quarter.

The combined agriculture, fishery and forestry sector showed the fastest pace of growth among the three major sectors. It contributed the remaining 1.4 percentage points to the 6.3 percent GDP growth. The sector grew by 7.9 percent in the third quarter of 2004, higher than the previous year's increase of 4.7 percent and more than double the previous quarter's growth of 3.8 percent. Agricultural production expanded by 7.7 percent in the third quarter of 2004 mainly on account of the increased production of palay and corn, which benefited immensely from the extensive use of hybrid and certified seeds, as well as sugarcane, banana and coconut. On the other hand, livestock production contracted by 2.5 percent in the third quarter of 2004 from 3.1 percent a year ago and from 0.7 percent in the previous quarter, which could be traced mainly to the decline in hog and cattle production due to the higher cost of feedstuffs, particularly, corn prices which increased in the international market.

Fishery production likewise registered gains with an 8.6 percent expansion during the third quarter of the year from 6.0 percent in the second quarter and from 4.7 percent a year ago due to increased production of seaweeds. The introduction of new planting materials and cultivating methods particularly in the

nurseries of Quezon and Batangas contributed to the upsurge in seaweed production. Finally, the increase in log production from plantations and natural forests led the growth of forestry to 9.7 percent in the third quarter of 2004, significantly lower than the 62.4 percent growth in the second quarter of 2004 and the 122 percent recorded in the same period a year ago.

Looking forward, the economy is expected to grow by 6.1 percent in real GDP terms in 2004 as the impact of the December typhoons on agriculture may be felt much later. This is higher than the target GDP growth of 4.9-5.8 percent for the year due to the better-than-expected expansion of the economy over the last three quarters of the year.

For 2005, real GDP is expected to grow at a moderate pace of 5.3-6.3 percent. The impact of the El Niño and the recent typhoons may result into slower growth of the agriculture sector estimated at around 4.2-5.2 percent. However, the threat of the El Niño can be mitigated by the build up of water supply in Angat Dam due to the recent typhoons. Likewise, continued government support to agriculture will also mitigate the impact of El Niño in agriculture production. Meanwhile, according to the NSCB, the effect of the recent typhoons on GDP growth is estimated at about by 0.35 percentage point reduction in the fourth quarter GDP and 1.7 percentage points equivalent of the combined output of the agriculture, fishery and forestry. This accounted for the ₱2.7 million worth of crop damages.

Growth in the industry sector will likewise be modest, and is expected at 4.6 percent in 2005. Mining and quarrying will benefit from the planned start-up of at least four large scale mining projects on the production of gold, silver, copper and nickel. Manufacturing is also likely to increase due to the continued investments in IT-related sectors, growth of remittances from overseas Filipinos and a more vibrant rural economy. Construction will be bolstered by the infrastructure projects involving the North and South rails, SLEX-Star and Subic Clark Toll Road.

Meanwhile, services sector is projected to grow by 5.7-6.6 percent in 2005, led by transportation, and communication and storage. Continuing demand for wireless communication and the expansion of call centers will help boost the sector. Private

services is also seen to grow in line with the strong growth of educational, medical, health, and business enterprises.

On the demand side, consumption is expected to ease in 2005 due to higher prices. Nonetheless, consumption will be propped up by the increase in rural incomes, remittances from the OFWs and new jobs created in the IT-enabled industries. Investments activities will be boosted by public investments and private-sector participation in the key infrastructure projects mentioned above. Exports growth will depend on the pace of external demand. The growth in these areas will cushion the expected decline in government spending in line with the fiscal consolidation program.

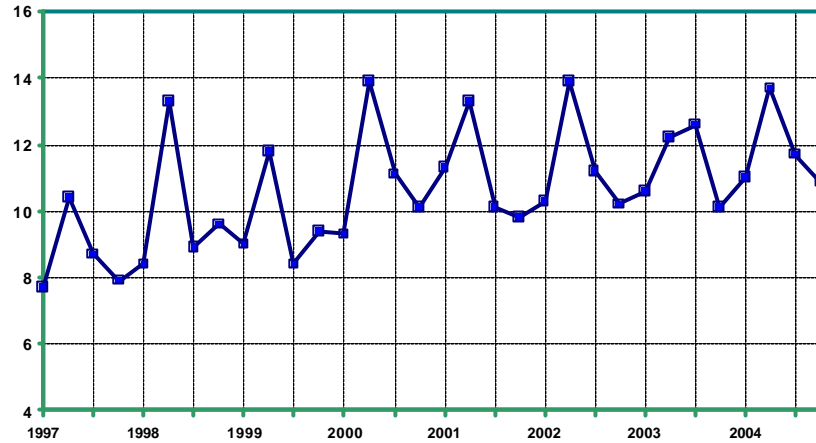
## **Employment Conditions and Wages**

*Labor market conditions remain soft as the unemployment rate inches up.*

Employment conditions in the fourth quarter of 2004 indicated the continuation of a calm and orderly market. Nationwide calls for wage increases--addressed and largely settled during the previous quarter--were completed during the quarter and the cumulative incidence of labor strikes (from January to 22 December 2004) was lowest in 26 years, suggesting improved labor-management relations. However, the unemployment rate increased as the rate of job creation fell below the growth in the labor force population. The latest Labor Force Survey (LFS) published by the National Statistics Office (NSO) indicated that the unemployment rate increased to 10.9 in October 2004 compared to 10.2 percent for the same period last year. This, however, represent an improvement from the 11.7 percent unemployment rate in July 2004. This came about with the 0.6 percent decline in the labor force participation rate as the labor force population increased by 1.4 percent to 35.6 million from 35.1 million in October 2003. The increase in unemployment was also attributed to the decline in employment in the industry sector and the deceleration in employment in agriculture. These factors pulled down the gains seen in the services sector led by its wholesale and retail trade, and repairs subsector, transport, storage and communications subsector and public administration and defense subsector.

**Unemployment Rate**

Annual Change in percent



*Sixteen of the 17 regions implement wage increases during the year.*

During the quarter, addressing national calls for wage adjustments was virtually completed. Wage adjustments in the form of increase in cost of living allowance (COLA) or increases in the minimum daily wage have become effective during the period in Regions I, IV and XII, with only Region II remaining to implement wage increases in January 2005. It may be recalled that for 14 regions (including the NCR), the increases became effective during the third quarter, while Regions IX and XI had effected wage increases in the first semester.

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)	1 August 2004
Ilocos (Region I)	₱2 to ₱10; and ₱5 (COLA)	11 November 2004
Cagayan Valley (Region II)	₱8.00 (ECOLA)	8 August 2004
Central Luzon (Region III)	₱15.00 (COLA)	20 August 2004
Southern Tagalog (Region IV)	₱5.00 to ₱18.00	1 November 2004
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)	₱10 to ₱40 (minimum wage) in Basilan, and ₱20 (minimum wage) ATB <sup>b/</sup> in other provinces	23 September 2004 (Issued) <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 wage increase shall take effect only after publication in a newspaper with general circulation  
 b/ ATB = across-the-board.  
 c/ According to the wage research group of the NWPC, the wage order for ARMM is up for publication.

## Fiscal Developments

*Full year 2004 fiscal deficit is lower than programmed.*

The National Government's (NG) budget deficit in 2004 stood at ₱186.1 billion, 5.9 percent below the program of ₱197.8 billion and 6.9 percent lower than the ₱199.9 billion deficit level during the previous year. This is the second consecutive year that the NG outperformed its fiscal deficit goal, affirming the fiscal authorities'

steadfast resolve to achieve fiscal consolidation. These positive developments should help strengthen confidence in the current administration, which is a key concern among foreign investors/creditors.

The commendable fiscal performance was the outcome of sustained vigilance in revenue collection efforts with collections increasing by 11.4 percent from ₱626.6 billion in 2003 to ₱698.3 billion in 2004 and surpassing the target by ₱21.8 billion. Tax revenues grew by 11.2 percent while non-tax revenues improved by 12.6 percent over last year's level of ₱537.4 billion and ₱89.3 billion, respectively.

Expenditures reached ₱884.4 billion representing an increase of 7 percent over the 2003 spending level and ₱10 billion more than programmed for 2004. Improved revenue collections allowed some fiscal space for increased government spending.

<b>National Government Fiscal Position</b>					
Full Year 2004 and 2003					
(In billion pesos)					
Particulars	Actual		Growth (%)	2004 Program	Percent of Program
	January-December 2004	2003			
Surplus/(Deficit)	-186.1	-199.9	-6.9	-197.8	94.1
Revenues	698.3	626.6	11.4	676.4	103.2
Expenditures	884.4	826.5	7.0	874.2	101.2

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

**Box: The Impact on Inflation of Higher Excise Tax Rates on Cigarettes and Alcoholic Beverages**

**Rising budget deficit highlights need for fiscal consolidation.**

The budget deficit of the National Government (NG) has been rising over the past decade, from less than one percent of GDP in 1995 to 5.3 percent in 2002 and to 4.6 percent in 2003. The sustained rise in the NG budget deficit resulted in a rising level of public debt as the government resorted to more borrowings to finance the resource gap. From 61 percent of GDP in 1995, the total stock of NG debt rose to 78 percent in 2003. Relative to the emerging economies in Asia, the country's levels of fiscal deficit and public debt are higher than the average. Recognizing the need to ensure fiscal sustainability, the NG has intensified its efforts to institute the needed expenditure and revenue reforms to improve its fiscal position and balance the budget by 2010. Its fiscal consolidation program is anchored on new tax measures, tax administration improvements, and disciplined fiscal spending.

**New tax measures can help strengthen the revenue base.**

The NG proposed the passage of eight (8) revenue measures by Congress, namely: indexation of the excise tax on alcohol and tobacco; a general tax amnesty; rationalization of fiscal incentives; review of the VAT System; tax on telecommunication; excise tax on petroleum products; institutionalization of an attrition system; and adoption of Gross Income Taxation (GIT). These legislative revenue measures are expected to increase the government's tax revenue stream from 12.5 percent of GDP in 2003 to 17.2 percent in 2010.<sup>1</sup> The increase in excise tax rates on alcohol and tobacco products was enacted into law under Republic Act (RA) No. 9334 on 23 December 2004 and took effect in January 2005. Meanwhile, the Lateral Attrition Bill was signed into law under RA 9335 on 25 January 2005. Similarly, the bill on the rationalization of fiscal incentives is with the Senate.

**Increase in excise tax rates on tobacco/cigarettes and alcohol products could lead to a temporary rise in inflation.**

The increases in excise tax rates under RA 9334 are as follows:

Increases in the Excise Tax		
Period	Tobacco/Cigarettes <sup>1/</sup>	Alcohol <sup>2/</sup>
Initial Year	12 percent + ₱0.40	20 percent
Succeeding two years until 2011	3.6 percent + ₱0.16	8 percent
<sup>1/</sup> Per pack of 20 sticks of cigarettes <sup>2/</sup> Per bottle or per liter of volume capacity		

<sup>1</sup> NEDA, Medium Term Philippine Development Plan 2004-2010

Relatively inelastic demand for a commodity implies that the price increase—due to higher taxes—can be passed on to the final consumer. The impact of higher excise tax rates on tobacco/cigarettes and alcohol products on the overall prices is determined by the magnitude of the increase in the tax rates and by the relative share or weight of these products in the total CPI basket. In addition, the extent to which additional amount of tax can be passed on to the final consumer depends on the price elasticity of demand for these commodities. Estimates of price elasticity of demand for fermented liquor and machine-packed cigarettes suggest that except for low-priced brands, these commodities are price inelastic with computed elasticities of less than one.<sup>2</sup> DOF estimates of elasticities range from 0.21 to -2.21 for fermented liquor and 0.47 to -0.57 for machine-packed cigarettes (see table below). This implies that demand for cigarettes/tobacco and alcohol products will not significantly be affected by changes in prices (such as those arising from higher tax rates). Thus, in estimating the impact of this tax measure on inflation, it is reasonable to assume that the increase in taxes would be borne entirely by consumers.

Due to data constraints, the analysis is limited to the measured price changes on fermented liquor and machine-packed cigarettes. These items account for relatively a small portion of the 2000-based CPI basket of about 1.6 percent.<sup>3</sup> However, the prices of fermented liquor and machine-packed cigarettes are on average, estimated to rise by about 8.84 percent from their pre-RA 9334 levels.

Estimates from 1994 Input-Output (IO) Model indicate that the 20 percent- and 12 percent-increase in the excise tax of alcohol and tobacco commodities, respectively, will raise the January inflation rate by about 0.14 percentage point and the 2005 full-year inflation by 0.08 percentage point.<sup>4</sup> Such inflationary impact is expected to taper over a 12-month period. This implies that the impact of the tax measure is not likely to lead to persistent pressures on prices.

<sup>2</sup> The price elasticity was estimated as the percentage change in volume—indicated by product removals—between 1999 and 2000 divided by the percentage change in price as a result of the 12 percent-increase in the excise tax rate (Source: Department of Finance).

<sup>3</sup> Due to unavailability of data on prices of wine, liquor, cigars and other tobacco products, data analysis was confined to only 1.6 percent, comprising the shares of beer and cigarettes only. The share of beer and cigarettes is about 0.4 percentage point short of the total share (1.97 percent) of alcohol products and tobacco. Hence, the impact on prices may be understated.

<sup>4</sup> These estimates do not capture the changes in consumer pattern as consumers' substitute between goods depending on their relative prices.

Item	CPI Weight 2000=100	Elasticity <sup>1</sup>	Weighted Price Growth Rate <sup>2</sup>	Estimated Impact on Inflation <sup>3</sup>
Machine-packed cigarettes	1.1610		10.26	
Net retail price per pack is:				
Below ₱5.00		0.47	14.38	
₱5.00, not over ₱6.50		-0.57	6.61	
Over ₱6.50, not over ₱10.00		-0.45	8.07	
over ₱10.00		n.a.	49.30	
Fermented Liquor	0.3969		7.43	
Net retail price per liter of volume capacity:				
less than ₱14.50		0.21	6.45	
₱14.50 up to ₱22.00		-0.50	7.19	
More than ₱22.00		-2.21	7.64	
Total	1.5579		8.84	
Impact on Inflation <sup>4</sup>				
1 <sup>st</sup> month				0.1439
Full-year				0.0779

<sup>1/</sup> The price elasticity was estimated as the percentage change in volume—indicated by product removals—between 1999 and 2000 divided by the percentage change in price as a result of the 12 percent-increase in excise tax.

<sup>2/</sup> The weights used are based on data on product removals for 2003.

<sup>3/</sup> The impact on inflation was estimated based on the computed sensitivity of inflation to for every one percent change in price of the given commodity multiplied by the weight of the commodity item in the CPI basket (2000=100) divided by the weight of the commodity in the I-O table

<sup>4/</sup> Impact on the first month inflation represents full impact with the inflation impact on the succeeding months decelerating cumulatively by 1/12 over a 12-month period to generate an average full-year impact of 0.08 percentage point.

## Conclusion

The expected increase in prices of selected commodities and its impact on the overall CPI arising from the new tax measure can be viewed as administrative or policy-induced movements in prices. Such price changes are not linked to cyclical demand conditions. The resulting change in prices is, therefore, outside the sphere or control of monetary policy. Under the inflation targeting framework of monetary policy, extraordinary movements in prices due to changes in government policies such as the implementation of new tax measures comprise one of the exemptions to the inflation target. These exemptions 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.<sup>5</sup>

<sup>5</sup> The exemptions to the inflation target are listed on page iii of this report.

**Financial Market Conditions**

*Appetite for local stock and government securities remain healthy.*

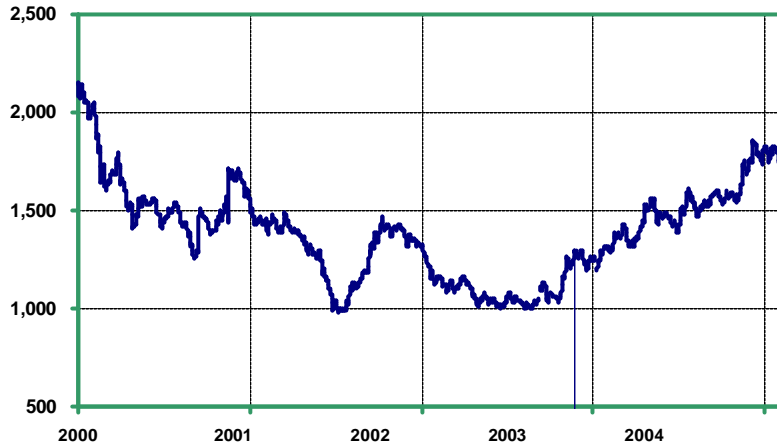
Trading in the domestic financial markets improved further in the fourth quarter of 2004, characterized by stronger demand for both local equities and government debt papers. Optimism in the local bourse has been helped by positive macroeconomic and corporate developments during the period, including the prospects of stable economic growth for 2005, among others. Ample liquidity in the financial system has also fueled appetite for government securities. The regular Tbill auctions generally received bids in excess of the offered amount, as banks looked for safe places to park their excess cash.

*Stock Market*

*Upbeat market sentiment buoys stock trading.*

Philippine share prices continued to strengthen in the last quarter of 2004, with the Philippine composite index (PHISIX) staying consistently well above the 1,700-level during the period. The PHISIX averaged 1,797.9 index points by end-October, carried on to its highest monthly average for the year at 1,802.3 index points for November, and 1,796.3 index points by year-end. The PHISIX attained its highest level for the year on 4 October 2004, reaching 1,851.6 index points; a record high for almost the past four years. Resilient GDP numbers for the third quarter, fueled by consumption and further growth in the services sector gave investors the impetus to invest in the local bourse. Moreover, the gains in share prices were supported by year-end accumulation and positioning on select stocks and the optimism generated by the passage into law of the bill raising the excise taxes on cigarettes, tobacco and alcoholic products on 23 December 2004.

**PSE Composite Index (Phisix)**



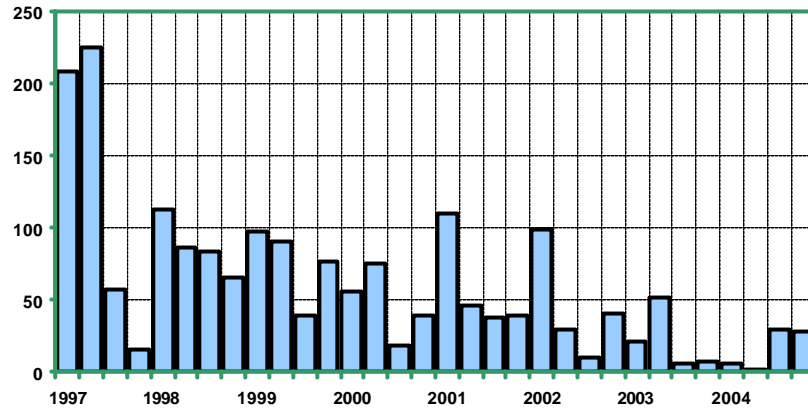
Philippine share prices are likely to advance further in 2005, as the robust consumer spending could provide a boost to corporate earnings. However, the continued threat of a credit downgrade by international credit ratings agencies due in part to the sizable budget deficit of the national government, as well as the specter of rising foreign interest rates may dampen optimism and future gains in the PHISIX.

*Government Securities*

*T-bill auctions continue to attract bids in excess of offered amount.*

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 fourth quarter of 2004. Total oversubscriptions for the quarter amounted to around ₱27.4 billion, slightly lower than the ₱28.7 billion posted in the third quarter. This resulted as the five regular T-bill auctions in the fourth quarter drew a total of ₱82.4 billion tenders as against the ₱55.0 billion total offering. The fourth quarter average oversubscription level of ₱5.5 billion was also higher than that of the seven auctions in the previous quarter of ₱4.1 billion. 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 ₱33.5 billion. However, this was ₱14.7 billion less than the ₱48.2 billion rejection in the third quarter.

**Oversubscription of Primary T-bill Auction**  
in billion pesos



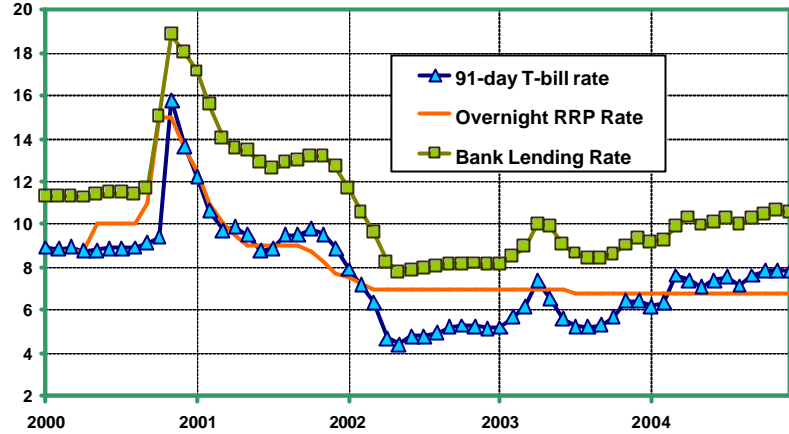
## II. Recent Monetary Conditions

### Interest Rates

*Market interest rates edge higher in the fourth quarter.*

Domestic interest rates were generally higher during the fourth quarter. The weighted average benchmark 91-day T-bill rate rose to 7.8 percent in the fourth quarter from 7.5 percent in the third quarter. The rise in T-bill yields reflected concerns over the continued rise in inflation, fiscal sustainability and the possible downgrade in the country's credit rating. Interest rates charged on bank loans followed the same upward trend during the quarter. From a range of 10.3-12.4 percent in September, average bank lending rates rose to 10.5-12.6 percent in December.

**91-day T-bill, BSP RRP rate and KBs Lending Rate**  
In percent

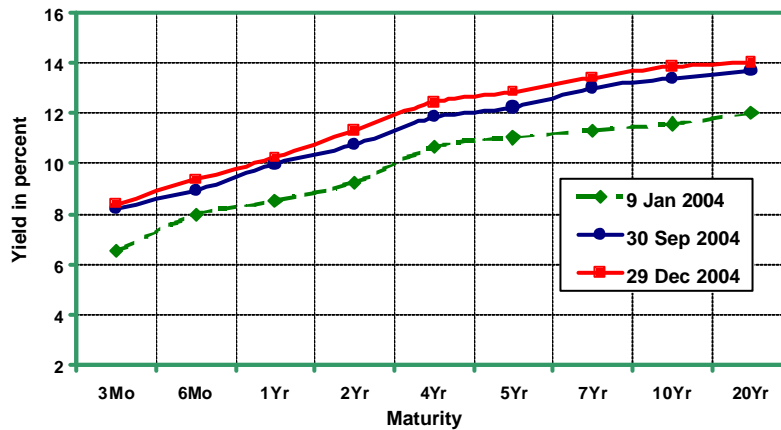


*Yield Curve*

*Yield for government securities in secondary market shifts upward.*

Reflecting the uptrend in market rates in the primary market, the yield curve for government securities in the secondary market as of 29 December 2004 shifted upward relative to that of 30 September 2004.

**Yield of Government Securities in Secondary Market**  
in percent



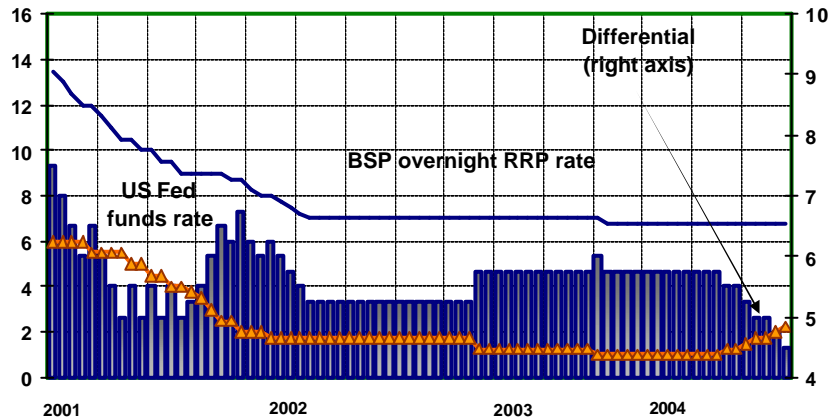
*Interest Rate Differentials*

***RP-US spreads narrow but remain at comfortable levels.***

Philippine interest rate differentials with those of the US have generally tightened compared to the third 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 418.9 basis points and 421.9 basis points, as of September respectively, to 372.8 basis points and 395.3 basis points as of end-December. 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 fourth 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 450 basis points as the US Federal Open Market Committee (FOMC) decided to raise the federal funds target rate by 25 basis points each on 10 November and 14 December 2004 to reach 2.25 percent. Meanwhile, the Monetary Board of the BSP opted to keep policy rates unchanged during the review quarter.

**BSP RRP Rate and US Fed Funds Rate**  
In percent



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 fourth quarter. The risk-adjusted differential narrowed to 54 basis points as of 30 December 2004 from 111 basis points registered on 30 September 2004, a result

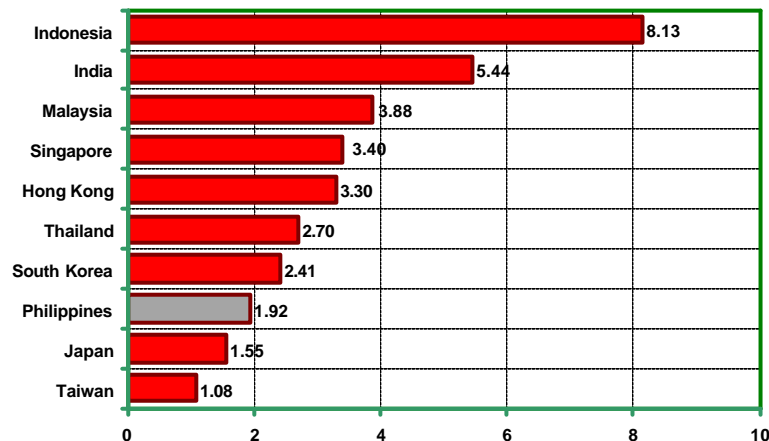
mainly of the upward adjustment in the US federal funds target rate in November and December 2004.

*Real Lending Rate*

***RP's real lending rate eases further in the fourth quarter.***

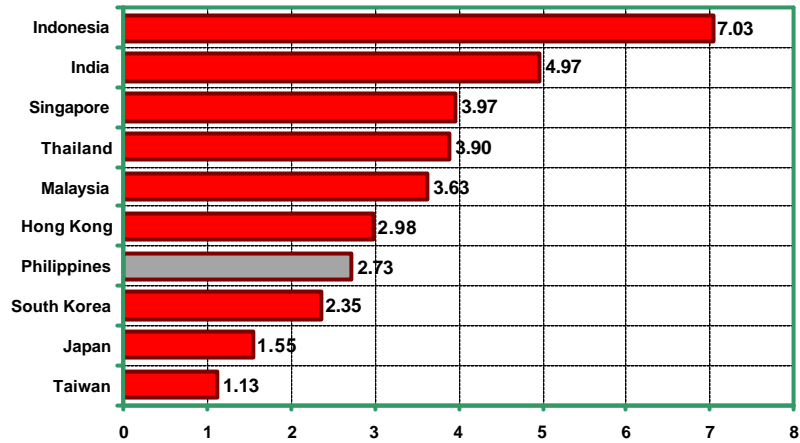
The real lending rate in the Philippines edged lower during the fourth quarter, declining from 2.8 percent in October to 2.5 percent in November and further to 1.9 percent in December to average 2.4 percent for the fourth quarter. This was due mainly to the higher inflation even as banks' lending rates also rose during the quarter. The average level was 92.4 basis points higher than the previous quarter's average of 3.3 percent. The Philippines' average real lending rate in December at 1.9 percent ranked the third lowest in a sample of 10 Asian countries with real lending rates ranging from 1.1-8.1 percent during the same period.

**Average Real Lending Rates: Selected Asian Countries**  
in percent



Meanwhile, the spread between the Philippine lending rate and the benchmark 91-day Tbill rate widened slightly to 273 basis points in December 2004, compared to 266 basis points in September 2004, due mainly to the larger increase in the average lending rate. Among the 10 Asian countries surveyed, the Philippines ranked the fourth lowest in terms of the spread between lending rates and benchmark interest rates.

**Spread of Lending Rates over Benchmark Rates**  
in percent



**Exchange Rate**

*The peso depreciates but is less volatile during the fourth quarter.*

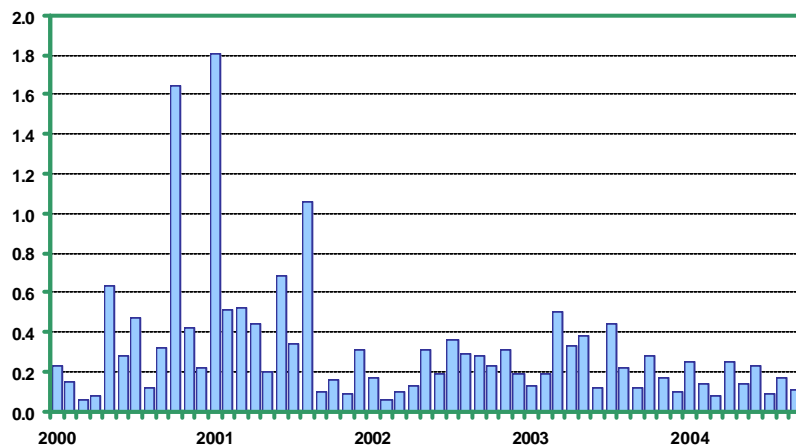
The peso weakened slightly relative to the US dollar during the fourth quarter of 2004, averaging ₱56.34/US\$1 at end-December 2004 from the end-September level of ₱56.28/US\$1. The slight depreciation of the peso against the US dollar was due largely to higher dollar demand by corporates to service end-quarter and end-year obligations as well as to cover import requirements. Market apprehensions of a possible sovereign credit rating downgrade and persistent concerns over the country’s fiscal situation also put pressure on the peso. Moreover, external developments, particularly the volatility in world oil prices contributed to the depreciation of the peso. However, the peso’s fall was tempered by the strong remittance inflows by overseas Filipino workers (OFWs) and sustained economic growth momentum. The marked weakness of the US dollar also partly curbed the depreciation of the peso.

**Daily Peso-US Dollar Rate**



The peso was less volatile during the review period, with the standard deviation of the daily exchange rates declining slightly to ₱0.10 from ₱0.11 at end-September.

**Volatility of the Peso**  
Monthly Standard Deviation



Compared to its level at end-December 2003, the peso-dollar rate depreciated by 1.39 percent as of 29 December 2004, along with the Indonesian rupiah (9.41 percent). The same period saw most of the Asian currencies appreciating vis-à-vis the US dollar, including the South Korean won (14.53 percent), the New Taiwan

dollar (6.28 percent), the Japanese yen (3.87 percent), the Singapore dollar (4.03 percent), and the Thai baht (1.43 percent).

CHANGES IN SELECTED DOLLAR RATES	
Currencies	Appr/Depr(-) from 31 December 2003
South Korean won	14.53
New Taiwan dollar	6.28
Singapore dollar	4.03
Japanese yen	3.87
Thailand baht	1.43
Philippine peso	(1.39)
Indonesian rupiah	(9.41)

*External competitiveness improves on a real, trade weighted basis following the nominal depreciation of the peso.*

On a real, trade-weighted basis, the peso gained external price competitiveness relative to the currencies of its major trading partners as shown by the 1.92 percent depreciation in its REER index during the same period. The peso likewise posted real depreciations over the same period relative to two sets of currencies of the Philippines' competitor countries. The REER for the broad and narrow baskets of competitor countries declined by 2.2 percent and by 1.44 percent, respectively. The depreciation in the peso's REER relative to the currencies of the country's MTPs and competitor countries were due to the combined effects of the nominal depreciation of the peso and the narrowing of the price differentials between the peso and the three baskets of currencies. Overall, these developments indicate the sustained external price competitiveness of the county.

*Steady inflows of OFW remittances and favorable export prospects should help keep a relatively stable peso in 2005.*

The peso is expected to exhibit relative stability in 2005, broadly in line with the Government's 2005 expectations of ₱55-57/US\$1. Sustained remittances by OFWs as well as steady export performance, forecasted to grow by 6.0 percent and 10.0 percent, respectively, in 2005, are expected to provide support to the peso.

Moreover, the performance of the peso in 2005 is expected to be influenced by both domestic and external factors. In the domestic front, the approval by Congress of more revenue-raising measures to improve the country's fiscal scenario and forestall a possible credit rating downgrade is expected to have a positive impact on the peso. On the other hand, apprehensions over the volatility in world oil prices may exert pressure on the peso, as the country

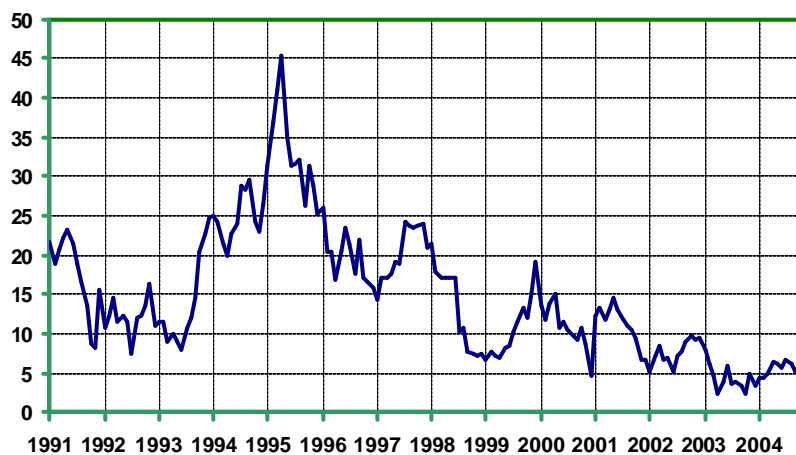
imports an estimated 84.6 percent of its oil requirements.<sup>8</sup> These concerns intensified with the Organization of Petroleum Exporting Countries' (OPEC) decision to cut back on oil production effective 1 January 2005 due to the observed decline in world crude prices.<sup>9</sup>

**Monetary Aggregates**

*Demand for money continues to rise, though still at a modest pace.*

Demand for money continued to grow in the fourth quarter as reflected by the average year-on-year growth in M3 at 6.3 percent. This was a slight improvement from the average growth rate of 6.0 percent posted in the previous quarter. The continuing increase in M3 could be traced mainly to the sustained expansion in the net foreign assets (NFA) of the monetary system—consisting of the BSP and the banking system—and the improvements in the levels of domestic credits of both the public and private sectors. Net purchases of foreign exchange by banks and other corporates combined with the reduction in foreign liabilities of the BSP and the banking system—due to net repayments of their foreign-denominated obligations—helped beef up the NFA position of the monetary system.

**Domestic Liquidity**  
Annual Growth Rate in percent



<sup>8</sup> Department of Energy (DOE) estimate for 2004.

<sup>9</sup> Press Release, 133<sup>rd</sup> Meeting of the OPEC Conference, 10 December 2004.

Meanwhile, the 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 Treasury (BTr) and banks' reserve balances with the BSP) declined to an average of 7.2 percent for October-December 2004 from 9.9 percent in the third quarter of 2004.

## Banking System

*Banking system remains generally stable.*

The Philippine banking system during the period remained buoyant notwithstanding the challenges of modest demand for loans, persistent asset quality concerns and fiscal position. Data for the period under review showed general improvement in key banking indicators. The banking system's total resources aggregated ₱4,112 billion as of October 2004, slightly higher by 0.25 percent than the 4.101 billion posted in September 2004 and a much higher increase of 11.1 percent compared to the year-ago level of ₱3,700 billion. The modest growth in the system's resources may be traced to the continued expansion in investments and loans and discounts, as well as other asset accounts of commercial banks.

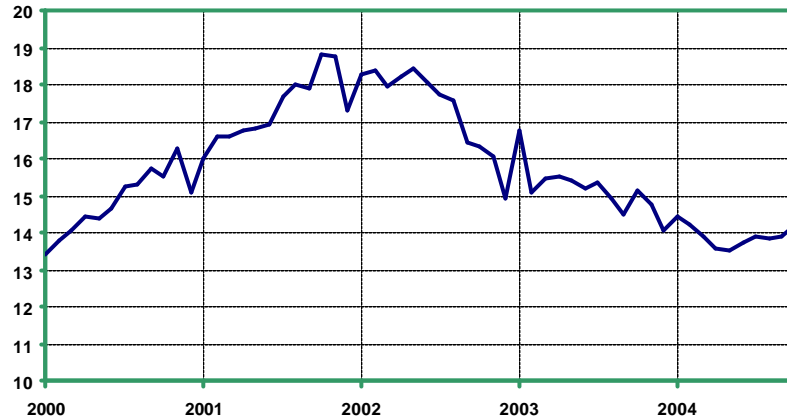
### *Asset Quality*

*Asset quality improves.*

With modest credit expansion, commercial banks' asset quality improved steadily as the non-performing loans (NPL) ratio declined to 13.7 percent as of end-November 2004 compared to the level a year ago of 14.9 percent. The decrease in the ratio during the period was mainly due to the 3.5 percent increase in total loan portfolio and the 4.9 percent decline in NPLs. Compared to those of other countries in the region, the Philippines' NPL ratio was higher than Thailand's 11.6 percent, Malaysia's 7.3 percent, Korea's 2.2 percent and Indonesia's 6.9 percent.<sup>10</sup> The lower NPL ratio in other Asian countries may be traced to the publicly-owned asset management companies' (AMC) purchases of the bulk of their NPLs. Despite the improvements, the country's NPL ratio remains relatively high. The BSP continues to encourage banks to clean up their balance sheets of non-performing assets through private special purpose vehicles (SPVs).

<sup>10</sup> Source: ARIC Financial Indicators, ADB website. Thailand (October 2004, commercial banks), Malaysia (October 2004, commercial banks); Korea (June 2004, commercial banks); and Indonesia (September 2004, financial system).

**Non-Performing Loans of Commercial Banks**  
 Percentage of Total Commercial Bank Loans



*Efforts to unload non-performing assets gain momentum.*

After starting at a slow pace, availment of incentives under the Special Purpose Vehicle (SPV) Act of 2002 to dispose of non-performing assets (NPAs) is finally gaining momentum. As of September 18, 2004, the deadline for registration of SPVs with SEC, thirty-six (36) SPVs were registered making them eligible to acquire NPAs until 8 April 2005. This is a good indication that banks are pursuing serious efforts to unload their NPAs under the SPV Law.

As of end-2004, the BSP had issued one hundred twenty-one (121) Certificates of Eligibility (COEs) involving a total amount of ₱26.2 billion worth of NPAs transferred under the SPV Law. One hundred nineteen (119) COEs were issued to 22 financial institutions (21 banks and 1 non-bank). In addition, two (2) COEs were issued for the sale of the non-performing loan (NPL) of National Steel Corp. (NSC) by a consortium of creditors represented by PNB in the amount of ₱11.050 billion. In a period of three months, the amount of NPAs transferred under the said Law increased from ₱4.5 billion as of end-September 2004 to ₱26.2 billion as of end 2004.

The COEs issued so far involve various transactions such as the sale of ROPOAs of banks to individuals, settlement of NPLs by *dacion en pago* and bulk sale of NPAs to SPV. To date, none of the SPVs established by banks has been a party to the bulk sale of NPAs.

The BSP is likewise processing applications for COEs from five (5) banks involving bulk sale of ₱53.8 billion worth of NPAs. If the NPAs qualify under the SPV Law, this will bring the total amount of NPAs transferred under the Law to ₱80 billion which is close to the immediate target of ₱100 billion.

*Loan-loss Provisions*

Notwithstanding the decline in banks' NPL, banks' loan exposure remained adequately covered as the banking system's NPL coverage ratio<sup>11</sup> remained steady at 53.3 percent as of November 2004, reflecting banks' diligent compliance with the loan-loss provisioning requirements of the BSP as a cushion against possible losses.

*Capital Adequacy*

***Capital adequacy ratio exceeds statutory level set by the BSP and the BIS.***

Using the new risk-based framework, the KB's capital adequacy ratio (CAR)—a measure of net worth-to-risk assets—increased to 18.3 percent as of March 2004 from 17.35 percent in December 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>12</sup> The high CAR reflects the banking system's improved ability to cover risky assets.

So far, the Philippines' CAR was relatively high compared to that of Malaysia (13.9 percent), Thailand (12.7 percent) and Korea (10.9 percent).<sup>13</sup> Indonesia posted the highest CAR in the region with 20.5 percent as of September 2004.

*Bank lending*

***Growth in bank lending is still modest.***

Loans outstanding of commercial banks (KBs) grew by 3.6 percent year-on-year to ₱1.543 trillion as of end-November 2004, following a similar increase in October. On a month-on-month basis, total KB loans increased by 4.2 percent in November, a reversal from

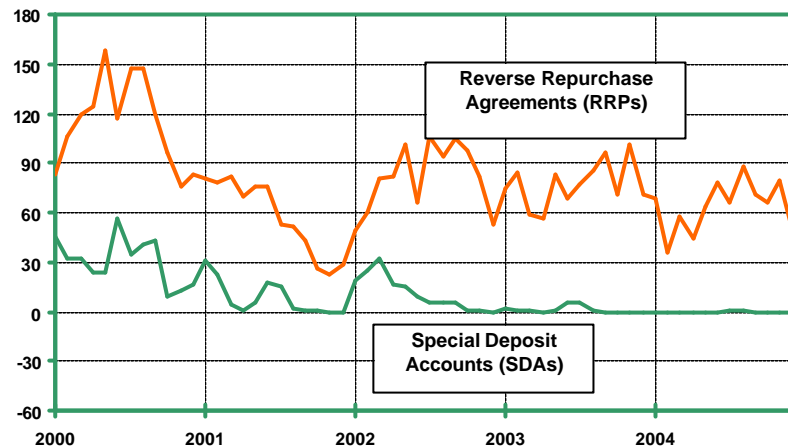
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<sup>11</sup> Computed as the ratio of loan loss reserves to the NPL level, based on the new framework provided for by BSP Circular No. 351.  
<sup>12</sup> BSP Circular No. 280, dated 29 March 2001, approved the guidelines for the adoption of the risk-based capital adequacy ratio along the criteria prescribed by the Bank for International Settlements (BIS).  
<sup>13</sup> Source: ARIC Financial Indicators, ADB website. Commercial banks CAR: Malaysia (October 2004); Thailand (October 2004); and Korea (June 2004).



placements under the special deposit accounts (SDAs) as of end-December 2004.

**Banks' Placements with the BSP**  
in billion pesos



### III. External Developments

*The global economic growth is moderating but overall prospects remain generally favorable.*

Global economic growth continued to show signs of moderation but overall economic activity remained robust. Industrial production and private consumption appeared to have slowed down in most economies while export gains tapered off due mainly to the weakening of the US dollar. Meanwhile, business investment registered a robust rate of expansion in most economies. Stronger inflationary pressures are expected to persist over the short term owing to the volatility in world oil prices, but the medium-term outlook remains in line with price stability. Against this background, the overall prospect for sustaining the global economic growth and Philippine external demand remains generally positive. However, the presence of global imbalances, such as the large fiscal and current account deficits of the US, alongside the continued volatilities of world oil prices and global transition towards higher interest rates present downside risks to the outlook.

*US economy continues with its solid recovery but certain vulnerabilities remain.*

- ? The US economy continued to show strength but certain vulnerabilities remain. Revised estimates indicate that the US economy grew faster than expected in the third quarter as growth of the real gross domestic product increased to 4.0 percent from 3.3 percent in the previous quarter. Consumer spending rose strongly in the recent months boosted by the recent gains in jobs and earnings while business investments maintained a robust rate of expansion owing to the generally solid performance of the manufacturing sector. Labor market conditions likewise improved considerably, as evidenced by the broad-based growth in jobs creation during the quarter. On the price front, price pressures stemming from oil price developments appear to remain fairly well contained despite the recent rise in headline inflation. Going forward, the mounting budget and current account deficits could dampen prospects for sustained economic growth in case foreign investors eventually slow down accumulation of dollar-denominated assets to finance the deficit. At the same time, there are concerns over the sustainability of brisk consumer spending given the uneven gains in jobs creation and earnings growth.
  
- ? Economic recovery in the Euro area lost some momentum on weaker export gains and subdued private consumption. Real GDP growth moderated to 0.3 percent in both the Euro-zone and EU25 during the third quarter of 2004 from the previous quarter's growth of 0.5 percent and 0.6 percent in the respective zones. The weaker production growth in the industries and services sector contributed to the economic slowdown as well. Meanwhile, investment growth accelerated and inventories were built up. Euro-zone and EU25 annual HICP inflation eased slightly to 2.2 percent in November compared to previous month's level of 2.4 percent and 2.3 percent, respectively. Despite this, upward pressures on the short-term outlook for inflation are expected to persist owing to the sizeable impact of oil price developments on consumer prices. The ECB noted, however, the lack of evidence pointing to the build-up of inflationary pressures over the medium term as wage growth appears limited and real GDP growth remains moderate. Going forward, conditions for continued economic recovery remain in place with the favorable financing conditions, greater corporate

efficiency, and gradual improvements in earnings in the Euro area.<sup>14</sup>

***British economy moderates.***

- ? UK economic growth moderated in the third quarter of 2004 on account of a significant investment decline alongside flat consumption growth. UK real GDP growth slowed down to 0.5 percent following the 0.9 percent rise posted in the previous quarter. Gross fixed capital formation declined by 0.1 percent from a rise of 2.4 percent in the second quarter while household expenditure growth was steady at 0.6 percent compared to previous quarter. The weaker expansion was also linked to the output contraction in the production sector. Annual inflation remains well below the target but is on an uptrend. Despite the observed economic slowdown, most analysts held the view that the UK economy is set to grow around its trend rate over the next two years with inflation possibly exceeding the government's target as tight labor market conditions translate to higher wages.<sup>15</sup>

***The Japanese economy remains on a recovery track.***

- ? The Japanese economy remained on a recovery trend despite weak movements in industrial production and exports. Real gross domestic product (GDP) grew by 0.1 percent quarter-on-quarter in the third quarter of 2004 following a contraction of 0.1 percent in the previous quarter. The slowdown in global electronic demand due in part to the "soft patch" in the US economy in the second quarter translated into weaker demand for electronics which resulted in lower export-demand and related inventory adjustments for Japan. Meanwhile, business fixed investment remained on a general uptrend with the observed improvement in corporate profits. Private consumption rebounded slightly as household income showed some positive movements. Despite the minimal increase in consumer prices in September and October, the BOJ expects consumer prices to continue falling slightly on a year-on-year basis, as supply and demand conditions remain relatively soft. On the whole, the recovery of Japanese economy is expected to

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

<sup>15</sup> The Futures Market, "UK Economic Growth to Slow to 2.8% in 2005 from 3.2 in 2004-NIESR", 28 October 2004, available online at <http://www.futures.fxstreet.com/Futures/news/afx>

continue further depending on future developments in IT-related demand and the volatility of crude oil prices.<sup>16</sup>

*China stays at the forefront of growth in East Asia.*

? East Asia recorded strong growth in the latter part of 2004, driven by rapid increases in exports and continued strength in domestic demand combined with improved consumer and business confidence. The seven big economies of the region posted an average annual GDP growth rate of 7.4 percent in the third quarter of 2004 following the 8.1 percent rise in the previous quarter. China continued to lead the regional expansion even as real GDP growth slowed down slightly to 9.1 percent from 9.6 percent in the previous quarter.<sup>17</sup> Domestic demand remained robust with the continued—albeit slower—rise in fixed investment and robust consumption expenditure. At the same time, the agriculture sector is expected to perform strongly in the autumn cropping given the Chinese Government’s direct and effective policy measures to support the agriculture sector. Consumer prices have subsided in the recent months, due in part to the slowdown in oil and food prices. Annual inflation eased to 2.5 percent in November after averaging 4.4 percent in the second and third quarters of 2004. Going forward, the region is expected to demonstrate a moderate, yet solid, growth performance, consistent with the expected economic slowdown in the world’s major economies and macro control measures put in place to slow down China’s economy.

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

Given the sustained output expansion and the potential price pressures, the US Fed decided to raise its policy rates by 25 basis points during its latest policy meeting. By contrast, monetary authorities in Japan, Euro area and England kept their monetary policy settings unchanged during the quarter in review.

? In its meeting on 14 December 2004, the US Federal Open Market Committee (FOMC) decided to raise its target for the federal funds rate by 25 basis points to 2.25 percent. The Fed, however, maintained its view that the stance of the monetary policy remains accommodative, and coupled with the robust underlying growth in productivity, it will continue to provide

<sup>16</sup> Bank of Japan, “Monthly Report of Recent Economic and Financial Developments”, 17 December 2004, available online at <http://www.boj.or.jp/en>

<sup>17</sup> Asian Development Bank, “East Asia’s Growth and Restructuring – A Regional Update”, December 2004, available online at <http://www.aric.adb.org>

support to economic activity. The FOMC noted further that the balance of risks to the attainment of sustainable growth and price stability for the next few quarters 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>18</sup>

- ? On 2 December 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 deposit facility steady at 2.0 percent, 3.0 percent, and 1.0 percent, respectively. The Council noted that while oil price developments have had a sizeable impact on consumer prices this year, there is no clear and preponderant evidence yet that stronger underlying inflationary pressures are building up over the medium-term.<sup>19</sup>
- ? On 8-9 December 2004, the Bank of England’s (BOE) Monetary Policy Committee voted to maintain the BOE's key repo rate at 4.75 as latest data and surveys suggest that domestic activity has remained broadly in line with Staff projections along weaker than expected world activity and oil prices.<sup>20</sup>
- ? At its Monetary Policy Meeting held on 16-17 December 2004, 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>21</sup>

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<sup>18</sup> Federal Reserve, FOMC Statement dated 10 November 2004, available online at <http://www.federalreserve.gov/boarddocs/press/monetary/2004>

<sup>19</sup> European Central Bank, Introductory statement to the ECB Press Conference on 2 December 2004 by ECB President Jean-Claude Trichet, available online at <http://www.ecb.int>

<sup>20</sup> Bank of England, Minutes of the Monetary Policy Committee Meeting, 22 December 2004, available online at <http://www.bankofengland.co.uk/mpc/mpc0412.pdf>

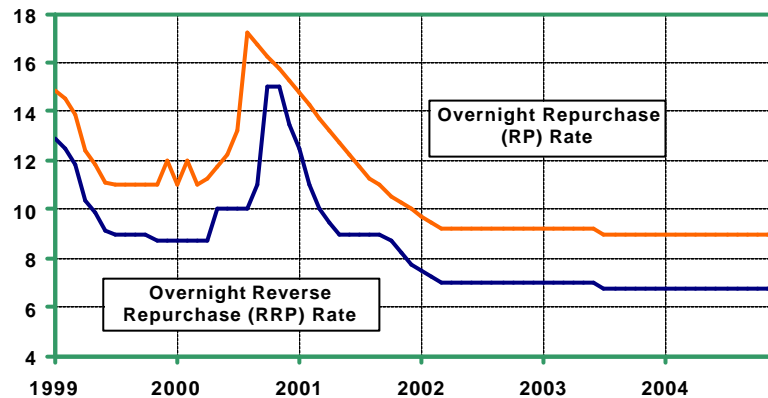
<sup>21</sup> Bank of Japan, Statement of Monetary Policy dated 17 December 2004 available online at <http://www.boj.or.jp/en/seisaku/seisaku>

## IV. Monetary Policy Developments

*BSP maintains monetary policy settings in the fourth quarter.*

The Monetary Board—the policy-making body of the BSP—met three times during the quarter and had voted unanimously on each scheduled meeting to maintain the BSP’s key policy rates at current levels. The overnight reverse repurchase rate (RRP) or borrowing rate was left unchanged at 6.75 percent while the overnight repurchase rate (RP) or lending rate was maintained at 9.0 percent. These key interest rates were last changed on 2 July 2003.<sup>22</sup>

**BSP Policy Interest Rates**  
In percent



*Inflation is expected to ease to the 4-5 percent range by 2006.*

In the regular press statements issued by the BSP following each monetary policy meeting, the Monetary Board emphasized that despite the higher outturns for both headline and core inflation, their assessment of the inflation dynamics remains unchanged as in the previous quarter. The members of the Monetary Board noted that while actual inflation exceeded the 2004 target of 4.0-5.0 percent with the possibility of a continued breach in 2005, inflation is nevertheless expected to revert back to the 4.0-5.0 percent range by 2006. The overall pattern of price data remained consistent with the assessment that (1) the ongoing pressures on inflation remained tied to supply-side influences and (2) the likely path of future inflation will be hump-shaped. This view conforms to previous experiences involving episodes of oil- and food-driven

<sup>22</sup> Please refer to the Chronology of Monetary Policy Decisions for a listing of the dates of the monetary policy meetings of the Monetary Board and their corresponding decisions on the BSP’s policy stance.

supply-side inflation, during which inflation tended to quickly revert to manageable trend after a brief upsurge.

*Supply-side factors are of central influence to the inflation dynamics.*

The members of the Monetary Board believed that current price and output conditions support keeping the policy settings unchanged. Current price pressures continued to be linked primarily to supply-side rather than demand-side factors such as the increases in commodity prices, chiefly food and oil. Looking forward, monetary authorities were of the view that supply-side factors will continue to be the central influence on the inflation outlook, particularly the volatility in global oil prices. However, of recent, somewhat easing conditions in the world energy markets have already led to a downward shift in the projected inflation path, particularly in the months leading to 2006. In addition, direct policy action undertaken by government agencies such as Department of Agriculture (DA) and the Department of Trade and Industry (DTI) appeared to have resulted into notable gains in food prices.

*Demand-side pressures on prices are limited by the presence of some slack in resource utilization.*

The members of the Monetary Board noted that demand-side pressures are kept largely at bay by the continued presence of slack in resource use. They pointed out that growth in domestic demand, as evidenced by strong consumption spending and increased merchandise trade activity, continued to be accompanied by sizeable unemployment and moderate lending activity.

*Any policy decision at this point must be geared towards safeguarding the 2006 target.*

The members of the Monetary Board also recognized that monetary policy decision normally requires 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 will have only a minimal impact on 2004-2005 inflation. Prospective decisions should therefore be oriented towards safeguarding the 2006 inflation target.

*Despite the increases in foreign interest rates, differentials between local and foreign rates are still at comfortable levels.*

With reference to the continued rise in foreign interest rates and the tightening stance pursued by major central banks, the members of the Monetary Board believed that current differentials between domestic and foreign interest rates remained at comfortable levels. Moreover, exchange rate movements continued to be relatively stable despite the observed narrowing of interest rate differentials.

*The Monetary Board is prepared to undertake a monetary policy action as necessary.*

Against this backdrop, members of the Monetary Board also indicated its readiness to undertake necessary monetary policy action. They pointed out that the observed rise in both headline and core inflation measures could signal persistent movements in prices, which could impact adversely on inflation expectations. Thus, the readiness to undertake a properly calibrated policy response by monetary authorities will help contain the possible spill-over effects of short-term rise in inflation into long-term inflation expectations. The Monetary Board believed monetary policy action may be undertaken when the available evidence begins to point more strongly to the following conditions: (1) the emergence of demand-side pressures on consumer prices; (2) the emergence of inflationary pressures that are over and above those generated by ongoing supply shocks; and (3) increased risk of possible exchange rate market pressures arising from narrowing interest rate differentials which could feed into inflation and inflation expectations. At the same time, members of the Monetary Board also expressed its continued support for non-monetary intervention in the importation, distribution and delivery of goods and services.

## V. Inflation Outlook

### Inflation Forecasts

*Inflation may remain above target in 2005 but will revert to the 4-5 percent range in 2006.*

Based on its assessment of demand and supply conditions, the BSP expects inflation to remain above target in 2005 but revert to the 4-5 percent range in 2006. Inflationary pressures emanated largely from the supply side in the light of the impact of recent typhoons on food supply and uncertainty in the trend of world oil prices. Meanwhile, on the demand side, overall output conditions still indicate slack in the economy. The growth in domestic demand, as evidenced by the strong growth in consumption spending as well as increased energy sales and merchandise trade activity, continue to be accompanied by indications of slack in economic activity, notably sizeable unemployment and moderate lending activity. Reduced business and consumer optimism (as shown in the recent BSP's Business and Consumer Expectations Survey) as well as slower global economic activity, which imply

downside risks for external demand, could also dampen the outlook for economic activity.

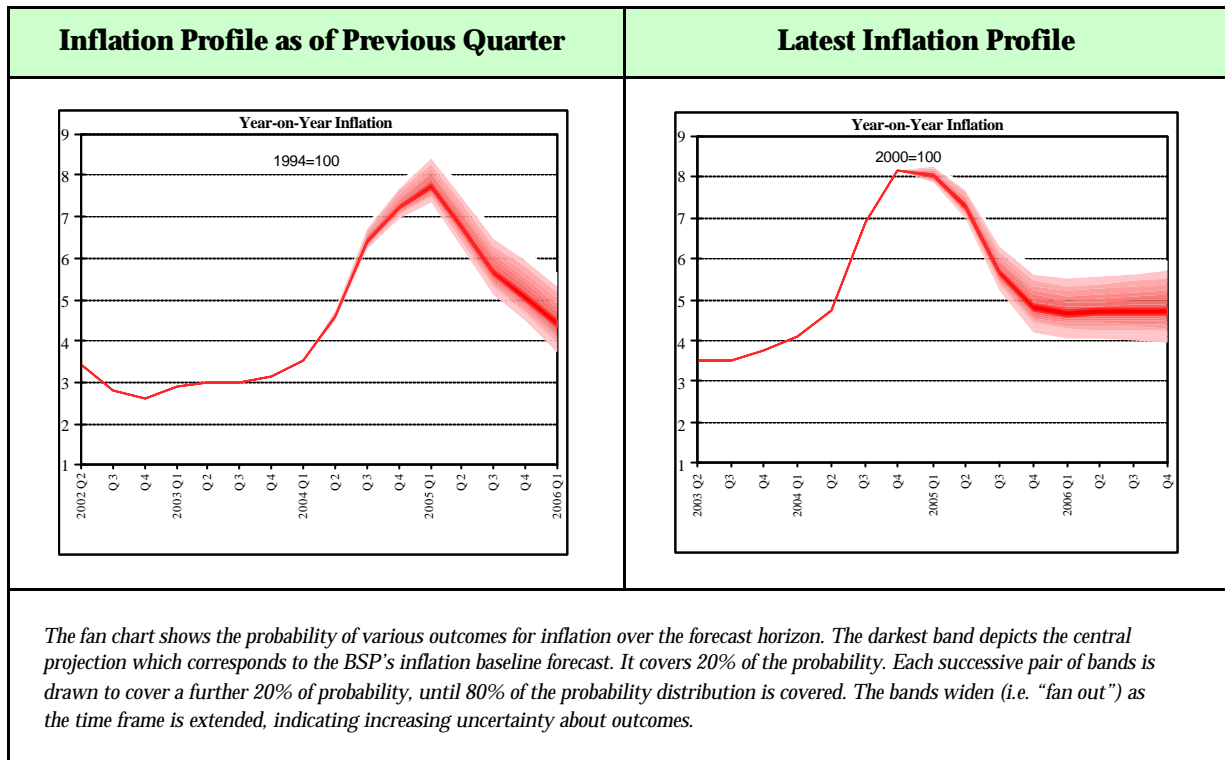
Using the 2000-based CPI series, the BSP forecasts that average headline inflation will continue to surpass the 4-5 percent for 2005. The BSP's forecasts are based on the following assumptions:

- 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 6.5-7.5 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 December 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 16 December 2004, based on futures prices) of US\$33.55 for 2004, US\$34.93 for 2005, and US\$33.81 for 2006;

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

*Uncertainty in the trend of oil prices, constraints on food supply as well as volatile movements in the foreign exchange market could pose 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. The current fan chart is based on the 2000-based CPI series and extends the inflation profile until the fourth quarter of 2006. As the trend of world oil prices began its descent in the fourth quarter of 2004, inflation is expected to taper off by the first quarter of 2005. Barring any adverse shock on oil and food supply, inflation will continue its downtrend to settle within the 4-5 percent target by the fourth quarter of 2005.



Nevertheless, the risks to the inflation outlook remain. These include the uncertainty in the trend of oil prices, prospects on food supply and possible volatile movements in the peso-dollar exchange rate.

*Uncertainty in the trend of oil prices*

While world oil prices have begun to soften during the fourth quarter of 2004, the decline in oil prices could be reversed by the lingering fears of terror attacks in the Middle East, existing demand for heating oil related to the ongoing winter season and the OPEC's decision to cut oil production by 1.0 mb/d effective 1 January 2004.

*Prospects on food supply*

The typhoons in the fourth quarter and the threat of El Niño phenomenon could dent agricultural growth which could, in turn, constrain food supply. Nonetheless, the Department of Agriculture has drafted a rehabilitation plan to help replenish

crops damaged by the typhoons and to ensure the achievement of the annual targets for rice and corn production. To help farmers recover their losses due to the typhoons, the DA will be providing seeds to farmers of typhoon-affected areas. Moreover, recent weather readings (such as the Southern Oscillation Index (SOI) and sea surface temperature) indicate a weak form of El Niño phenomenon. To mitigate the impact of El Niño on the agricultural sector, the DA has proposed a budget of ₱644 million for the intervention measures against El Niño, of which about ₱420.0 million for seed procurement and assistance program already forms part of the existing budget of the GMA Rice and Corn Program.

#### *Movements in the peso-dollar exchange rate*

The movement of the peso-dollar exchange rate depends on both domestic and external factors. On the domestic front, the passage of revenue-raising measures to alleviate the country's fiscal position and prevent a possible credit rating downgrade could prop up the local currency. On the external front, concerns over the volatility in world oil prices could also weigh down on the peso.

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

*Private forecasters see higher inflation and confirms expectations of strong output growth in 2005.*

Forecasters from the private sector see inflation to remain high in 2005 as the full impact of higher world oil prices and adjustments in utility charges and transport fares. In addition, the increase in excise taxes on cigarettes and alcohol products as well as the potential increase in the value added tax (VAT) on goods and services could also translate into higher prices. Concerns over the swift implementation of the government's fiscal reforms as well as the gradual increase in the US Fed fund target rate were also cited as factors that may affect negatively the general price trends for the year. Results from an informal poll of various private institutions show that the mean inflation forecasts of 6.3 percent (1994=100) for 2005 and 5.3 percent in 2006. This is partly comparable to the BSP's forecast of a downtrend in inflation in 2006 to about 4.5 percent.

On the outlook for economic growth, the survey of private analysts show that real GDP is expected to grow by 4.9 percent

in 2005, the low end of the Government's growth target of 4.9-5.8 percent for the year. The strong growth in global demand feeding into the country's exports, especially that of semiconductors, tourism and foreign investments are seen to help fuel overall demand. Private analysts also expect that the vibrance of the country's telecommunications and IT sectors will contribute largely to the country's economic growth. With the increase in jobs created in business processing outsourcing (BPO) and call centers, the strong growth forecast is likewise expected to continue in 2006.

<b>Private Forecasts for GDP and Inflation for 2005 and 2006</b>						
	<b>GDP</b>		<b>Inflation 1994 (Base Yr)</b>		<b>Inflation 2000 (Base Yr)</b>	
	<b>2005</b>	<b>2006</b>	<b>2005</b>	<b>2006</b>	<b>2005</b>	<b>2006</b>
Equitable-PCI	5.3	6	7.5	6.5		
Banco de Oro	5.5		7.5			
BPI	5.0		6.5			
CEMEX	4.4					
Credit Lyonnais SA	3.0		7.5			
Deutsche Bank	4.2		6.5			
DBS	4.5		5.0			
Citibank	4.0		8.5			
Multinational Investment	6.6 (6.5-6.7)		5.8 (5.5-6.0)		5.5-6.0	
Wallace Business Forum	5.0	5.4	5	4.7		
University of Asia & the Pacific	5.2	5.4	5.6	4.6		
UBS Warburg	4.5		6.0			
Makati Business Club			5.3			
Metrobank	5.75(5.4-6.1)		6.7(6.3-7.1)			
Nomura Securities	4.3		4.8			
ING Bank	5.2	5.0	6.8	5.4		
Land Bank	5.0		6.0			
ATR Kim Eng Securities	5-6		6.5			
UP School of Economics						
Median Forecast	5.0	5.4	6.4	5.4	5.8	
Mean Forecast	4.9	5.5	6.3	5.3	5.8	
High	6.6	6.0	8.5	6.5	6.0	
Low	3.0	5.0	4.8	4.6	5.5	
Number of observations	17	4	17	4	1	
Memo Item:						
Government Target			4.0-5.0	4.0-5.0	4.0-5.0	4.0-5.0

## VI. Implications for the Monetary Policy Stance

*Inflation in 2004 is a predominantly supply-side phenomenon.*

The uptrend in inflation in 2004 and the eventual breach of the inflation target may be best described as a predominantly supply-side phenomenon. The worldwide increase in oil prices in 2004 that pushed up transport costs and other prices as well as the spate of typhoons and domestic supply constraints that affected the availability of certain food items comprised the supply shocks to prices during the year. Supply shocks are events or disturbances that either cause increases in the cost of producing goods and services or reduce the supply of the same goods and services available in the economy. Changes in central bank policy interest rates as a rule cannot be used to offset the impact of such disturbances on prices, because monetary action affects inflation mainly by influencing demand. Increases in the BSP's policy interest rates tend to, among other things, reduce bank lending and investment spending, which are components of aggregate demand. In 2004, aggregate demand was on the whole uneven despite strong consumption spending. The growth in bank lending, in particular, was slow, while unemployment was cyclically high. This meant that the risk of demand-driven inflation pressures, or demand-pull inflation, was relatively low and did not support the need for monetary tightening.

*The effects of the BSP's monetary decisions on the economy are not instantaneous but with a lag.*

In determining the appropriate monetary policy stance, going forward, it is important to recognize that the effects of monetary decisions by the BSP on the economy are not instantaneous. Rather, they reach their maximum only after a certain time lag (currently estimated at 15-21 months). Because of this transmission lag, monetary assessment under the inflation targeting approach needs to be forward-looking and focus on the outlook for inflation rather than on contemporaneous price data.

*Decisions at this point will be oriented mainly toward safeguarding the 2006 inflation target.*

Prospective decisions will thus be oriented mainly toward safeguarding the 2006 inflation target, since monetary actions undertaken at this point will primarily affect inflation in 2006 and have only a minimal impact on 2005 inflation.

*Although current inflation is rising, future inflation is on a downtrend.*

More importantly, the latest evidence indicates that although current inflation is rising, future inflation is on a downtrend. Inflation is expected to follow a declining trend over the next few quarters, beginning as early as March, and is likely to settle around 5 percent by the fourth quarter of 2005. The 2005 inflation target is still likely to be exceeded, but average inflation in 2006 should fall within the range target. Taken with evidence of slack in the economy and the potential risk of a slower pace economic activity, such prospects would argue for keeping policy interest rates unchanged.

*However, the outlook for prices is not altogether risk-free.*

On the other hand, the outlook for prices is not altogether risk-free. Supply-side pressures from oil prices and other sources continue to loom over the policy horizon, and the risk of demand-side effects from these supply shocks could very well increase in the near term and spill over into wage- and price setting behavior. The price pressures reflected in the observed rise in NSO- and BSP-generated core inflation measures exemplify this risk and thus merit closer attention.

*The outlook for inflation supports keeping monetary policy settings unchanged, but also argues for continued readiness by authorities to act quickly against spillover demand-side pressures.*

In sum, the outlook for inflation and other economic evidence support keeping the present monetary policy settings unchanged, but also argues for continued readiness on the part of authorities to act against spillover demand-side pressures well ahead of time. In the event that the rising pattern of commodity prices persists over the near term, and if exchange market pressure develops during the period, the main priority and chief focus of prospective policy actions will be to guide and prevent unfavorable shifts in the public's inflation expectations. Through all this, direct non-monetary action by the relevant agencies against supply-side risks will remain a key policy priority, because such efforts tend to have a more palpable effect on supply constraints and similar sources of pressures.

## VII. Concluding Remarks

*An oil price shock poses a special challenge for monetary policy.*

An oil price shock poses a special challenge for monetary policy, because it does not only increase the prices of other goods but also tends to reduce the level of aggregate output. Authorities therefore need to be careful not to worsen the output effects of the oil shock while guarding against the onset of second-round effects.

*In the case of monetary policy, “no action” is in itself a positive act.*

It is worth noting that, in the case of monetary policy, taking no action can be a productive tactic, since keeping policy interest rates at their prevailing levels provides implicit support to credit activity by preventing large upticks in market interest rates. Moreover, previous experience has shown, and forecasts have confirmed, that inflation would subside by 2006—which means that the inflation pressures are likely to die down before policy actions taken in 2004 can exert their full impact. In any case, the BSP did not slip into inaction, as it actively supported the use of non-monetary government intervention measures to address more directly the supply-side risks, particularly in the case of food prices.

*The sharp rise in inflation is not due to policy error.*

All of this is meant to say that the sharp rise in inflation in the past year was largely due to factors that were outside the control of the BSP. The authorities believe that the overshooting relative to the target was not a result of policy error.

It is also true that the monetary policy framework of inflation targeting allows sufficient flexibility for authorities to deal with unforeseen developments or shocks to prices by setting out clearly defined acceptable circumstances under which an inflation-targeting central bank may fail to achieve its inflation target. In so doing, it recognizes the limits of the effectiveness of monetary policy under certain circumstances. In the case of the BSP, the predefined 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. The use of such exemptions to the inflation target is consistent with best practice in monetary policy among central banks.

*Finding the right response to inflation pressures remains a challenge for policymakers.*

Nevertheless, finding the right response to inflation pressures remains a challenge for the BSP. In 2005, supply-side pressures remain the principal threat to the inflation target, and authorities have become even more vigilant against possible second-round effects from supply shocks. The Bangko Sentral remains strongly committed to fighting inflation and minimizing the unfavorable effects of ongoing supply shocks on inflation and economic growth. It therefore reasserts its continued readiness to act in order to prevent supply shocks from having second-round effects on the public's inflation expectations and on wage and price-setting behavior.

## 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 rate 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, 21 October, 18 November, 16 December 2004.**

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.

**2005****13 January 2005**

The Monetary Board decided to maintain the BSP's key overnight RRP and RP rates unchanged at 6.75 percent and 9.0 percent, 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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