INFLATION REPORT

Second Quarter

2007

Bangko Sentral ng Pilipinas

FOREWORD

The 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 identify the risks to price stability and discuss their implications for monetary policy; and (ii) to document the rigorous economic analysis behind the conduct of monetary policy and convey to the public the overall thinking behind the BSP's decisions on monetary policy. The broad aim is to make monetary policy easier for the public to follow and understand and enable them to better monitor the BSP's commitment to the inflation target, thereby helping both in anchoring inflation expectations and encouraging informed debate on monetary policy issues.

The government's targets for annual headline inflation under the inflation targeting framework have been set at 4.0-5.0 percent for 2007 and 4.0 percent with a tolerance interval of ± 1.0 percentage point for 2008.

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 also features a box article on the monetary policy instruments of the BSP.

The Monetary Board approved this Inflation Report at its meeting on 19 July 2007.

AMANDO M. TETANGCO, JR.
Governor

July 2007

List of Acronyms, Abbreviations and Symbols

AMCs	Asset Management Companies
ARMM	Autonomous Region of Muslim Mindanao
BAS	Bureau of Agricultural Statistics
BES	Business Expectations Survey
BI	Bureau of Immigration
BIR	Bureau of Internal Revenue
BNM	Bank Negara Malaysia
BNBs	Bank Negara Bills
BOC	Bureau of Customs
BOE	Bank of England
BOJ	Bank of Japan
BOK	Bank of Korea
BOT	Bank of Thailand
BTr	Bureau of the Treasury
CalPERS	California Public Employees' Retirement System
CAMPI	Chamber of Automotive Manufacturers of the Philippines, Inc.
CAR	Capital Adequacy Ratio
CBD	Central Business District
CCRs	Credit Card Receivables
CES	Consumer Expectations Survey
CPI	Consumer Price Index
DBCC	Development Budget Coordinating Committee
DCS	Depository Corporations Survey
ECB	European Central Bank
ERC	Energy Regulatory Commission
FBT	Food, Beverage and Tobacco
FIREBS	Financial Institutions, Real Estate and Business Services
FLW	Fuel, light and water
FOMC	Federal Open Market Committee
GDP	Gross Domestic Product
GNP	Gross National Product
GRAM	Generation Rate Adjustment Mechanism
GS	Government Securities
HICP	Harmonized Indices of Consumer Prices
ICERA	Incremental Currency Exchange Rate Adjustment
IMF	International Monetary Fund
KBs	Commercial Banks
KWH	Kilowatt hour
LFS	Labor Force Survey
LPG	Liquefied Petroleum Gas
LTO	Land Transportation Office
MAS	Monetary Authority of Singapore
MEM	Multiple Equation Model
Meralco	Manila Electric Company
MISSI	Monthly Integrated Survey of Selected Industries
MS	Monetary Survey
MSBs	Monetary Stability Bonds
MT	Metric Tons
MTP	Major Trading Partner
NCR	National Capital Region
NEER	Nominal Effective Exchange Rate

NFIA	Net Factor Income From Abroad
NG	National Government
NIA	National Income Accounts
NPC	National Power Corporation
NPLs	Non-performing loans
NSO	National Statistics Office
OFs	Overseas Filipinos
OMOs	Open market operations
OPEC	Organization of Petroleum Exporting Countries
PBC	People's Bank of China
PSEi	Philippine Stock Exchange Composite Index
PSS	Postal Savings System
PSIC	Philippine Standard Industry Classification
PTIC	Philippine Telecommunications Investment Corporation
RDA	Reserve Deposit Account
REER	Real Effective Exchange Rate
RM	Reserve Money
ROP	Republic of the Philippines
RP	Repurchase
RRP	Reverse Repurchase
RVAT	Reformed Value Added Tax
SEM	Single Equation Model
SDA	Special Deposit Account
TLP	Total Loan Portfolio
TMA	Truck Manufacturers Association
TransCo	National Transmission Corporation
U/KBs	Universal/ Commercial Banks
VAPI	Value of Production Index
VOPI	Volume of Production Index
WESM	Wholesale Electricity Spot Market

THE MONETARY POLICY OF THE BANGKO SENTRAL NG PILIPINAS

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 a 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 (RP) rate and reverse repurchase (RRP) rate as the key policy rates to set the monetary policy stance. These two interest rates are typically adjusted in tandem by the Monetary Board.

Policy Target

The BSP uses the Consumer Price Index (CPI) or headline inflation rate which is compiled and released to the public by the National Statistics Office (NSO) as its target for monetary policy. The policy target is set by the Development Budget Coordinating Committee (DBCC)[1] in consultation with the BSP. For 2007, the Government's target for annual headline inflation has been set at 4.0-5.0 percent. For 2008, the inflation target has been set at 4.0 percent with a tolerance interval of ±1.0 percentage point.

BSP's Explanation Clauses

These refer to the predefined set of acceptable circumstances under which an inflation-targeting central bank may fail to achieve its inflation target. These clauses 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 inflation 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; and (d) significant government policy changes that directly affect prices such as changes in the tax structure, incentives and subsidies.

[1] The DBCC created under Executive Order (E.O.) No. 232 dated 14 May 1970, is an inter-agency committee tasked primarily to formulate the National Government's fiscal program. It is composed of the Department of Budget and Management (DBM), National Economic and Development Authority (NEDA), & the Department of Finance (DOF). The BSP sits as a resource agency.

The Monetary Board

The powers and functions of the BSP, 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. Beginning in July 2006, the Monetary Board meets every six weeks to review and decide on the stance of monetary policy. Prior to July 2006, monetary policy meetings by the Monetary Board were held every four weeks.

Chairman	Amando M. Tetangco, Jr.
Members	Romulo L. Neri
	Vicente B. Valdepeñas, Jr.
	Raul A. Boncan
	Juanita D. Amatong
	Nelly F. Villafuerte
	Alfredo C. Antonio

The Advisory Committee

The Advisory Committee was established as an integral 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 every six weeks (beginning July 2006) but may also meet in between the regular meetings, whenever it is deemed necessary. Prior to July 2006, the Committee met every four weeks.

Chairman	Amando M. Tetangco, Jr. Governor
Members	Diwa C. Guinigundo Deputy Governor Monetary Stability Sector
	Nestor A. Espenilla, Jr. Deputy Governor Supervision and Examination Sector
	Ma. Cyd N. Tuaño-Amador Managing Director Monetary Policy Sub-Sector
	Ma. Ramona GDT Santiago Managing Director Treasury Department
	Antonio B. Cintura Director Department of Economic Research; Head of Technical Secretariat[2]

[2] The Advisory Committee is supported by a Technical Secretariat composed of officers and staff from the Department of Economic Research, Center for Monetary and Financial Policy, and the Treasury Department.

SCHEDULE OF THE MEETINGS ON MONETARY POLICY AND PUBLICATION OF HIGHLIGHTS FOR 2007-2008			
Mtg. No.	Advisory Committee [1/]	Monetary Board [2/]	Publication of Monetary Board Highlights [3/]
2007			
1	22 January, Monday	25 January, Thursday	22 February, Thursday
2	5 March, Monday	8 March, Thursday	4 April, Wednesday [a/]
3	16 April, Monday	19 April, Thursday	17 May, Thursday
4	28 May, Monday	31 May, Thursday	28 June, Thursday
5	9 July, Monday	12 July, Thursday	9 August, Thursday
6	20 August, Monday	23 August, Thursday	20 September, Thursday
7	1 October, Monday	4 October, Thursday	31 October, Wednesday [b/]
8	12 November, Monday	15 November, Thursday	13 December, Thursday
9	17 December, Monday	20 December, Thursday	24 January 2008, Thursday

Notes:
1/ Under MB Resolution No. 630, the frequency of meetings of the Advisory Committee and the Monetary Board was set at every six weeks starting July 2006. Prior to this, the Advisory Committee and Monetary Board meetings were held every four weeks.
2/ Monetary Board meetings on monetary policy are held on the Thursday after the latest Advisory Committee meeting.
3/ Under MB Resolution No. 630, the lag in the publication of the highlights of the Monetary Board meetings on monetary policy issues was reduced to four weeks. Prior to this, the highlights were published six weeks after the reference meeting date.
a/ The minutes of the meeting will be published a day earlier since 5 April 2007 (the fourth week after the 8 March 2007 meeting) is a legal holiday (Maundy Thursday).
b/ The minutes of the meeting will be published a day earlier since 1 November 2007 (the fourth week after the 4 October 2007 meeting) is a legal holiday (All Saints' Day).

CONTENTS

OVERVIEW

- **Inflation continued to ease in Q2.** The downward path of inflation was sustained by stable food prices and a strong peso even as the demand for goods and services continued to show moderate improvement.

- **Output surged to its highest first-quarter growth in 17 years in Q1 of 2007, driven by the vigorous expansion in services and higher growth in agriculture, which more than offset the moderation in manufacturing growth.** Consumption spending continued to drive domestic demand even as other indicators showed a broad strengthening trend. While property prices in real terms were stable, unemployment declined further and BSP surveys showed a positive business outlook and improving consumer expectations.

- **Domestic interest rates eased further in Q2.** Ample liquidity and lower inflation helped bring down primary market yields. Bank lending rates also went down further.

- **Domestic liquidity growth decelerated but remained strong.** Robust dollar inflows from remittances, exports, and investments sustained the increase in net foreign assets of the BSP and banks. Bank lending to the productive sectors of the economy gained momentum as economic expansion accelerated. In addition, the trend in bank lending may have reached a respectable growth, given the continued broadening of financial markets which made non-bank sources of financing increasingly available to the private sector.

- **The peso's sustained appreciation against the US dollar reached a seven-year high.** Positive market sentiment on the back of the country's continuing solid macroeconomic fundamentals invited stronger dollar inflows which, in turn, helped strengthen the local currency.

- **Sustained global economic growth is fuelling inflationary pressures.** This is mainly coming from the growth in major economies such as the Euro area and Japan, along with the brisk pace of expansion in China and India. The US economy grew moderately as the slowdown in its housing sector continued to dampen overall performance.

- **As in the previous quarter, the central projection for inflation remains below the 4.0-5.0 percent target range in 2007 and within the 4.0 percent ± 1.0 percentage point target for 2008.** The near-term outlook for inflation remains subdued and unchanged from the previous report. On the demand side, several indicators exhibit a broad upward trend while some posted declines, whereas the continued ample supply of food supports relatively tame price pressures from the supply side. Risks to the inflation outlook remain, such as continued strong liquidity growth, possible wage increases, and volatile oil prices.

- **The Monetary Board kept policy rates unchanged during the quarter but introduced new measures to mop up excess liquidity.** The inflation readings over the policy horizon remained benign. However, the risk posed to future inflation by the continued strong growth of domestic liquidity prompted monetary authorities to take preemptive steps to address this risk. Effective 10 May 2007, the BSP encouraged government-owned and -controlled corporations to deposit funds with the BSP; allowed BSP-supervised trust entities to deposit funds with the BSP; and allowed special deposit account (SDA) placements of banks to the BSP as compliance with the liquidity floor requirement for government deposits.

- **Changes in the monetary policy stance will require the careful review of risks to future inflation, particularly those coming from strong liquidity growth.** Although initial results are encouraging, more information will help assess the overall effectiveness of the monetary measures implemented last May in containing liquidity. Meanwhile, the tiering system on banks' placements under the BSP's RRP and SDA windows will also need to be reviewed as it may have already served its purpose of stimulating growth in bank lending to the productive sectors of the economy.

  [Subsequently, on 12 July 2007, the Monetary Board decided to maintain a neutral monetary policy stance by implementing two complementary moves. Effective 13 July 2007, the tiering system on placements with the BSP was lifted and the BSP's key policy interest rates were adjusted to 6.0 percent for the overnight borrowing or reverse repurchase (RRP) rate and 8.0 percent for the overnight lending or repurchase (RP) rate. This policy stance is neutral relative to future inflation and output.]

I. INFLATION AND REAL SECTOR DEVELOPMENTS

Prices

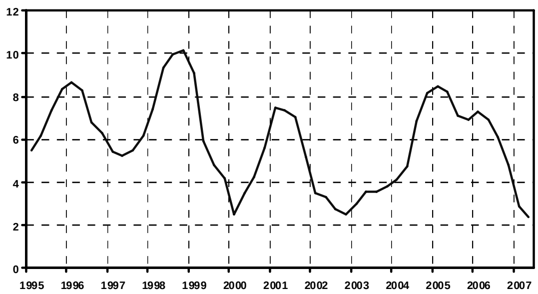
Headline inflation sustains its downward path.

Price pressures continued to abate in Q2 2007. Measures of underlying inflation also eased during the period.

The continued downtrend in inflation can be attributed to favorable supply conditions, particularly the sustained growth in agriculture, which has kept food prices stable. The peso has also continued to strengthen on strong dollar inflows from remittances of overseas Filipinos, export earnings, and foreign investments. The strength of the peso helped reduce import prices and contributed to quelling inflationary pressures.

At the same time, demand-side price pressures appear to be limited given the still moderate improvement in demand conditions and continued easing in core inflation.

Headline Inflation
Quarterly average in percent (2000=100)



Headline and Core Inflation

Average headline inflation continued to decelerate and settled at 2.4 percent in Q2 from 2.9 percent in the previous quarter and 6.9 percent in the same quarter a year ago.

Of the 2.4 percent average headline inflation rate for Q2, 1.2 percentage points were attributed to food. Services contributed 0.3 percentage point while housing and repairs contributed 0.2 percentage point.

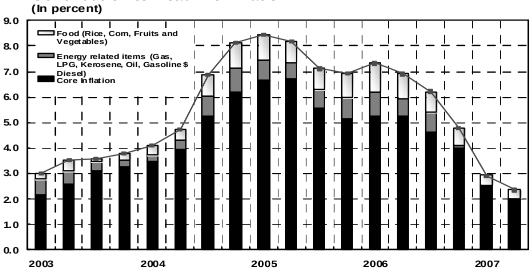
In terms of contribution to headline inflation, core inflation accounted for 2.0 percentage points of the headline inflation rate in Q2, lower than the 2.5 percentage points posted in Q1 and the 5.2 percentage points recorded in the same quarter a year ago. The contribution of non-core CPI items decreased marginally to 0.33 percentage point from 0.35 percentage point in the previous quarter; it was also lower than the 1.67 percentage points recorded in the same quarter a year ago.

Contribution to Quarter-on-Quarter Inflation
in percent

Item	Weight in Headline CPI	Percentage Contribution to Quarter-on-Quarter Headline Inflation		
		Q2 2007	Q1 2007	Q2 2006
Core Inflation	***81.6***	***2.02***	***2.55***	***5.23***
Non-core Items	*18.4*	*0.33*	*0.35*	*1.67*
Rice	9.4	0.15	0.15	0.41
Corn	0.9	0.04	0.06	0.03
Fruits and Vegetables	5.3	0.15	0.20	0.51
Gas, LPG	1.3	0.05	-0.06	0.26
Kerosene	0.3	0.00	0.01	0.08
Oil, Gasoline and Diesel	1.3	-0.05	-0.01	0.38
Headline Inflation	***100.0***	***2.35***	***2.89***	***6.90***

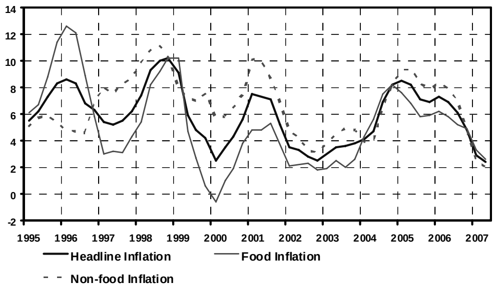
Source of Basic Data: NSO, BSP

Contribution to Headline Inflation
(in percent)



Both food and non-food show decelerating inflation trend.

Headline, Food and Non-food Inflation
Quarterly average in percent (2000=100)

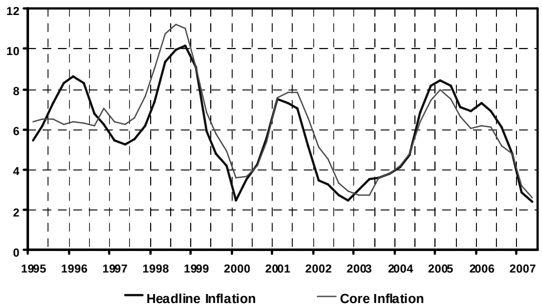


Both food inflation and non-food inflation were lower compared to the previous quarter and year-ago levels. Inflation for food, beverages and tobacco (FBT) declined to 2.7 percent in Q2 from 3.3 percent in the previous quarter. Likewise, non-food inflation was lower at 2.0 percent relative to 2.4 percent in the last quarter.

Compared to their year-ago rates, FBT inflation and non-food inflation fell sharply by 3.1 percentage points and 5.9 percentage points, from 5.8 percent and 7.9 percent, respectively.

Likewise, core inflation is on a steady decline.

Headline and Core Inflation
Quarterly average in percent (2000=100)



Core inflation, an indicator of the long-term trend of inflation, also sustained its downtrend during the review quarter. The official NSO core inflation measure eased to 2.6 percent in Q2 compared to 3.2 percent in the previous quarter. This was also 3.5 percentage points below the 6.1 percent core inflation recorded in the same quarter a year ago.

Alternative Core Inflation Measures

Quarterly averages of year-on-year change

Quarter	Trimmed Mean 1/	Weighted Median 2/	Net of Volatile Items 3/ *
2005	***6.2***	***5.6***	***8.8***
Q1	6.9	5.9	9.9
Q2	6.4	5.9	9.3
Q3	5.8	5.3	8.1
Q4	5.7	5.2	7.8
2006	***5.4***	***5.0***	***6.9***
Q1	5.9	5.4	8.1
Q2	5.8	5.0	7.6
Q3	5.2	5.2	6.7
Q4	4.5	4.2	5.0
2007	***2.6***	***2.4***	***2.7***
Q1	2.9	2.5	3.0
Q2	2.2	2.2	2.5

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.

** The series has been recomputed using a new methodology that is aligned with NSO's method of computing the official core inflation, which re-weights remaining items to comprise 100 percent of the core basket after excluding non-core items. The previous methodology retained the weights of volatile items in the CPI basket while keeping their indices constant at 100.0 from month to month.*

Source: NSO, BSP estimates

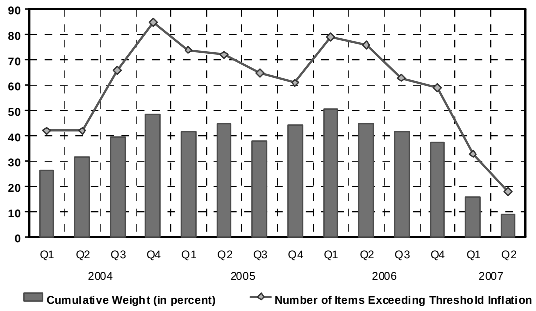
Alternative measures of core inflation estimated by the BSP (such as the trimmed mean, the weighted median, and the "net of volatile items") displayed a similar decelerating trend. All three measures were lower relative to their quarter- and year-ago rates.

The continued easing of core inflation demonstrates the absence of demand-based pressures on consumer prices in the near term, consistent with the still moderate improvements in demand indicators.

Looking at the distribution of price changes in the CPI basket, it would also be useful to determine the proportion of CPI basket components (at the 4-digit Philippine Standard Industry Classification (PSIC) level) showing inflation rates above a given threshold—in this case the upper end of the 4.0-5.0 percent target for 2007—and find out whether that proportion has been increasing or decreasing. This would provide an indication as to whether pressures on consumer prices are becoming generalized over time.

Data show fewer CPI items with above-target inflation rates.

CPI Items with Inflation Above Threshold



As may be expected with lower inflation, the number of items with inflation rates greater than the threshold of 5.0 percent fell to 18 in Q2 from 33 in the previous quarter and 76 a year earlier. Likewise, these items accounted for a smaller proportion of the CPI basket at 8.9 percent compared to 16.1 percent last quarter and 44.8 percent a year ago.

Specifically, there were 8 food items with inflation rates above threshold compared to 14 in the previous quarter. Meanwhile, 10 non-food commodities posted inflation rates higher than the upper end of the 2007 target in the current quarter compared to 19 a quarter earlier.

Food Prices

Favorable agricultural production supports the further slowdown in food inflation.

Inflation Rates for Selected Food Items
Quarterly averages in percent (2000=100)

Commodity	2007		2006		
	Q2	Q1	Q4	Q2	Q1
Food, Beverage and Tobacco	***2.7***	***3.3***	***4.9***	***5.8***	***6.2***
Food	2.6	3.3	4.9	5.8	6.2
Cereal & Cereal Products	2.2	2.7	2.9	4.9	6.8
o/w Rice	1.6	1.6	1.4	4.4	7.5
Corn	4.1	6.7	9.3	3.5	1.2
Dairy Products	4.1	4.4	5.5	6.0	6.8
Eggs	6.3	5.5	6.1	5.7	5.1
Fish	3.3	3.4	5.2	4.9	4.9
Fruits & Vegetables	2.8	3.8	8.6	9.6	7.4
Meat	2.4	2.3	2.9	1.8	3.0
Misc. Food	2.3	3.8	6.3	9.0	8.1
Beverages	3.5	5.4	6.0	6.7	5.8
Tobacco	2.1	2.2	2.8	4.0	5.8

Source of Basic Data: NSO, BSP

Food inflation declined steadily during the quarter as all food items—except for meat and eggs—registered a deceleration in prices.

The continued downtrend in food inflation was due largely to favorable agricultural production. The agriculture sector registered a 4.2 percent growth in Q1 2007, higher than the year-ago growth of 4.1 percent.[3] The major contributions to output growth came from *palay*, corn, fishery, and livestock. This was supported by normal weather conditions, increased market demand—particularly for fish during the Holy Week—and the Government's intensified programs on irrigation, seed technology and post-harvest facilities for *palay* and corn.

Meanwhile, higher input costs (i.e. corn feeds, vaccine) resulted in higher prices of meat—particularly poultry—and eggs. Prices of meat and eggs rose by 2.4 percent and 6.3 percent, respectively, from the 5.7 percent and 1.8 percent inflation registered in the same period last year.

Going forward, food prices are likely to remain stable given the favorable outlook for farm production. According to the Department of Agriculture (DA), increased public spending on seed technology and rural infrastructure, in addition to the Government's intervention programs on rice and corn, would be able to push up growth to reach the DA's target for the year of 4.5 percent. Moreover, the increasing market demand for livestock, fish and poultry—attributed to population growth and expectations of continued economic expansion—will also support the positive outlook for farm production.

However, there remain downside risks of a strong incidence of a La Niña occurrence coupled with the usual strong rains and typhoons in the second half of the year, which could affect the supply of agricultural commodities. The country experiences an average of 20 tropical storms annually.

[3] "Gross Value Added in Agriculture, Fishery and Forestry, Q1 2007,"

Non-Food Prices

Likewise, non-food inflation continues to slow down in the second quarter.

Non-food inflation continued to decelerate during the quarter with all sub-components of the non-food index registering slower price changes relative to their previous quarter and a-year-ago rates, except for fuel, light and water (FLW), which showed higher prices in Q2 relative to the previous quarter.

The housing and repairs item was the main driver of the decline in non-food inflation in Q2, followed by services and miscellaneous items, with inflation rates declining to 1.5 percent, 2.1 percent and 1.6 percent, respectively, from their quarter-ago rates of 2.2 percent, 2.8 percent and 2.1 percent. This more than offset the price increases in the FLW sub-components as a result of the series of upward adjustments in domestic pump prices during the quarter.

Inflation Rates for Selected Non-Food Items

Quarterly averages in percent (2000=100)

Commodity	2007		2006		
	Q2	Q1	Q4	Q2	Q1
Non-Food Items	***2.0***	***2.4***	***4.7***	***7.9***	***8.5***
Clothing	2.5	2.8	3.0	3.1	3.1
Housing & Repairs	1.5	2.2	3.7	4.1	4.3
Fuel, Light & Water	3.3	2.4	8.1	14.2	16.4
Fuel	3.5	-1.1	5.3	18.8	27.1
Light	2.8	3.8	10.5	12.7	11.9
Water	5.0	6.9	6.5	8.0	6.8
Services	2.1	2.8	4.9	10.9	11.3
Transpo & Comm.	-0.5	0.5	4.4	16.8	17.9
Miscellaneous	1.6	2.1	2.6	3.1	3.2

Source of Basic Data: NSO, BSP

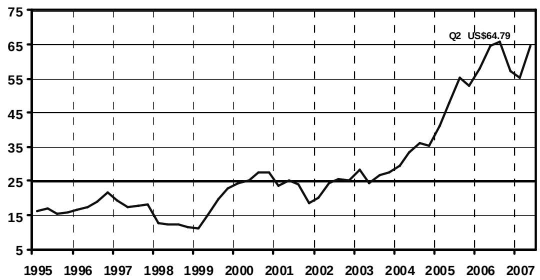
Energy Prices

Global oil prices were higher in Q2 on geopolitical concerns and supply bottlenecks in the US.

International oil prices were higher in Q2 as Dubai crude oil averaged US$64.79, increasing by about 17 percent (US$9.40) from the previous quarter's average of US$55.41 per barrel. Prices increased during the quarter due to market concerns on continued geopolitical tensions, supply problems arising from refinery outages in the US, and stronger demand for oil.

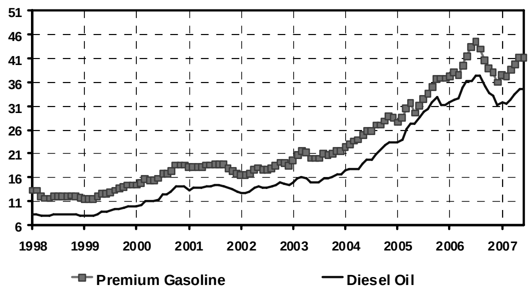
Dubai Crude Oil

Quarterly average spot price in US dollars per barrel



Average pump prices were generally higher during the quarter.

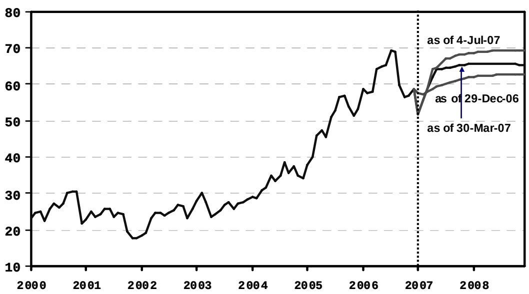
Local Retail Prices of Selected Oil Products
Price in pesos per liter



In the domestic market, average pump prices of premium gasoline and diesel oil were higher during Q2 relative to the previous quarter. Prices of gasoline products were raised six times during the quarter as local oil companies reflected higher international oil prices. There were no reductions in Q2. During Q1, domestic pump prices were raised three times and reduced four times (in January and February).

Outlook for world prices remains tight.

Spot and Estimated Future Prices of Dubai Crude Oil*
Price in US dollars per barrel



*Futures price derived using Brent crude futures data.

The futures price of Dubai crude oil shifted upward in early July relative to March 2007. The recent uptrend in price continued to point to relative tightness in the international oil market. Estimates by the US Energy Information Administration (EIA) indicate that OPEC would have to increase production by over one million barrels per day to keep normal inventory levels and to limit upward price pressures. At present, however, there is no commitment yet from OPEC to increase oil output. Robust demand for oil combined with uncertainty on whether OPEC will raise production renders the international oil market vulnerable to geopolitical and supply uncertainties.[4]

Utility Charges

Electricity rates may be adjusted due to higher transmission charges.

.

Effective March 2007, the National Power Corporation (NPC) reduced its power rates based on the latest adjustments under the Energy Regulatory Commission's (ERC's) provisionally approved 7th Generation Rate Adjustment Mechanism (GRAM) and 6th Incremental Currency Exchange Rate Adjustment (ICERA). Such adjustments, however, are expected to have a minimal impact on Meralco's electricity charge because NPC supplies only around 25 percent of Meralco's power requirements.

[4] IMF, World Economic Outlook, April 2007

In addition, such reductions could be offset when the ERC issues the guidelines on the adjustment of billing rates that would implement the increase in Transco's rate charges.

In a related development, the Department of Energy amended on 21 June 2007 Section 4(e) of Rule 3 of the Implementing Rules and Regulations of the Electric Power Insudtry Reform Act, which in effect now excludes GRAM and ICERA adjustments, among others, from the list of adjustments that require prior ERC approval. Citing said amendment, on 28 June 2007, ERC allowed Meralco to automatically pass on to its customers increases in generation charges.

[Consequently, Meralco increased electricity rates by ₱1.00 per kilowatt hour in July.][5]

Meanwhile, water rates will be lowered in the coming months.

Effective Q3 2007, Manila Water Company and Maynilad Water Services Inc. will implement an average of two percent reduction in their basic charges amounting to ₱0.37 per cubic meter and ₱0.44 per cubic meter, respectively. The reduction in water rates was on account of the continuing strength of the peso which effectively lowered both companies' financing costs.

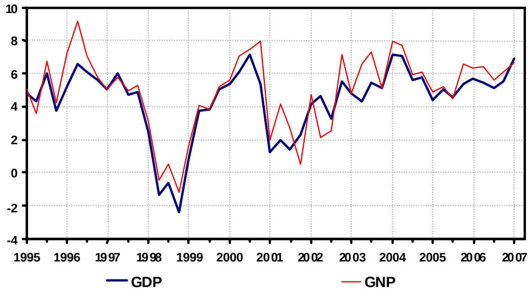
[5] Meralco says P1-billing hike just a pass-on cost, 21 July 2007, available online at www.abs-cbnnews.com

Aggregate Demand and Supply

Q1 2007 economic growth accelerates to its highest first quarter growth in 17 years.

Growth in Gross Domestic Product (GDP) in Q1 2007 surged to 6.9 percent, its highest first quarter growth since Q1 1990. On the supply side, the strong economic performance was driven by the vigorous expansion in services and higher growth in agriculture, which more than offset the moderation in manufacturing growth. On the demand side, GDP growth was buoyed by robust consumption spending and net exports. On a seasonally-adjusted basis, GDP grew at a faster pace of 2.5 percent compared to 1.7 percent in Q4 2006.

GDP and GNP Growth Rates*
Annual Growth in Real Terms



** Data for 1995-2003 is based on the old series of the National Income Accounts (NIA) of the NSCB. The quarterly GDP data from Q1 2004-Q1 2007 has been revised by the NSCB as of May 2007. The revision involves the addition or re-estimation of source subsectors under business process outsourcing (BPOs), manufacturing, and construction. The target for the release of the revised series from 1980-2003 is on December 2007.*

Meanwhile, growth in net factor income from abroad (NFIA) decelerated sharply to 3.8 percent from its double-digit growth in the previous year as the decline in investment income and the faster increase in investment expense offset the higher growth in compensation income which includes Overseas Filipinos' (OF) remittances. Consequently, growth in Gross National Product (GNP) settled below GDP growth at 6.6 percent.

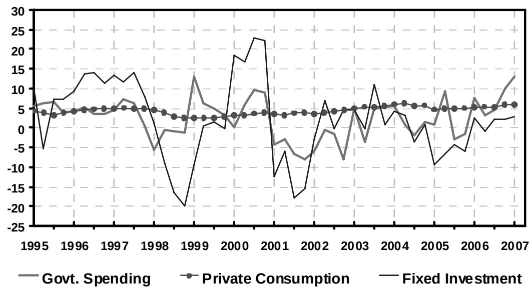
Aggregate Demand

Expenditures by major economic sectors

Consumption spending continues to drive domestic demand.

Personal consumption expenditure (PCE) continued to drive aggregate demand, rising by 5.9 percent in Q1 on the back of strong inflows of OF remittances and increased spending ahead of the May elections. Posting higher growth in Q1 2007 relative to the same quarter last year were expenditures on food (which accounted for 3.4 percentage points of total PCE growth), clothing and footwear, tobacco, and fuel, light and water.

Domestic Demand
Annual Growth in Real Terms



Government consumption sustained its year-round increases last year, expanding by a further 13.1 percent in Q1 2007. Growth in fixed capital investments improved but remained modest at 2.7 percent, supported by the solid expansion in construction investment.

Economic Performance
Growth rate (in percent)

Sector	2007	2006	
	Q1	Q4	Q1
By expenditure item			
Personal consumption	5.9	5.8	5.3
Government Consumption	13.1	9.9	7.6
Capital Formation	0.6	1.8	0.3
Fixed Capital Formation	2.7	2.2	2.4
Exports	9.1	2.3	13.0
Imports	-2.5	1.4	0.7

Source: NSCB

Total imports (based on 1985 peso prices) declined by 2.5 percent in Q1 as the 3.4 percent drop in merchandise imports more than offset the double-digit growth in the importation of non-factor services.

Merchandise Imports

Category	April 2007		
	Percentage Share	Y-o-Y Growth Rate	Contribution to Growth
Total	***100.0***	***-1.8***	***-1.8***
Capital Goods	23.6	-25.8	-8.0
Raw Materials & Intermediate Goods	46.0	-5.4	-2.6
Mineral Fuel & Lubricants	21.4	74.1	9.0
Consumer Goods	8.0	6.7	0.5
Special Transactions	1.0	-39.2	-0.7

Source of Basic Data: NSO

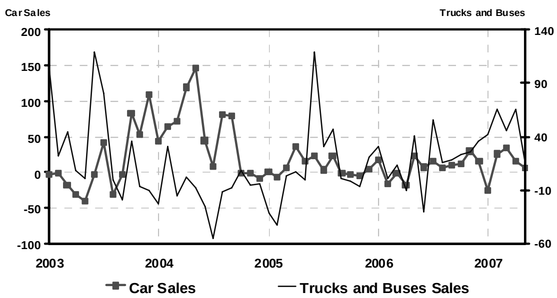
As reported by the National Statistics Office (NSO), merchandise imports (based on FOB value in US dollars) recorded a 1.8 percent year-on-year decline in April, reversing the previous month's increase of 8.0 percent. This can be attributed to the decline in imports of capital goods as well as raw materials and intermediate goods. For the first four months of 2007, merchandise imports rose by 3.4 percent, less than half of the 7.6 percent growth in the comparable period in 2006. On a month-on-month basis, merchandise import payments declined by 5.8 percent in April following a 2.2 percent increase in March.

Other Demand Indicators

Other data continue to show a broad strengthening trend.

Other indicators of demand continued to show a broad strengthening trend. Vehicle and energy sales sustained their growth, while consumer and business outlook improved. Forecasts by real estate experts point to a sustained increase in property prices and a continued decline in vacancy rates. Meanwhile, appliance sales and survey-based production indices of manufacturing activity remained weak.

Sales of Passenger Cars and Trucks and Buses
Year-on-year change in percent

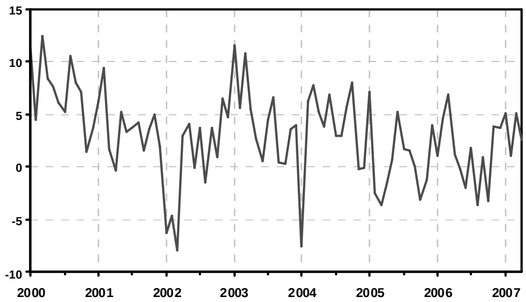


- Growth in passenger car sales continued but at a slower pace of 6.1 percent year-on-year in May. Year-to-date sales, however, reached a double-digit growth of 10.0 percent from only 0.3 percent in the first five months of 2006.

- On a month-on-month basis, seasonally-adjusted sales expanded by 4.5 percent. According to the Chamber of Automotive Manufacturers of the Philippines, Inc. (CAMPI), sales increased due to promotion packages, improved stock level and new model introductions.

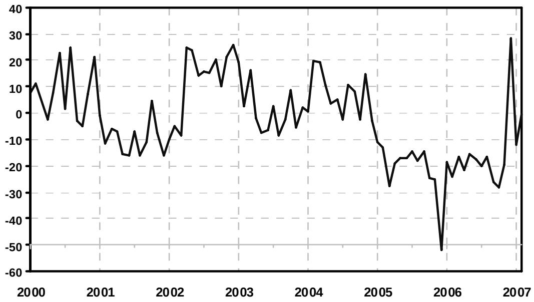
- The year-on-year growth in sales of trucks and buses similarly continued but at a slower rate of 16.0 percent in May. Meanwhile, year-to-date sales of trucks and buses surged by 44.2 percent, more than thrice the 14.3 percent growth registered in the comparable period last year. Month-on-month, seasonally-adjusted sales declined by 5.5 percent in May, a reversal of the previous month's 0.6 percent growth.

Meralco Power Sales
Year-on-year change in percent



- Energy sales by Meralco rose at a slower pace of 2.5 percent year-on-year in April from 5.1 percent in March. This reflected the relatively slower growth in electricity demand by the commercial and industrial sectors. Year-to-date energy sales remained broadly unchanged compared to the same period last year. On a seasonally-adjusted basis, sales declined by 3.7 percent month-on-month, following the 3.8 percent growth in March.

Appliance Sales
Year-on-year change in percent



- Latest data for February showed that appliance sales slid slightly by 0.7 percent year-on-year after declining by 12.0 percent in January. Similarly, year-to-date sales declined at a slower pace of 6.6 percent compared to 21.2 percent in the first two months of 2006. On a seasonally-adjusted basis, the growth in appliance sales decelerated to 4.1 percent in February from 5.9 percent in the previous month.

Indicators of Property Market Activity

Sector	2006	2007		Forecast 2008
	Q2	Q1	Q2	Q2
Estimated land values ('000 pesos/sq.m.)				
Makati CBD	220.0	222.5	235.0	258.3
Ortigas Center	100.5	107.5	114.8	125.3
Vacancy Rates, Makati CBD (%)				
Office	6.0	3.7	3.4	3.7
Residential (3-bedroom condominiums)	10.4	9.3	7.1	5.1
Rental Values, Makati CBD (pesos/sq.m.)				
Office *	578	678	738	822
Residential	430	491	519	546

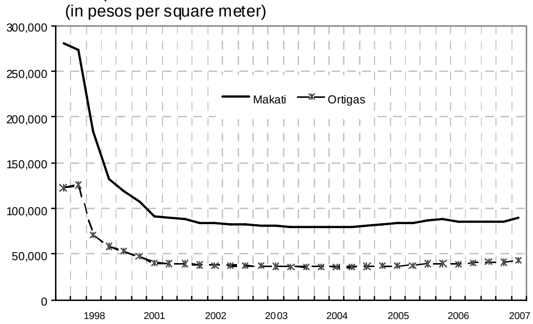
Source: Colliers International Research
** Average of Premium, Grade A and Grade B rental values*

- Based on data from Colliers International Research, land values in Q2 2007 rose by 6.8 percent year-on-year for the Makati Central Business District (CBD) and 14.2 percent for Ortigas Center**.** Quarter-on-quarter, the estimated land values in the Makati CBD and Ortigas as of end-June 2007 were 5.6 percent and 6.7 percent higher relative to the end-March levels. Colliers expects land values to rise further by 9-10 percent year-on-year in Q2 2008 given increased pricing power of developers in both office and residential segments; impressive take-up in residential pre-sales market; and pre-lease take-up in the office market.[6]

- Office and residential vacancy rates in the Makati CBD as of Q2 2007 continued to decline to 3.4 percent and 7.1 percent, respectively. The average office vacancy rate is forecasted to hover around 4.0 percent in Q2 2008 due to continued demand for office space by the business process outsourcing (BPO) sector. Colliers expects the average residential vacancy rate to decline to 5.1 percent by Q2 2008 with only a single residential condominium project (the Columns Tower 2 in Makati) slated for completion by end-2007.

[6] Colliers International Philippine Property Market Overview, July 2007, available at http://www.colliers.com

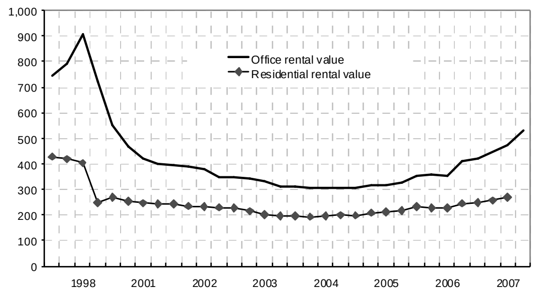
Average Land Values, Makati CBD and Ortigas
Real prices, based on rebased CPI
(in pesos per square meter)



Source of basic data: Colliers, NSO

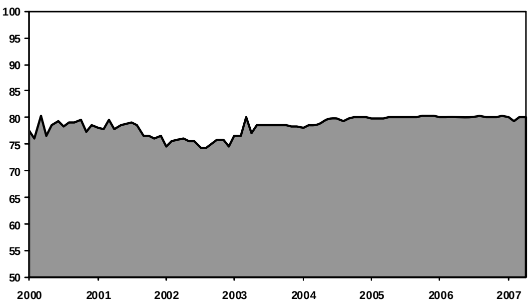
- Land values during Q2 were around 50-60 percent of their 1997 levels in nominal terms and around one-third of the 1997 levels in real terms. While rental values for the same period were approaching their peak levels in mid-1990s in nominal terms, they remained below two-thirds of their 1997 levels after deflating for inflation

Office and Residential Rental Values
Real prices, based on rebased CPI
(in pesos per square meter per month)



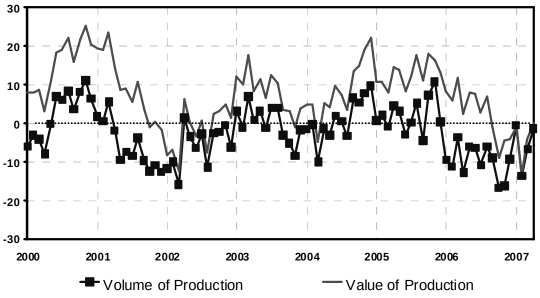
Source of basic data: Colliers, NSO

Average Capacity Utilization for Manufacturing
In percent



- Based on the NSO's Monthly Integrated Survey of Selected Industries (MISSI), average capacity utilization in manufacturing was broadly unchanged in April at 80.1 percent compared to 80.0 percent in March.

Growth in Volume and Value Indices of Manufacturing Production
Year-on-year change in percent



- MISSI data also showed that the value of production index (VAPI) recovered slightly, growing by 0.1 percent year-on-year in April after seven consecutive months of declines. Month-on-month, VAPI sustained its increase at 3.9 percent in April, although decelerating from the previous month's 15.8 percent. Meanwhile, the volume of production index (VOPI) continued to decline by 1.3 percent year-on-year in April, but posted a modest expansion of 4.1 percent on a month-on-month basis.

Business Expectations Survey

Index	Q2 07	Q1 07	Q2 06	Q4 06
Business Outlook Index				
Current Quarter	46.4	44.9	31.6	49.4
Next Quarter	44.7	49.4	32.8	37.1

Source: BSP

- In Q2 2007, businesses continued to have an optimistic view of macroeconomic conditions. The overall business confidence index (CI) remained above the 40 percent level for the third consecutive quarter, after rising to a record high of 49.4 percent in Q4 2006. The Q2 2007 CI remained strong at 46.4 percent, higher relative to comparable levels year-on-year and quarter-on-quarter. Respondents attributed their optimism to the following factors: 1) a generally stable macroeconomic environment; 2) expansion in Asian economies; 3) greater business opportunities during the election period; 4) brisker business during the dry/summer season; 5) increased consumer spending due to the opening of classes in June; and 6) new and enhanced business strategies. The survey also showed continuing confidence in Q3 2007 with the CI rising by almost 12.0 points year-on-year at 44.7 percent.

Consumer Expectations Survey

Index	Q2 07	Q1 07
Current Quarter	-26.0	-33.3
Next 3 months	-6.7	-11.1
Next 12 months	5.8	0.8

Source: BSP

- Similarly, consumer confidence improved based on the Q2 2007 Consumer Expectations Survey (CES). The overall consumer CI was less negative in Q2 2007, indicating that the number of optimistic respondents increased. Consumers were more upbeat about the country's economic condition as well as their own family income and financial situations, attributing the former to the strength of the peso, stable prices and more job opportunities.

- Meanwhile, the expected improvement in household finances was attributed to new business opportunities, employment of more household members, salary increases, and higher agricultural income. Consumer confidence for the third quarter and the next 12 months also improved, particularly among households in the National Capital Region where the Q2 2007 confidence indices in NCR reached their highest levels since the start of the CES in Q3 2004.

External Demand

Real export growth remains strong.

Preliminary NSO data showed that growth in merchandise exports rose to 6.1 percent year-on-year in May from 5.1 percent in April but declined from the 7.3 percent recorded in March. This was due mainly to higher growth in manufactures (including electronics) and petroleum products, which together accounted for 85.8 percent of total merchandise exports. The cumulative growth rate for January - May was 7.7 percent, lower than the previous year's 17.7 percent. Month-on-month, export receipts rose slightly by 0.1 percent in May following an 8.1 percent decline in April.

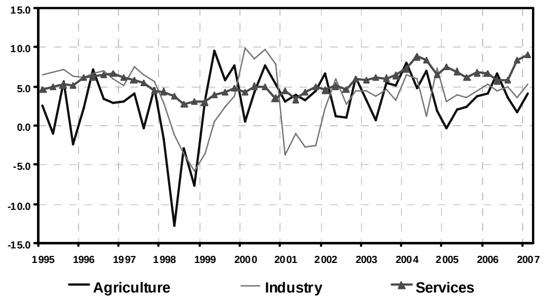
Merchandise Exports

Category	May 2007		
	Percentage Share	Y-o-Y Growth Rate	Contribution to Growth
Total	***100.0***	***6.1***	***6.1***
Total Agro-Based Products	5.1	9.2	0.5
Forest Products	0.1	90.1	0.0
Mineral Products	6.6	49.9	2.3
Petroleum Products	2.1	42.0	0.7
Manufactures	83.7	5.8	4.8
Special Transactions	2.4	-46.3	-2.2

Source of basic data: NSO

Aggregate Supply

Agriculture, Industry and Services Sectors
Annual Growth in Real Terms



On the production side, GDP growth was boosted by the services sector which posted its highest growth rate since 1983 at 9.1 percent. Services accounted for nearly two-thirds of total GDP growth (4.4 percentage points) in Q1 2007. By subsector, trade services expanded briskly by 9.1 percent due to robust retail trade, with the opening of new malls and department stores, while finance grew by 13.4 percent given the strong performance of the banking and insurance industries. Communications and land transport both expanded by around 10.0 percent given sustained demand for wireless phone services and increased patronage of the rail system. Meanwhile, the uptrend in the property market was reflected in higher growth in real estate services at 18.6 percent from only 4.9 percent in Q1 2006. Business process outsourcing (BPO) buoyed private services while increased public sector employment drove up government services.

Services propel output growth.

Economic Performance

Growth rate (in percent)

Sector	2007 Q1	2006 Q4	2006 Q1
By industrial origin			
Agriculture, Fishery & Forestry	**4.2**	**1.7**	**4.1**
Agriculture and Fishery	4.1	1.7	4.1
Forestry	25.6	8.6	-9.2
Industry	**5.3**	**3.6**	**5.3**
Mining and quarrying	11.0	-25.1	1.8
Manufacturing	4.6	4.8	5.0
Construction	8.6	7.6	10.7
Electricity, gas and water	4.1	4.5	3.9
Services	**9.1**	**8.4**	**6.7**
Transport., Comm., & Stor.	9.6	7.0	6.9
Trade	9.1	8.1	5.3
Finance	13.4	15.6	14.6
O. Dwellings & real estate	5.4	6.6	3.4
Private services	8.9	8.4	7.7
Government services	7.1	6.1	3.7

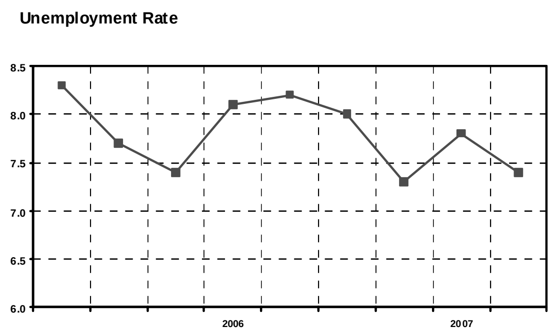
Source: NSCB

Agriculture, fishery and forestry (AFF) grew at a slightly faster pace of 4.2 percent in Q1 2007 compared to 4.1 percent posted a year ago. Fishery output rose by 8.7 percent, due to favorable weather conditions, lower gasoline prices, and the introduction of new commercial fishing vessels (CFVs). Corn production expanded by 11.4 percent on the back of sufficient rainfall, crop shifting to yellow corn, greater availability of high quality seeds, and government intervention programs which encouraged corn cultivation. Meanwhile, rice production rose at a slower pace of 1.7 percent due to advanced plantings by farmers in Q4 2006 as a result of sufficient rainfall, additional support from the government's rice program and in anticipation of the El Niño phenomenon. Nevertheless, rice production accounted for a significant 15.6 percent of AFF gross value added (GVA). Livestock registered a 2.2 percent increase in output, with hog, goat and dairy production as the main sources of growth. Poultry output inched up by 2.3 percent due to the substantial increase in commercial broiler production.

The industry sector grew at a steady pace of 5.3 percent compared to the level posted a year ago. Mining and quarrying output surged by 11.0 percent due to strong gains in gold mining; nickel mining; and crude oil, natural gas and condensate production. Meanwhile, manufacturing expanded at a slower pace of 4.6 percent relative to Q1 2006 but remained the biggest contributor to industry output, drawing support from food, furniture and fixtures, chemical and chemical products, and basic metals.

Labor Market Conditions

Unemployment and underemployment rates decline.



Based on the preliminary results of the April 2007 Labor Force Survey (LFS), the unemployment rate declined to 7.4 percent in April 2007 from 8.2 percent in April 2006.[7]

According to the NSO, 33.7 million were employed in April out of approximately 36.4 million Filipinos in the labor force. Total employment grew by 3.1 percent year-on-year.

The services sector employed almost half or 49.3 percent of the total employed population. Meanwhile, employed persons in the agriculture and industry sectors accounted for 35.2 percent and 15.6 percent, respectively, of the total employed population.

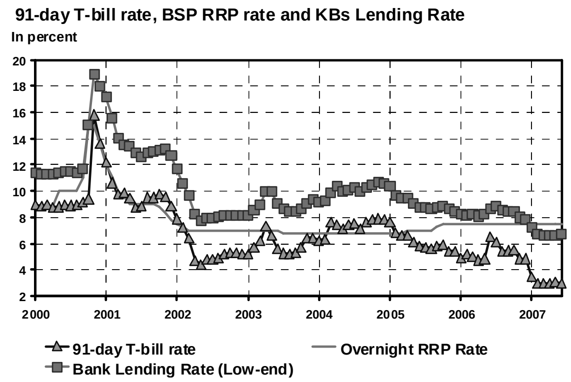
The number of underemployed persons declined to 18.9 percent in April 2007 from 25.4 percent in the same period last year. About 48 percent of the underemployed persons are in the agriculture sector.

[7] Starting April 2005, the new LFS questionnaire defines the unemployed to "include all persons who were 15 years old and over as of their last birthday and were reported as without work, and currently available for work, seeking work or not seeking work for valid reasons."

II. MONETARY AND FINANCIAL CONDITIONS

Interest Rates

Domestic interest rates ease further in Q2.



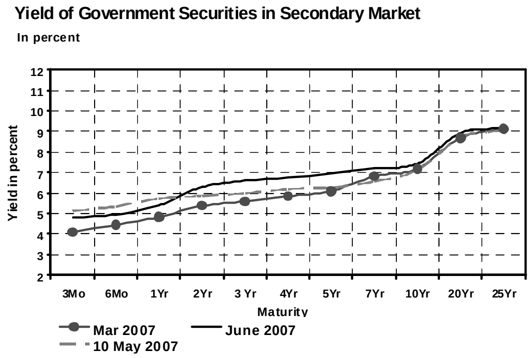
Domestic interest rates eased further in Q2 reflecting ample liquidity in the system. The benchmark 91-day T-bill rate averaged lower at 2.974 percent from 3.149 percent in the previous quarter.

Yields for the 182-day tenor also dropped to 3.713 percent from 3.688 percent last quarter, while the 364-day tenor rose to 5.174 percent from 4.165 percent in Q2.

The range of bank lending rates was broadly unchanged at 6.7-8.4 percent as of end-June from the 6.6-8.3 percent range recorded as of end-March.

Yield Curve

The secondary market yield curve shifts upward.



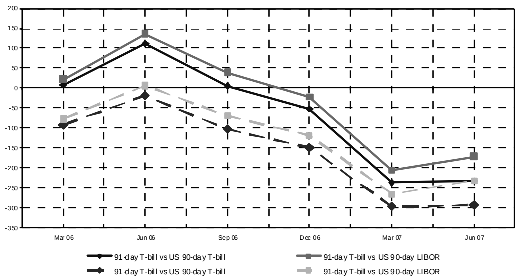
In contrast to the downward shift in the primary market, the yield curve for government securities in the secondary market rose across all tenors as of end-June 2007, compared to the yields registered at the end of the previous quarter.

The yield curve shifted upward on speculations that there will be less demand for emerging market securities given the rise in the yield for 10-year US Treasuries. Yields rose across most tenors led by the 5-year, 4-year and 3-year tenors.

On 10 May 2007, the short end of the yield curve moved upward with the implementation of the BSP's new monetary measures, whereas yields on the longer-dated maturities remained generally stable.

Before- and after-tax interest rate differentials narrow.

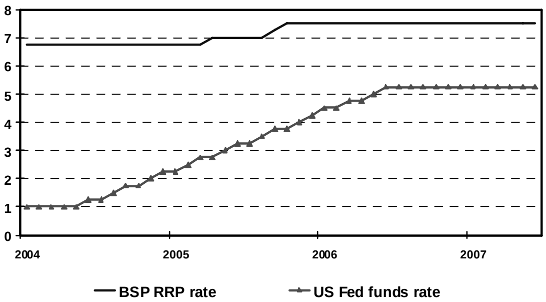
Interest Rate Differentials
in basis points



Interest Rate Differentials

The negative differentials between domestic and US T-bill rates at the end of Q2 narrowed relative to Q1 due to the increase in domestic interest rates accompanied by a decline in US T-bill rates.

BSP RRP Rate and US Fed Funds Rate
In percent



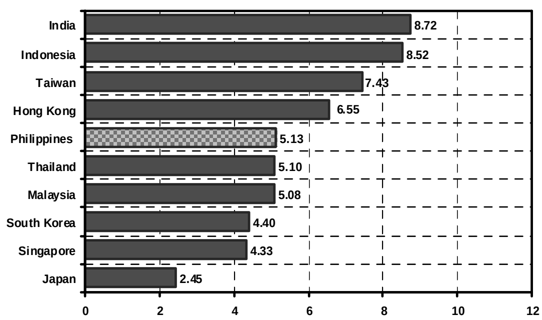
The differential between the BSP's policy interest rate (overnight borrowing or RRP rate) and the US federal funds target rate remained at 225 basis points in Q2.

Adjusted for the risk premium—as measured by the differential between the 10-year Republic of the Philippines (ROP) note and the 10-year US Treasury note—the differential between the BSP's policy rate and the US federal funds target rate widened to 82 basis points as of end-June 2007 compared to 78 basis points in end-March 2007.

Real Lending Rate

Real lending rate eases during the quarter.

Average Real Lending Rates: Selected Asian Countries
In percent



The real lending rate—measured as the difference between the median bank lending rate and inflation—fell marginally to 5.1 percent in Q2 from 5.2 percent in Q1. This was due to the decline in bank lending rates coupled with the continued easing in inflation. Among a sample of 10 Asian countries, the Philippines' real lending rate ranked fifth highest.

Financial Market Conditions

Bullish market sentiment continues to strengthen the demand for both equities and government securities. A string of positive developments in the domestic economy helped sustain investor interest in the market.

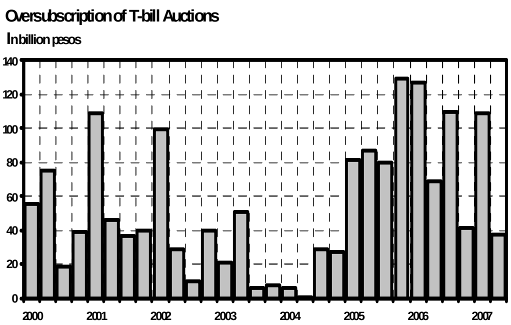
Stock Market

Positive market sentiment continues to spur demand for equities.

Trading in the local stock market sustained an uptrend in Q2, as market sentiment remained optimistic. The Philippine Stock Exchange Composite Index (PSEi) averaged 3,470.2 index points in Q2, higher by 300.1 points than last quarter's 3,170.1 average PSEi. Trading in the local bourse was driven by strong Q1 growth, continued strong remittance inflows, and the orderly conduct of the elections in May. The PSEi closed at a record high of 3,718.9 on 20 June 2007, the highest so far during the year. The easing of domestic inflation and interest rates also helped sustain investor interest in the market.

Government Securities

T-bill auctions continue to be oversubscribed.



The Bureau of the Treasury (BTr) auctions continued to be oversubscribed as tenders for Q2 totaled ₱55.6 billion compared to the total offerings of ₱18.0 billion. However, oversubscription for the four T-bill auctions during the quarter was lower at ₱37.6 billion compared to the ₱109.1 billion posted in the previous quarter, due to the cancellation of auctions in June 2007. Consequently, average monthly oversubscription during the quarter was also lower at ₱6.4 billion compared to ₱18.2 billion in the previous quarter.

Banking System

The Philippine banking system continued to perform favorably during the period under review, supported by improving macroeconomic conditions. Key performance indicators reflected overall soundness. Bank lending showed double-digit expansion and bank asset quality has remarkably improved with NPL ratio nearing pre-crisis level. Likewise, banks remained adequately capitalized in spite of higher loss provisioning levels and stricter alignment of capital requirements with international standards.

Savings Mobilization

Deposit liabilities increase.

The banking system's deposit liabilities as of end-April 2007 continued to grow robustly, posting an increase of 23.9 percent to ₱3.6 trillion from its year-ago level of ₱2.9 trillion. Demand and time deposits sustained year-on-year growth, increasing by 40.3 percent and 30.5 percent, respectively. Savings deposits, which continued to account for half of the banks' funding base, similarly increased by 15.5 percent compared to its level a year ago. Compared to the level at the end of Q1, the banking system's deposit liabilities increased moderately by 1.5 percent.

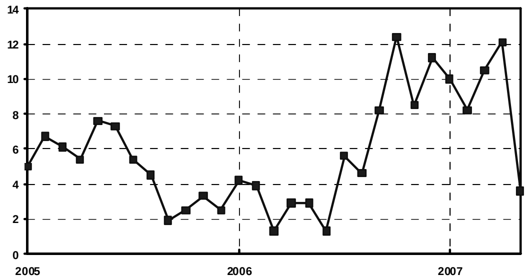
Lending Operations

Growth in bank lending continues.

Loans Outstanding: Other Depository Corporations Net of RRPs
Year-on-year change in percent

Outstanding loans of commercial banks, thrift banks and rural banks to the productive sectors of the economy (i.e., net of banks' RRP placements with the BSP), continued to gain momentum at 6.7 percent from the 6.1 percent posted in the previous month. There has been a clear pick-up in this lending since December 2006, after the BSP implemented the tiering system in November. Given the continued broadening of the financial markets, which has enabled the private sector to diversify funding sources, this trend in bank lending can be considered to have reached a respectable level.

Loans Outstanding: Other Depository Corporations Including RRPs
Year-on-year change in percent



Meanwhile, bank lending including RRPs expanded at a slower rate of 3.6 percent year-on-year in May compared to the 12.1 percent growth recorded in the previous month. This was nevertheless higher than the 2.9 percent expansion registered in the same month a year ago.

The deceleration in aggregate bank lending was led by the financial institutions, real estate and business services (FIREBS) sector, which grew by only 1.0 percent year-on-year in May from a 14.6 percent growth in the same period last year and 25.5 percent in the previous month. This was due mainly to the lower volume of banks' reverse repurchase transactions (RRPs) with the BSP as there was a shift in placements to the special deposit accounts (SDAs) following the introduction of new monetary measures in early May. Net of RRPs, however, FIREBs continued to post a strong growth of 13.2 percent, higher than the 5.1 percent recorded in May last year and the 4.8 percent growth posted in the previous month.

Growth in lending to the agriculture sector rose to 5.1 percent from 2.1 percent in April. Meanwhile, the lower stock of loans outstanding in other sectors such as manufacturing, which comprise about a fifth of the banks' total loan portfolio, was due to repayments by firms of their financial obligations. The lower level of outstanding loans to the mining sector was traced to the settlement of corporate loans.

KBs' consumer loans increase.

Meanwhile, the KBs' credit card receivables (CCRs) as of end-March 2007 increased by 20.5 percent year-on-year to ₱91.6 billion but went down by 3.1 percent from the end-December 2006 level of ₱94.6 billion. The ratio of CCRs to the total loan portfolio (TLP) was at 4.1 percent. Of the total KBs' CCRs, 14.7 percent was past due, lower than the 17.0 percent and 20.5 percent recorded at the end of the previous quarter and for the same quarter a year ago.

Similarly, KBs' total auto loans as of end-March 2007 rose by 19.6 percent to ₱69.3 billion from P57.9 billion in March 2006, and by 5.7 percent from the end-December 2006 level of ₱65.6 billion. In terms of the ratio to TLP, auto loans accounted for 3.1 percent of TLP and only 4.4 percent of total auto loans were past due.

KBs' outstanding loans to the residential property sector went up to ₱37.9 billion as of end-March 2007, 6.2 percent higher than its year-ago level of ₱35.7 billion. The 8.8 percent increase in the loans for the acquisition of individual units contributed to the higher aggregate outstanding loans to the sector.

Institutional Developments

The resources of the banking system rise.

The total resources of the banking system rose by 15.6 percent as of end-April 2007 from the previous year's level to ₱5.1 trillion. It was also slightly higher by 0.8 percent compared to the end of previous quarter. The year-on-year rise was due mainly to the increase in banks' deposits with the BSP (due from central bank) and loans and discounts accounts. KBs accounted for almost 90 percent of the total resources of the banking system.

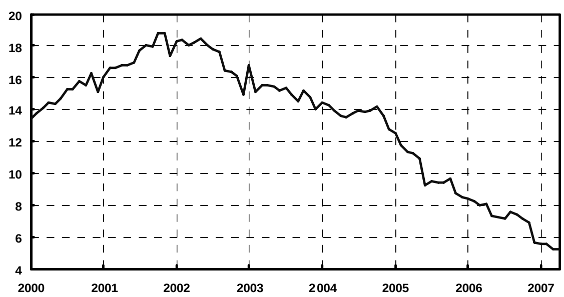
The number of banking institutions falls due to consolidations and closures of banks but the operating network continues to expand.

The number of banking institutions (head offices) fell further to 861 as of end-March 2007 from the year-ago level of 872, reflecting continued consolidations and mergers, as well as the closure of some banks. The total number of banking institutions was comprised of 39 KBs, 84 TBs and 738 RBs. Meanwhile, the operating network of the banking system increased to a total of 7,704 banks as of end-March 2007 from 7,672 at end-March 2006, reflecting mainly the increase in TBs and RBs' branches/agencies. On a quarterly basis, the number of banking institutions also declined slightly to 861 as of end-March 2007 from 862 as of end-December 2006.

The asset quality of the banking system further improved as the non-performing loans (NPL) ratio was lower at 5.7 percent as of end-April 2007 compared to 8.5 percent a year ago. The NPL ratio was, however, only marginally lower compared to the previous month. Relative to the previous year, the improvement in the ratio was sustained due to the 23.4 percent decline in the level of NPLs, complemented by the 13.9 percent expansion in TLP.

Banks' NPL ratio improves.

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



Meanwhile, the loan quality of universal and commercial banks (U/KBs) likewise improved as their NPL ratio slid to 5.3 percent in end-April 2007 from 8.1 percent registered a year ago and unchanged from that in March. The year-on-year improvement was spurred by the 27.0 percent drop in NPLs and the 12.0 percent expansion in TLP.

Compared with other countries in the region, the Philippine banking system's NPL ratio at 5.7 percent as of end-April 2007 was lower than Indonesia's 6.7 percent, but higher than Malaysia's 4.4 percent, Thailand's 4.2 percent, and Korea's 0.8 percent.[8] The lower NPL ratio in Malaysia, Thailand, and Korea could be attributed in part to the creation of publicly-owned asset management companies (AMCs), which purchased the bulk of their NPLs, a strategy not applied to the Philippines.

[8] Sources: Various central bank websites. Thailand (KBs, April 2007); Malaysia (Banking system, April 2007); Korea (KBs, December 2006); and Indonesia (Banking system, April 2007)

The loan exposure of banks was adequately covered as the banking system's NPL coverage ratio remained steady at 73.2 percent as of end-April 2007, reflecting banks' diligent compliance with the loan-loss provisioning requirements.

The capital adequacy ratio is higher than the minimum levels set by the BSP and the BIS.

Using the new risk-based framework, banks remained adequately capitalized as of end-December 2006, with the industry's capital adequacy ratio (CAR) at 16.8 percent on a solo basis and 18.1 percent on a consolidated basis. These ratios were higher than the previous year's ratios of 16.4 percent and 17.6 percent, respectively, but lower than the end-September 2006 CARs of 17.4 percent and 18.6 percent, on solo and consolidated basis, respectively. The industry's CAR continued to exceed the statutory level set by the BSP at 10.0 percent and the Bank for International Settlements' (BIS) standard of 8.0 percent. This reflects the banking system's ability to cover risky assets.

The Philippines' CAR remains comparatively higher than those of Thailand (13.8 percent), Malaysia (13.1 percent), and Korea (12.3 percent). Indonesia posted the highest CAR in the region at 22.1 percent.[9]

Placements under the BSP's RRP and SDA facilities reflect ample liquidity in the system.

The total volume of banks' placements with the BSP under the RRP window amounted to ₱194.4 billion as of end-June 2007, higher by ₱23.5 billion than its year-ago level. Similarly, SDA placements rose by ₱254.7 billion to almost ₱280 billion as of end-June 2007 from last year's level of ₱25.2 billion. The significant increase in SDAs could be attributed to the recent monetary measures that were implemented on 10 May 2007.[10]

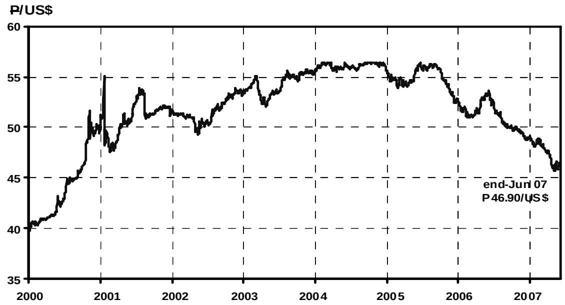
[9] Sources: Various central bank websites, Thailand (KBs, March 2007); Malaysia (Banking system, April 2007); Korea (KBs, December 2006); and Indonesia (KBs, April 2007).
[10] For a thorough discussion of the monetary measures implemented on 10 May 2007, please see the section on Monetary Policy Developments.

Exchange Rate

The peso continues to strengthen against the US dollar…

The peso appreciated by 6.0 percent against the US dollar as of 29 June 2007 vis-à-vis its end-2006 level.[11] On a quarterly basis, the peso appreciated by 3.5 percent to average ₱46.90/US$1 in the second quarter of 2007 from ₱48.61/US$1 in the preceding quarter. Robust dollar inflows from overseas Filipinos' remittances, export earnings, foreign investments and a buoyant regional currency market sent the peso to its highest level in seven years to average ₱45.72/US$1 on 5 June.[12] Market sentiment remained positive, despite recent concerns about the country's ability to meet its fiscal deficit target, due to the country's relatively solid macroeconomic fundamentals. The generally orderly conduct of the national elections in May also contributed to investor optimism.

Daily Peso-US Dollar Rate



… in line with most regional currencies.

The strengthening of the peso in end-June was in line with regional currencies except the Indonesian rupiah, New Taiwan dollar and Japanese yen, which depreciated against the US dollar on a year-to-date basis.

Volatility, as measured by the standard deviation of the daily exchange rates, reached ₱0.79 in the second quarter of 2007, higher than ₱0.30 in the first quarter, as the peso moved within a wider range of ₱45.72/US$1 to ₱48.29/US$1.

Changes in Selected Dollar Rates

	Appr./Depr. (-) Year-to-date	
	29 Jun 07	**30 Mar 07**
Philippine peso	**6.03**	**1.55**
Thai baht	2.66	1.20
Chinese yuan	2.47	0.94
Malaysian ringgit	2.14	2.11
South Korean won	0.68	-1.14
Singaporean dollar	0.39	1.40
New Taiwan dollar	-0.82	-1.50
Indonesian rupiah	-0.51	-1.49
Japanese yen	-3.56	0.90

[11] Dollar rates or reciprocal of the peso-dollar rates were used to compute for the percent changes.
[12] The figures are based on reference rates.

On a real, trade-weighted basis, the peso lost some external price competitiveness in the second quarter against the basket of currencies of major trading partners (MTPs) as well as against the baskets of currencies of competitor countries in the narrow and broad series. The nominal appreciation of the peso offset the narrowing price differential, which translated to an appreciation of the real effective exchange rate (REER) of the peso by 2.9 percent against the basket of currencies of MTPs.[13] Likewise, the peso's REER index appreciated by 2.2 percent and 2.8 percent against the baskets of currencies of the narrow and broad series of competitor countries, respectively, for the same reasons.

The peso is expected to maintain its strength for the rest of the year despite the risks posed by volatile oil prices, the unwinding of global imbalances and volatility in the financial markets. The peso is expected to weather these external shocks given the country's sound macroeconomic fundamentals—particularly the country's resilient economic growth and benign inflation. Sustained dollar inflows from overseas foreign workers' remittances, portfolio and foreign direct investments as well as exports receipts are seen to further strengthen the currency.

[13] The REER index represents the Nominal Effective Exchange Rate (NEER index) of the peso, adjusted for price differentials with the countries whose currencies comprise the NEER index basket. The NEER index, meanwhile, represents the weighted average exchange rate of the peso vis-à-vis a basket of foreign currencies.

Monetary Aggregates

Money demand slows down.

Demand for money slowed down to 21.1 percent year-on-year in May from the 24.6 percent recorded in March 2007. This was also the 14th consecutive month of double-digit growth in domestic liquidity since April 2006. M3 growth had also been above 20 percent for the past six months. Growth in the net foreign assets of depository corporations continued to drive M3, albeit at a slower pace. Net domestic assets likewise declined, as credit to the public sector as of end-May slowed down to 11.8 percent from 20.7 percent as of end-March. This was partly offset by the continued expansion in credit to the private sector, which rose by 5.8 percent from 4.0 percent, as lending to entities other than financial corporations was sustained during the quarter.

Similarly, the year-on-year growth in reserve money, a narrower measure of monetary aggregates, declined to an average of 69.4 percent in Q2 from 70.3 percent in the first quarter.[14]

[14] Reserve money (RM) is defined as the sum of currency issue net of cash in vaults of the BTr and banks' reserve balances with the BSP.

Box Article: MONETARY POLICY INSTRUMENTS OF THE BSP

Introduction

The monetary policy decisions of the Bangko Sentral (BSP) aim to maintain price stability through stable and low inflation. The BSP uses various monetary instruments to achieve the desired level of money supply in the financial system consistent with the economy's growth and inflation targets. The adoption of inflation targeting as the framework for conducting monetary policy allowed the BSP to focus on its principal mandate of promoting price stability.

Open Market Operations

Open market operations (OMOs) consist mainly of borrowing/lending under the reverse repurchase (RRP)/repurchase (RP) facilities of the BSP and outright sales/purchases of the BSP's holdings of Treasury bills (T-bills). OMO using the RRP/RP facilities is market-based, with banks and financial institutions under the BSP's supervision determining the volume and the timing of the transactions in response to the rates announced by the BSP. OMO has advantages over the other monetary tools. First, OMO is flexible in terms of amount and timing. Second, OMO transactions are voluntary and undertaken by the institutions, with the BSP setting only the rates for the transactions. Third, OMO is quick to implement and its results are immediately observable. Since the change in policy rates is implemented immediately after the Monetary Board makes the decision, any effect on the market is felt soon after its implementation, usually in the next few days.

RRP/RP Policy Interest Rates. The overnight repurchase (RP) and overnight reverse repurchase (RRP) rates are the primary monetary policy instruments of the BSP. The RRP (RP) rate is the interest rate at which the BSP borrows from (lends to) banks using government securities as collateral. The RRP facility allows the BSP to siphon off liquidity from the banking system on a relatively temporary basis, as compared to the long-term effect of a change in reserve requirements. The BSP policy interest rates currently stand at 7.5 percent on RRP and 9.75 percent on RP.[15] At present, the BSP enters into repurchase agreements with tenors of two weeks to one month, plus the overnight window, which is the shortest.

There are many channels by which changes in the policy interest rates are transmitted to the economy.[16] Changes in policy rates immediately impact on the level of Reserve Money (RM) and domestic liquidity (M3) through a shift from banks' reserve deposits to RRP placements with the BSP. Raising the policy rate is contractionary as it induces banks to increase their RRP placements with the BSP, thus reducing RM and, eventually through the money multiplier, the level of M3. The opposite occurs when policy rates are lowered—banks reduce their RRP placements with the BSP, thus increasing RM and M3.

Apart from its immediate impact on the level of RM and M3, changes in policy rates also exert their influence on the real sector of the economy as they affect financing costs through three major channels. The most direct channel is the interest rate channel which influences aggregate demand via its impact on the level of investment and consumption in the economy. An increase in policy rates, for example, will have an upward pressure on the benchmark 91-day T-bill rate used by banks in pricing loans. This increases the cost of investments and therefore investments will fall. Higher

[15] Effective 13 July 2007, the RRP and RP rates were reduced to 6.0 percent and 8.0 percent, respectively.
[16] For a more comprehensive discussion of the Transmission Mechanism of Monetary Policy, please refer to the following box articles: "Transmission Mechanism of Monetary Policy" in the Q1 2006 Inflation Report; "The Impact of BSP Policy Rates on Market Interest Rates" in the 3Q 2005 Inflation Report; and "Features and Mechanism of Open Market Operations" in the 3Q 2004 Inflation Report.

Higher interest rates also induce more savings and less spending—the net impact is that aggregate demand[17] will fall. This reduction in aggregate demand reduces the pressure on prices and eventually on inflation.

The second channel is the credit channel (which has been separated into the bank lending channel and the balance sheet channel). The credit view arises mainly due to the informational asymmetry existing between borrowers and lenders. Raising the policy rate induces an increase in the lending rate, which attracts riskier projects due to imperfections in the market. This increases banks' monitoring costs, which is reflected in a wider spread between the lending and deposit rates. The supply of credit is reduced as a result, and, consequently, the level of investments fall.

The bank lending channel, in particular, refers to the mechanism whereby the credit effect occurs when bank loans are of special importance as in the case of bank lending-dependent small firms. The bank lending channel is based on the premise that small to medium-sized firms, facing imperfect information in financial markets, rely primarily on bank loans for external finance because it is more expensive for them to issue securities in the open market. Hence, higher interest rates due to a rise in the policy rate result in less financing and subsequently fewer investments for these firms.

The balance sheet channel, on the other hand, arises because rising interest rates, following tight monetary policy, directly increase the interest expenses of the non-financial firms whose funds rely heavily on short-term borrowings, reducing their net cash flows and weakening their balance sheet positions. Hence, small and medium-sized firms that have relatively weaker access to short-term credit markets tend to draw down inventories and cut investment more than larger firms in response to their deteriorated balance sheets.

The third channel related to financing costs arises from a reduction in asset prices resulting from higher interest rates. When the value of a company, approximated by its market value, is less than the cost of capital there would be a downward revaluation of its assets. For that reason, when interest rates are increased, stock prices fall and companies have a hard time getting financing therefore resulting in lower investment. In addition, the fall in the stock market implies a decline in the wealth of market investors, who will cutback on consumption as a result of this shock.

For economies open to both trade and capital flows like the Philippines, changes in the interest rate also affect the economy via the exchange rate channel. When there is an increase in interest rates, investment in peso-denominated bonds becomes more attractive and encourages the inflow of more capital. This flow results in an appreciation of the exchange rate, which will translate to a reduction in the price of tradable goods in peso terms. Such fall in the price of tradable goods makes the production of non-tradable goods more attractive, and a reallocation of resources away from the tradable sectors and towards the non-tradable ones occurs. From the demand side, when non-tradable goods become relatively more expensive, quantity demanded will fall. The changes in the quantity supplied and quantity demanded between the two sectors affect the relative prices between tradeable and non-tradeable goods which, in turn, alter the pattern of spending between the two sectors and eventually influence the general price level.

Outright Sale/Purchase of Government Securities. Open market operations also consist of outright purchases or sales of the BSP's holdings of government securities. To contract money supply, the BSP may sell outright the BSP's holdings of government securities. Conversely, to expand money in circulation, the BSP may purchase government securities.

[17] Aggregate Demand = Consumption + Government Expenditures + Investments + Net Exports

When the BSP buys securities from a bank, the transaction results in the expansion of liquidity through its impact on RM. This is inasmuch as the proceeds of the sale that is credited to the seller bank's DDA with the BSP increases. Conversely, when the BSP sells securities, the reduction in the buying bank's DDA balance with the BSP exerts a contractionary impact on RM. Buying/selling securities increases/decreases RM on a more permanent basis compared to the RP/RRP facility. In such a transaction, the parties do not commit to reverse the transaction in the future, thus creating a more permanent effect on RM and on the banking system's level of liquidity.

Reserve Requirement

The reserve requirement is an immediate and powerful monetary instrument that has significant effects on the level of liquidity in the banking system. The reserve requirement is the portion of deposits and deposit substitute liabilities that banks are required to set aside for monetary management purposes and for prudential reasons; i.e., to help protect depositors by ensuring sufficient cash to service depositors' withdrawals. It may be held by banks as cash in their vaults or as deposits with the BSP, or in reserve-eligible government securities (REGS).[18] In contrast to OMO and rediscounting, which operate indirectly through the market mechanism, reserve requirements help manage money and credit by directly affecting the level of funds that banks can lend.

Reserve requirements are categorized as either regular or liquidity reserves. Banks satisfy statutory reserve requirement by holding cash in their vaults, maintaining balances in their DDAs with the BSP and by holding REGS. On the other hand, banks satisfy the liquidity reserve requirement by placing term deposits in the Reserve Deposit Account (RDA) with the BSP. The shift in the mode of compliance with the liquidity reserve requirements to RDA was to enable the BSP to build up its portfolio of domestic securities for OMOs.

The BSP currently imposes a unified regular reserve requirement of 10 percent and liquidity reserve requirement of 11 percent for peso deposit and deposit substitutes of commercial and thrift banks. The BSP is reviewing the level of reserve requirements to help reduce banks' intermediation costs. The BSP requires 25 percent of total reserves to be in the form of bank's balances with the BSP, and the remaining balance in the form of cash in bank's vault and REGS. The interest rate paid to regular reserves is 4 percent. On the other hand, interest rates applied to the RDAs are set at one half percent (1/2%) below the prevailing market rate for comparable government securities.

Special Deposit Accounts

The BSP accepts special deposits from banks through the Special Deposit Account (SDA) facility, which was first introduced in 1998. As a monetary instrument, it allows BSP to mop up excess domestic liquidity in the system through competitive SDA rates, usually at a premium over RRP rates. Banks' placements under SDAs are classified as fixed-term deposits and the income derived is subject to 20 percent final withholding tax. Compared with other instruments, the SDA facility offers some measure of flexibility in the way that it allows pre-termination, subject to a reduction in contracted rates. SDA tenors are 14 days, 1 month, 2 months, 3 months, and 6 months. However, in 2006, the BSP needed to augment further its capacity to manage liquidity brought about by the strong foreign exchange inflows to the country. This paved the way for the opening of the seven-day SDA facility with the same trading hours as the RRP overnight window of the BSP. In May 2007, the SDA facility was also opened to trust entities of banks to encourage them to deposit their funds with the BSP.

[18] These securities refer to bonds or other evidences of indebtedness representing direct obligations of the National Government. These securities have the following features: (1) bear an interest of 4 percent per annum, non-negotiable, and must carry BSP support. Most of these have already matured, with the outstanding level reported by banks amounting to P4.9 billion as of end-April 2007.

Rediscounting

Rediscounting is a privilege of qualified banks to obtain loans or advances from BSP using the eligible papers of their borrowers as collateral. It is a standing credit facility provided by the BSP to help banks liquefy their positions by refinancing the loans they extend to their clients.

The BSP uses rediscounting to influence the volume of credit in line with maintaining price stability. When the prevailing market conditions call for a reduction in domestic liquidity, the BSP may limit the amount of credit extended under this facility. Conversely, when there is a need to expand money supply, the BSP makes full use of its credit operations.

In line with the objective of providing a more efficient and effective rediscounting facility, the BSP developed the Electronic Rediscounting System otherwise known as eRediscounting. A product of technological advances, this facility allows banks to conduct their rediscounting transactions and inquiries with the BSP on an online, real-time basis at the convenience of their own bank premises. The eRediscounting facility paved the way for the immediate availability and fast delivery of credit to banks. Furthermore, it allowed the BSP to integrate all rediscounting transactions in a centralized database.

Other Liquidity Management Measures

Tiering System. The tiering system subjects banks' placements with the BSP's RRP and SDA facilities to the following: the applicable BSP published rate (RRP or SDA) for the first P5 billion; a lower interest rate for the next P5 billion; and an even lower interest rate for amounts in excess of P10 billion. In November 2006, the BSP revived the tiering system on banks' placements with the BSP to promote business activity by encouraging banks to seek alternatives to placing their excess funds with the BSP, such as lending to the public.[19]

Moral Suasion. Moral suasion is the influence that the BSP exercises to induce banks to conduct operations in a manner that would promote the public interest. The use of moral suasion is expected to convince banks to contribute to the attainment of monetary goals that may not necessarily support the profit-maximizing objectives of the banks.

Other Schemes for Absorbing Liquidity. In May 2007, the BSP implemented additional measures to broaden its monetary tool kit. These include: (1) Encouraging GSIS, SSS and other GOCCs to deposit funds with the BSP, (2) Allowing BSP-supervised trust entities to deposit funds with the BSP, and (3) Allowing SDA placements of banks to be deemed as alternative compliance by banks to BSP requirements on liquidity floor for government deposits.

[19] The tiering system was subsequently lifted on 13 July 2007.

Table 1: Impact of Monetary Policy Instruments on Money Supply		
Monetary Policy Instruments	Expansionary	Contractionary
1. Open Market Operations	Decrease policy rates Purchase outright government securities	Increase policy rates Sell outright government securities
2. Reserve Requirement 3. Special Deposit Account	Decrease the reserve requirement Decrease the interest rate	Increase the reserve requirement Increase the interest rate
4. Rediscounting	Increase the rediscounting budget/volume of grants	Decrease the rediscounting budget/volume of grants

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Fiscal Developments

January-June 2007 NG deficit is higher than a year ago and exceeds program.

National Government Fiscal Performance
January-June 2007
In billion pesos

	January-June		Percent Change	Q1-Q2 2007 Program	Program vs Actual (%)
	2007	2006			
Surplus/(Deficit)	-41.0	-31.5	-30.1	-31.3	-9.7
Revenues	510.3	471.1	8.3	558.0	-47.7
Expenditures	551.3	502.6	9.7	589.3	38.0

Source: BTR

The January-June deficit of the NG reached ₱41.0 billion, about ₱9.7 billion higher than the programmed ceiling of ₱31.3 billion. The under-performance can be attributed to the ₱47.7 billion shortfall over the first semester revenue program of ₱558.0 billion, which was partially offset by the ₱38.0 billion lower spending due mainly from savings in interest payments. The ₱47.7 billion year-to-date collection shortfall in revenues can be traced to the ₱38.6 billion and ₱13.1 billion shortfall in the collections of the Bureau of Internal Revenue (BIR) and the Bureau of Customs (BOC), respectively.

Despite the deficit and revenue shortfall, the year-to-date revenue collections increased by 8.3 percent to ₱510.3 billion. The increase in revenue collections came from the 5.1 percent growth in the collections of the BIR, which contributed 65.6 percent to total revenues. The BOC and the Bureau of the Treasury posted 2.7 percent and 6.3 percent decline in collections, respectively, while collections of other offices grew by 129.5 percent.

External Developments

Global economic growth remains buoyant, and the sustained growth is building up inflationary pressures.

Global economic conditions, although growing at a moderate pace, continued to be favorable in Q1 leading up to Q2 2007, with a gradual rebalancing in the composition of global growth. Initial estimates by the International Monetary Fund (IMF) in June show that the world economy is growing this year at a rate faster than expected in the previous months. Steady growth in major economies such as the Euro area and Japan, coupled with the brisk pace of expansion in China and India, sustained the strong global economic performance. However, the US economy experienced moderate expansion, as the slowdown in the housing market exerted a drag on economic growth.

Growing domestic demand, investment, exports, buoyant labor market conditions and benign financial conditions were the key growth drivers in the global economy. However, a number of risks remain, notably the expected slower growth trajectory of the US economy, a disorderly unwinding of global imbalances, and a potential increase in financial market volatility. Meanwhile, the sustained expansion has already resulted in a build-up of global inflationary pressures, thus posing an upside risk to inflation and interest rates. Nevertheless, global inflation would still be influenced mainly by developments in energy prices.

The US economy grows moderately.

The US economy grew by 0.6 percent in Q1 2007 from the initial estimate of 1.3 percent, as the strong consumption growth was offset by drags in net exports, inventories, and residential investment.

The weakness in the housing sector has persisted in the past months. However, the country's robust labor market and upbeat consumer sentiment are expected to provide support to economic activity, going forward. Similarly, the Institute of Supply Management (ISM) index continued its steady rise, a firmer indication of a steady improvement in manufacturing. Overall, output growth is expected to improve marginally in Q2, as the negative effects of weak activity in the housing market could dampen consumption spending.

However, latest core inflation readings show that inflationary pressures will remain stable, as indicated by the adjustment in bond prices in June. Nevertheless, the FOMC declared in their latest statement that they have yet to see whether moderation in inflation pressures can be sustained further and that a high level of resource utilization has the potential to sustain those pressures.[20]

The Euro area continues to grow solidly, supported by strong exports and robust domestic demand.

Recent Euro area economic indicators further reaffirm expectations of a solid growth momentum throughout the year. Annual real GDP growth rose to 3.1 percent in Q1 2007 from 2.8 percent in 2006. On a quarterly basis, real GDP growth in the Euro Area dropped slightly to 0.6 percent in Q1 2007 from 0.9 percent in Q4 2006. The main drivers of growth were exports and domestic demand particularly in Germany, which posted stronger-than-expected GDP growth in Q1.

Latest survey indicators such as manufacturing orders, consumer confidence, retail sales as well as data on Euro area labor market conditions point to overall sustained improvements in the industry and household sectors.

The Euro-zone Harmonized Indices of Consumer Prices (HICP) inflation for Q2 2007 was at 1.9 percent, slightly higher than the 1.8 percent recorded in the previous quarter. The developments in energy prices in recent months have exerted a strong influence on inflation. Higher prices of motor fuels and household energy had a marked impact on the prices of energy-related components such as transportation.

[20] "FRB Press Release," FOMC, 28 June 2007, available at http://www.federalreserve.gov .

Nevertheless, the less volatile components of the HICP have also been rising, suggesting domestic price pressures stemming from the economic expansion in the Euro area. Thus, the risks to the inflation outlook still remain on the upside, particularly those coming from movements in oil prices, further increases in indirect taxes and the stronger-than-expected wage developments.[21]

Japanese economic activity has been steadily improving while inflation remains subdued.

Revised economic growth in Japan in Q1 2007 was 3.3 percent year-on-year, stronger than the 2.4 percent preliminary report by the Cabinet Office on account of higher-than-expected spending by companies. On a quarterly basis, Q1 2007 GDP growth was slightly lower at 0.8 percent from the 1.3 percent growth in Q4 2006. Growth was fuelled by the acceleration in net exports and the rebound in consumer spending. Business investments as well as corporate spending also surged during the first quarter, while the unemployment rate fell to 3.8 percent in April from 4.0 percent in March, helping households increase spending for the fourth month.

Prices were steady in April, due to earlier declines in crude oil prices, as evidenced by the negative inflation recorded in February and March. However, inflation is seen to follow an upward trend in the coming months, owing to renewed increases in energy prices and the positive output gap.[22]

Going forward, the steady economic expansion in Japan is expected to continue, driven by robust domestic demand and the surge in exports.

[21] "June Monthly Bulletin." European Central Bank Monthly Bulletin, available at www.ecb.int.
[22] Output gap is the difference between actual GDP and potential GDP or potential output. The calculation for the output gap is Y-Y* where Y is actual output and Y* is potential output or the natural level of output. If this calculation yields a positive number it is called an expansionary gap and indicates an economy in expansion; if the calculation yields a negative number it is called a recessionary gap and indicates an economy in recession.

Strong external demand and industrial production supported overall economic activity in emerging Asia.

Emerging Asia continued to show stronger-than-expected growth in Q1, backed by robust external demand and exports. China's real GDP in Q1 2007 expanded by 11.1 percent year-on-year, driven by a rise in private consumption as well as exports. Meanwhile, India's GDP growth accelerated to a near-two-decade high of 9.4 percent in Q1 2007, due mainly to the continued momentum in the manufacturing sector—which was spurred by strong domestic and external demand. Investment growth was also strong, while consumption spending was moderate. Asia's growth prospects for 2007 remain favorable, although there are a number of risks, namely the uncertainty in the U.S. economy, global imbalances and the possibility of financial market volatility, among others. Inflationary pressures across the region have remained broadly moderate, due to subdued inflation expectations and currency appreciation in most emerging Asian economies as well as previous episodes of monetary tightening in the major Asian economies of China and India. Nevertheless, risks to the inflation outlook remain on the upside, especially the possibility of further increases in oil prices.

Monetary policy rates are left unchanged by major central banks.

The federal funds rate was kept at 5.25 percent for the 7th consecutive time at the 9 May 2007 US FOMC policy meeting given the slow growth in the US economy in Q1 2007, coupled with concerns that inflation will fail to moderate as expected. The Bank of Japan likewise voted to keep its uncollateralized overnight call rate steady at 0.5 percent during its 14 June 2007 monetary policy meeting, on the premise that the monetary environment should be accommodative to ensure price stability while achieving sustainable growth in the medium to long term. The Bank of England's Monetary Policy Committee decided to leave its key interest rates unchanged following its decision to raise the official Bank Rate by 25 basis points in its previous meeting.

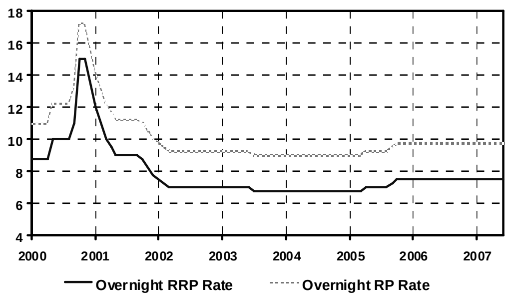
In contrast, the ECB raised its key policy rate.

Meanwhile, the European Central Bank (ECB) Governing Council decided to raise its key interest rate by 25 basis points during its 7 June 2007 policy meeting. This decision was taken in view of the prevailing upside risks to price stability over the medium term.

IV. Monetary Policy Developments

The BSP maintains its monetary policy stance.

BSP Policy Interest Rates
In percent



The Monetary Board decided to maintain the BSP's key policy interest rates at 7.5 percent for the overnight borrowing or reverse repurchase (RRP) rate and 9.75 percent for the overnight lending or repurchase (RP) rate during its policy meetings on 19 April and 31 May 2007. The tiering system on bank placements with the BSP was also kept in place, including those on SDA placements by trust entities. In addition, the Monetary Board approved new monetary measures effective 10 May 2007 as follows:

a) Encourage GSIS, SSS, and other GOCCS to deposit funds with the BSP;
b) Allow trust departments of banks to deposit with the BSP; and
c) Allow SDA placements of banks to be deemed as alternative compliance with the liquidity floor requirements for government deposits.

The Monetary Board assessed that the outlook for inflation over the policy horizon continues to be benign, due mainly to easing supply-side pressures, moderate demand pressures and well-contained inflation expectations. Ample supply of major food items, the subsiding base effect of the RVAT on the CPI, and the strengthening of the peso have contributed to the continued downtrend in inflation.

Risks to the inflation outlook remain.

However, sustained growth in domestic liquidity remains a key policy concern. Domestic liquidity expansion has remained strong in the past several months and although current inflation has continued to decelerate, a prolonged surge in liquidity could eventually pose risks to inflation. In addition, volatility in oil prices remains a risk to the inflation outlook, given the limited production capacity and the threat of possible geopolitical disruptions. The possibility of additional wage adjustments also provides some upside risks.

New monetary measures are expected to help siphon off additional liquidity.

The implementation of the new monetary measures is expected to help siphon off additional liquidity in the system and thereby exert a mitigating impact on future inflation. While initial results have been encouraging, the recent policy moves need to be given time to fully work their way through the financial system and achieve their objective of keeping domestic liquidity growth down to a more modest pace. This will also allow further assessment of the liquidity impact of the continued strong foreign exchange inflows into the economy.

The new monetary measures are expected to broaden the scope and depth of the BSP's set of monetary policy instruments as well. Recent banking reforms, particularly a strong risk management system, will be supportive of this initiative. This is also consistent with the development of the domestic capital market.

For the next several months, the BSP will closely monitor the impact of the new measures on monetary conditions which will serve as basis for subsequent monetary policy actions to ensure that the benign inflation environment is maintained over the policy horizon.

V. INFLATION OUTLOOK

Inflation Forecasts

The BSP expects a generally subdued inflation path over the policy horizon but foreseeable risks to future inflation remain.

The near-term outlook for inflation remains essentially unchanged from the assessment in the previous Inflation Report. Limited, albeit increasing, demand-based pressures, favorable supply-side conditions and well-anchored inflation expectations continue to point to a subdued inflation environment going forward.

Demand Conditions

Demand-based price pressures remain limited amid mixed trends of various indicators.

On the demand side, several indicators exhibit a broad upward trend while others posted a general decline. GDP accelerated to its highest first quarter growth in 17 years. This was accompanied by a sustained expansion in external trade, continued growth in vehicle and energy sales, improving consumer and business outlook, and lower unemployment. The increase in property prices and the decline in vacancy rates are expected to continue based on forecasts by real estate experts. On the other hand, the growth of power consumption decelerated while appliance sales declined. In addition, survey-based production indices from NSO showed weaker manufacturing activity. Moreover, the continued deceleration in core inflation suggests an easing of overall demand-based pressures on consumer prices.

Supply Conditions

Favorable food supply and the general strength of the peso could help counter the upward pressure exerted on prices by high oil prices.

Meanwhile, the continued ample supply of food is seen to temper price pressures in the near term. In particular, agricultural output is expected to continue to expand for the rest of the year on account of the expected increase in public spending on seed technology and rural infrastructure. The growth for the whole year, however, will be slower than in 2006 due to the rains and cold weather in January, the base effects from last year's relatively high levels, and also in anticipation of a La Niña event sometime in Q3 2007. Movements in oil prices will also continue to influence future inflation. The uptrend in spot and futures prices of oil continues to point to relative tightness in the international oil market. The sustained appreciation of the peso, nonetheless, should continue to exert a moderating impact on the upward pressure exerted by rising oil prices.

Output Gap Estimates

The slight increase in the output gap points to the subdued influence of demand-side price pressures.

The balance of demand and supply conditions, as captured by the output gap (or the difference between actual and potential output) likewise provide an indication of potential inflationary pressures in the near term. Inflation tends to rise (fall) when demand for goods and services in the economy is greater (less) than the economy's ability to produce goods and services, i.e. when the output gap is positive (negative). Based on revised GDP data, preliminary estimates yielded an output gap of 3.1 percent in Q1 2007. It represents a slight increase from the 2.9 percent reading in Q4 2006. The marginal rise in the output gap despite the record high expansion in output in Q1 2007 could indicate that demand pressures are still limited. This gives further support that inflationary pressures from the demand side remain subdued.

Inflation Expectations

Based on the results of the BSP's survey among private forecasters, inflation expectations appear to be well contained. While majority of respondents in the latest round of Consumer Expectations Survey (CES) and Business Expectations Survey (BES) expect prices to increase in the near term, private sector analysts anticipate inflation to slow down in the remaining months of 2007 and until 2008.

Baseline forecasts by the BSP show a declining inflation path.

Emerging baseline forecasts by the BSP continue to indicate a generally manageable inflation environment over the policy horizon. In the absence of further adverse shocks, latest estimates showed that average inflation is expected to fall below the 4.0-5.0 percent target range in 2007. Meanwhile, inflation is forecasted to settle within the 4.0 percent ± 1.0 percentage point target for 2008.

The BSP's forecasts are based on the following assumptions:

a. The National Government (NG) deficit will amount to ₱63.0 billion in 2007. The NG was assumed to achieve a balanced budget in 2008.

b. The headline overnight RRP rate was assumed constant at 7.5 percent from July 2007 to December 2008.

c. The 91-day T-bill was assumed to average 4.5 percent for the last five months of 2007 and 5.0 percent in 2008.[23]

[23] For the BSP's Multi-Equation Model, the 91-day T-bill rates were determined endogenously.

d. International crude oil prices are consistent with the latest BSP projections (as of 10 July 2007, based on futures prices) of US$63.97 for 2007 and US$69.05 for 2008.

e. The nominal wage rate was assumed to increase by 7.1 percent in 2007 and 6.7 percent in 2008.

f. The exchange rate is determined endogenously in the BSP Multi-Equation model through purchasing power parity and interest rate parity relationships.

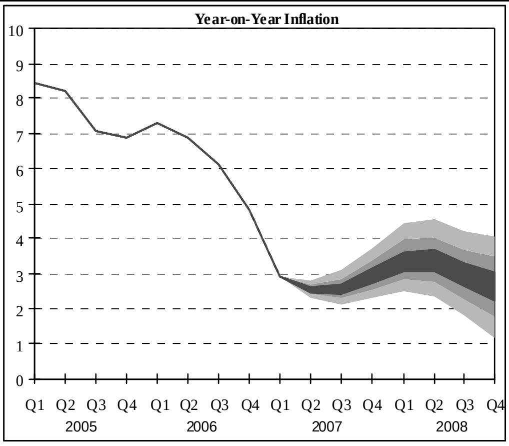
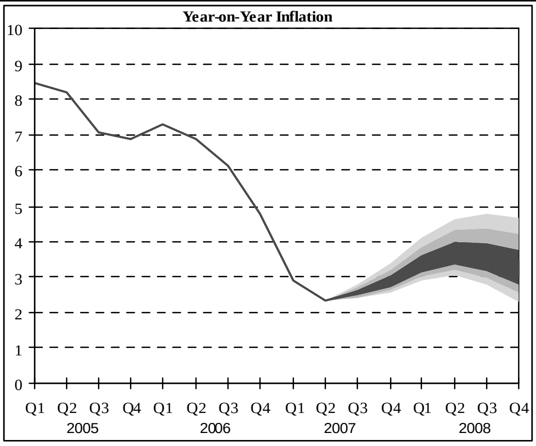
Risks to the Inflation Outlook

Latest fan chart continues to show a benign inflation outlook.

The fan chart depicts the probability of different inflation outcomes based on the central projection (corresponding to the baseline forecast of the BSP) and the risks surrounding the inflation outlook.

As in the previous quarter, the central projection for inflation (corresponding to the darkest band of the current fan chart) remains below the 4.0-5.0 percent target range in 2007 and within the 4.0 percent ± 1.0 percentage point target for 2008. In addition, inflation is likewise projected to rise steadily until Q2 2008 amid assumptions of increasing oil prices based on crude futures and a rise in wages. Nonetheless, inflation is projected to decelerate in the current fan chart after peaking in Q2 2008 due to the continued appreciation of the peso and some base year effects. Meanwhile, considerable uncertainty continues to surround the inflation outlook, as illustrated by the wide bands of the fan chart.

The bands above the central projection are wider than those below, indicating that upside risks dominate the outlook on inflation. The main risks to the inflation outlook relate to the continued volatility of oil prices, probable occurrence of weather disturbances, possible increases in wages and transport fares, and prolonged surge in liquidity.

Inflation Profile as of the Previous Quarter	Latest Inflation Profile
	

The fan chart shows the probability of various outcomes for inflation over the forecast horizon. The darkest band depicts the central projection, which corresponds to the BSP's inflation baseline forecast. It covers 25 percent of the probability. Each successive pair of bands is drawn to cover a further 25 percent of probability, until 75 percent of the probability distribution is covered. The bands widen (i.e. "fan out") as the time frame is extended, indicating increasing uncertainty about outcomes.

Risks to the inflation outlook remain.

Continued Volatility of Oil Prices

Oil prices have been a key influence on future price movements, and are likely to remain so in the near future. The global oil market is expected to remain relatively tight given robust oil demand, limited production capacity and the always present threat of geopolitical disruptions. As projected by the EIA, the combination of rising consumption, the continued effects of production cuts by members of the OPEC, and only modest increases in non-OPEC production, have pulled commercial oil inventories down from their highest levels since 1998.[24] Along with geopolitical tensions and weather concerns, the tightening of the world oil balance continues to put upward pressure on oil prices. EIA projections for OPEC members' oil production in the second half of this year point to a further decline in commercial oil inventories, with inventories (on a days-forward-cover basis) falling to historically low levels by the end of the year. The timing of a possible decision to raise output in the second half of this year and uncertainty surrounding the oil production disruptions in Nigeria will affect market conditions in the months ahead.

Possible Occurrence of Weather Disturbances

International weather forecasting centers have predicted elevated chances of a La Niña weather disturbance in the second half of 2007. Moreover, the local weather bureau has announced the onset of the rainy season which is expected to peak in Q3. The occurrence of weather disturbances could impact on the planting period for the main harvest season (September-December) which, in turn, could affect food prices. Nonetheless, the DA has allocated "standby funds" in preparation for the onslaught of the rainy season to ensure a continuous flow of agricultural produce from farmers to markets despite the onslaught of typhoons.[25]

[24] http://www.eia.doe.gov/emeu/steo/pub/contents.html
[25] "DA prepares funds for rainy season woes" <http://business.inquirer.net/money/breakingnews/view_article.php?article_id=76165>

By having a strong farm-to-market link, agriculture produce shortages and unwarranted price increases can be avoided during the rainy season. Moreover, the Government is intensifying its efforts to construct uniform drying and storage systems for major commodities to improve the farmers' capability to store and move their produce.

Possible Increases in Wages and Transport Fares

The possibility of additional wage adjustments likewise provides some upside risks to the inflation outlook. The 10 percent increase in the compensation of government employees—which accounts for 7.6 percent of the total employed population[26]—was followed by similar calls for wage increases among private sector employees. At present, there are six pending petitions before the RTWPBs for daily wage adjustments ranging from ₱75 to ₱93. Meanwhile, the petition by transport groups to remove the 50-centavo discount on the minimum fare approved by the LTFRB on 28 June 2007—once implemented—could also add to inflation pressures.[27] The restoration to ₱7.50 of the minimum fare is expected to take effect in Metro Manila, Central Luzon and Southern Tagalog, as soon as the LTFRB gets clearance from NEDA.[28]

[26] Based on the NSO's April 2007 Labor Force Survey
[27] These transport groups include the Alliance of Transport Operators and Drivers Organization of the Philippines; the Federation of Jeepney Drivers Association of the Philippines; Pasang Masda; and Pagkakaisa ng mga Samahan ng mga Tsuper at Operators Nationwide.
[28] The adjustment of said minimum fare needs clearance from NEDA, in accordance with the new Memorandum Circular No. 132 dated 19 June 2007, issued by Executive Secretary Eduardo Ermita. The memorandum enjoins all departments, bureau, commissions, agencies, offices and instrumentalities of the NG including GOCCs to seek prior approval from the NEDA Board before imposing fees or increasing fees.

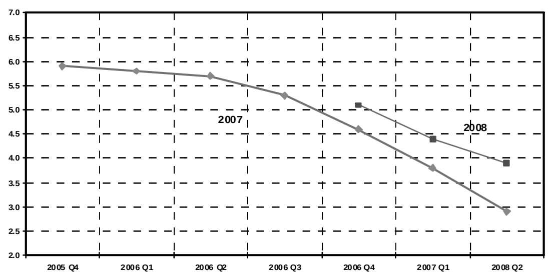
Continued Strong Growth in Liquidity

Trends in monetary aggregates remain important in the assessment of the outlook for inflation. The recent slowdown in M3 growth, due in part to the additional liquidity management measures implemented by the BSP in early May 2007, is favorable to the inflation outlook. However, the underlying rate of liquidity growth remains relatively strong with M3 growth still slightly higher than 20 percent. Nevertheless, the strong growth in domestic liquidity has not contributed to inflationary pressures, due partly to the increasing absorptive capacity of the economy and financial innovations that shift money around in the economy without affecting the transactions demand for money to purchase goods and services. However, the BSP will continue to keep a close watch on developments in monetary aggregates to ensure that monetary conditions are consistent with the price stability objective.

Private Sector Economists' Inflation Forecasts

Private sector forecasts point to below-target inflation in 2007.

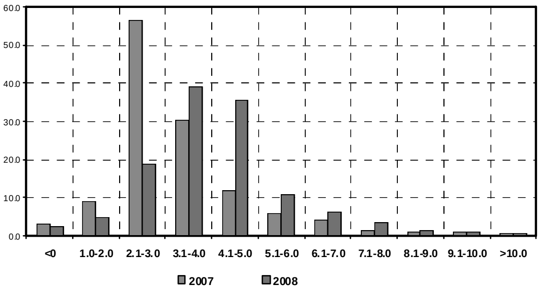
Mean Inflation Forecasts by Private Sector Economists/Analysts
In percent



Private economists' forecasts during the 2Q 2007 BSP survey showed benign inflation outlook for both 2007 and 2008. This quarter's mean inflation forecast for 2007 fell further to 2.9 percent from 3.8 percent in the last quarter's survey result. Analysts cited that inflationary pressures will be tame because of the strong peso, the subsiding base effects resulting from the implementation of the RVAT Law, and the relatively lower international oil prices. Meanwhile, they noted some upside risks to their forecasts such as wage increases; high domestic liquidity; possibility of increases in oil prices; political instability; and bad weather, which could impact on the prices of basic food commodities.

The mean inflation forecast for 2008 is also lower at 3.9 percent from the 4.4 percent projection in the previous quarter.

Probability Distribution for Analysts' Inflation Forecasts*
2007 and 2008



*Probability distributions were averages of those provided by 14 respondents.
(Source: BSP Survey)

Based on the probability distribution of respondents' forecasts, there is a 56.5 percent chance that inflation will be at 2.1-3.0 percent, which falls below the low-end of the 4.0-5.0 percent target for 2007.

Private Sector Forecasts for Inflation

Annual percent change

	Inflation	
	2007	**2008**
ATR Kim Eng Securities	3.0	3.5
Bank of America	2.5	3.2
Deutsche Bank	2.3	3.0
Development Bank of Singapore	2.4	3.6
Forecast Pte Ltd. (Singapore)	2.9	4.3
HSBC	3.4	5.1
IDEA	2.5	3.3
ING Bank	2.9	4.3
Lehman Brothers	2.7	3.5
Metrobank	3.1-3.8	
Multinational Investment Bank	2.4-2.7	4.0-4.5
Nomura Securities	3.0	3.5
Philippine Equity Partner	2.5	3.8
RCBC	3.5-4.5	4.0-5.0
Standard Chartered Bank	3.3	5.0
The Economist Intelligence Unit (EIU)	3.1	3.5
Median Forecast	2.9	3.6
Mean Forecast	2.9	3.9
High	4.0	5.1
Low	2.3	3.0
Number of Observations	16	15
Memo Item		
Government Target	4.0-5.0	4.0±1.0

Source: BSP Survey

VI. IMPLICATIONS FOR THE MONETARY POLICY STANCE

While the continued growth in domestic liquidity and the volatility of oil prices constitute major risks to future inflation, baseline forecasts continue to indicate a manageable inflation outlook.

Domestic liquidity continued to grow but has slowed down in May. The sustained growth in domestic liquidity has not resulted in price pressures with inflation remaining broadly stable at an average of 2.6 percent for the first six months of the year. It is possible that the relationship between money growth and inflation in the short term has been influenced by financial innovations that merely shift money around but do not feed into price inflation. Under such conditions, increased liquidity may not necessarily translate to higher demand for goods and services and therefore, does not necessarily translate to higher consumer prices. Hence, the inflation outlook remains broadly benign with the latest forecasts showing that inflation could fall below the 4.0–5.0 percent target range in 2007 and within the 4.0 percent +/-1.0 percentage point target in 2008.

Liquidity management measures implemented in early May 2007 have begun to exert the desired cooling effect on liquidity conditions.

The monetary policy measures implemented on 10 May 2007 could have influenced liquidity growth which has slowed down to 21.1 percent in May. However, the impact of these measures may not have fully worked its way through the system because of some realignments between RRP and SDA placements of banks and trust entities. Additional data points will be required to validate the assessment of the overall effectiveness of these measures in containing liquidity.

It is timely to review the tiering system.

Meanwhile, there are indications that the tiering system that has been in effect for the past eight months has had a beneficial impact on bank lending to the productive sectors of the economy. Given the continued broadening of financial markets, which made non-bank sources of financing increasingly available to the private sector, the trend in bank lending may have reached a respectable level.

The benign inflation outlook over the policy horizon suggests a neutral policy stance.

In the absence of a clearer direction on the potential risks to the inflation outlook, a neutral stance of monetary policy is appropriate given moderate demand conditions and manageable inflation expectations. The BSP will continue to be closely attentive to emerging risks with a view to formulating preemptive monetary policy that will safeguard price stability. This will ensure that a low-inflation environment supportive of healthy and strong economic growth is sustained over the policy horizon.

VI. Concluding Remarks

While inflation readings over the two-year target period remain benign, monetary authorities need to address significant risks to the inflation target. The sustained strong growth of domestic liquidity is one such risk. Other potential risks to the inflation outlook are potential wage pressures and volatile international oil prices.

To address the sustained surge in domestic liquidity, the Monetary Board introduced new measures to help contain M3 growth. While more data points may be necessary to assess the overall effectiveness of these measures, initial results are encouraging.

The tiering scheme reintroduced late last year to induce banks to lend, needs to be reviewed given indications that bank lending to productive sectors are already on a respectable growth path. The Monetary Board will consider this development and take appropriate steps if warranted.

[Subsequently, on 12 July 2007, the Monetary Board decided to maintain a neutral monetary policy stance by implementing two complementary moves. Effective 13 July 2007, the tiering system on placements with the BSP was lifted and the BSP's key policy interest rates were adjusted to 6.0 percent for the overnight borrowing or reverse repurchase (RRP) rate and 8.0 percent for the overnight lending or repurchase (RP) rate. This policy stance is neutral relative to future inflation and output.]

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 RRP and 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 2002. 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 the overnight RRP and RP rates unchanged 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 Board 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, 10 February, 10 March 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.

7 April 2005

The Monetary Board voted unanimously to raise the overnight RRP and RP rates by 25 basis points each to 7.0 percent and 9.25 percent, respectively.

5 May, 2 June, 30 June 2005

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

7 July 2005
(Special Monetary Board meeting)

The Monetary Board raised the regular and liquidity reserve requirement ratios by 100 basis points each to 10 percent and 11 percent, respectively, effective 15 July 2005.

28 July, 25 August 2005

The Monetary Board left key policy rates unchanged at 7.0 percent and 9.25 percent for the overnight RRP rate and overnight RP rate, respectively.

22 September 2005

The Monetary Board decided to raise the overnight RRP rate and RP rate by 25 basis points to 7.25 percent and 9.5 percent, respectively.

20 October 2005

The Monetary Board raised the key policy rates by 25 basis points to 7.5 percent and 9.75 percent for the overnight RRP and RP rates, respectively.

17 November, 15 December 2005

The key policy rates were left unchanged at 7.5 percent and 9.75 percent for the overnight RRP and RP rates, respectively.

2006

12 January, 9 February, 9 March, 6 April, 4 May, 1 June, 29 June 2006, 10 August, 21 September

The Monetary Board decided to maintain the policy rates at 7.5 percent and 9.75 percent for the overnight RRP and RP rates, respectively.

2 November

The Monetary Board decided to keep policy rates unchanged at 7.5 percent and 9.75 percent for the overnight RRP and RP rates, respectively.

At the same time, the Monetary Board adopted a tiering system on banks' aggregate placements with the BSP under the RRP and SDA windows effective 2 November 2006. In particular, placements under the said windows would be subject to the following interest rates: the applicable BSP published rate for the first ₱5 billion, the applicable BSP published rate less 200 basis points for the next ₱5 billion; and, the applicable BSP published rate less 400 basis points for amounts in excess of ₱10 billion.

14 December

The key policy rates were left unchanged at 7.5 percent and 9.75 percent for the overnight RRP and RP rates, respectively. The tiering system for bank placements under the RRP and SDA windows was also maintained.

<u>2007</u>

25 January, 8 March

The key policy rates were left unchanged at 7.5 percent and 9.75 percent for the overnight RRP and RP rates, respectively. The tiering system for bank placements under the RRP and SDA windows was also maintained.

16 April

The key policy rates were left unchanged at 7.5 percent and 9.75 percent for the overnight RRP and RP rates, respectively. The tiering system for bank placements under the RRP and SDA windows was also maintained.

The Monetary Board also approved new monetary measures as follows:
a) Encourage GSIS, SSS, and other GOCCS to deposit funds with the BSP;
b) Allow trust departments of banks to deposit with the BSP; and
c) Allow SDA placements of banks to be deemed as alternative compliance with the liquidity floor requirements for government deposits.

These measures will take effect on 10 May 2007.

28 May

The key policy rates were left unchanged at 7.5 percent and 9.75 percent for the overnight RRP and RP rates, respectively. The tiering system for bank placements under the RRP and SDA windows was also maintained.

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:

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