Good morning. Thank you for joining us in this mid-year economic briefing.

I am pleased to speak before you on the developments in the monetary, external and banking sectors. After providing you with an overview of recent economic developments, I will discuss the outlook for the next two years which takes into account the challenges that our economy is facing. Then, I will walk you through how the BSP has responded to these challenges. I will close with the BSP’s policy thrusts going forward.

Let me start with the latest price developments.

Inflation averaged 8.8 percent for the first 8 months of the year, rising to 12.5 percent in August from 4.9 percent in January 2008. Core inflation, which measures the underlying trend in inflation by excluding specific food and energy prices, climbed to 7.0 percent year-on-year in August, from 3.4 percent in January.

Price pressures have been building up since early this year. Initially the price increases were due to supply-side factors, specifically from elevated international oil and non-oil commodity prices. However, second round price pressures subsequently became apparent, as evident in the rise in core inflation and the adjustments in the pricing of services as well as wages. These have resulted in a more challenging inflation environment.

Meanwhile, the country’s external payments profile remains a major source of strength for the economy. The BOP remained in surplus for the first eight months of 2008 at US$2.0 billion. Remittances from overseas Filipinos continued to boost the BOP, reaching US$9.6 billion for the first seven months of 2008, higher by 18.2 percent relative to the year-ago level.

The sustained BOP surplus resulted in the continued build-up of the country’s gross international reserves (GIR), which stood at US$36.7 billion as of end-August 2008. At this level, the GIR is equivalent to 6.0 months’ worth of import cover, 2.9 times the country’s short-term external debt based on residual maturity.

The strong external position has allowed both the public and private sectors to prepay some of their FX obligations, resulting in further improvements in the country’s external debt ratio. As of end March 2008, the external debt ratio stood at 35.6 percent, less than half its level in 2001 of 72.9 percent.

The peso has weakened in recent months. On a year-to-date basis, the peso depreciated against the US dollar by 12.3 percent as it closed at P47.09/US$1 on 15 September 2008. This is on account of rising risk aversion due to worries over global economic slowdown and credit tightening. Concerns over rising inflation further added pressure against the peso. For the period 2001-2008 (to-date), the peso appreciated by 9.1 percent, generally in tandem with most currencies in the region.

The Philippine peso has been generally competitive against our major trading partners and competitors in real terms. If we take 2001-2002 as the comparator period given both good GDP and inflation numbers, coupled with the manageable external payments position, the end points remain broadly on the same level.
On the financial sector, the banking system remains generally sound and stable. The banking system’s asset base has been expanding steadily. The continued asset clean-up of banks, accomplished without the use of public funds, has enhanced asset quality, bringing the NPL ratio closer to the pre-Asian crisis level of around 4.0 percent. Banks remained capitalized at levels above both the BSP-regulatory requirement and the BIS standard.

Owing to reforms earlier instituted, the Philippine banking system has not been significantly affected by the financial stresses experienced from the US subprime mortgage market. Furthermore, the Philippine domestic banks’ exposure to structured products, such as CLNs and CDOs, issued by investment houses like Lehman Brothers has been limited and are well cushioned by banks’ capital base. However, we continue to closely monitor developments in the global financial markets, including further risk aversion against emerging markets including the Philippines, as these may adversely impact the growth of the banking sector.

Where are we heading?

The inflation path is expected to be hump-shaped, with the peak around Sept/Oct this year, after which we expect a gradual leveling off. We expect to see the single-digit level again by late Q1/early Q2 next year. Nevertheless, the forecasts still indicate that inflation could exceed the 2008 and 2009 targets. The BOP surplus by end 2008 is estimated at around US$2.0 billion. This would result in a GIR level of US$37 billion by the end of 2008.

What are the challenges that we face as we try to achieve these projections?

The Philippines – like many emerging countries – is faced with the challenge of rising inflation and slower economic growth. The slowdown in US and global growth could result in a deceleration of Philippine export growth and a decline in foreign investments. While global commodity prices have started to show some easing, world oil prices are expected to remain volatile due to low global production capacity and rising demand in emerging economies. Non-oil commodity prices may take longer to unwind because of strong demand from growing consumption of emerging countries and as inputs for biofuel production. The risk of high inflation remains present.

Meanwhile, the strains in global financial markets continue to persist and have heightened risk aversion. While emerging markets, including the Philippines, have been fairly resilient to the global credit turmoil, they could face greater risks because of higher borrowing costs and reversals in capital flows.

How has the BSP addressed these? Consistent with our primary mandate, we have responded through policies appropriately aimed at sustaining price stability. We believe this is essential in ensuring sustained long-term economic growth.

As I mentioned earlier, the BSP noted that the spikes in prices in early 2008 were supply-side in origin. These had mainly global roots and were expected to be largely transitory. As is well accepted, such supply-side shocks are best addressed by non-monetary measures. Acknowledging that the impact of monetary policy under that scenario would be limited, the BSP followed a prudent approach by accommodating these first-round effects. In other words, BSP treated the resulting rise in prices as a shift in relative prices, and allowed it to go through. Thus, BSP kept its policy settings steady during our March and April meetings.

Subsequently, however, we noted changes in the inflation dynamics. First, inflation expectations were rising. More specifically, consumer and business expectations surveys began to show more respondents expecting headline inflation to go up in the coming months. BSP’s survey of private sector economists/analysts showed higher inflation forecasts for both 2008 and 2009. Moreover, the term spreads on secondary market yields for government securities were on the rise, reflecting market sentiment for a continued rise in the future.

Second, real interest rates continued to be in negative territory. This would pose some complications to making decisions on savings, investment and production, which over time could weigh down on capital flows, exchange rate and ultimately, inflation.
Given the new information, the BSP responded with a combination of policy rate hikes and careful communication of BSP’s inflation-fighting resolve. During its policy meetings in June, July and August, the BSP gradually raised its policy rates from 5 percent to 6 percent. The cumulative 100 basis points hike was a recognition that it was necessary to act promptly and preemptively to: 1) address price pressures that were coming more evidently from second-round effects; 2) guide inflationary expectations, to arrest self-perpetration into higher actual inflation; and 3) rein in inflation and allow it to fall within the target range over the policy horizon.

Latest indicators show that inflation is losing speed but risks remain. Global commodity prices are now starting to show some easing. However, we still need to remain cautious given the inherent volatility in commodity prices. The BSP remains confident that its current monetary policy stance could be accommodated by resilient demand conditions. The buoyancy of domestic demand suggests room for measured interest rate action without causing serious effects on the real sector.

Meanwhile, we have continued to institute reforms to further strengthen the banking system and deepen the domestic capital market. These reforms are focused on further enhancing the regulatory framework through the continued implementation of the BASEL II framework; accelerating the implementation of risk-based supervision; improving corporate governance, including by promoting compliance with international accounting and financial reporting standards; continuing to promote microfinance lending to improve small businesses’ access to credit; and supporting the deepening of the domestic capital market.

What can you expect from the BSP going forward?

The policy thrusts of the BSP are aimed at ensuring that the headway that we have achieved in nurturing a resilient economy and a sound banking sector will continue even in the face of the challenges we all face. First, monetary policy will continue to be sufficiently cautious and vigilant to the emerging balance of risks. It will continually reassess the evolving situation as price pressures show initial signs of slowing down and as demand conditions moderate. This will ensure a responsive conduct of appropriate monetary policy.

In the external sector, our policies will continue to be directed at maintaining a market-determined exchange rate with scope for occasional official action to address sharp volatilities in the exchange rate; maintaining a comfortable level of reserves as self-insurance; and ensuring the sustainability of our external debt. These policies will continue to promote strong fundamentals that will help reduce the economy’s vulnerability against global economic risks and support the needs of a more dynamic and globally integrated economy.

In the financial sector, we remain firmly committed to sustain key reforms that will lead to greater efficiency, effective risk management, stronger capital base and improved corporate governance standards in the banking system. These financial and banking sector reforms will continue to raise savings and help boost financing for productive activities.

In summary, let me assure you that the BSP is prepared to take all necessary action to address the threat of high inflation and promote price stability. We stress here that high inflation erodes the community’s purchasing power, reduces their consumption expenditure and slows down economic growth. We are therefore mindful of the impact of our monetary policy action on the economy’s growth momentum. The resiliency of our economy allows us to have greater flexibility in responding to the challenges that come our way.

Thank you very much.