

Philippines: one more cut

The BSP unexpectedly cut interest rates last week. We expect one more 25bp cut by year-end but see little scope for further cuts

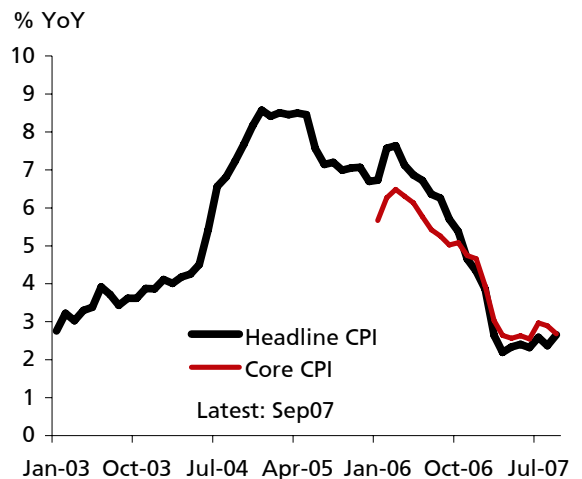
The BSP on Oct 4 unexpectedly cut its key policy rates by 25bps, taking the borrowing (reverse repo) and lending (repo) rates to 5.75% and 7.75% respectively. With growth near a twenty-year high there seemed little reason for doing so. In retrospect, however, there was more to be gained from lowering rates than not. Its motivations will remain relevant over the remainder of the year, and should mean one more 25bp cut by the year-end, taking the overnight repo rate to 5.50%. The scope for further cuts beyond that appears limited, however, given our expectation that the US Fed will not cut rates below 4.50%. Importantly, inflationary risks also lie to the upside in 2008, with the output gap set to widen and this year's rate cuts coming ahead of a projected rise in budget spending in 2008.

Inflation is at multi-year lows

Inflation is low and will stay low

The key message in the BSP's post-meeting statement was that inflation was low and would likely remain so. The central bank reiterated that inflation would undershoot its 4-5% projection this year, and would fall within the 3-5% range forecast in 2008. This is reasonable – we expect the headline CPI to rise by 2.6% this year and 3.5% in 2008. More recent data showed September inflation at its highest since Jan07, at 2.7% YoY, but in MoM terms inflation was up only a mild 0.1%. Importantly, inflation, while creeping slightly higher, remains at multi-year lows (*Chart 1*).

Chart 1: Inflation is low



M3 growth less of a threat

Going forward, the upside risks to inflation from excess liquidity have also receded. Though liquidity growth is still out-pacing inflation – and for that matter real activity – M3 is now up by around 15.0% YoY, about half the 26.1% peak rate reached in Apr07 and well within the central bank's sub-20% comfort zone (*Chart 2*).

A little stimulus is harmless; real interest rates are high

That real interest rates remain high also suggests that the near-term risks of monetary policy proving overly accommodative are low. Real GDP growth is close to a twenty-year high, but the risks of overheating / inflation are being kept in check by high real borrowing rates. Thanks to the sharp slowdown in inflation since 2005, the rise in real rates has far surpassed the increments made to the nominal policy rate (*Chart 3*). Following the latest rate cut, the real borrowing rate is now at 3.05%; this compares to an average real rate of 2.1% since 2002, when the repo/reverse repo rates came into effect as the BSP's official targets.

Chart 2: M3 poses less risk to inflation

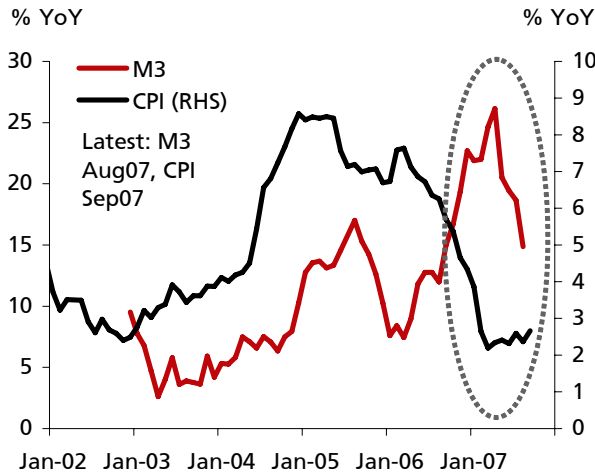
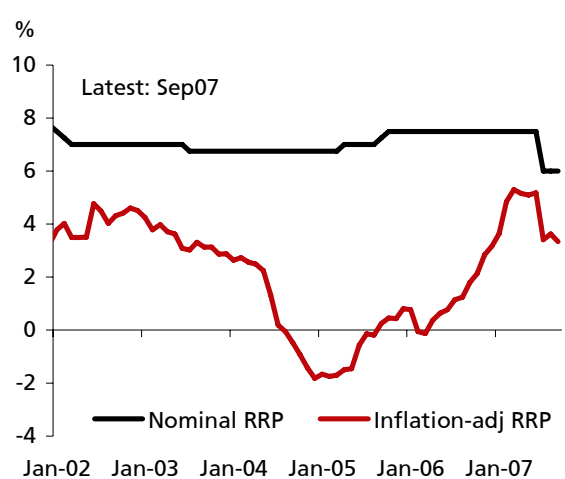


Chart 3: Real borrowing rates high on low inflation



Funds into the BSP's Special Deposit Account facility have surged since access was widened in May07

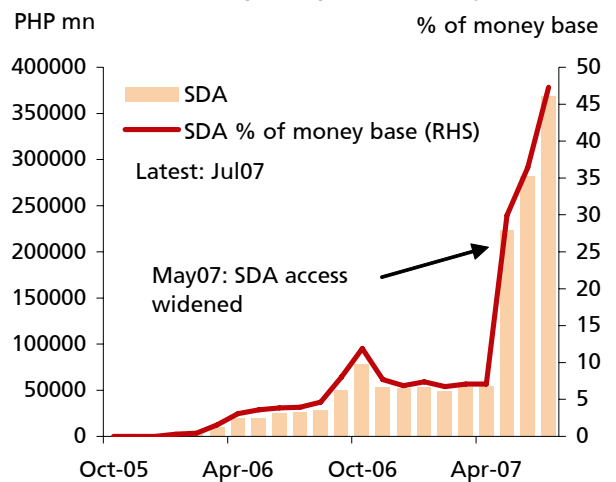
Reducing the cost of SDA

The interest rate cut has also helped reduce the negative carry the BSP is facing with regards to the Special Deposit Account (SDA), which has been pivotal in helping to cool liquidity growth. In May this year, access to this facility, which draws in funds from the banking system by offering higher interest rates than what is available in the money or interbank markets, was widened from banks to include trust units and state firms. The effect was dramatic, with the level of SDAs quadrupling (*Chart 4*).

But the BSP suffers negative carry on SDAs. Interest rate cuts help reduce the spread

But the negative carry for the BSP would have been large - prior to last week's interest rate cut, the SDA was on average paying 6.2-6.4%, significantly higher than the returns the BSP would have been making on its FX reserves. Four-fifths of these reserves are USD-denominated, and the 10yr T-bond is currently yielding just above 4.60%. Last week's interest rate cuts have slightly reduced this negative carry, with a 6mth SDA deposit now earning 6.25% compared to 6.50% earlier.

Chart 4: SDAs have quadrupled since May07



Interest rate cuts are better than nothing as a rapidly rising peso erodes overseas earnings and possibly domestic consumption

The Peso: Doing something is better than nothing

Arguably, an interest rate cut will also help to temper the peso's rise. In actuality the narrowing/widening of yield differentials has meant very little for the direction the peso, largely because of the overwhelming magnitude of remittance flows (*Chart 5*). In 2006 remittances totalled USD 14bn, compared to a trade deficit of USD 6.5bn and a capital/financial account deficit of USD 1.5bn.

Still, it is probably preferable that the BSP attempts to do what it can with regards to the peso, rather than nothing. The central bank is not likely to be looking to reverse the peso's trend – this is a near-insurmountable task, and importantly a stronger peso does have its benefits when it comes to imports (especially oil) and debt repayments. But it has to balance these benefits against

the erosive effects that a stronger peso has on foreign workers' earnings, and in turn, domestic consumption. As it stands, in local currency terms remittances have already been contracting since May 07 (*Chart 6*).

Chart 5: Yield differentials not stopping Peso

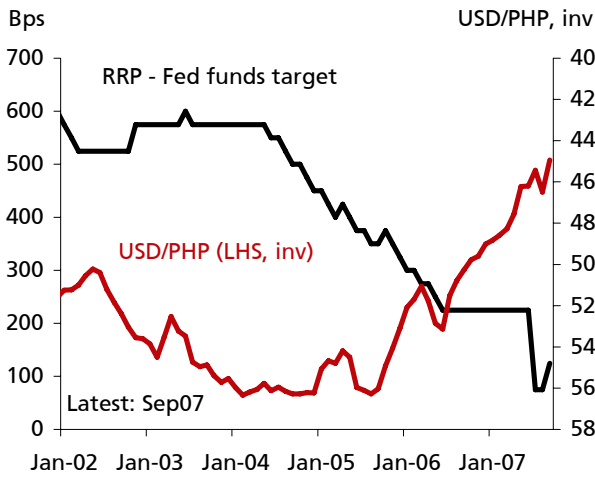
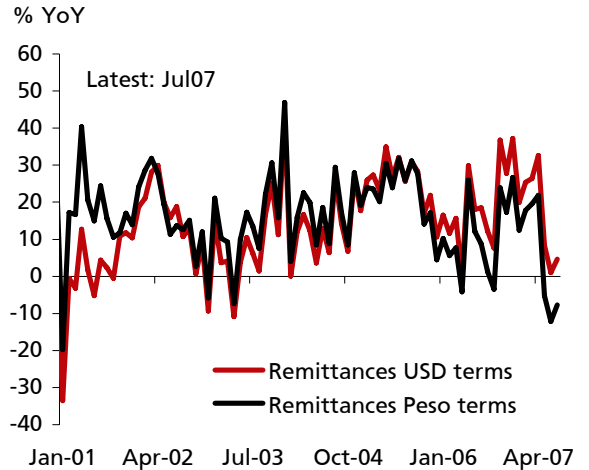


Chart 6: Peso rise eroding remittance earnings



But the window is closing

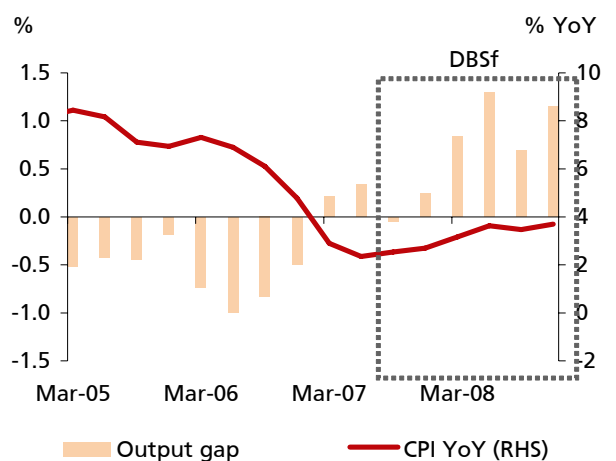
If the BSP moved for the reasons we outlined above, then there continues to be basis for further easing in the months ahead. In 2008, however, room for further cuts is likely to start narrowing.

Firstly, the US Fed is almost done with its easing cycle. We expect one more 25bp cut in the Fed funds target rate to 4.50% at the upcoming Oct 31 meeting, before a pause. As noted earlier, USD/PHP interest rate differentials have been near inconsequential in the face of remittance-driven peso strength. But narrowing the spread between domestic and US rates should, at a minimum, go some way to mute the more speculative aspects of the peso's rise.

Secondly, as the economy continues to grow at a fairly robust pace, slack in the economy will disappear, eventually placing upward pressure on prices. Our estimates suggest that the 6.9% and 7.3% YoY expansions recorded in 1Q and 2Q07 were above the long-term potential growth of around 6.0%, resulting in a moderately positive output gap. This gap is only likely to widen in the coming quarters – we are forecasting growth of 6.9% and 6.6% this year and the next, and inflation of 2.6% and 3.5% respectively (*Chart 7*).

Indeed risks to the outlook on growth – and hence inflation – lie to the upside, considering that the current easing bias in BSP policy is coming ahead of a projected rise in budget spending in 2008. It remains to be seen if President Arroyo will keep her promise and step down in 2010, but it is clear that she intends to make infrastructure development her legacy – over the next three years there are plans to spend PHP 1.7trn on building

Chart 7: Rising output gap will lift inflation



Scope for further cuts in 2008 is limited. The US Fed will not cut below 4.50%

Our growth estimates point to a rising output gap and inflation pressure

roads, railways, air and sea ports. Next year a budget of PHP 1.23trn has been proposed, up 9.0% from 2007; of this, PHP 147.7bn has been proposed for capital outlays, faster than the increase this year and also accounting for a larger chunk of the budget (**Chart 8**).

Lastly, we are also wary of the rise in food prices, which sequentially have been rising a little faster since May07 (**Chart 9**). At 46.6% food is the largest component in the CPI basket. That said, we acknowledge that food-price pressures in the Philippines have not been as acute or long-running as compared to some other countries in the region like Indonesia. The central bank believes that weather conditions have “broadly normalized, supporting favorable supply of agricultural products”. No doubt the peso’s strength has also helped in this regard, with its 12.0% appreciation against the USD in the year to date making it the best-performing currency in the region.

The bottom-line, then, is that the BSP does not have significant room to manoeuvre policy-wise in the coming months.

If anything, given that the risks to 2008 inflation currently lie to the upside and our view that the Fed will be lifting interest rates again from 3Q08, we cannot rule out the possibility that the BSP will do likewise in 2H08. Data in the coming quarters will provide greater clarity on the probability of such a scenario, but until then we look for the BSP to cut policy rates by another 25bps before the year is up. This will take the RRP to 5.50% and the RP to 7.50%.

We are also watching food prices

Bottom-line: One more 25bp cut in policy rates by year-end, taking the RRP and RP to 5.50% and 7.50%

Chart 8: Budget - capital outlays on the rise

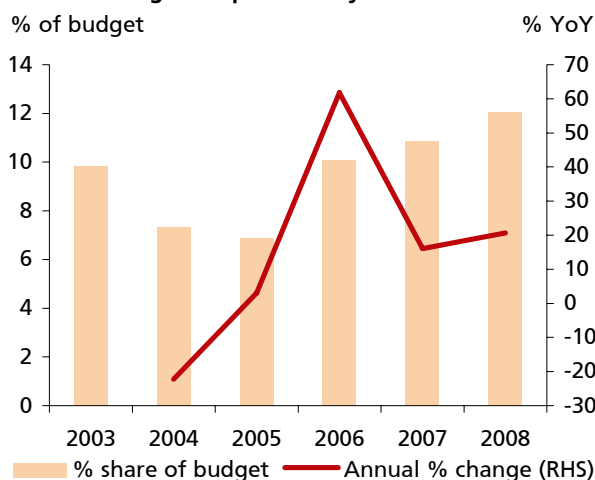
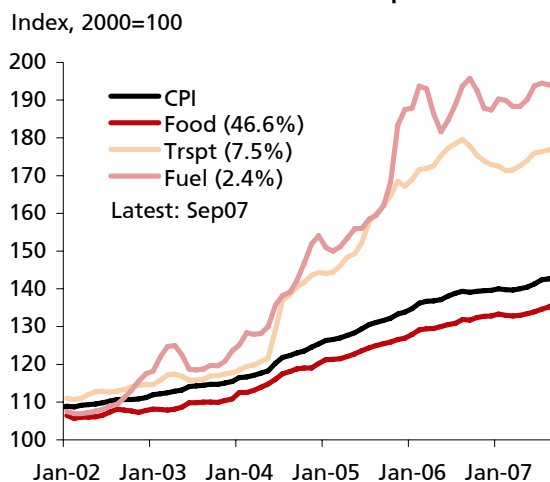


Chart 9: CPI and selected sub-components



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