HIGHLIGHTS OF THE MEETING OF THE MONETARY BOARD ON MONETARY POLICY ISSUES HELD ON 18 NOVEMBER 2004*

The Advisory Committee[1] submitted the following recommendations for the consideration of the Monetary Board:

1) Maintain the current monetary policy settings as follows:

   (a) Maintain the BSP's policy rates at the current uniform rates of 6.75 percent for the overnight RRP (borrowing) rate and 9.0 percent for the overnight RP (lending) rate;

   (b) Maintain the current interest rates on the term RRPs, RPs, and Special Deposit Accounts (SDAs); and

   (c) Maintain the current reserve requirement ratios.

2) Continue to strengthen support for the use of non-monetary measures to address supply-side risks, particularly those relating to food prices, through representation and coordination with the relevant government agencies.

I. Key Considerations in the Formulation of the Monetary Policy Stance

The above recommendations were based on the following considerations:

- Year-on-year headline inflation (1994=100) accelerated further to 7.1 percent year-on-year in October from 6.9 percent in September. This brought the average inflation for the period January to October 2004 to 5.1 percent, marginally exceeding the upper end of the Government-set inflation target of 4.0-5.0 percent for 2004. As in previous months, the increase in the prices of food and energy-related CPI components accounted for the largest contribution to the observed increase in inflation.

* The highlights of the discussions of the 18 November 2004 Monetary Board meeting were approved by the Monetary Board during its meeting held on 16 December 2004.

[1] The Advisory Committee is composed of the Governor of the BSP as Chairman and four members, namely: the Deputy Governor for the Banking Services Sector, Research and Treasury, the Deputy Governor for Supervision and Examination Sector, the Assistant Governor, In-Charge of Research and the Director of the Treasury Department.

- The 2000-based headline inflation rate displayed a similar uptrend, reaching 7.7 percent in October 2004 from 7.2 percent in the previous month, with a year-to-date average inflation of 5.4 percent.

- Core inflation (defined as headline inflation excluding selected food and energy products) also edged higher in October. The 1994-based core inflation increased to 6.9 percent in October from 6.6 percent in September, while the 2000-based core inflation also rose to 6.7 percent in October from 6.6 percent in September.

- Forecasts generated by BSP inflation forecasting models continue to indicate that inflation is likely to exceed the 4.0-5.0 percent inflation target set by the Government for 2004 and 2005 before easing back to 4.0-5.0 percent by 2006.

- Aggregate demand indicators showed positive trends but unemployment and loan growth rates continue to point to soft spots in the domestic economy.

  - Average capacity utilization in manufacturing has remained at close to 80 percent in recent months. Data for August 2004 showed average capacity utilization at 79.2 percent (revised), a slight deceleration from the 79.7 percent in July. This level was higher than the 78.7 percent registered for the same month a year ago.

  - The value of production index (VAPI) for manufacturing increased by 3.2 percent year-on-year (revised) in August, a slowdown from the 7.7 percent registered in July. Meanwhile, the volume of production index (VOPI) for manufacturing declined by 3.6 percent year-on-year (revised) in August following a 0.2 percent contraction in July.

  - Exports posted an 8.4 percent year-on-year growth in September 2004, slower than the 13.7 percent recorded in the previous month. This brought the January-September 2004 annual exports growth to 8.5 percent.

  - Total merchandise imports accelerated to 8.9 percent year-on-year in August 2004 from 5.6 percent growth in July 2004. For the January to August 2004 period, the cumulative annual growth of imports was 7.1 percent.

  - Growth in passenger car sales was flat in October as reported by the Chamber of Automotive Manufacturers of the Philippines, Inc. (CAMPI). This came after a 76.6 percent sales increase in the previous month. This also represented a deceleration from the 81.9 percent increase in October 2003. Meanwhile, the combined truck and bus sales posted an 8.7 percent year-on-year growth in October, a reversal from the 7.8 percent dip in September.

- Energy sales by the Manila Electric Company (Meralco) increased by 5.7 percent year-on-year in September, higher than the 3.0 percent growth in August, and the 0.4 percent rise in September of last year.

- Unemployment rate remained relatively high at 11.7 percent in July 2004. Nevertheless, the July 2004 unemployment rate represented an improvement from the 12.6 percent registered for the comparable period in the previous year. This is still considerably higher than 7.4 percent, the lowest unemployment rate recorded during the peak growth years 1993-1996.

- The demand for money and credit continued to post modest growth.

  - Domestic liquidity (M3) rose by 5.3 percent year-on-year in September 2004, a slight deceleration from the 6.1 percent rise posted in the previous month. At 5.3 percent, however, the growth in M3 remained significantly below the double-digit levels posted in the growth years during the pre-Asian crisis period of 1993-1996.

  - Commercial bank lending rose by 1.9 percent year-on-year to ₱1.5 trillion as of end-September 2004. This was a marked slowdown from the 5.5 percent increase recorded in the previous month, and lower than the double-digit growth rates registered during the pre-Asian crisis period of 1993-1996.

- At the same time, domestic interest rates continued to rise. Reference yields for the 91-day and 182-day T-bills rose during the 8 November 2004 auction of the Bureau of the Treasury relative to those of 11 October 2004. By contrast, the yield for the 364-day T-bill declined during the said auction. The rise in yields reflected market concerns that rising oil prices would push inflation higher as well as worries relating to sustainability of the fiscal position and the country's credit rating.

- Supply-side factors continue to dominate the risks to the inflation outlook. These risk factors include primarily the rise in world oil prices, which will affect the cost of producing other goods and services. Nonetheless, the prospect of favorable agricultural output for the rest of the year is expected to provide a cushion for food prices.

  - The agriculture sector posted a robust 6.6 percent growth in the first semester of 2004. This supports expectations of favorable agricultural production for the rest of the year. However, the possibility of a weak El Niño episode in early 2005 could pose upside pressures to food prices in the first quarter of 2005.

- The international price of Dubai crude oil eased somewhat in early November 2004 after peaking in the previous month. The international oil market was slightly calmed after seeing that stocks remained adequate and the growth in demand for oil could moderate due to high oil prices. In the domestic oil market, retail pump prices of petroleum products increased five times in October from their end-September levels, reflecting the recent uptrend in world oil prices.

- The peso weakened slightly against the US dollar in October through early November due to continuing market jitters over rising global oil prices, and the consequent inflation uptrend, weaker regional currency markets, the increase in dollar purchases by oil and other manufacturing companies, and renewed worries over the government's fiscal position.

- In the fiscal sector, data showed that the NG budget deficit in the third quarter of 2004 reached ₱61.8 billion, lower than the deficit level for the same period last year of ₱63.1 billion. This deficit for the first three quarters of ₱141.9 billion was likewise lower than the ₱142.7 billion fiscal gap recorded in the same period a year ago.

- Global economic activity continued to show signs of firming up, underpinned by robust industrial production and rising corporate profits. This was accompanied by the strengthening of consumer demand and labor market conditions in most regions. On the price front, stronger global inflationary pressures are likely to persist over the near term owing to the volatility in oil prices.

  - US economic activity remained on track as indicated by continued improvements in consumer spending, business investment, and employment conditions.

  - Recovery of real economic activity in the euro area continued with the upturn in private consumption, rise in business investment, and robust export performance.

  - UK's economic expansion moderated in the third quarter, as indicated by the decline in housing prices, which suggest that interest rates have peaked and that further increases in borrowing rates could be deferred until 2005.

  - Japan's economic recovery appeared to be slowing down, based on evidence of lower export demand for electronics and slower retail sales.

- The US Federal Open Market Committee (FOMC) raised its policy rates by 25 basis points at its 10 November 2004 meeting. Other central banks which have tightened their policy rates were Canada, Thailand, and New Zealand. The main reasons cited by these central banks for raising policy rates were rising inflationary pressures due to robust domestic demand and tight labor market conditions.

- Meanwhile, the Bank of England (BOE), Bank of Japan (BOJ), and the European Central Bank (ECB) remained cautious and kept their monetary policy settings unchanged during their respective policy meetings. Similarly, monetary authorities in Australia and South Korea opted to keep their policy settings unchanged. These decisions were generally based on the possible impact of tighter monetary conditions on output concerns given the sluggish growth in private consumption and investments and soft labor market conditions.

II. Review of the Monetary Policy Stance

- The members of the Monetary Board noted that average inflation is likely to exceed the 4-5 percent target in 2004-2005 but should revert toward the same range target by 2006.

- The Monetary Board also noted that the inflation dynamics have remained largely unchanged since the previous assessment of the monetary stance, and that prevailing price pressures continue to be linked primarily to supply-side rather than demand-side factors, notably the increases in commodity prices, particularly food and oil.

- The members of the Monetary Board noted that demand-driven inflationary pressures remain for the most part limited and supply-side factors continue to have a central influence on the inflation outlook. Such conditions provide a strong argument for leaving policy interest rates at their present setting. This argument was further amplified by lingering concerns about the underlying strength of demand, particularly in view of the relatively high unemployment rate and the moderate pace of credit activity.

- On the other hand, price pressures reflected in seasonally-adjusted CPI data and the observed rise in official and internally generated core inflation measures suggest the possibility of demand-side effects from ongoing supply shocks. Such conditions, although tentative, require closer attention over the next few months, and should be complemented by information on whether public inflation expectations continue to be well-anchored in the face of sustained commodity price increases.

- The members of the Monetary Board were, therefore, of the view that the accumulated evidence supports keeping present policy settings unchanged, and suggests a greater need for the continued readiness of monetary authorities to respond to inflation pressures. They noted that the readiness to act will be particularly important given that the uptrend in commodity prices is likely to persist over the policy horizon, and negative market sentiment surrounding the fiscal situation could fuel a prolonged episode of exchange market pressure, thereby feeding into inflation and inflation expectations.

- The Monetary Board also stressed that prospective actions toward monetary tightening, should they become necessary, would be oriented primarily towards guiding inflation expectations. Significant monetary tightening does not appear justified by present conditions, and is only bound to do more harm than good to the ongoing recovery.

- Moreover, the Monetary Board believes that direct action against supply-side risks should remain a key policy priority, and all possible avenues for non-monetary intervention in the importation, distribution and delivery of goods and services should continue to be explored, evaluated and pursued accordingly.

- On the basis of the discussion, the members of the Monetary Board agreed unanimously to maintain current monetary policy settings. However, the Monetary Board emphasized that monetary authorities stand ready to respond to the potential second-order inflationary effects of ongoing supply shocks and other conditions that could generate persistent price pressures.

III. Monetary Policy Decision

- Upon assessment of the balance of risks to inflation and the evidence that has become available since its previous meeting on monetary policy, the Monetary Board approved unanimously the following measures:

  1) Maintain the current monetary policy settings as follows:

     (a) Maintain the BSP's policy rates at the current uniform rates of 6.75 percent for the overnight RRP (borrowing) rate and 9.0 percent for the overnight RP (lending) rate;

     (b) Maintain the current interest rates on the term RRPs, RPs, and SDAs; and

     (c) Maintain the current reserve requirement ratios.

2) Continue to strengthen support for the use of non-monetary measures to address supply-side risks, particularly those relating to food supply, by strengthening the BSP's representation and coordination with various government agencies.

The next meeting of the Monetary Board to discuss the monetary policy setting is scheduled on 16 December 2004.

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