HIGHLIGHTS OF THE MEETING OF THE MONETARY BOARD ON MONETARY POLICY ISSUES HELD ON 11 MARCH 2004*

The Advisory Committee[1] submitted for the consideration of the Monetary Board the following recommendations: (1) maintain the BSP's policy rates at the current levels of 6.75 percent for the overnight reverse repurchase (RRP) rate and 9.0 percent for the overnight repurchase (RP) rate; (2) maintain the current interest rates on the term RRPs, RPs, and Special Deposit Account (SDAs); and (3) maintain the current reserve requirement ratios.

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

The above recommendations were based on the following considerations:

- Headline inflation in February 2004 was steady at 3.4 percent year-on-year as in the previous month using the 1994-based series for the consumer price index (CPI). The relative stability in overall consumer prices was due mainly to steady food prices and lower inflation for some services items in the CPI which cushioned the impact of higher prices of fuel and oil-related products, clothing materials as well as the increased costs for housing repairs. Based on the new CPI series released by the National Statistics Office (NSO) using 2000 as the reference or base year, inflation slowed down slightly to 4.0 percent in February 2004 from 4.1 percent in January.

- Meanwhile, the 1994-based core inflation showed a slight uptrend to 3.7 percent in February from January's 3.6 percent. Likewise, core inflation

* The highlights of the discussions of the 11 March 2004 Monetary Board meeting were approved by the Monetary Board during its meeting held on 5 April 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 Managing Director, In-Charge of Research and the Director of the Treasury Department. The 11 March 2004 meeting of the Monetary Board—the 3rd monetary policy meeting for 2004—followed the Advisory Committee meeting held on 8 March 2004.

derived from the 2000-based CPI series inched higher to 4.1 percent from the previous month's 4.0 percent.

- The overall outlook for inflation for 2004-2005 continued to point to a moderate uptrend but should remain within the range of the Government's target of 4.0-5.0 percent. This outlook remained consistent with expectations of improving aggregate demand conditions as well as the impact of cost-side factors such as movements in fuel prices.

- Domestic demand indicators continued to show modest improvements, supported by a generally positive business outlook. However, unused capacity in the manufacturing sector and the unemployment level remained fairly high, posing downside risks to overall domestic demand.

    - Based on the survey conducted by the BSP, the outlook of the business sector remained optimistic in the first half of 2004. For the first quarter of 2004, the overall business outlook index increased to 26.0 percent from 24.9 percent in the fourth quarter of 2003, due mainly to the expected increase in consumption expenditures with the forthcoming national elections. This was, however, dampened in part, by persistent political uncertainty, stiff competition and the weakening of the peso. For the second quarter of 2004, the overall business outlook diffusion index rose to 25.2 percent compared to 20.1 percent recorded during the previous quarter as respondents expected economic growth to continue.

    - The value of production index (VAPI) for manufacturing rose by 3.6 percent (revised) in December 2003, a reversal of the 0.8 percent (revised) contraction reported in the previous month. In contrast, the volume of production index (VOPI) for manufacturing declined further by 2.9 percent (revised) in December 2003 following an 8.4 percent (revised) drop in the previous month.

    - Average capacity utilization in manufacturing in December 2003 improved slightly to 78.4 percent (revised) from the November level of 78.2 percent (revised). This was also higher than the 74.5 percent posted a year ago. About 13.4 percent of the responding establishments operated at full capacity (90-100 percent), 51.2

percent reported operation at 70-89 percent capacity, and 35.4 percent operated below 70 percent capacity.

- Exports data from the National Statistics Office (NSO) showed a 4.1 percent increase in January 2004, higher than the 3.9 percent growth posted a year ago but lower than the 9.0 percent growth in December 2003. Electronic exports—which accounted for 67.8 percent of the aggregate export revenue in January—rose by 1.2 percent. This was slower than the 7.0 percent annual growth registered in the previous month and the 3.3 percent increase recorded a year ago.

- Growth in merchandise imports as reported by the NSO accelerated to 14.9 percent (revised) in December 2003 from 4.3 percent in the previous month. The December imports brought the full year growth to 5.7 percent, slightly below the 7.2 percent recorded a year ago.

- Car sales increased by 31.4 percent year-on-year in January 2004 to 2,436 units. This was slower than 109.7 percent rise in December 2003.

- Registered energy sales by the Manila Electric Company (Meralco) declined by 7.6 percent year-on-year in January 2004, the first contraction since the 1.6 percent decline recorded in August 2002.

- On the supply-side, forecasts of neutral weather conditions along with Government measures to enhance agricultural productivity support expectations of continued stability in food prices. This should help cushion against possible cost-side price pressures that could emanate from fuel price adjustments.

  - Based on the estimates of the Bureau of Agricultural Statistics (BAS), rice production will be robust in the first half of 2004, with an expected 10.8 percent year-on-year growth in the first quarter followed by an 8.7 percent growth in the second quarter. Similarly, strong corn output is expected to register a 12.5 percent growth in the first quarter and an 8.3 percent growth in the second quarter.

  - The international price of Dubai crude oil eased slightly to an average of US$28.57 per barrel for the period 1-26 February 2004 relative to US$28.87 per barrel average price in January with the end of the winter season in the Northern Hemisphere. However, the futures price of crude oil continued to trend higher following the announcement of an oil supply cut by OPEC in April. Domestic oil prices were steady at their February levels, except for the ₱0.84 average decline in the price of liquefied petroleum gas (LPG) in the first week of March. Meanwhile, transport fare has increased for the deregulated transport sector while petitions for fare hike for the regulated sector have been filed with the regulatory agency, the Land Transportation Franchising and Regulatory Board (LTFRB).

- Moderate growth in liquidity and bank lending continued to characterize domestic monetary conditions. Nominal interest rates showed an uptick in February as persistent concerns over the political environment led to high bids and thin appetite for government securities in the primary market.

  - Based on preliminary data, domestic liquidity (M3) growth in January 2004 accelerated to 4.4 percent (revised) year-on-year from 3.3 percent in December 2003.

  - The total volume of commercial bank (KB) loans grew by 3.8 percent year-on-year to ₱1.49 trillion as of end-December 2003, recording 14 straight months of sustained expansion. However, the December year-on-year growth in bank lending was slower than the 4.3 percent increase recorded in November 2003.

  - All tenders were rejected during the 1 March 2004 Treasury bill auction of the Bureau of the Treasury (BTr) as banks displayed generally weak appetite for government debt papers. Nominal interest rates trended upward, reflecting higher risk premium associated with concerns over political uncertainties ahead of the May 2004 elections.

- The peso continued to weaken for the fourth consecutive month since October 2003. It depreciated by about 54 centavos to average ₱56.09/US$1 in February 2004 from its January 2004 average of ₱55.55/US$1 due to persistent concerns over the fiscal deficit and pre-election uncertainties.

- The deficit of the National Government (NG) for January 2004 stood at ₱16.1 billion, 15.6 percent higher than the ₱13.9 billion deficit recorded in January 2003, owing mainly to stronger growth in expenditures relative to the revenue collection performance.

- Recent developments in the world economy continued to point to a firmer recovery, with a solid pick-up in growth in the US and Japan accompanied by less brisk improvements in the euro area. The main downside risks facing the international economy over the past two years—notably those pertaining to the geopolitical risks, corporate and financial governance issues and the SARS outbreak in Asia—have largely dissipated. Nevertheless, the global outlook has remained not altogether risk-free as economic and structural imbalances in the major economies may limit the pace and strength of the recovery process. This outlook suggested a moderate improvement in external demand for the Philippines.

  - Prospects for the US economy continued to look firmer. The most recent indicators suggested that the US economy has started the year 2004 strongly with good prospects for sustaining the expansion in the period ahead. The one missing element in all this was a convincing pick up in employment, although encouraging signs have been observed recently.

  - Growth in the euro area in 2003 was modest, although there were signs of gradual improvement. The relatively slower pace in recovery can be traced to structural factors, reflecting the economy's underlying lack of flexibility. However, business confidence in Europe has improved in recent months, which may be an indicator of better prospects ahead.

  - The UK economy has picked up strongly. Strong GDP growth was recorded in the fourth quarter of 2003, fueled by healthy retail sales and record consumer borrowing, against a backdrop of steady CPI and core inflation.

  - The Japanese economy has gathered strength on the back of a rise in domestic consumption, coupled with strong exports, especially to China. Bank of Japan (BOJ) officials noted that the recovery momentum has become stronger. Nevertheless, deflation remained a problem, as core inflation continued to be negative.

- Amid increased evidence of stronger economic activity, monetary authorities in the US, the UK, euro area and Japan kept their monetary policy settings unchanged.

II. Review of the Monetary Policy Stance

- Based on all the above considerations, the Monetary Board's assessment of future price movements pointed to a generally manageable inflation over the policy horizon with some upside risks. They noted that the current pace of economic activity could translate into a moderate increase in average inflation to levels consistent with the Government's inflation targets. They were also of the view that the outlook for future prices is accompanied by risks from the supply-side, beginning with the impact of volatile movements in international oil prices, mounting calls for transport fare adjustments, and possible adjustments in utility charges.

- For the most part, however, the members of the Monetary Board pointed out that the overriding risk to the inflation outlook could stem presently from sentiment-driven movements in the exchange rate, which have given rise to persistent concerns of a possible sustained episode of currency depreciation which could have adverse implications on inflation and inflation expectations.

- The members of the Monetary Board believed that the depreciation pressures on the peso are likely to persist as long as excess money balances remain in banks amid sluggish lending, and the public continues to prefer holding foreign currencies due to uncertainty. They were of the view that the incentive for financial institutions to seek profits from currency trading is compounded by the present climate of political uncertainty.

- Given the generally accepted difficulty of calibrating an optimal policy response to potential inflationary risks arising from volatile exchange rate movements, the members of the Monetary Board expressed the view that the standard prescription for central banks is to adopt a conservative approach. This approach would be in consonance with the observed modest pace of money and credit demand, which points to downside risks for the overall strength of economic activity. They highlighted the need for monetary policy stance to ensure that the general macroeconomic environment remains conducive to credit demand and investment activity and financing conditions do not become unduly restrictive to constrain economic activity. The members of the Monetary Board considered this as the main argument against any monetary tightening in response to perceived inflationary pressures.

III. Monetary Policy Decision

- After an assessment of the balance of risks to inflation and the evidence that have been made available since the last meeting on monetary policy presented by the Advisory Committee, the Monetary Board approved unanimously the following policy measures:

  a. Maintain the BSP's policy rates at the current levels of 6.75 percent for the overnight RRP rate and 9.0 percent for the overnight RP rate;

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

  c. Maintain the current reserve requirement ratios.

The next meeting of the Monetary Board to discuss the monetary policy setting was scheduled on 15 April 2004.