HIGHLIGHTS OF THE MEETING OF THE MONETARY BOARD ON MONETARY POLICY ISSUES HELD ON 10 APRIL 2003[*]

Background

The Monetary Board held its fifth meeting for the year to discuss monetary policy issues on 10 April 2003. This followed the Advisory Committee meeting held on 8 April 2003.[1] During the meeting, the Advisory Committee presented a policy paper for the Monetary Board's consideration. The said paper contained an extensive discussion of the developments in the agriculture sector, foreign exchange market, oil prices, user charges in utilities, interest rates, domestic credit conditions and other key demand indicators as well as the developments and outlook in the world economy. The policy paper also incorporated the results of the discussions and the recommendations of the Advisory Committee. This served as the basis for the Monetary Board's assessment of the appropriate stance of monetary policy.

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

- Headline inflation decelerated in March due to lower food inflation, which helped cushion the impact of higher fuel prices. First quarter average inflation was 2.9 percent, significantly lower than the 3.6 percent average inflation recorded during the same period last year and the 4.5-5.5 percent target for the year. Core inflation also slowed down in March. Estimated core inflation (CPI less food and energy) eased slightly to 2.6 percent in March from 2.7 percent in the previous month. Average core inflation for the first quarter was 2.6 percent, about half of the average core inflation rate of 5.1 percent for the same period in 2002.

[*] The highlights of the discussions of the 10 April 2003 Monetary Board meeting were approved by the Monetary Board during its meeting held on 15 May 2003.

[1] The Advisory Committee is composed of the Governor of the BSP as Chairman and four other 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.

- Domestic demand indicators showed encouraging signs but no evidence of a sustained pickup. The overall strength of aggregate demand remained quite moderate, as may be gauged from the following indicators:

  a. Manufacturing activity continued to improve in January 2003. The volume of production index (VOPI) rose by 3.7 percent (revised) year-on-year as against the 6.1 percent decline in February 2003. Likewise, the value of production index (VAPI) expanded by 12.8 percent (revised) year-on-year in January. Average capacity utilization in manufacturing also improved slightly to 76.1 percent (revised) in January from 74.5 percent in the previous month.

  b. Commercial bank lending rose for the fifth consecutive month by 4.4 percent year-on-year in January 2003.

  c. The volume of passenger car sales surged by 14.6 percent month-on-month in January 2003, reflecting a marked turnaround from the 10.8 percent drop in December 2002.

  d. Growth in energy sales of the Manila Electric Company (Meralco), a leading indicator of overall power consumption, slowed down sharply to 5.6 percent annually in February following an 11.6 percent rise in the previous month.

  e. Unemployment remained relatively high at 10.6 percent in the first quarter compared to 10.2 percent in the previous quarter and 10.3 percent a year earlier.

- Supply-side pressure on inflation showed some signs of weakening. For example, the effects of the El Niño phenomenon have started to recede as temperature levels over the tropical Pacific registered sharp declines in January 2003. This suggests more favorable food supply conditions and stable food prices. International crude oil prices have also begun to soften on expectations of a quick resolution of the US-Iraq conflict. From a high of US$30.02 per barrel in February 2003, the average monthly price of Dubai crude declined by 8.8 percent to settle at US$27.38 per barrel in March 2003.

- Market interest rates inched up in March, although liquidity remained ample. The average yield on the benchmark 91-day T-bills reached an 11-month high of 7.145 percent, up by 78.9 basis points from 6.356 percent in the previous auction on 17 March 2003. Meanwhile, domestic liquidity (M3) grew by 6.7 percent year-on-year as of end-February 2003.

- The peso weakened further in March against the US dollar but recovered following stricter regulatory and monitoring measures on foreign exchange transactions of banks by the BSP. The lifting of the tiering scheme of banks' placements with the BSP under the RRP and SDA and the one-percentage point increase in the liquidity reserve requirement to 8 percent helped contain the pressures in the foreign exchange market, which posed a threat on the inflation outlook.

- The fiscal deficit for the first two months of the year was lower than the levels posted for the same period a year ago. This supports expectations that the NG could likely keep the deficit for the year on track with the target.

- Economic indicators in the major economies continued to point to a hesitant and uneven global economic recovery. Greater cautiousness among consumers and businesses has dampened firms' hiring outlook. As a result, the growth of industrial production was sluggish, labor markets remained soft and the main leading economic indicators continued to be weak in advanced economies.

    a. US GDP growth slowed to an annual rate of 1.4 percent in the fourth quarter of 2002 compared to 4 percent in the previous quarter while unemployment in March remained at 5.8 percent as in the previous month. Consumer confidence appeared to weaken as the University of Michigan's consumer confidence index fell sharply to 77.6 in March from 79.9 in the previous month. Manufacturing activity showed signs of a contraction, with the Institute for Supply Management (ISM) index of manufacturing falling further to 50.5 percent in February from 53.9 percent in January 2003.

    b. Euro area unemployment rate rose further to 8.7 percent in February from 8.6 percent a month earlier, while inflation edged up to 2.3 percent in February from 2.2 percent a month earlier. The Bank of England revised downwards its outlook for growth in the UK over the next two years due mainly to weaker prospects for the world economy as well as further declines in equity prices and business investment.

    c. Economic activity in Japan remained stagnant as weak consumer spending and continued deflationary pressures offset improvements in employment. Unemployment fell unexpectedly in February to 5.2 percent from 5.5 percent in the previous month. However, spending by Japanese wage earners fell by 1.6 percent in real terms in February from a year-ago level, and consumer prices declined anew by 0.2 percent year-on-year in February following a 0.4 percent drop in the previous month.

- The fragile state of the global economy implies that the current accommodative stance of the majority of central banks would likely be maintained to support economic recovery and growth. During their most recent monetary policy meetings, the US Federal Reserve, the European Central Bank and the Bank of England all voted to keep policy interest rates unchanged. Meanwhile, the Bank of Japan voted unanimously to maintain its current account balance target to a range of 17-22 trillion yen beginning April 2003 from 15-20 trillion yen, noting that the economy is unlikely to show clear signs of recovery for some time as business investment remained weak and high levels of unemployment and debt persisted.

II. Review of the Monetary Policy Stance

- During the Monetary Board's discussion on the appropriate monetary stance, the members noted that the overall outlook for inflation has not drifted away from the full-year average inflation target of 4.5-5.5 percent in 2003. The recent pressures on headline inflation have remained largely driven by specific CPI components, notably fuel prices. In addition, the relative absence of broad-based price increases suggests that demand-side pressures on inflation are largely muted. Thus, the Monetary Board believed that the major risks to future inflation relate mainly to cost-push influences which are also expected to be largely transitory.

- The Monetary Board also noted that the absence of strong demand-side risks to inflation coincides with the lack of clear-cut signs of sustained improvement in domestic economic activity. The overall strength of aggregate demand remains tentative, given soft labor market conditions (which have prevented strong calls for wage adjustments) and sizable spare capacity in key areas such as the manufacturing sector. They agreed that there is still adequate room for the impact of monetary policy to feed on through to the real sector without endangering the government's inflation objective. Moreover, the continued mixed evidence on domestic activity is complicated by weakness in external demand.

- In sum, therefore, the Monetary Board was of the view that the near-term risks to the inflation outlook appear to be largely contained. Future inflation is expected to remain benign, given the absence of demand-side risks to prices and the short-lived nature of potential supply-side pressures. Average headline inflation in 2003-2004 is expected to broadly track the government's targets. At the same time, the muted demand-side influences on the outlook for inflation and growth support the case for ensuring that liquidity conditions remain appropriate for the domestic economy's requirements.

III. Monetary Policy Decision

- Based on the analysis of various indicators on the macroeconomy and the financial sector that have become available since the special meeting of the Monetary Board on 19 March 2003 and a careful assessment of the balance of risks on inflation and inflationary expectations, the Monetary Board believed that the current monetary policy stance continued to ensure price stability at the same time that it was appropriately supportive of the economy's growth objective. Thus the Monetary Board, by a unanimous vote, approved the following measures:

    a. Maintain the BSP's policy rates at the current levels of 7.0 percent for the overnight RRP (borrowing) rate—without the tiering scheme—and 9.25 percent for the overnight RP (lending) rate; and

    b. Maintain the reserve requirement ratios for banks at their current levels of 9 percent for regular reserves and 8 percent for liquidity reserves.

The next meeting of the Monetary Board to discuss the monetary policy setting was scheduled on 8 May 2003.

- The Monetary Board of the Bangko Sentral ng Pilipinas