HIGHLIGHTS OF THE MEETING OF THE MONETARY BOARD ON MONETARY POLICY ISSUES HELD ON 2 OCTOBER 2003[1]

Background

The Monetary Board held its eleventh meeting for the year on monetary policy issues on 2 October 2003. During the meeting, the Advisory Committee presented its assessment of the trends and developments in key macroeconomic and financial indicators and its implications on the inflation outlook and the economy's growth prospects.[2] At the same time, the Committee also submitted its monetary policy recommendations to the Monetary Board. These served as basis for the Monetary Board's discussion on the appropriate course of action for monetary policy.

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

The Advisory Committee recommended the following measures to the Monetary Board: (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 given the adequate level of liquidity in the system. These recommendations were based on the following considerations:

- Price conditions remained subdued as headline inflation continued to edge down in August. Year-on-year headline inflation eased to 3.0 percent in August from 2.9 percent in July. The deceleration was traced mainly to lower year-on-year inflation rates for food items, utilities, and services. Meanwhile, the BSP's measure of core inflation also remained relatively low.

[1] The highlights of the discussions of the 2 October 2003 Monetary Board meeting were approved by the Monetary Board during its meeting held on 23 October 2003.
[2] 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 for the Treasury Department.

- The near-term outlook for inflation remains essentially unchanged, with available evidence on demand and supply conditions still pointing to benign price dynamics over the policy horizon.

- The pace and strength of domestic economic activity remained uneven and tentative. Key areas of demand have continued to register signs of sluggishness, with slower growth observed in indicators such as bank lending, passenger car sales, and exports.

  - Production in the manufacturing sector improved in July 2003 as the volume of production index (VOPI) rose by 4.4 percent year-on-year in June after falling by a revised 1.5 percent in the previous month. Meanwhile, the increase in the value of production index (VAPI) accelerated to 12.9 percent year-on-year in July from 6.6 percent in June.

  - Average capacity utilization of the manufacturing sector was almost unchanged at 78.8 percent in July from its month ago level of 78.5 percent.

  - Labor market conditions remained soft. The jobless rate inched up in July 2003 to 12.7 percent from 12.2 percent in April 2003 and from 11.2 percent in the same period a year ago.

  - Demand for Philippine exports weakened in July as total merchandise exports declined by 7.9 percent year-on-year, a reversal of the 4.2 annual rise in the preceding month.

  - Developments in other demand indicators also remained tentative. Passenger car sales registered a sharp decline of 30.7 percent year-on-year in August, a turnaround from the 41.2 percent rise in July. Meanwhile, registered energy sales by the Manila Electric Company (Meralco) increased by 4.5 percent on an annual basis in July following a 0.5 percent increase in June.

- Supply-side or cost-push factors are expected to exert only a moderate influence on prices going forward.

  - Food prices are expected to remain stable given improving weather conditions and government programs aimed at boosting production. Moreover, adequate and timely importation would further support the relative stability in food prices.

  - World oil prices, which have softened recently due to steady production and easing global demand, are expected to hold firm. The international spot price of Dubai crude oil fell to an average of US$25.37 per barrel for September 2003 from US$27.66 per barrel in August 2003. Following the decline in world oil prices, local oil companies have implemented a reduction in pump prices on 12 September 2003.

- Mild upticks in nominal and real interest rates were observed in September. Latest data on the growth in M3 and bank lending also showed some deceleration. This may be attributed in part to the removal in late August of the tiering scheme on bank placements with the BSP, which encouraged banks to park their excess funds with the BSP.

  - During the Bureau of the Treasury's (BTr) 15 September 2003 Treasury bill (T-bill) auction, the average yield on the bellwether 91-day T-bills went up by 10 basis points relative to the previous auction on 18 August 2003 to settle at 5.325 percent. Bids at the 1 September 2003 auction were deemed too high and were rejected in full by the Auction Committee.

  - Growth in domestic liquidity (M3) decelerated to 3.6 percent year-on-year as of end-July 2003 from 5.9 percent in June.

  - The total volume of commercial bank (KB) loans grew by 3.7 percent year-on-year to ₱1.43 trillion as of end-July 2003, recording 11 straight months of continued expansion. However, the increase represented a slowdown from the 5.1 percent annual rise in June.

- The peso gained slightly in nominal terms against the US dollar following the BSP's decision to remove the three-tiered system on banks' placements with the BSP. The peso was also less volatile during the period, with the standard deviation dipping to ₱0.12 in September compared to ₱0.22 in August 2003. On a real and trade weighted basis, data for August showed that the peso depreciated against the currencies of the Philippines' major trading partners and competitor countries. These indicated some improvements in the country's external competitiveness.

- The National Government's (NG) fiscal deficit for the month of August reached ₱18.2 billion, higher than the ₱8 billion target deficit for August and the ₱12.2 billon fiscal deficit registered for the same month a year ago. The Department of Finance (DOF) noted that the higher-than-target fiscal deficit in August resulted, in part, from the NG's efforts to raise fiscal spending to stimulate economic activity given the observed slowdown in

GDP growth in the second quarter. Nevertheless, the January-August 2003 fiscal deficit at ₱114.5 billion was still ₱12.9 billion lower than the ₱127.5 billion target for the period. Moreover, the fiscal deficit for the first eight months of the year was also lower than the ₱144 billion deficit posted for the same period in the previous year.[3]

- Recent indicators pointed to a stronger global economic recovery, led primarily by a pick-up in US economic activity. However, the pace of growth across the major industrial economies continued to be uneven and risks to the outlook remained. These include the possibility of a further fallout in the equities market, still-weak corporate investment, continuing adjustments in global current account imbalances, and security concerns.

  - The US economy continued to show signs of a gradual pick-up in economic activity. This has been supported by strong consumer spending, increased business investment and a recovery in the stock market. However, certain vulnerabilities remained, such as the persistently high unemployment rate and current account deficit along with concerns about the sustainability of expansionary fiscal spending.

  - Growth prospects in the euro area remained subdued, reflecting persistent weakness in domestic demand and exports.[4] The European Central Bank (ECB) noted, however, that both external and domestic factors continued to support the expected pick-up in economic activity. The prevailing low level of interest rates is expected to strengthen the incentives to invest and complement the ongoing adjustment efforts by companies to enhance competitiveness and profitability. Taken together, these developments should improve the conditions for an economic upswing in the euro area.[5]

  - In the UK, the Bank of England noted that imbalance between components of domestic demand growth continued to limit growth prospects. Consumption spending remained strong but weakness in corporate balance sheets persisted.

[3] Department of Finance press release entitled, "Pump priming in August raises fiscal deficit to ₱18 billon," dated 18 September 2003

[4] Twelve member-countries comprise the euro area, viz: Belgium, Germany, Greece, Spain, France, Ireland, Italy, Luxembourg, the Netherlands, Austria, Portugal and Finland.

[5] European Central Bank, "Testimony before the Committee on Economic and Monetary Affairs of the European Parliament with the President of the European Central Bank, in accordance with Article 113(3) of the Treaty on European Union Introductory statement by Dr. Willem F. Duisenberg, President of the European Central Bank, Brussels, " 10 September 2003, available online at http:///www.ecb.int

- Japan's economy grew at its fastest pace in two and half years during the second quarter as companies stepped up spending on machinery to feed the increasing demand for exports. The latest assessment of the Bank of Japan (BOJ) indicated that business fixed investment has been recovering gradually. However, private consumption continued to be weak, housing investment remained sluggish, and public investment has been declining.[6] The sustainability of the stronger-than-expected second quarter growth thus remained uncertain as significant vulnerabilities in the economy remain, particularly in the corporate and banking sectors.

- In the presence of continued imbalances across major economies, which pose a risk to the sustainability of the economic recovery process, the major central banks have pursued a generally accommodative monetary policy stance to help ensure that the recent gains translate into a sustainable recovery path.

II. Review of the Monetary Policy Stance

- The members of the Monetary Board noted that the economic data that have become available since the previous review of the monetary policy stance on 28 August 2003 continued to indicate a benign inflation environment going forward, against a backdrop of moderately improving economic activity. The Monetary Board's assessment of a benign inflation environment was based on moderate strength in aggregate demand, particularly credit demand, soft labor market conditions, the restrained influence of cost-push factors such as energy prices, and relative stability in the foreign exchange market.

? The members of the Monetary Board also pointed out that, despite robust consumption spending and other signs of improvements, key areas of domestic demand continued to show signs of sluggishness, with slower growth observed in demand indicators such as bank lending, passenger car sales, and exports. They agreed that such developments would argue for ensuring that monetary policy settings remain supportive of real sector activity.

? Nevertheless, the Monetary Board believed that the outlook for inflation still contains an undercurrent of risk in the form of adverse cost-side

[6] Bank of Japan, Monthly Report of Recent Economic and Financial Developments September 2003 (The Bank's View), 16 September 2003, available online at http://www.boj.or.jp/en/seisaku/03/pb/gp0309_f.htm

developments and adjustments in the foreign exchange market, which have a bearing on public expectations about future prices. They underscored the need to continuously assess the evolving balance of risks and respond in a measured fashion to the inflation outlook in order to maintain an environment of price stability and provide support to the economy's growth objective.

- In light of the considerations presented by the Advisory Committee, the members of the Monetary Board considered the following monetary policy options:

  - Further monetary easing to increase the stimulus to economic activity; and
  - Maintaining current monetary policy settings to preserve the ongoing stimulus to the real sector.

- Among the arguments raised by the Monetary Board against further easing were as follows:

  The Monetary Board was of the view that a further easing of the monetary policy stance through a reduction in policy interest rates may not be feasible, as authorities also need to guard against excessive easing, given that available liquidity remains ample. They also argued that, at present, it is uncertain whether further relaxation will induce an appreciable improvement in credit growth and aggregate demand.

- The considerations for maintaining current monetary policy stance were as follows:

  The members of the Monetary Board raised the following arguments in favor of keeping policy interest rates unchanged: (a) the outlook for 2004 inflation suggests that average inflation will be in line with the target, implying that further easing may not be necessary; (b) the monetary policy stance needs to be sufficiently cautious to guard against a possible build-up of price pressures over the near term; and (c) there continues to be evidence of sufficient liquidity to fuel the economy's growth requirements.

- In conclusion, the members of the Monetary Board believed, that given the undercurrent of risk factors, maintaining the monetary policy stance would help guard against possible threats to price stability while ensuring adequate liquidity to support growth in domestic demand. They have also agreed to monitor continuously the developments in the local economy and to ensure that the monetary policy decisions are calibrated appropriately to meet the BSP's price stability objective conducive to a balanced and sustainable economic growth.

III. Monetary Policy Decision

- After a careful assessment of the balance of risks on inflation and inflationary expectations and the evolving domestic and external conditions, the Monetary Board, by a unanimous vote, decided to:

  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 given the adequate level of liquidity in the system.

The next meeting of the Monetary Board to discuss the monetary policy setting was scheduled on 23 October 2003.