HIGHLIGHTS OF THE MEETING OF THE MONETARY BOARD ON MONETARY POLICY ISSUES HELD ON 4 JULY 2002*

Background

The Monetary Board held its seventh meeting on monetary policy issues on 4 July 2002. This followed the 2 July 2002 meeting of the Advisory Committee where the members discussed their assessment of the inflation outlook and macroeconomic conditions, which formed the basis for their recommendations on the appropriate monetary policy stance.[1] The Advisory Committee submitted, for the consideration of the Monetary Board, a policy paper and a comprehensive set of economic and financial indicators relevant for the deliberation on monetary policy. In particular, the Monetary Board discussed the factors affecting inflation and inflation expectations, including the direction of world oil prices, possible adjustments in power and water rates, monetary conditions, demand and output indicators, fiscal performance of the national government, global economic developments and outlook, and the implications of these factors on the BSP's monetary policy stance.

I. Considerations in the Formulation of the Monetary Policy Stance

Current inflation and the inflation outlook

1. After a deceleration in the first quarter, headline inflation was steady in April and May at 3.6 percent year-on-year. Upticks in non-food inflation caused by increases in electricity rates and domestic oil prices were mostly offset by lower food inflation. Average headline inflation for the first five months of 2002

* The highlights of the discussions of the 4 July 2002 Monetary Board meeting were approved by the Monetary Board during its meeting held on 8 August 2002.

[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 or the Director of the Department of Economic Research, and the Director of the Treasury Department.

reached 3.6 percent, lower than both the 6.7 percent average recorded a year earlier and the government's revised target of 4.5-5.5 percent for the year.

2. Inflation continued to be well contained in April and May 2002 due to favorable food prices—owing to ample food supply—and broadly stable exchange rates. In addition, the impact of the series of oil price increases during the period was cushioned by the action of transport operators to hold back plans to raise fares. Moreover, pressures from the demand side continued to be tame given the current levels of unemployment, bank lending and spare capacity. The jobless rate rose to 13.9 percent in April from 13.3 percent a year ago. After posting an upturn in March—following an 8-month contraction—bank lending dropped by 2.2 percent from the level a year ago. At the same time, capacity utilization in manufacturing has continued to be sluggish as it slipped slightly to 75.3 percent in April 2002 from 75.9 percent in the previous month. Meanwhile, the value and volume of production indices (VAPI and VOPI) grew strongly in April 2002 by 14.8 percent and 17.0 percent, year-on-year, reflecting a significant turnaround from the negative growth rates of 3.7 percent and 1.6 percent registered in the previous month.

Historical inflation performance and the BSP's latest forecast readings suggest that inflation would remain well-behaved in the near term. In particular, ample food supply conditions and broad stability in the exchange rate support a benign inflation picture. The lack of buoyancy in aggregate demand also contributed to subdued inflationary expectations.

Agricultural output forecasts

3. The Philippine Atmospheric Geophysical and Astronomical Services Administration (PAGASA) announced that the warming conditions in the Central and Eastern Pacific Ocean and the weakening of the easterly winds supported the development of a weak El Niño starting July 2002, which may last up to the first quarter of 2003.[2] The PAGASA noted that the peak of the El Niño episode is likely to occur from October to December this year although this is not expected to be as severe as the episode in 1997-98, according to recent general

[2] The Southern Oscillation Index (SOI) is a measure commonly used by meteorologists to monitor monthly fluctuations in the air pressure difference between the Central Pacific and Indian oceans. Sustained negative values of the SOI often indicate episodes of the El Niño weather phenomenon in the tropical Pacific region.

circulation computer model results.[3] Despite the dry weather, the Climatology and Agrometeorology Branch (CAB) of the PAGASA reported generally favorable planting conditions in May for most parts of the country, particularly for rice and corn.[4] For the third quarter, the Department of Agriculture (DA) expects palay output to approximate last year's harvest crop of 2.4 million metric tons.[5]

4. The potential adverse effects of warm weather on agricultural output could be cushioned by well-timed importation and implementation of mitigating measures such as the construction and rehabilitation of irrigation and water improvement facilities. The DA has announced its plans to conduct cloud seeding operations in Pantabangan Dam in Nueva Ecija to help raise the water level of the dam to service farmlands in Central Luzon.[6] The President has also approved the importation of 250,000 metric tons of rice to shore up the National Food Authority's (NFA) buffer stock and ensure adequate supply and stable rice prices.[7]

The implementation of various government initiatives to counter the negative impact of the El Niño weather disturbance such as the improvement of water facilities and programmed rice importation suggests that, going forward, the impact of the El Niño episode on overall prices should be well-contained.

Exchange rate developments

5. The peso weakened slightly in June by 0.8 percent relative to its level in May to average ₱50.41/US$1 from ₱49.83/US$1 in the previous month. The large end-of-quarter and end-of-semester demand for dollars by corporates for servicing their foreign obligations contributed to the peso decline. In addition, market's concerns over the fiscal deficit weighed on the peso. Higher demand for dollars by banks as investors' reduced their Asian bond holdings on concerns over the post-election results in Brazil and their repercussions on emerging markets added

[3] PAGASA, El Niño Watch, Update on the Development of El Niño, No.02/03, 3 July 2002
[4] Climatology and Agrometeorology Branch (CAB), PAGASA, Seasonal Climate Outlook for the Philippines for Year 2002
[5] Department of Agriculture, "Rice and Corn Situation and Outlook", www.da.gov.ph
[6] Department of Agriculture, "DA prepares to hold cloud seeding on Pantabangan Dam," www.da.gov.ph
[7] Department of Agriculture, "DA Statement on Additional Rice Imports", www.da.gov.ph

some pressures on the peso. However, the peso decline in June was, in part, capped by steady inflows of remittances from overseas Filipino workers (OFWs). As a result, the variability of the peso was reduced, as standard deviation fell to 21 centavos in June 2002 as against 37 centavos in the previous month.

6. On a trade-weighted basis and in real terms, the peso appreciated relative to the basket of currencies of major trading partners by about 1.9 percent during the first six months of the year. In contrast, the peso tracked a depreciation trend vis-à-vis the currency baskets of competitor as reflected in the decline in the real effective exchange rate (REER) of the peso against the broad and narrow baskets of competitor currencies by about 1.3 percent and 8.8 percent, respectively.[8]

The relative stability of the peso continued to exert a favorable influence on inflation and inflation outlook.

Oil price developments

7. Oil prices in the world market were softer in June 2002 compared to the levels in the previous month. The international spot price of crude oil (Dubai) eased by 1.6 percent to US$24.29 per barrel as of 26 June 2002 from the US$24.69 per barrel average price in May 2002. Reduced hostilities in the Middle East, reports of a build-up in US oil inventories and claims that Venezuela would raise its production level in violation of the OPEC production limits have tempered the movements of oil prices in the world market. Softening world oil prices have encouraged local oil companies to cut local pump prices of petroleum products anew by 35 centavos per liter on 25-26 June 2002. The net increase in domestic oil prices thus far in 2002 amounted to 91 centavos per liter for gasoline, diesel and kerosene.[9]

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[8] The broad basket is composed of the currencies of Singapore, South Korea, Taiwan, Malaysia, Thailand, Indonesia and Hong Kong while the narrow basket is composed of the currencies of Indonesia, Malaysia and Thailand.

[9] In 2001, pump price of petroleum products declined by ₱1.81 per liter for gasoline and ₱1.30 per liter for kerosene and diesel oil (Source: Department of Energy).

8. In the futures market, the price of the benchmark Brent crude oil moved steadily, with August 2002 deliveries settling at US$24.98 per barrel.[10] For the second half of 2002, the price of Brent crude oil in the futures market showed a slight uptrend to reach an average of US$25.03 per barrel. However, even with relative calm in world oil market, a spike in oil prices cannot entirely be ruled out should hostilities in the Middle East intensify anew and OPEC decide to impose tougher quota limits on its members.

9. It is estimated that an increase in domestic oil prices could raise average annual inflation directly by about 0.38 percentage points. Meanwhile, the indirect impact arising from the pass-through of the price shock to other commodity groups is estimated to be about twice that of the direct impact, for a total impact of 1.22 percentage points.[11]

As a major input of production, an increase in the price of oil could trigger a second round impact on the cost of transport and other commodities as well as wages.

Petitions for upward adjustment in user charges on utilities

10. The reduction in the purchased power cost adjustment (PPCA) of the National Power Corporation (NPC) to just 40 centavos per kwh effective 8 May 2002 was reflected in the 50 centavos per kwh initial reduction in the Manila Electric Company's (Meralco) purchased power adjustment (PPA) charges.[12] Similarly, the Department of Energy (DOE) noted that the implementation of the Wholesale Electricity Spot Market (WESM) by September 2002 could also bring down the cost of electricity by another 40 centavos per kwh. With the operationalization of a WESM, electricity will be traded at the spot market, where generators will compete against each other to supply power to distributors. The creation of the WESM is aimed at ensuring efficiency and transparency in

[10] Source: Asian Wall Street Journal, 27 May 2002, The futures price for Brent crude—a close substitute for Dubai crude— is used as indicator of future world oil prices since futures data on Dubai crude are not readily available.
[11] These findings were based on the simulation results using Input-Output (I-O) analysis and the structural inflation forecasting model for estimating the total impact and direct impact of an oil price increase on inflation, respectively. This simulation was based on the assumption that the average price of Dubai crude would reach about US$27.50 per barrel in 2002.
[12] The purchased power adjustment (PPA) refers to the automatic cost recovery mechanism used by the NPC and Meralco, which covers the fluctuations in the exchange rate, fuel prices and the cost of electricity generated.

generation charges.[13] Meanwhile, the proposed graduated power rate adjustments by Meralco—under its petition for the "unbundling" of power rates dated 2 April 2002—still have to be decided upon by the Energy Regulatory Commission (ERC). The proposed rates would likely raise the cost of electric power consumption by an average of ₱0.65 per kwh or about 10.3 percent across all residential users.[14] Meanwhile, the proposed power rate increases for commercial and industrial establishments will be moderate, estimated at about 2.7 percent and 3.2 percent, respectively. Combined with the reduction in the PPA, the unbundling of power rates could result in a net increase in the cost of electricity by about 15 centavos per kwh or an increase of about 2.4 percent.

11. While the reduction in PPA charges would ease the strain on the consumer, this could have repercussions on the future fiscal position of the National Government (NG). Specifically, this could constrain the financial position of the NPC, which could impact adversely on the NG's fiscal budget in case the contingent liabilities arising from the NG-guaranteed loans of NPC become real obligations of the NG.

12. Even with the relatively small share of light to the total CPI basket (only 2.73 percent), the pass-through impact of an increase in power cost could lead to a price-spiral on other commodity groups. Based on I-O analysis, a net increase in power rate, equivalent to 2.4 percent of the current rates, would raise average annual inflation by about 0.11 percentage points.

13. The Manila Water Company Inc. (MWCI)[15] and Maynilad Water Services Inc. (MWSI)[16] have applied for increases in water rates with the regulatory

[13] Pursuant to RA No. 9136 entitled the Electric Power Industry Reform Act, the Power Sector Assets and Liabilities Corp. (PSALM) shall manage an orderly sale and privatization of all existing independent power producers (IPP) contracts and generation facilities of the NPC. After the sale and privatization of generation companies and IPP contracts owned by the NPC, these private companies are expected to participate in retail competition under the WESM for the sale of power to distributors.

[14] According to Meralco, the unbundling of power rates is not expected to result in any power rate increase for residential users at the lowest consumption bracket. (Source: Meralco, Press Release entitled, "Meralco Submits New Alternative on Rate Unbundling," 2 April 2002)

[15] MWCI services Metro Manila's east zone which covers Mandaluyong City, Pasig City, Pateros, San Juan, Taguig, and portions of Makati City, Manila City, Marikina City and Quezon City as well as Angono, Antipolo, Baras, Binangonan, Cainta, Jala-Jala, Morong, Pililia, Tanay, Teresa, Rodriguez and San Mateo, all in Rizal.

agency, the Metropolitan Waterworks and Sewerage System (MWSS). MWCI and MWSI have asked to increase their water rates by ₱1.00 and ₱6.00 per cubic meter, respectively, representing an average increase of 26.8 percent from current levels.[17] The planned adjustments in water rates are expected to be implemented within the year. Given the relatively small share of water to the CPI basket of 0.7 percent, the proposed increase in power rates would likely result in a slight increase in the CPI inflation of 0.1 percentage point.[18]

14. The combined impact of the proposed adjustments in power and water rates along with the possible increase in oil prices could raise the average annual CPI inflation by an estimated 1.43 percentage points.

The pass-through impact on inflation of the proposed unbundling of power rates by Meralco could be mitigated by the reduction in PPA and the proposed implementation of the WESM. Meanwhile, the impact of the planned adjustments in water rates pose downside risks to inflation and inflation outlook.

Interest rates and interest rate differentials

15. The differentials between the RP 91-day T-bill rate (net of RP withholding tax) and the 90-day US LIBOR and 90-day US T-bill rate for the month of June widened to 1.9 percent and 2.1 percent, respectively, compared to the previous month's average differentials of 1.6 percent and 1.8 percent. The widening trend could be attributed to the rise in the RP 91-day T-bill rate since 3 June 2002 by a total of 21 basis points, which was accompanied by declines in both the 90-day US LIBOR and 90-day US T-bill rate. Meanwhile, foreign interest rates have continued to drop as the weakness in the U.S. equities market as well as the slow pick-up in consumer spending and business investments have

[16] MWSI services Metro Manila's west zone which covers Valenzuela, Bulacan, Malabon, Navotas, parts of Quezon City and Makati City, Manila City, Pasay City, Las Piñas, Parañaque City, Muntinlupa City and areas in Cavite.

[17] The MWC and MWSI have proposed increases in water rates by ₱1.00 and ₱6.00 per cubic meter or by 38.8 percent and 14.8 percent, respectively, from ₱6.75 and ₱15.46 per cubic meter, respectively, for an average increase of 26.8 percent.

[18] Based on analysis using input-output (I-O) tables published by the National Statistical Coordination Board (NSCB)

reinforced market expectations that the Fed will not likely raise interest rates until the end of the year.

16. The differential between the BSP's policy interest rate (overnight borrowing or RRP rate) and the US federal funds target rate was unchanged at 525 basis points as the BSP policy rates and the US federal funds target rate remained steady at their 15 March 2002 and December 2001 levels, respectively. Adjusted for the risk premium—measured by the differential between the 10-year ROP note and the 10-year US Treasury note—the differential between the BSP policy interest rate and the US federal funds target rate narrowed anew in June, as the risk premium for the Philippines started to rise after trending downward in January 2002.

17. The RP 91-day T-bill rate rose gradually from 4.381 percent during the 13 May 2002 auction to 4.778 percent in the 5 June 2002 auction. The steady upward movement of the RP 91-day T-bill rate in May-June 2002 was driven mainly by market concerns over the higher-than-target fiscal deficit figure for January-April 2002.

The country's average interest rate differentials with the US widened in June as the RP benchmark market interest rate moved up while US interest rates trended downward.

18. The spread of the RP lending rate over the benchmark 91-day T-bill rate for the period 17-21 June 2002 narrowed down slightly to 312 basis points from 315 basis points in the previous week due mainly to the decline in the low-end of bank lending rates by about 3 basis points. This differential was below the average of 347 basis points for a sample of Asian countries.

19. During the period 17-21 June 2002, the Philippines' real lending rate (based on the low-end of the range of banks' lending rates) remained at approximately the same level as in the previous week of 4.3 percent. At this level, the Philippines' real lending rate was lower compared to almost all of the countries surveyed**:** Hong Kong, India, Malaysia, Singapore, Taiwan, Indonesia and Thailand, with the exception of South Korea and Japan.

RP lending rates remained steady and lower than the lending rates of other Asian countries. The current low interest rate environment—due in part to the past monetary easing measures of the BSP—is expected to

support the underlying strength in consumption spending and to pave the way for a steady growth in bank lending as well as a brisker economic activity ahead.

20. The slope of the yield curve for government securities in the secondary market as of 25 June 2002 has dropped but steepened slightly compared to that at the beginning of 2002 due to sizeable declines in the yields reflected in the shorter maturities. This was mainly on account of the general drop in yields of government securities, which ranged from 111-454 basis points across all maturities since 4 January 2002, with the higher decline at the short-end of the yield curve (2 years and below). However, compared to 27 May 2002, the yield curve has shifted upward in tandem with the rise in the yields of government securities in the primary market.[19]

The general steepness of the yield curve reflected the larger declines in the short-dated government securities in the secondary market.

Domestic stock market movements

21. The domestic stock market consolidated further in June 2002 as the average Phisix slid to 1,262 index points, the lowest level recorded since January 2002. Investors' appetite for local stocks was tempered by concerns over the higher-than-expected fiscal deficit, the lack of positive corporate news as well as the corporate equity battle over an index heavyweight firm. Moreover, uncertainties sparked by the political impasse in the Senate and the still fragile recovery of the global economy dampened market sentiments and investor confidence.

22. The sluggish mood in the market was reflected in the thin market activity. Total volume of transactions for the period 3-25 June 2002 fell by 6.0 percent to 4.7 billion shares from 5.0 billion shares recorded in May 2002 while total value turnover in June amounted to ₱6.6 billion, 34 percent lower than the ₱10 billion turnover in May. Meanwhile, foreign participation in the domestic stock market declined to 52 percent from 54 percent in the previous month. Foreign investors

[19] Yield curve presented in the previous meeting of the Monetary Board on monetary policy dated 6 June 2002

remained net sellers for the third consecutive month as foreign selling dominated foreign buying by ₱601.8 million.[20]

The domestic stock market continued to consolidate in June with the bulk of the trading activities supported mainly by bargain hunting. The recovery of the local bourse would depend on firmer signs of improved corporate performance and the pace of the strengthening of the US and other major economies.

Monetary aggregates and bank lending

23. Domestic liquidity (M3) growth slowed down as of end-April 2002, increasing by 6.6 percent year-on-year compared to the 8.6 percent growth as of end-March 2002. This developed as the growth in net domestic credits eased despite recent signs of improvement in economic activity. The slowdown in domestic liquidity growth was accompanied by a decline in the outstanding loans of commercial banks (KBs) in April 2002, which fell anew by 2.2 percent, year-on-year, after posting a 0.1 percent growth in the preceding month. On a monthly basis, KB loans grew by ₱5.83 billion or 0.4 percent to reach ₱1.42 trillion as of end-April 2002 from the previous month's level. At 0.4 percent, the month-on-month growth in bank lending for April was slower than the 0.7 percent posted in March due, in part, to the efforts of banks to preserve asset quality given the relatively large non-performing loans (NPLs), which stood at 18.2 percent of total loans outstanding in April 2002. In addition, the relatively low rate of capacity utilization in manufacturing continued to rein in firms' financing plans for reinvestment or expansion.

24. Banks' excess funds continued to be channeled to placements with the BSP and government securities. Based on latest data, banks' placements under the RRP window rose by ₱8.8 billion to reach ₱110.2 billion as of 17 June 2002 from ₱28.2 billion as of end-December 2001 while placements under the SDA window amounted to ₱13.5 billion from zero during the same period.

Bank lending continued to be weak although the rate of decline has eased in April. Banks have maintained their cautious lending stance due to the still high NPLs and weak corporate credit demand. At the same time,

[20] Source: Philippine Stock Exchange (Figures as of 25 June 2002)

banks have opted to park their excess funds in government securities and placements with the BSP.

25. For the period January-April 2002, the NG budget deficit reached ₱82.96 billion, ₱4.7 billion or 6.0 percent above the programmed deficit for the period. The higher-than-programmed budget deficit of the NG was due to the combined shortfall in revenue collections and the frontloading of expenditures as well as the payment of accrued accounts payable. The possibility that the NG would breach its programmed deficit for the year could have implications on the BSP's conduct of monetary policy as the need to finance the deficit could compel the NG to raise its domestic borrowing or withdraw from its deposits with the BSP.

Developments and outlook in the rest of the world

26. After slipping into recession starting March 2001, the US economy grew strongly by 6.1 percent (revised) year-on-year in the first quarter. However, more recent statistics suggested that the pace of the US recovery has slackened in the second quarter. Consumers have turned cautious amid concerns about the possibility of more job losses, internal security and global tensions. The University of Michigan's consumer sentiment index fell to 90.8 in June from 96.9 a month ago which was reinforced by retail sales figures which showed a 0.9 percent slowdown in consumer spending in May. Capacity utilization in industry has stayed at historically low levels of around 75 percent, significantly below the 83 percent level that has traditionally been associated with capacity constraints and inflation.

27. The decision of the US Fed to keep the federal funds target rate unchanged following its two-day meeting on 25-26 June 2002 highlighted the Fed's assessment which maintains that "the degree of strengthening of the US economy remains uncertain".[21] The specter of continued high unemployment and the belief that consumers do not have a lot of pent-up demand coming out of recession combined with depressed stock prices have shaped markets' perception that the US Fed would likely keep its accommodative stance by holding interest rates steady in the near term.

[21] Cranford, Jan, C. Torres and M. McKee, "Fed leaves Benchmark Lending Rate at 1.75 percent", www.Bloomberg.com

28. In the euro zone, the European Central Bank (ECB) kept policy rates unchanged during its 6 June 2002 meeting, noting that economic recovery, while under way, still lacks strength. The mixed turnout in leading economic indicators across the euro zone indicated that the growth outlook in the area has remained uncertain. The Bank of England has also kept policy rates steady on its 6 June 2002 meeting as weaknesses in the manufacturing sector in the United Kingdom (UK) continued to cloud the strength of the economic recovery. Meanwhile, in Japan, evidence of sustained economic recovery has been focused mainly on the export and service sectors. Reflecting these developments, the monetary policies of the central banks in the UK, euro zone and Japan have been accommodative, aimed at allowing growth to firm up.

The uneven pace of the US-led global economic recovery indicate that less reliance could be placed on external demand as a source of growth for the Philippine economy.

II. Discussion on the Review of the Monetary Policy Stance

29. The members of the Monetary Board noted that despite signs of improving economic activity, overall domestic demand conditions remain subdued, as indicated in sluggish bank lending activity and weak corporate credit demand. The global slowdown has shown firm indications of bottoming out but questions have remained about the pace of the recovery and its durability. This meant that domestic demand would continue to be the main source of impetus for economic expansion in the near term and should thus be the focus of supportive macroeconomic policies.

30. However, the members of the Monetary Board shared the view that the presence of downside risks to future inflation and inflationary expectations amid the slow improvement in domestic demand provided a case for navigating carefully monetary policy so as to maintain stimulus for growth while guarding closely against inflationary threats. The risks to the inflation objective relate to the uncertainty over the impact of El Niño weather phenomenon on agricultural crop production in 2003, the uncertainty in the direction of world oil prices, and the expected adjustment in power and water rates as well as the possible increase in transport charges. Moreover, the present scope for monetary easing has also been capped by the fact that policy rates have already been reduced to a significant extent over the past year.

31. The members of the Monetary Board agreed that the potential risks factors on inflation and inflationary expectations, the still weak—though improving—economic activity and the uncertainty over the pace of the global economic recovery have created a case for maintaining a cautious monetary policy stance so as to ensure that price pressures remain well-contained.

III. Monetary Policy Decision

32. Based on the analysis of data that have become available since the last meeting of the Monetary Board on 6 June 2002 and a careful assessment of the balance of risks on inflation and inflationary expectations, the members of the Monetary Board by a unanimous vote decided as follows:

a. maintain the BSP's policy rates at the current levels of 7.0 percent for the overnight RRP (borrowing) rate and 9.25 percent for the overnight RP (lending) rate;

b. maintain the tiering scheme on banks placements with the BSP under the RRPs and SDA windows;

c. maintain the current interest rates on the term RRPs, RPs, and SDAs; and

d. maintain the reserve requirements at their current levels 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 1 August 2002.

- The Monetary Board of the Bangko Sentral ng Pilipinas

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