Bangko Sentral ng Pilipinas

HIGHLIGHTS OF THE MEETING OF THE MONETARY BOARD ON MONETARY POLICY ISSUES HELD ON 5 MAY 2005 *

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 interest rates at 7.0 percent for the overnight RRP (borrowing) rate and 9.25 percent for the overnight RP (lending) rate; and

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

2) Maintain the current reserve requirement ratios; and

3) Continue to articulate support for the intensified use of non-monetary measures to address supply-side risks, particularly those relating to food supply, by strengthening representation and coordination with various government agencies.

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

The above recommendations were based on the following considerations:

- Headline inflation remained steady at 8.5 percent in March 2005 as in the previous month. Clothing, housing and repairs, and services posted higher year-on-year inflation in March. Services inflation rose, owing mainly to the increase in inflation for transportation and communication due to higher prices of gasoline and oil products. However, inflation for food, beverage and tobacco as well as fuel, light and water was lower in March compared to the previous month.

* The highlights of the discussions of the 5 May 2005 Monetary Board meeting were approved by the Monetary Board during its meeting held on 2 June 2005.

[1] The Advisory Committee is composed of the Governor of the BSP as Chairman and four members, namely: the Deputy Governor for the Monetary Stability Sector, the Deputy Governor for Supervision and Examination Sector, the Assistant Governor, Monetary Policy Sub-Sector and the Managing Director of the Treasury Department.

- Core inflation—defined as headline inflation after excluding volatile food and energy items such as rice, corn, fruits and vegetables, liquefied petroleum gas (LPG), kerosene and gasoline—slowed down to 8.0 percent year-on-year in March 2005 from 8.1 percent a month ago.

- Supply-side factors continued to dominate the risks to inflation. Of the 8.5 percent headline inflation for March, 3.6 percentage points were attributed to food, beverage and tobacco, 1.7 percentage points to transportation and communication services and 1.3 percentage points to fuel, light and water

- The outlook for inflation continued to show a decelerating path. For 2005, inflation would likely exceed the target of 5.0-6.0 percent as the full impact of supply-side pressures sets in. In the absence of further adverse shocks, average inflation for 2006 could fall to the target range of 4.0-5.0 percent.

- The risks to the inflation outlook continued to be dominated by the influence of supply-side factors particularly, the movement in international oil prices.

  - The volatility in world oil prices remained as one of the key driving factors behind the inflation process. This could intensify pending demands for adjustments in transport fares and further increase in utility charges, which may eventually feed into the prices of other goods and services.

  - Furthermore, the loss in purchasing power due to rising inflation would likely compel authorities to grant petitions for adjustments in minimum nominal wage rates.

  - Meanwhile, the current El Niño weather disturbance would impact adversely the agriculture sector, particularly rice production.

  - In addition, the passage into law of new legislative revenue measures such as the expanded VAT reform, could exert upward pressures on prices in the short run. Nevertheless, the impact of said revenue measures on inflation could be classified as part of the BSP's exemption clauses. Also, the passage of the VAT reform bill is expected to improve the government's fiscal position, shore up investor confidence, and thereby, improve the economy's growth prospects over time.

- Selected indicators suggest improvements in domestic demand but some evidence of resource slack remains.

- Average capacity utilization in manufacturing was steady at 79.8 percent in February 2005.

- The value of production index (VAPI) for manufacturing increased by 11.0 percent year-on-year in February 2005, lower than the revised January growth rate of 13.6 percent. Year-on-year growth in volume of production index (VOPI) for manufacturing was slightly lower at 2.4 percent in February compared to the revised figure of 2.7 percent for January.

- Total merchandise exports fell slightly by 0.6 percent year-on-year in February 2005. This was a downturn from growth rates of 15.4 percent in the previous month and 7.6 percent in February 2004.

- Merchandise imports declined further by 4.8 percent year-on-year in February 2005 from a 2.1 percent drop in the previous month. This was a downturn from the 6.3 percent expansion in the same month last year.

- Passenger car sales increased by 6.4 percent year-on-year in March 2005 following the previous month's decline of 7.1 percent. Meanwhile, sales of trucks and buses continued to fall by 23.3 percent year-on-year in March from 42.4 percent in February.

- Energy sales by the Manila Electric Company declined by 2.5 percent year-on-year in February 2005 as against the 7.2 percent increase in the previous month.

- The latest Labor Force Survey conducted by the National Statistics Office (NSO) showed that unemployment rate rose to 11.3 percent in January 2005 from 11.0 percent a year ago. This was also higher than the 10.9 percent unemployment rate in October 2004.

? In the financial sector, the growth in domestic liquidity accelerated. Bank lending likewise showed an improvement but remained modest. Meanwhile, Treasury bill rates rose during the 25 April 2005 auction relative to the 14 March 2005 auction[2] but declined relative to the previous week's auction on 18 April 2005.

- The growth in domestic liquidity (M3) accelerated to 11.7 percent (revised) year-on-year in February 2005, based on Depository

[2] During the three auctions between 14 March 2005 and 18 April 2005, the Bureau of Treasury rejected all bids for the 364-day tenor.

Corporations Survey (DCS) from the 11.0 percent rise in the previous month.[3]

- ✍ Outstanding loans of commercial bank (KB) loans grew by 5.8 percent year-on-year to ₱1.525 trillion as of end-February 2005. This was higher than the 4.0 percent year-on-year growth recorded in January 2005.

- ✍ Relative to the 14 March 2005 auction, T-bill rates rose across all tenors during the 25 April 2005 auction. The increase in yields was influenced partly by the upward adjustment in the BSP's policy rates by 25 basis points on 7 April 2005. Relative to the 18 Ap ril 2005 auction, T-bill yields for the 91-day, 182-day and 364-day T-bills eased by 10.6 basis points, 12.3 basis points and 11.4 basis points, respectively. This could be traced to the presence of ample liquidity in the system.

? The peso was relatively steady against the US dollar in April. However, compared to March, the peso weakened slightly in April due mainly to high corporate dollar demand for month-end import obligations, market concerns over the possible delay in the passage of the expanded VAT reform measure and the recovery of the US dollar. Exchange market pressure remained a risk to the inflation environment due to the possibility of further narrowing of interest rate differentials.

? In the fiscal sector, the National Government's (NG) budget deficit reached ₱23.4 billion in March, bringing the first quarter 2005 NG budget deficit to ₱63.5 billion. This was ₱14.3 billion lower than the programmed level for the period as growth in revenue collections continued to outpace that of expenditures.

? The global economy—led by the US and China— grew steadily in the first quarter of 2005. Improving labor market conditions and generally positive consumer confidence in most markets continued to underpin the strength of consumer spending and the observed pick-up in manufacturing. Overall, the outlook for 2005 suggested a sustained pace of economic recovery, although at a modest pace. The widening global imbalances alongside continued volatility in world oil prices continued to exert downside risks to the outlook.

- ✍ The US economy continued to expand in the first quarter of this year, characterized by improvement in labor market conditions and robust

[3] M3 refers to the stock of broad money based on data on the Depository Corporations Survey (DCS). The DCS, which replaces the Monetary Survey (MS) as the basis for measuring domestic liquidity, features an expanded list of surveyed institutions that includes the BSP, commercial banks, thrift banks, rural banks, non-stock savings and loan associations and non-banks with quasi-banking functions.

consumer spending despite rising energy prices and rising interest rates. Manufacturing activity also continued at solid levels.

- Recent data, although mixed, suggest a possible rebound in economic activity in the euro area in the first quarter of 2005. Industrial production and retail sales regained some momentum. However, subdued consumer confidence continued to weigh down on consumption growth. Meanwhile, moderate economic growth and weak labor markets contained the rise in wages.

- Overall output growth in the UK remained strong in the first quarter of 2005 despite some weakness in industrial production and household spending. Improvements in housing market activity, modest growth in retail sales, and resilient real income and wealth, indicated a potential pick up in consumption spending.

- Prospects for the Japanese economy remained mixed. Exports have started to pick-up while employment conditions continued to improve. Meanwhile, weak consumer spending and cautious business sentiment alongside continued volatility in world oil prices weighed down on the prospects for sustained economic recovery.

- Given the outlook for inflation and economic growth in the major economies, the US Federal Open Market Committee raised its policy rate by 25 basis points to 3.0 percent during its last meeting held on 3 May 2005. By contrast, monetary authorities in Japan, in Euro area, and in UK kept their monetary policy settings unchanged during their last meetings in April.

II. Review of the Monetary Policy Stance

- The members of the Monetary Board noted that latest forecasts indicate that inflation may have levelled off, leading to the targeted 4-5 percent range in 2006, in the absence of further adverse shocks. This was supported by the slowdown in year-on-year core inflation. Taken together, the expectations of a decelerating path for inflation alongside the presence of slack in the economy supported the maintenance of current policy settings.

- The members of the Monetary Board recognized that there are risks to inflation over the policy horizon given the prospects for sustained cost-side pressures via high oil prices, impending second-round effects in the form of nominal wage increases and ancillary adjustments in other key prices such as transport fares and power costs.

? The members of the Monetary Board pointed out that under such circumstances, monetary authorities may opt to respond in order to guide inflation expectations down. Such a move would help contain prevailing inflation risks and underline the BSP's strong commitment to fighting inflation.

? On the other hand, the members of the Monetary Board noted that there was also enough flexibility to keep monetary policy settings unchanged for the time being.

- The recent policy rate increase should be given time to fully work its way into the economy and exert its impact on inflation expectations.

- Any significant monetary tightening may not be warranted under present conditions, given that demand pressures continued to be softened by sluggish employment conditions, moderate capacity utilization, and generally modest credit demand.

- The Board also recognized that the term spreads or the differentials between long-term and short-term interest rates narrowed in recent months, indicating that long-term inflation expectations remained anchored.

? Based on these considerations, the members of the Monetary Board agreed that present monetary policy settings should be kept unchanged for the time being.

? At the same time, the Monetary Board members underscored the need to support Government's efforts in intensifying supply intervention measures such as timely and increased importation of rice and other measures that will facilitate distribution of agricultural commodities to the final consumers.

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 interest rates at 7.0 percent for the overnight RRP (borrowing) rate and 9.25 percent for the overnight RP (lending) rate; and

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

2) Maintain the current reserve requirement ratios; and

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

The next meeting of the Monetary Board to discuss the monetary policy setting is scheduled on 2 June 2005.