HIGHLIGHTS OF THE MEETING OF THE MONETARY BOARD ON MONETARY POLICY ISSUES HELD ON 6 JUNE 2002[*]

Background

The Monetary Board held its sixth meeting for the year on monetary policy issues on 6 June 2002. This came after the 4 June 2002 meeting of the Advisory Committee wherein 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, the subsequent uptrend in domestic oil prices, possible adjustments in power and water rates as well as the petitions for transport fare increases, monetary conditions, demand and output indicators, 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. The inflation rate remained at 3.6 percent in May. This brought the average inflation rate since January to 3.6 percent. At this level, the average annual inflation rate for the first five months of the year was well below the

[*] The highlights of the discussions of the 6 June 2002 Monetary Board meeting were approved by the Monetary Board during its meeting held on 11 July 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, the Director of the Department of Economic Research, and the Director of the Treasury Department

government's target of 4.5-5.5 percent (revised) average inflation for the whole year 2002. Continued favorable food supply, broad stability in the exchange rate and relatively weak but resilient domestic demand kept price pressures subdued.

2. The Philippine economy grew by a stronger 4.9 percent in terms of real GNP and 3.8 percent in terms of real GDP in the first quarter of 2002, a marked increase from the 3.4 percent and 2.9 percent growth, respectively, that were registered a year ago. By sector, the growth in the agriculture, fishery and forestry sector as well as the services sector contributed to the increase in real output, with the year-on-year growth registered at higher levels relative to the figures posted in the previous year. However, the growth of industry sector was lower at 1.9 percent in the first quarter, although this was higher than the 0.6 percent growth recorded a year ago. The relatively slow pick-up in industry could be traced to the presence of spare capacity at 75.6 percent in March 2002 and the relatively high unemployment rate of 10.3 percent in the first quarter of 2002.

3. The sustained slowdown in headline and core inflation bolstered expectations of a generally favorable inflation environment for the rest of 2002 as past and contemporaneous inflation performance feed through consumption, investment spending and wage setting decisions of economic agents.

Inflationary pressures were held at bay even as the economic growth gathered momentum. Based on the BSP's latest forecast readings, the average annual inflation rate for 2002 is expected to be in line with the 4.5 - 5.5 percent revised average inflation target for the year. The generally favorable inflation environment is expected to be supportive of the economy's growth objectives.

Agricultural output forecasts

4. The agricultural crops subsector grew by 2.8 percent year-on-year to ₱34.4 billion during the first quarter of 2002 (BAS) from ₱33.4 billion in the same period a year ago on the back of a strong palay production. The palay subsector, which accounts for the largest share of farm output, registered the highest growth of 8.8 percent or ₱9.89 billion, among the major crops. Favorable weather conditions and government action to improve farm facilities boosted output.

Well-timed importation of rice and prompt implementation of mitigating measures by the government could provide cushion for any possible adverse impact on agricultural output of the onset of the El Niño weather phenomenon in the last quarter of 2002 through the first half of 2003.

Recent data on the strong performance of the agriculture sector reinforced expectations of continued favorable food supply in 2002. Adequate food production, in turn, could help ensure that food prices will be relatively low for the rest of the year.

Exchange rate developments

5. The peso-US dollar rate averaged ₱49.84 against the US dollar in May 2002, reflecting a steady appreciation of 3.9 percent since December 2001. The peso was buoyed up by the continued strength in regional currencies led by the Japanese yen and robust inflows of foreign exchange remittances. However, the peso had shown substantial gyrations in the last two weeks of May through early June, partly due to the markets' view that the Bank of Japan (BOJ) was intervening in the market by buying US dollars to slow down the appreciation of the yen.

6. Based on estimates of the real effective exchange rate (REER) in May 2002, the country's external competitiveness has weakened relative to major trading partners. Relative to the broad competing countries, however, the country's external competitiveness has remained steady, while compared with the narrow basket of competing countries' currencies, the external competitiveness of the peso improved as the narrowing inflation gap between the Philippines and competing countries more than offset the relative appreciation of the peso.

The broad stability of the peso has contributed to keeping inflationary pressures in check.

Oil price developments

7. The spot international price of crude oil (Dubai) eased slightly by 0.1 percent to US$24.48 per barrel as of 23 May 2002 from the US$24.51 per barrel average price recorded in April 2002. However, compared to the US$17.83 per barrel price in December 2001, the price of Dubai crude has increased sharply by about 40.1 percent in May 2002. The general uptrend in world oil prices during the first four months of the year has translated into a series of increases in the local pump prices of petroleum products. With the recent round of price hikes in May 2002, pump prices of petroleum products have increased four times since 7 January 2002 by a total of ₱1.61 per liter for all gasoline products and ₱1.56 centavos per liter for diesel and kerosene from end-December 2001.[2]

8. In the futures market, the price of benchmark Brent crude oil for July 2002 deliveries settled at US$25.88 per barrel.[3] For the second half of 2002, the price of Brent crude oil in the futures market is expected to remain relatively stable, averaging at US$25.78 per barrel. The reported increase in US oil inventories by 6.0 percent year-on-year in April 2002 and Russia's plan to hike oil exports by 15 percent in the third quarter provided reassurance that market supply will be adequate throughout the summer in the Western hemisphere. However, uncertainty continued to cloud the direction of world oil prices since a possible intensification of violence in the Middle East and of the conflict between India and Pakistan could upset the current relative stability in world oil prices.

9. As a major input of production, an increase in the imported cost of oil products could translate directly into an increase in the domestic prices of goods and services. Moreover, an increase in oil prices could trigger a second round impact on the cost of transport and other commodities. The direct impact on inflation was estimated at 0.4 percentage points while the indirect impact was estimated to be about twice that of the direct impact, for a total impact of 1.22 percentage points.[4] Meanwhile, the successive increases in pump oil prices have prompted a group of jeepney operators to file a petition for a 50-centavo or 12.5 percent increase in minimum fare to ₱4.50.

An increase in oil prices could lead to a build up of inflationary pressures since oil comprise a major input in the production of goods and services.

---

[2] In 2001, the average pump price of petroleum products has declined by a total of ₱1.81 per liter in 2001 (Source: Department of Energy).

[3] Source: Asian Wall Street Journal, 27 May 2002, The futures price for Brent crude—a close substitute for Dubai crude— was used as indicator of future world oil prices since futures data on Dubai crude were not available.

[4] 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 US$27.50 in 2002.

Petitions for upward adjustment in user charges on utilities

10. Manila Electric Company (Meralco) proposed graduated power rate adjustments under its revised petition for the "unbundling" of power rates submitted to the Energy Regulatory Commission (ERC) dated 2 April 2002. Under this proposal, the proposed rates will 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.[5] Meanwhile, plans to defer the collection of the purchase power adjustment (PPA) could lead to a temporary reduction in the cost of electricity.[6] This, however, could constrain the financial position of the National Power Corporation (NPC), which could impact adversely the National Government (NG) fiscal budget in case the contingent liabilities arising from NG-guaranteed loans of NPC are eventually absorbed by the NG. A higher budget deficit, in turn, could constrain the ability of NG to achieve fiscal consolidation by 2006. At the same time, a higher deficit could lead to a possible build-up in inflationary pressures.

11. While light accounts for only 2.73 percent of the CPI basket, 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 10 percent increase in power rates could raise the average annual inflation rate by about 0.48 percentage points.

12. The two water utility companies servicing Metro Manila, the Manila Water Company (MWC) and Maynilad Water Services Inc. (MWSI), have served their notices for the increase in water rates with the regulatory agency, the Metropolitan Waterworks and Sewerage System (MWSS). The MWC and MWSI have proposed to increase water rates by ₱1.00 and ₱6.00 per cubic meter, respectively, representing an average increase of 26.8 percent from the current rates.[7] Given the relatively small share of water to the CPI basket of

[5] Meralco, Press Release entitled, "Meralco Submits New Alternative on Rate Unbundling," 2 April 2002

[6] The purchase 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.

[7] 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.

0.7 percent, the proposed increase in power rates could result in an increase in the CPI inflation estimated at a minimal 0.1 percentage point.[8]

13. The combined impact of the possible increase in world oil prices, proposed adjustment in power and water rates as well as the proposed increase in the minimum transport fares was estimated to raise the average annual CPI inflation by about 1.7 percentage points.

The petitions for adjustments in power and water rates as well as in transport fares could likely raise inflation and the inflation outlook as the expected flow-on effects of the increase in user charges feed through the prices of other commodities.

Interest rates and interest rate differentials

14. The differentials between the RP 91-day T-bill rate (net of RP withholding tax) and the 90-day LIBOR and 90-day US T-bill as of 27 May 2002 widened to 1.8 percent and 1.9 percent, respectively . However, on average, the differentials between the RP 91-day T-bill rate and the US 90-day LIBOR and the 90-day US T-bill rate for the entire month of May in 2002 narrowed to 1.6 percent and 1.8 percent, respectively, reflecting the lowest monthly interest rate differentials since November 2000 before the series of reduction in the BSP's policy rates. The recent widening trend that started as early as the second week of May 2002 could be attributed to the successive increases in the RP 91-day T-bill rate since 29 April 2002 by a total of 27 basis points, which was accompanied by the decline in the 90-day US LIBOR and US 90-day T-bill rates.

15. In the domestic market, market players appeared to have refrained from locking in excess funds in government securities, as evidenced by the undersubscriptions in T-bills during the last two fortnightly auctions of the Bureau of Treasury. This has resulted in an uptick in the RP 91-day T-bill rates.

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—as measured by the differential between the 10-year ROP

[8] Based on the I-O analysis

note and the 10-year US Treasury note—the differential between the BSP policy interest rate and the US federal funds target rate rose sharply in May, as the risk premium for the Philippines continued to decline considerably. The broadly stable peso coupled with a low interest environment has sparked renewed interest in the Philippine economy by international rating agencies and fund managers alike.

The country's average interest rate differentials with the US narrowed further in May. A narrowing of interest rate differential, in turn, could limit the scope for a further cut in the BSP's policy rates. This could risk the relative stability in the foreign exchange market in case of an adverse external shock leading to a dramatic shift in market sentiments.

17. Market interest rates have shown a significant downtrend since the BSP began to reduce its policy rates in December 2000. As of 27 May 2002, the benchmark RP 91-day T-bill rate has declined by 1,123 basis points since the beginning of December 2000 while banks' lending rates have fallen by almost the same magnitude (1,118 basis points) during the same period.[9]

18. During the period 16-22 May 2002, the Philippines' real lending rate remained at its previous week's rate of 4.1 percent. At this level, the Philippines' real lending rate was lower compared to almost all of the countries surveyed**:** Hong Kong, India, Malaysia, Singapore, South Korea, Taiwan, Indonesia and Thailand, with the exception of Japan.

The continued downtrend in RP lending rates relative to its historical levels and to other Asian countries indicated that the past monetary easing measures of the BSP have been gradually working its way into the financial system.

19. The slope of the yield curve for government securities in the secondary market as of 3 June 2002 has flattened compared to the yield curve on 29 April 2002 due mainly to the rise in yields across all maturities—ranging from 13-187 basis points—with higher increases recorded at the shorter end of the yield curve

[9] The decline in banks' lending rate was measured as the difference between average of the low-end of banks' lending rate for the period 1-29 May 2002 and that which was recorded prior to the successive monetary easing measure of policy rates in December 2000. The decline in the 91-day T-bill rate was measured as the difference between the average 91-day T-bill rate in May 2002 and the average monthly 91-day T-bill rate in November 2000.

(2 years and below).[10] The recent increases in the yields in the shorter tenors have reduced the relative steepness of the yield curve at the shorter end. However, relative to the slope of the yield curve on 4 January 2002, the yield curve has declined markedly but remained steeper at the long end..

20. However, the slope of the yield curve could drop in the coming months, with many market analysts believing that the short term interest rates have bottomed out already. This is evident in the uptrend in the 91-day T-bill rate in the 13 and 27 May 2002 auctions. Moreover, as of 27 May 2002, the yields across all maturities of government securities in the secondary market were little changed compared to those recorded a week ago.

The generally swifter downward shift at the shorter end of the yield curve reflected a faster feed-through of the impact of monetary policy easing on short-term instruments than on the longer tenor instruments. Meanwhile, the long-end of the yield curve remained steep due to higher inflationary expectations and uncertainty inherent in the long run.

Domestic stock market movements

21. For the period 1-28 May 2002, the Phisix averaged 1345.65 index points, down by 42.82 index points or 3.1 percent lower than April's average of 1388.47 index points. Most investors preferred to stay on the sidelines and to concentrate on selected issues with strong first quarter corporate performances. Analysts expect that the selectiveness in the local bourse could persist as investors await for better signals of corporate performance before committing funds to the domestic equities market.

22. Reflecting the bearish tone in the stock market, the volume of transactions fell by 50.6 percent to 5.01 billion shares in May from 10.14 billion shares in April 2002 while value turnover dipped by 48.9 percent from ₱19.60 billion in April 2002 to ₱10.02 billion in May 2002.[11] Moreover, foreign participation in the local bourse dropped slightly to 51 percent in May 2002 from 52 percent (revised) in the previous month. Meanwhile, foreign selling dominated foreign buying by ₱674.81 million.

[10] The comparative yield curves pertain to that of the most recent curve (3 June 2002) and that which was presented during the last MB meeting on monetary policy (29 April 2002).

[11] Based on preliminary figures for May 2002

The domestic stock market consolidated in May but long-term outlook has remained positive as the current favorable macroeconomic settings and the improvements in policy credibility could translate into better corporate performance.

Monetary aggregates and bank lending

23. Domestic liquidity or M3 grew strongly by 8.6 percent on an annual basis to reach ₱1.56 trillion as of end-March 2002 from the 7.2 percent growth recorded in the previous month. The uptrend in domestic liquidity marked the highest year-on-year growth registered since November 2001 and also reflected a faster month-on-month growth of 2.5 percent compared to 0.8 percent growth in February. However, preliminary data for April 2002 showed that the growth in M3 in April 2002 slowed down to 6.7 percent, year-on-year from 8.6 percent in the previous month.[12] Using seasonally adjusted data, however, the growth in M3 continued to exhibit an accelerating trend in April 2002, estimated at 1.9 percent, month-on-month from 1.4 percent in March 2002. Continuing the trend experienced a month ago, bank lending in March 2002 trended upward as the outstanding loans of commercial banks rose by ₱1.56 billion or 0.1 percent year-on-year to reach ₱1.41 trillion as of end-March 2002, a marked contrast to the general contraction registered over the past seven months after August 2001. Compared to the previous month's level, bank lending in March 2002 rose by ₱10.2 billion or 0.7 percent.

24. Banks' excess funds still continued to be channeled to placements with the BSP and government securities. Based on the latest data from the BSP, banks' placements under the RRP window rose significantly by almost four times to reach ₱104.7 billion as of 29 May 2002 from ₱28.2 billion as of end-December 2001 while placements under the SDA window amounted to ₱15.3 billion from zero during the same period. Using seasonally adjusted data, the level of RRPs rose by 44.6 percent in March relative to February, up from the 8.6 percent month-on-month growth registered in the same period a year ago. By contrast, the seasonally-adjusted volume of banks placements under the SDA window declined by 49.6 percent month-on-month as against a more than tenfold expansion recorded in the same period last year.

[12] Based on the reports of 44 banks, of which the reports of thirteen banks were still subject to validation as of 31 May 2002.

The successive monetary easing measures in the past have resulted in the continued growth in domestic liquidity and some improvements in bank lending. Meanwhile, banks have continued to channel their excess liquidity into the BSP's RRP and SDA windows and into other government securities.

Developments and outlook in the rest of the world

25. The string of positive economic news provided increased evidence that the US economy has entered the expansion phase from what has been generally described as the shortest and mildest period of recession in US history. The US Commerce Department reported a 5.6 percent (revised) GDP growth in the first quarter of 2002. Consumption spending remained as one of the main drivers of recovery in the US. Retail sales in April grew by 1.2 percent from 0.1 percent in March. Sales of motor vehicles and parts were also brisk, rising by 1.9 percent in April following a 0.8 percent contraction in March. These developments demonstrated the bullish sentiment of American consumers, as captured by the University of Michigan's index of consumer sentiment, which rose from 93.0 in April to 96.0 in May 2002, its highest since December 2000. The expansion in US GDP also reflected the upturns in inventory investment, federal government expenditures and exports.[13]

26. Other US indicators showed that the recovery has remained tentative. Evidence that the US economy has been recovering more slowly than some earlier forecasts came when the Conference Board said that its index of leading indicators fell by 0.4 percent in April 2002. Thus, some market analysts continued to cast doubts on the strength of the recovery of the world's largest economy. The US manufacturing sector continued to be sluggish as evident in the drop in the Institute for Supply Management (ISM) index to 53.9 in April from 55.6 in March. Moreover, unemployment rate was still high at 6 percent. These indicators suggested that the recovery in production may not be very robust.[14] As the Fed remained uncertain about the prospects of a vigorous recovery, market analysts believed that the chance of interest tightening is unlikely to come in the near term as market believed that the recovery is still in the first gear. In particular, analysts speculated that the hike in the Fed's rates would not come until August 2002. The likely neutral stance of the Federal Reserve could give the US economy more time to regain solid footing.

[13] Source: www.doc.gov, US Department of Commerce

[14] Source: UFJ Institute Economic Research Department, Global Watch, May 2002

27. For other economies, the quality of growth remained an issue. The mixed turnout in leading economic indicators in these economies pointed to the fragility of the resurgence in the global economy. In UK, there were signs that business confidence has picked up with the recent announcement of a British supermarket chain's plan to open eight new stores and create 1250 new jobs. However, the uncertainty in the UK's economic recovery was underscored in the zero growth of its GDP for the first three months of 2002.[15] In Japan, the government's all industries index—a proxy for GDP—inched up by 0.6 percent in the first quarter of 2002, its first increase in four quarters. This was fueled mainly by the rebound in the service sector, rising exports, firming job market and easing of deflation. The improved prospects of the Japanese economy were also reflected in the strengthening of the yen against the dollar.[16] Despite these signs of reduced weakness in the Japanese economy, analysts were still cautious on Japan's recovery as consumption spending continued to be weak. Latest readings on the UK and Japan suggested that monetary tightening may not be possible in the near term.

Market analysts believed that the US Fed will likely maintain its neutral monetary policy stance as it awaits for stronger evidences of a robust recovery in consumer spending and business investment.

II. Discussion on the Review of the Monetary Policy Stance

28. The members of the Monetary Board were of the view that expectations of good agricultural output, continued broad stability in the exchange rate combined with still relatively soft—but improving—domestic demand and the continued presence of spare capacity indicated a generally quiescent inflation outlook for 2002. However, the members of the Monetary Board also noted the presence of some headwinds in the price movements such as the uncertainty over the full impact of the El Niño weather phenomenon on agricultural crop production in 2003, uncertainty in the direction of world oil prices as well as the expected adjustment in power and water rates and transport fares. All these factors pose downside risks to future inflation and inflationary expectations.

29. Moreover, the members of the Monetary Board shared the view that the scope for cutting policy rates has been partly limited by the fact that current interest

[15] Source: www.reuters.com, UK Economy flirts with recession in first quarter, 24 May 2002

[16] Source: www.reuters.com, As Japan economy rebounds, yen rise triggers alarm, 22 May 2002

rates have reached historically low levels. The members of the Monetary Board pointed out that the overnight RRP rate has already reached a decade-low level, and that monetary conditions have already been eased to a significant extent over the past year. Since the BSP started to ease policy rates in December 2000, the BSP's policy rates have declined by 800 basis points. In response to the past monetary easing, the benchmark 91-day T-bill rate has likewise declined by about 1,123 basis points during the 27 May 2002 auction relative to that which prevailed prior to December 2000. Similarly, the low end of banks' lending rates has declined by 1,118 basis points during the same period. Moreover, the growth in M3 increased by 8.6 percent year-on-year in March 2002, marking an acceleration for the second consecutive month. There were also signs of improving economic activity as evident in the expansion in real GNP and GDP in the first quarter and the improvement in average capacity utilization.

30. The members of the Monetary Board agreed that these considerations argue for continued caution in monetary policy. This would entail allowing the past monetary easing measures to flow through the economy, with the BSP monitoring carefully evidences of the sustainability of the growth process while seeing to it that inflationary pressures are not stoked up.

31. The Monetary Board also discussed the possible implications of the NG fiscal position on monetary management. The NG reported a budget deficit of ₱61.2 billion for the first quarter of 2002, about 16 percent higher than the programmed amount for the period. Fiscal authorities attributed this largely to the frontloading of expenditures and payments for accrued accounts payable, along with a shortfall in revenue collections. Monetary Board members noted that the requirements of financing the budget deficit may compel the NG to increase its domestic borrowings. Such a situation could impact the level of domestic liquidity and, consequently, inflation. However, the Monetary Board also noted that the NG remains firmly committed to achieving the 2002 target budget deficit of ₱130 billion through administrative revenue measures, the rationalization of expenditures and recourse to alternative sources of financing.

III. Monetary Policy Decision

32. Based on the weight of evidence and the discussions, the members of the Monetary Board by a unanimous vote decided as follows:

a. to 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. to maintain the tiering scheme on bank placements with the BSP under the RRPs and SDA windows; and

c. to maintain the current levels of the reserve requirements at 9 percent for regular reserves and 7 percent for liquidity reserves.

The next meeting of the Monetary Board to discuss the monetary policy setting was scheduled on 4 July 2002.

- The Monetary Board of the Bangko Sentral ng Pilipinas

o:\mdgparaso_MB minutes\MB minutes 06-06-2002 meeting-rev