HIGHLIGHTS OF THE MEETING OF THE MONETARY BOARD ON MONETARY POLICY ISSUES HELD ON 17 JANUARY 2002*

Background

The accountability of the BSP for the inflation target underscores the importance of improved transparency. This is to be achieved by reinforcing the disclosure and reporting mechanisms to help the public understand what the BSP is doing and the reasons for its monetary policy actions as well as enable the public to monitor the commitment of the monetary authorities to the inflation target. As part of its efforts to promote greater transparency in the conduct of monetary policy, the highlights of the Monetary Board discussion on monetary policy will be published with a lag of six (6) weeks.

The Monetary Board held its first meeting for the year on monetary policy issues on 17 January 2002. Earlier, on 15 January 2002, the Advisory Committee[1] met and formed recommendations on the appropriate monetary policy setting. The Advisory Committee submitted, for the consideration of the Monetary Board, a policy paper and various information relevant for the deliberation on monetary policy. In particular, the Monetary Board discussed inflation developments and expectations, monetary conditions, external developments and the global economic outlook, demand and output indicators and the implications of these factors on monetary policy. It will be recalled that the BSP Governor announced on 26 December 2001 the target inflation of 5.0-6.0 percent for 2002 and 4.5-5.5 percent for 2003. These targets were set in coordination with the Development Budget and Coordination Committee (DBCC).

* The highlights of the discussions of the 17 January 2002 Monetary Board Meeting were approved by the Monetary Board during its meeting held on 21 February 2002.

[1] 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 Director of the Department of Economic Research, and the Director of the Treasury Department

I. Considerations in Setting the Monetary Policy Stance

Current inflation and inflation outlook

1. December inflation slowed down further to 3.9 percent year-on-year from 4.4 percent in November, bringing the average inflation rate for 2001 to 6.0 percent, which is the low end of the government's 6-7 percent inflation target.[2] Based on the latest macroeconomic assumptions on growth, money supply, Treasury bill rates, the government's fiscal position, exchange rate, domestic oil prices and prices of non-oil imports, future inflation is expected to track broadly the inflation target for 2002 and 2003. In addition, the sustained slowdown in all the measures of core inflation since August 2001 further validates the continued favorable inflation environment.

The prospects for inflation over the policy horizon are broadly in line with the inflation targets.

2. Despite the seasonal uptick in world oil prices during the winter season, information in the futures market point to broadly stable oil prices in 2002. Softening oil prices are expected to contribute to tamer inflation over the near term.

3. The peso-dollar rate was range-bound at ₱51.254-₱51.721 for the period 2-14 January 2002, an improvement from the ₱51.153-₱52.058 per US dollar range recorded in December 2001. This can be attributed to the continued positive influence of seasonal inflows of overseas Filipino workers' remittances. The volatility of the exchange rate—measured by the standard deviation—dropped to 16.6 centavos in January thus far, compared to 31.1 centavos in December 2002.

Broad stability in the peso-US dollar rate is expected to have a favorable influence on inflationary expectations.

Interest rates and interest rate differentials

4. Despite the slight decline observed in the first week of January, interest rate differentials between the benchmark RP 91-day T-bill rate and foreign interest rates

[2] The December 2001 inflation was subsequently revised to 4.1 percent bringing the average inflation rate for 2001 to 6.1 percent. Source: National Statistics Office (NSO), Summary Inflation Report Consumer Price Index, January 2002 and December 2001 released on 5 February 2002

continued to be large due mainly to the sustained decline in foreign interest rates. As of 14 January 2001, the differential between the 91-day T-bill rate (net of tax) and the 90-day LIBOR reached 465.1 basis points while the differential with that of the US 90-day T-bill reached 493.5 basis points. These levels are high relative to the interest rate differentials registered for the most part of 2001.

5. Similarly, the rate differential between the BSP's policy rate (overnight borrowing or RRP rate) and the US target federal funds rate remained large at 600 basis points following the latest 25-basis point cut in the BSP's policy rate on 14 December 2001. This differential remains relatively high compared to those recorded in the previous months.

6. The country's real lending rate—measured as the difference between the prime lending rate (defined as the low-end of the range of banks' lending rates) and the inflation rate—was high at 8.4 percent relative to those of other Asian countries during the period 27 December 2001-2 January 2002.

The significant decline in foreign interest rates relative to domestic interest rates provides additional leeway for monetary easing. Further interest rate easing could also help stimulate investments by enhancing the competitiveness of domestic firms relative to their regional counterparts.

Money supply

7. The growth in domestic liquidity (M3) remained subdued. As of end-November 2001, M3 growth slowed down further to 6.2 percent (preliminary) from a high of 14.7 percent year-on-year growth as of end-May 2001. This can be traced, in part, to the conservative lending stance of banks and weak corporate demand for new borrowings due to the presence of spare capacity in manufacturing, which limited firms' need for new bank credits, and the relatively high leverage positions of many firms. A comparison of the indicative monetary growth path—based on the expected output growth and inflation paths—and the actual growth in M3 reveals that the excess liquidity that was present in May has been effectively mopped..

8. Based on the results of estimation exercises for the money demand function for 2002 (consistent with the Government's forecasted GNP and inflation paths), a likely shortfall in M3 for the first three months was indicated. The results suggested that a reduction in the liquidity reserve requirement would bring the indicative estimated

M3 closer to the estimated liquidity requirements during the first quarter, given the assumptions for growth and inflation.

The sustained slowdown in the growth of domestic liquidity in 2001 and the indicative shortfall in domestic liquidity for the first quarter of 2002 (based on the results of the estimation exercises) suggest that a further easing of monetary stance could help stimulate economic growth by promoting increased consumer spending and bank lending for productive economic activities.

External Developments and Outlook

9. Signs that the US recession is nearing bottom and that an economic turnaround is on the way are mixed. On the one hand, consumer confidence rose, home sales increased, and orders in manufacturing and service companies picked up. On the other hand, unemployment climbed to a 6½-year high of 5.8 percent in November. Meanwhile, Japan's economy continued to slow down and there appears to be no signs yet that the economy is touching bottom as consumers and banks are still keeping a tight rein on their spending. Prices have fallen by an annual rate of 4 percent in 2001. In the Eurozone, real GDP growth is expected to remain weak in early 2002 due to the negative carryovers of a marked decline in industrial production at the end of 2001. In addition, consumer confidence in the Eurozone is likely to be hit by rising unemployment.

The weakness in the major industrial economies could exert pressures on the growth prospects of emerging market economies, including the Philippines. An accommodative response to the downside global prospects would seem appropriate as a means to provide stimulus to the domestic economy.

II. Discussion on the Review of the Monetary Policy Settings

10. The generally benign inflation outlook over the policy horizon suggested that there is room for some easing of the monetary policy stance in the form of a reduction in the BSP's policy rates and a lower liquidity reserve requirement. A reduction in policy rates would help lift domestic demand, which should take off some of the slack posed by the still fragile global economic conditions. The large margins between domestic and foreign interest rates indicated that there is still scope for a policy rate cut by the BSP while guarding against possible shifts to foreign-currency denominated assets that could lead to a resurgence of sharp volatility in the exchange rate, that in turn could lead to an increase in inflation and in inflationary expectations.

11. A one percentage-point reduction in the liquidity reserve requirement would free up liquidity into the system, estimated at about ₱13 billion.[3] Reducing the liquidity reserves from the current 9 percent to 7 percent would thus raise liquidity by about ₱26 billion, although with some time lag.[4] The actual impact on domestic liquidity or M3, however, depends on the ability of banks to transform the "free liquidity" into new loans for productive activities, which would increase the money multiplier and, consequently, boost the growth in domestic liquidity.

12. Despite the generally liquid position of banks, the Monetary Board members noted that lending activity has been restrained. A view was expressed to the effect that the main constraining factor could be the lack of demand for loans due to the perception of a still weak economy as well as the presence of excess capacity in the manufacturing sector given that the capacity utilization is only over 76 percent. It was observed, meanwhile, that the provision of greater liquidity could help boost aggregate demand as long as such an accommodative monetary policy stance would not undermine the stability of the exchange rate, and more importantly, the price stability objective. The boost to aggregate demand could arise as cautious monetary easing could reduce interest rates, helping to improve the repayment capability of firms, and building on market confidence.

13. The members of the Monetary Board recalled that the level of liquidity reserves reached a maximum of only 8 percent prior to 2001 and that was on 29 August 1997. This was reduced immediately by one percentage point within one week and by a further one percentage point two weeks later and every month thereafter until November 1997 when it reached 4 percent. Thus, the Monetary Board viewed that the 11 percent liquidity reserve requirement for the period 10 August-6 December 2001 has been maintained over a relatively extended period. Reducing liquidity reserves further by at least 2 percentage points from the current 9 percent will only restore the level of liquidity reserves to its pre-July 2001 level.[5]

---

[3] Estimated as follows: 1 percent x ₱1.290 trillion (total outstanding level of deposits and deposit substitutes as of end-November 2001) = ₱12.9 billion

[4] As of 17 January 2002, total reserve requirement is 18 percent, of which 9 percent is in the form of regular reserves and 9 percent is in the form of liquidity reserves.

[5] Effective 27 July 2001, liquidity reserves were raised from 7 percent to 9 percent and further to 11 percent effective 10 August 2001 to moderate domestic liquidity given the slower pace of economic activity and ease pressure on the peso.

14. Some members of the Monetary Board, however, expressed concern that the resulting increase in liquidity in the system may not necessarily lead to increased lending by banks given that lending activity has been restrained by the weakness in corporate demand. Instead, the liquidity that would be freed up by a reduction in liquidity reserves could find its way back to the BSP through higher placements under the reverse repurchase (RRP) and special deposit accounts (SDAs) or banks could take excessively long positions in US dollar which could increase speculative activity in the foreign exchange market instead of the "freed funds" being channeled into the productive sectors of the economy. Thus, the need for safeguards was also raised.

15. In this connection, Monetary Board members highlighted the need to restructure the tiering scheme for the overnight RRP placements and to continue close monitoring of banks' and their affiliates' foreign exchange transactions to address these concerns and encourage the resumption of more active lending to the private sector.

16. A Monetary Board member also noted that, with the trend decline in interest rates, banks would be compelled eventually to lend in order to improve their earnings.

17. Another Monetary Board member pointed out that the impact of monetary easing on foreign exchange is likely to be muted given the ample supply of foreign exchange in the market due to the strength of recent inflows, notably coming from the proceeds of government bond flotations and other loans as well as overseas Filipino workers' remittances.

III. Monetary Policy Decision

18. Based on the assessment of the inflationary outlook and the balance of risks bearing on inflation and output growth, the Monetary Board unanimously approved the following twin measures to ease monetary policy:

a. Reduction by 25-basis point each to 7.5 percent in the overnight RRP (borrowing) rate and 9.75 percent in the overnight RP (lending) rate effective 18 January 2002. (At 7.5 percent, the BSP's overnight RRP rate is the lowest since 1 September 1995.)

In a move to induce banks to shift their excess liquidity into lending for productive activities, the Monetary Board also approved a revision of the tiering scheme for the overnight RRP or borrowing rate of the BSP as follows: 7.5 percent for placements of up to ₱5 billion; 4.5 percent for the next ₱5 billion; and 1.5 percent for placements in excess of ₱10 billion.

b. Reduction in liquidity reserves by 2 percentage points to 7 percent, also effective 18 January 2002. The 2 percentage points reduction in liquidity reserve requirement shall apply on the following:

   1) peso demand, savings and time deposits and deposit substitute liabilities of universal banks (UBs), commercial banks (KBs) and non-bank financial intermediaries with quasi-banking functions (NBQBs) from 9 percent to 7 percent ; and

   2) peso-denominated common trust funds (CTFs) and trust and other fiduciary activities (TOFA)-Others of UBs, KBs, and non-bank financial intermediaries performing trust and other fiduciary business, common trust funds and investment management activities from 10 percent to 8 percent.

The next meeting of the Monetary Board to discuss the monetary policy setting is scheduled on 14 February 2002.

—The Monetary Board of the Bangko Sentral ng Pilipinas