HIGHLIGHTS OF THE MEETING OF THE MONETARY BOARD ON MONETARY POLICY ISSUES HELD ON 10 FEBRUARY 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 rates at the current uniform rates of 6.75 percent for the overnight RRP (borrowing) rate and 9.0 percent for the overnight RP (lending) rate;

   (b) Maintain the current interest rates on the term RRPs, RPs, and Special Deposit Accounts (SDAs); and

   (c) Maintain the current reserve requirement ratios.

2) Continue to articulate support for the use of non-monetary measures to address supply-side risks, particularly those relating to food supply, by strengthening the BSP's 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 decelerated in January 2005 due to the lower inflation for food, fuel, and transport and communication. In line with BSP projections, January 2005 inflation eased to 8.4 percent (2000=100) from 8.6 percent in December 2004.

- Meanwhile, core inflation (defined as headline inflation excluding selected food and energy products) increased to 7.9 percent (2000=100) in January 2005 from 7.8 percent in the previous month.

* The highlights of the discussions of the 10 February 2005 Monetary Board meeting were approved by the Monetary Board during its meeting held on 10 March 2005.

[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 Assistant Governor, In-Charge of Research and the Director of the Treasury Department.

- The 2005 average inflation target was revised upwards in line with the National Statistics Office's (NSO) shift to the new 2000-based CPI series. The revision was also intended to account for the additional inflation risks that have emerged since the target was set in 2004.

- The risks to the inflation outlook continued to be linked to supply-side factors such as the increases in food and oil prices. However, forecasts generated by the BSP's inflation forecasting models indicated that inflation will decelerate in the first quarter of 2005 and will settle below 5.0 percent by the last quarter of the year. Average inflation was expected to fall within the 4-5 percent range in 2006.

- Selected indicators suggested improvements in domestic demand but some evidence of resource slack remained.

  - Real GDP and GNP both grew at a robust pace of 6.1 percent in 2004, from the previous year's 4.7 percent and 5.6 percent, respectively. Growth was boosted by the continued growth in personal consumption, exports and construction spending.

  - Average capacity utilization in manufacturing declined slightly to 79.9 percent in November 2004 from 80.1 percent in October. This was, however, higher than the 78.4 percent posted a year ago.

  - The value of production index (VAPI) for manufacturing increased by 19.5 percent (revised) in November from the 14.8 percent (revised) growth in the previous month. Likewise, the growth in volume of production index (VOPI) for manufacturing rose by 8.7 percent (revised) year-on-year in November, from the 4.9 percent (revised) increase in October.

  - The country's major corporations reported strong revenue and profit growth in the first nine months of 2004. However, some firms registered a marked slowdown in third quarter income growth from the previous two quarters' outturn.

  - Exports grew at an annual rate of 19.5 percent in November, the fastest since July 2002. This brought the January-November 2004 annual exports growth to 9.9 percent.

  - Merchandise imports grew by 2.4 percent year-on-year in November, a significant slowdown from the previous month's 16.3 growth. For the January to November 2004 period, the cumulative annual growth of imports stood at 8.2 percent.

- Passenger car sales grew by 36.7 percent in 2004, higher than the previous year's growth of 11.9 percent. Meanwhile, combined truck and bus sales fell by 12 percent during the year.

- Energy sales by the Manila Electric Company (Meralco) declined by 0.2 percent year-on-year in December 2004 as in the previous month. This was also lower than the 3.9 percent expansion in December 2003.

- The unemployment rate remained relatively sizeable at 10.9 percent in October 2004 compared to the 10.2 percent registered for the same period in 2003. The October unemployment rate, however, was lower than the 11.7 percent posted in the preceding quarter.

- Money and credit demand continued to grow modestly while Treasury bill rates eased during the 31 January 2005 auction of the Bureau of the Treasury (BTr), leading to narrower spreads over foreign interest rates.

    - Domestic liquidity (M3) grew by 9.2 percent (revised) year-on-year in December 2004 from the 6.9 percent (revised) increase in the previous month.

    - The total volume of commercial bank (KB) loans rose by 3.6 percent year-on-year as of end-November 2004, following a similar increase in the previous month.

    - T-bill rates eased across all tenors during the 31 January 2005 auction. The decline was attributed to market optimism sparked by a string of positive news on economic growth, corporate performance, strengthening of the peso against the US dollar and indications of sufficient liquidity in the system.

- Supply-side factors, particularly the increases in prices of food and oil, were expected to continue to exert a central influence on the inflation outlook. In addition, the forecasted reduction in agricultural production in the first quarter of 2005—due to the negative impact of the El Niño—poses an upside risk to food prices.

    - Agricultural output grew by 5.1 percent in 2004—an improvement from the 3.7 percent growth posted in 2003—despite the damages caused by typhoons in November and December. However, the negative effects of the ongoing El Niño episode pose upside risks to food prices, and highlight the need for government measures to prevent supply shortages.

- International oil prices rose in January 2005 due mainly to the seasonally high winter demand for heating fuel in the Northern Hemisphere and concerns that OPEC would prevent oil prices from falling towards the end of the winter season. Meanwhile, pump prices of petroleum products in the domestic market eased in January, following the decline in world oil prices in the previous month.

- The peso strengthened against the US dollar due mainly to strong inflows of remittances from overseas Filipino workers (OFW) and foreign investments, strong regional currencies, and weak corporate demand for US dollar.

- In the fiscal sector, the National Government's (NG) budget deficit in 2004 settled at ₱186.1 billion (3.8 percent of GDP), lower than both the programmed level of ₱197.8 billion (4.2 percent) and the ₱199.9 billion deficit in 2003. This was the second consecutive year that the NG outperformed its fiscal deficit goal.

- Global economic activity continued to expand in the fourth quarter of 2004 but at a moderating pace. Recent indicators pointed to sustained improvements in investment spending although industrial production and private consumption appeared to have slowed down in most economies. On the price front, short-term inflationary pressures have diminished somewhat, on account of the recent declines in world oil prices.

  - Prospects for the US economy continued to look firmer but not altogether risk-free given the uncertainty in the direction of world oil prices, mounting budget and current account deficits, and uneven gains in employment and earnings.

  - Economic recovery in the euro slowed down in the third quarter due mainly to weaker export gains and subdued private consumption. Continued volatility in world oil prices and the further strengthening of the euro also present risks to the recovery.

  - Despite the marked slowdown in industrial production, the UK economy gained some momentum towards the end of 2004, boosted by growth in the services sector.

  - Despite the weakness in the manufacturing sector, Japan's economy remained on the recovery track as shown by the uptrend in business investment and steady improvements in corporate profitability.

- In response to these conditions, the majority of central banks kept their policy settings unchanged during their latest respective monetary policy meetings. However, the US Federal Open Market Committee (FOMC) decided to raise its policy rates by 25 basis points during its 1-2 February 2005 meeting, citing strong output expansion in the economy.

II. Review of the Monetary Policy Stance

- The members of the Monetary Board noted that conducting monetary policy in the face of an oil price shock poses a special challenge for monetary policy, because it raises the prices of goods and services while also reducing the level of aggregate output. The members of the Board, therefore, underscored the need to be careful not to worsen the output effects of an oil shock while also guarding against any second-round demand-side effects.

- The Monetary Board believed that the expected deceleration of headline inflation towards the target in 2006 constitutes a straightforward argument for keeping policy rates steady. This affirms the BSP's assessment that inflation uptrend is largely transitory, attributed primarily to supply-side factors.

- The members of the Monetary Board also argued that unlike in other Asian economies, there is no evidence of a positive output gap in the Philippines given that (1) the prevailing levels of capacity utilization and employment growth remain moderate and (2) the expansion in aggregate demand does not appear to be broad-based as yet. Moreover, the members of the Monetary Board were of the view that indications of a possible cyclical downturn in the Philippine economy strengthen the need to enhance policy intervention in order to extend expansion phase of the business cycle.

- The Monetary Board also recognized that the outlook for prices is not risk-free with the pressures coming from prices for oil and food, and the potential impact of new tax measures, such as the increase in the VAT. The risk of demand-side effects from these factors could very well increase in the near term and spill over into wage- and price-setting behavior.

- Nevertheless, the Monetary Board also noted a number of countervailing factors to expected supply-side pressures. These include: (1) the prospect of a weak US dollar, which should provide a stabilizing influence on import prices and consequently, on overall inflation; and (2) the predicted El Niño dry spell, which is widely expected to be brief and mild, and thus should not unduly disrupt agricultural output.

- On balance, the members of the Monetary Board were of the view that the outlook for prices and output continues to suggest keeping monetary policy settings unchanged. However, should calls for wage adjustment persist, a stronger risk of second-round effects from supply-side factors on domestic wage- and price-setting could ensue. This, in turn, would require a timely monetary response.

- On the other hand, the Monetary Board also noted that a decision to take no monetary action at present can be a beneficial tactic, since keeping policy interest rates at prevailing levels provides implicit support to credit activity by preventing large upticks in market interest rates. In any case, direct non-monetary action against supply-side risks remains a sensible tool against the likely pressures on prices over the near term, and should be encouraged accordingly.

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 rates at the current uniform rates of 6.75 percent for the overnight RRP (borrowing) rate and 9.0 percent for the overnight RP (lending) rate;

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

        (c) Maintain the current reserve requirement ratios.

    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 the BSP's representation and coordination with various government agencies.

The next meeting of the Monetary Board to discuss the monetary policy setting is scheduled on 10 March 2005.