HIGHLIGHTS OF THE MEETING OF THE MONETARY BOARD ON MONETARY POLICY ISSUES HELD ON 15 JANUARY 2004*

The Advisory Committee[1] submitted for the consideration of the Monetary Board the following recommendations: (1) maintain the BSP's policy rates at the current levels of 6.75 percent for the overnight reverse repurchase (RRP) rate and 9.0 percent for the overnight repurchase (RP) rate; (2) maintain the current interest rates on the term RRPs, RPs, and Special Deposit Account (SDAs); and (3) maintain the current reserve requirement ratios given the adequate level of liquidity in the system.

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

The above recommendations took the following into consideration:

- In line with staff forecasts, the year-on-year headline inflation slowed down in December 2003 to 3.1 percent from 3.3 percent in the previous month. This brought the full-year average to 3.1 percent, below the Government's target of 4.5-5.5 percent and equal to the 2002 average inflation. The low-inflation environment in 2003 may be traced largely to the absence of significant demand-driven pressures on consumer prices and the abatement of cost-push inflationary risks.

- Meanwhile, BSP's estimates of core inflation showed a deceleration in December. The BSP's main measure of core inflation (CPI less food and energy) was recorded at 3.4 percent year-on-year in December 2003, a slowdown from the previous month's 3.6 percent. The full-year average core inflation rate of 3.0 percent for 2003 was also lower than the 3.8 percent average for the previous year.

* The highlights of the discussions of the 15 January 2004 Monetary Board meeting were approved by the Monetary Board during its meeting held on 12 February 2004.

[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 and the Director of the Treasury Department. The 15 January 2004 meeting of the Monetary Board—the 1st meeting for 2004 to discuss monetary policy issues—followed the Advisory Committee meeting held on 12 January 2004.

- The Government inflation target of 4-5 percent for 2004-2005 represents a moderate rise in inflation, reflecting the impact of a projected rise in output growth and improvements in aggregate demand, possible wage adjustments as well as cost-push influences of planned adjustments in import tariff rates and utility charges. At the same time, the BSP's assessment of the outlook for inflation also considered the risks stemming from financial concerns over domestic political conditions, which may influence the movements of foreign exchange and other financial variables with potential inflationary effects.

- Demand-side price pressures are expected to remain manageable as the pace and strength of domestic demand showed a modestly improving trend but with continued soft spots.

  - Registered energy sales by the Manila Electric Company (Meralco) accelerated by 3.6 percent year-on-year in November 2003 following two consecutive months of very modest increases. The rise was due mainly to the growth in consumption by the industrial sector.

  - The October 2003 Labor Force Survey published by the National Statistics Office (NSO) showed an improvement in domestic labor market conditions. The unemployment rate decreased to 10.1 percent in October 2003 compared to 10.2 percent in October 2002 and 12.6 percent in July 2003.

  - Total merchandise imports recorded by the National Statistics Office (NSO) showed a 7.1 percent increase in October 2003, reversing the past two consecutive months of declines.

  - Philippine exports recorded by the NSO declined by 4.9 percent in November 2003 to US$2.95 billion, after two consecutive months of expansion. Year-to-date exports growth, however, remained positive at 0.5 percent.

  - Average capacity utilization in manufacturing was steady at 78.6 percent (revised) in October 2003 from the previous month's 78.7 percent (revised).

  - The increase in the value of production index (VAPI) for manufacturing in October 2003 slowed to 2.9 percent (revised) from 3.6 percent a month ago. On the other hand, the volume of production index (VOPI) for manufacturing declined for the second consecutive month by 5.5 percent (revised) year-on-year in October

2003 following a 3.1 percent (revised) year-on-year drop in September 2003.

- Car sales sustained its increase but at a slower pace of 53.3 percent year-on-year to 2,783 units of passenger cars sold in November 2003 from 81.9 percent in October

- On the supply-side, potential price pressures from adjustments in oil prices and utility charges could be mitigated by the favorable outlook for food supply.

  - The international spot price of Dubai crude oil rose to an average of US$28.10 per barrel in December 2003 from an average of US$27.66 per barrel in November. The relatively tight inventory situation and the projected increase in world oil demand imply that the current high level of oil prices are likely to be sustained over the near term.[2] In turn, increases in world oil prices are likely to be passed on to domestic pump prices of oil products.

  - In the utilities sector, the Energy Regulatory Commission granted the Manila Electric Company (Meralco) a provisional rate increase amounting to an average of 12 centavos per kwh effective January 2004. However, the Supreme Court suspended the implementation of the rate increase on 15 January 2004 in response to a petition filed by cause-oriented groups. The approved adjustment would have been reflected as increases in the distribution, supply and metering charge components of Meralco's unbundled bill.

  - Agricultural production grew by 2.9 percent in the first nine months of 2003, drawing mainly from the robust rebound in the crops sector (notably rice) in the third quarter. Given the agriculture sector's strong performance and the government's sustained efforts to ensure adequate supply, food prices are expected to remain fairly stable in the near term.

- With ample liquidity in the financial system and improving market sentiment over the Government's fiscal performance, nominal interest rates eased in early January.

[2] "This Week in Petroleum", Energy Information Administration, US Department of Energy, 31 December 2003, available online at http://www.eia.doe.gov

- Domestic liquidity (M3) growth in November 2003 accelerated to 4.9 percent (revised) year-on-year from 2.5 percent in October.

- The total volume of commercial bank (KB) loans expanded by 4.3 percent year-on-year to reach ₱1.49 trillion as of end-November 2003, reflecting 14 straight months of sustained expansion. The increase in bank lending also represents an improvement from the 0.8 percent annual rise in the previous month.

- Treasury bill rates eased in the first regular auction for 2004 as banks, still awash with excess liquidity from the holiday season, competed to bid lower rates for government debt papers. During the 5 January 2004 T-bill auction, the average yield on the bellwether 91-day T-bill fell by 28.6 basis points to 6.246 percent from the 6.532 percent yield registered during the last auction held on 24 November 2003 auction.

- The peso weakened slightly against the US dollar in December despite the seasonal inflows of remittances from Overseas Filipino Workers (OFWs). This was due to concerns surrounding the forthcoming national elections as well as the higher corporate demand for dollars to cover for anticipated short dollar positions in the first few months of 2004. The peso-dollar exchange rate averaged at P55.43/US$1 in December 2003, weaker by about 4 centavos from November's average of P55.39/US$1

- The NG fiscal position remained on track as revenues improved further while spending continued to be prudent. The NG fiscal deficit for November reached only P8.3 billion, P9.5 billion lower than the target deficit for November. This brought the NG budget deficit to P172.2 billion for the period January-November 2003, P17.5 billion below the program for the same period.

- Prospects for external demand for the domestic economy appear to be firmer. The world economy, led by the US, continued to show evidence of a moderate to strong recovery ahead. The economic performance of the euro area and Japan have been equally encouraging although slightly less brisk.

  - The US economy continued to gather strength in the fourth quarter of 2003 after posting a significant third quarter real GDP growth of 8.2 percent, the strongest since 1984. The US Federal Reserve noted that recent economic news have confirmed that "output is expanding briskly and that labor markets are improving modestly."[3]

- The European Central Bank (ECB) noted that indicators pointed increasingly to a gradual economic recovery in the euro area over the next quarters.[4] However, the recent appreciation of the euro against the US dollar poses downside risks to the Eurozone's export performance, which in turn can dampen the growth prospects for the region.

- The UK economy continued to strengthen in the third quarter of 2003 on account of robust household spending, supported by the stronger activity in the services sector. However, business investment spending declined during the quarter due to a fall in spending on plant and machinery.

- Japan's economy has shown a gradual recovery as evidenced by the steady growth in exports and business investments (private capital outlays).[5] However, consumption spending has remained virtually flat due to still-weak labor market conditions. Moreover, given persistent structural factors such as excessive debt, the Bank of Japan (BOJ) expected that the increase in business fixed investment would remain moderate.

- Against the current global economic backdrop, the major central banks remained generally cautious and kept their monetary policy settings unchanged as they await for firmer evidence of a sustained economic upturn. The US Federal Open Market Committee (FOMC), the Governing Council of the ECB, the Monetary Policy Committee of the BOE and the BOJ have all opted to keep current monetary policy guidelines unchanged.

[3] FOMC Statement dated 9 December 2003, available online at http://www.federalreserve.gov/ boarddocs/ press/ monetary/ 2003/20031209/default.htm
[4] European Central Bank, ECB Press Conference, Introductory statement by Jean-Claude Trichet, President of the European Central Bank, Lucas Papademos, Vice-President of the European Central Bank, Frankfurt am Main, 4 December 2003; available at http://www.ecb.int
[5] Bank of Japan, Monetary Policy Meetings, "Monthly Report of Recent Economic and Financial Developments December 2003 (The Bank's View)," 16 December 2003; available at http://www.boj.or.jp/en/ seisaku/03/seisak f.htm

II. Review of the Monetary Policy Stance

- Following the Advisory Committee's presentation on the developments in key macroeconomic and financial indicators, the members of the Monetary Board discussed the appropriate monetary policy stance. The Monetary Board members shared the view that the absence of material changes in the balance of risks for consumer prices over the policy horizon strongly underlines the argument for maintaining the present monetary policy settings to ensure continued stimulus to the real sector.

- The members of the Monetary Board argued that the modest pace of money and credit demand as well as the generally uneven character of the trends in other economic indicators suggested downside risks for the overall strength of economic activity. They pointed out the need for monetary policy to recognize the liquidity needs of economic growth against a backdrop of manageable inflation and ensure that the macroeconomic environment remained conducive to credit demand and investment activity. This would also affect over time the supply factors that could impinge on price stability.

- The following possible courses of action were presented by the Advisory Committee to the Monetary Board:

  a. An active approach through further monetary easing to increase the stimulus to economic activity and respond to the lingering weakness in overall demand; and

  b. Cautious optimism in the form of maintaining the current monetary policy settings to preserve the ongoing stimulus to the real sector.

  - Further easing of the monetary policy stance:

    The members of the Monetary Board agreed that the principal argument for further easing is the evidence of uneven conditions in aggregate demand, which pointed to downside risks to economic activity. However, they stressed that expected uptrend in inflation over the policy horizon suggests that a reduction in policy interest rates may not be warranted as this could fuel further pressures on consumer prices. The members of the Monetary Board also argued that a reduction in the policy rates may contribute to even higher demand for public sector credit, which could eventually constrain the sustainability of the NG's fiscal position.

In addition, the Monetary Board members raised the possibility of exchange market pressure when monetary policy settings are eased. The possibility of disorderly adjustments in the foreign exchange market, particularly due to political developments and shifts in market sentiment, underpin the need for continued caution in formulating the monetary policy stance. The members of the Monetary Board, however, pointed out that the pass through effect of exchange rate movements should be small given indications of negative output gap such as the sizable level of spare capacity in the manufacturing sector and the double digit unemployment level. However, they also noted that while the degree of exchange rate pass through to inflation is presently small, this should be carefully watched as a sharp and sustained depreciation of the peso could upset the inflation target.

- Maintaining current monetary policy stance:

  As in the previous Monetary Board meetings, the following arguments were again raised by the members of the Monetary Board in favor of maintaining current monetary policy settings:

  a. the outlook for 2004 inflation suggested that average inflation will be in line with the target, implying that monetary tightening may not be necessary;

  b. there continued to be evidence of sufficient liquidity to fuel the economy's growth requirements, hence, further easing may not be necessary; and

  c. the monetary policy stance should be sufficiently cautious to guard against any possible renewed price pressures that may emerge over the near term.

  In conclusion, the members of the Monetary Board agreed that the decision to maintain the monetary policy stance would continue to ensure adequate liquidity to support growth in domestic demand while helping guard against potential price risks.

III. Monetary Policy Decision

- After an extensive discussion of the balance of risks to inflation and the available data on domestic and external conditions presented by the Advisory Committee, the Monetary Board, by a unanimous vote, approved the following policy measures:

    a. Maintain the BSP's policy rates at the current levels of 6.75 percent for the overnight RRP rate and 9.0 percent for the overnight RP rate;

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

    c. Maintain the current reserve requirement ratios 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 12 February 2004.