# HIGHLIGHTS OF THE MEETING OF THE MONETARY BOARD ON MONETARY POLICY ISSUES HELD ON 13 MARCH 2003[*]

## Background

The Monetary Board held its third meeting for the year on monetary policy issues on 13 March 2003. This followed the Advisory Committee meeting held on 11 March 2003.[1] The Advisory Committee submitted for the Monetary Board's consideration a policy paper focusing on the developments in various key macroeconomic and financial indicators and their implications on the inflation and inflation outlook. In particular, the policy paper contained a comprehensive discussion of the emerging trend in the agriculture sector, foreign exchange market, oil prices, user charges in utilities, interest rates, domestic credit conditions and other key demand indicators as well as the developments and outlook in the world economy. During the 13 March 2003 meeting of the Monetary Board, the said policy paper served as the basis for the Monetary Board's discussion and assessment for the appropriate monetary policy stance.

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

### Domestic Price Developments and Outlook

**1.** Year-on-year headline inflation rose to 3.1 percent in February 2003 from 2.7 percent in the previous month. Average headline inflation for the first two months of 2003 at 2.9 percent was lower compared to the 6.8 percent average recorded during the same period last year and the 4.5-5.5 percent target for the year. The increase in February was traced to higher year-on-year inflation rates for food items such as fish, fruits and vegetables, meat and dairy products as well as increases in

[*] The highlights of the discussions of the 13 March 2003 Monetary Board meeting were approved by the Monetary Board during its meeting held on 14 April 2003.

[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.

petroleum prices, which fed into the fuel, light and water (FLW), and services components of the CPI basket. Similarly, estimates of core inflation showed a slight increase during the month. The BSP's main measure of core inflation rose to 2.7 percent in February from 2.6 percent in the previous month, and averaged 2.6 percent for the first two months.[2]

**2.** The overall strength of aggregate demand may be gauged from the mixed trends in various indicators of economic activity. For example, the growth in the MISSI Value of Production Index (VAPI) for manufacturing slowed down to 0.6 percent year-on-year in December 2002 following a 4.6 percent rise in November. Meanwhile, the Volume of Production Index (VOPI) continued to decline in December, falling by 5.0 percent year-on-year compared to a 0.9 percent decline in the previous month. Spare capacity in manufacturing remained as capacity utilization declined slightly further to 74.8 percent in December 2002 from 75.2 percent in the previous month. Moreover, labor conditions remained soft as unemployment reached 10.2 percent in the fourth quarter of 2002, up from the 9.8 percent recorded a year ago. Meanwhile, the contraction in passenger car sales slowed to 3.6 percent in January 2003 from 14.8 percent in December 2002. Power consumption also showed an improvement in the form of faster year-on-year growth of 11.6 percent in January from 4.7 percent in December 2002. A recovery in credit demand has also been observed as bank lending increased by 2.4 percent, year-on-year in December 2002, reflecting the fourth consecutive month of year-on-year growth.

***Movements in overall inflation remain confined to specific components of the CPI basket (notably food and fuel) rather than to broad price changes across commodity groups. This suggests that current pressures are driven mainly by supply-side factors, which may be transitory. On the whole, therefore, current price trends continue to underlie expectations of a generally subdued inflation environment going forward. The favorable inflation outlook has been supported by an appropriately prudent monetary policy stance of the BSP.***

[2] The BSP's measure of core inflation abstracts from the effects of temporary disturbances on headline CPI by excluding food and fuel components , which comprise 25.5 percent of the CPI basket.

**Developments in Agriculture**

**3.** Agricultural production is expected to grow by 3.0-4.0 percent in 2003 despite an anticipated drop in rice production in the second semester due to farmers' expectations of the lingering effect of the El Niño. Standing *palay* crops are expected to yield 3.2 million metric tons (MT) of rice for January to March 2003—about 4.9 percent higher than a year ago—due to the favorable weather in the last quarter of 2002. A positive first-quarter growth of 21.4 percent for corn production (2.1 million MT) is likewise expected due to the expansion in area planted and increase in yield with the use of higher-yielding varieties. Meanwhile, based on farmers' planting intentions, the expected harvests during the second quarter of 2003 may decline by 8.6 percent for *palay* (2.4 million MT) and 9.3 percent for corn (749,000 MT).[3]

**4.** To mitigate the impact of El Niño on agricultural production in 2003, the Department of Agriculture (DA) has allocated some ₱700 million for the following activities: (1) providing irrigation facilities and cloud seeding; (2) shifting of planting calendars or early planting; (3) planting of early maturing crops requiring less water and/or more tolerant to drought; (4) providing livelihood assistance to compensate for loss of income from farm and fishery; and (5) emergency food assistance.

**5.** The government's rice importation program could also help cushion the adverse impact of the El Niño phenomenon on domestic supply. Total rice import requirement under the new system of importation for 2003 is estimated at 800 thousand MT for 2003.[4] As of 24 February 2003, the total rice imports reached 33,742 MT. Meanwhile, the national rice inventory of 2.45 million MT as of 4 March 2003 is sufficient to last for 93 days.[5] Of this stock, the share of the National Food Authority (NFA) amounting to 749.6 thousand MT (about 31 percent) is sufficient to last for 28 days.

[3] Source: Bureau of Agricultural Statistics, Selected Tables on Crop Forecasts, 6 November 2002

[4] This is being implemented by the NFA under the letter circular dated 10 December 2002, which amended the NFA Council Resolution No. 14-2K2 dated October 2002.[4] Under the new circular, all rice importations other than NFA's shall be covered by letters of credit (LCs) to be opened initially only with the Land Bank of the Philippines (LBP).

[5] The national rice inventory consists of NFA palay and rice stocks as well as commercial and household inventories. Rice self-sufficiency is estimated based on the daily consumption of 26.4 thousand MT of rice. (Source: NFA)

**6.** In addition to the ongoing government programs, the NFA has also launched "Oplan Paghahanda" aimed at addressing food security in the event of war. Under this program, the NFA has started to intensify its procurement and milling of palay to ensure the availability of high quality rice for emergency and stabilization purposes and to augment the rice stocks in high consumption areas such as Manila, Cebu and Davao.

***The lingering El Niño weather phenomenon could impact adversely on the production of rice and corn. However, various government measures have been undertaken to mitigate the impact of dry weather conditions. These measures are expected to yield favorable harvests, indicating that prices of agricultural products could be relied upon to remain relatively stable in the near term.***

**Exchange rate developments**

**7.** The peso weakened further against the US dollar, averaging at ₱54.11/US$1 for the period 1-28 February 2003 compared to the ₱53.59/US$1 average in January 2002. As of 7 March 2003, the peso dipped to a 25-month low of ₱54.847/US$1 amid rising security concerns in the South. Moreover, uncertainties over the escalating tensions in the Middle East, higher dollar requirements by local oil companies and the corporate sector as well as apprehensions over possible global sanctions on the Philippines of the Financial Action Task Force (FATF)—prior to the amendment of the Anti-Money Laundering Law—weighed down on the local currency. However, the peso was less volatile during the period 1-7 March 2003 as the standard deviation in the daily exchange rate averaged ₱0.15 compared to ₱0.19 in February 2003.

**8.** On a real, trade-weighted basis, the peso continued to slightly depreciate relative to the currencies of the major trading partners by 2.7 percent in February 2003 from its level in December 2002, as shown in the real effective exchange rate (REER) index.[6] The peso also showed a similar depreciation trend over the same period vis-à-vis the two sets

[6] The basket of the major trading partners is composed of the currencies of the US, Japan, the euro area and the United Kingdom. The broad basket of competitor countries is composed of the currencies of Singapore, South Korea, Taiwan, Malaysia, Thailand, Indonesia and Hong Kong while the narrow basket is composed of the currencies of Indonesia, Malaysia and Thailand only.

of currencies of the Philippines' competitor countries. The REER for the broad and narrow baskets of competitor currencies declined by about 3.0 percent and 2.9 percent, respectively. These developments indicated an improvement in the country's external price competitiveness.

**9.** The possibility that the depreciation of the peso could persist for some time poses a risk to future inflation and inflation expectations. There are, however, indications of spare capacity in the economy as reflected by the fairly modest level of average capacity utilization in manufacturing—at 74.8 percent in December 2002—and relatively high unemployment rate of 10.2 percent in the fourth quarter of 2002. These indicators suggest that the pass-through coefficient for the exchange rate may be relatively low in the near-term estimated at about 0.15 percentage point increase in the average annual rate of inflation for every one peso depreciation of the exchange rate. Moreover, the impact of a currency depreciation on oil and non-oil imports may be mitigated by the fact that current import demand is relatively low and the country has reduced its dependence on imported oil in the last few years[7] Nevertheless, the possibility of a sustained currency depreciation in amidst a difficult geopolitical environment presents a concern for monetary authorities since this could lead to increased inflationary expectations.

***The nominal depreciation of the peso translated into real depreciation as measured by the decline in the average REER in March 2003 from December 2002, which indicates an improvement in external competitiveness. Meanwhile, the pass-through impact of a peso depreciation on inflation could be limited in the near-term due to the presence of spare capacity in the economy and the relative decline in the dependence on oil imports. However, the possibility of a sustained episode of depreciation could threaten the inflation target which, in turn, deserves a close watch by monetary authorities.***

[7] For example, the share of imported oil in the total energy mix for the Philippines has already declined to an estimated 39 percent in 2002 from 63 percent in 1990 and is expected to fall further to about 38 percent in 2003.

**Oil price developments**

**10.** The price of Dubai crude in the international market continued to rise since the end of 2002, averaging at US$30.02 per barrel in February 2003 or about 7.1 percent higher than the January 2003 level and 16.7 percent higher than December 2002 level. World oil prices continued to be volatile due to falling commercial crude oil stocks in the US and rising fears over the impact of the US-led war against Iraq on Middle East oil supplies.[8]

**11.** The higher world oil prices translated into increased retail prices of local petroleum products. Domestic oil companies raised their pump prices in the first week of March 2003 for the fifth time since the beginning of the year bringing the total increase in petroleum prices to ₱2.23 per liter for gasoline products, ₱1.34-₱1.51 per liter for other fuel products and ₱1.51 per liter for liquefied petroleum gas (LPG). Meanwhile, local oil companies have intensified efforts to build up their inventory levels in compliance to the government's directive aimed at ensuring adequate domestic supply in light of the war in the Middle East. As of 4 March 2003, the estimated oil inventory level of domestic oil companies was equivalent to about 70 days' consumption.[9] This was more than the 15-30 days required oil inventory level.

***Rising costs of crude imports—due to geopolitical conditions—have translated into a series of upward adjustments in domestic pump prices of oil. This, in turn, could present risks to the inflation outlook since oil is an input to production of most goods and services.***

**Developments in the Utilities Sector**

**12.** In an order dated 24 February 2003, the Energy Regulatory Commission (ERC) approved the Implementing Rules for the adoption of new cost-recovery mechanisms. The generation rate adjustment mechanism (GRAM) and the incremental currency exchange adjustment (ICERA)—which will replace the purchased power adjustment (PPA) and currency exchange rate adjustment (CERA)—will effectively remove

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[8] US Department of Energy, Latest Oil Market Developments in Energy Situation Analysis Report, 4 March 2003, available at http:// www.eia.doe.gov
[9] Ibid.

automatic adjustments by distribution utilities. The new recovery mechanisms require distribution utilities to file a petition with the ERC before introducing a rate adjustment to recover costs. The new schemes also call for quarterly cost-recovery related adjustments in electricity rates in contrast to the old schemes, which allowed adjustments on a monthly basis. Distribution utilities are expected to implement these deferred recovery mechanisms once their rates are unbundled.[10]

**13.** The ERC is expected to release the Meralco's rate unbundling petition soon.[11] However, power rates may eventually increase with the recomputation of Meralco's revenue requirements using a new base year and the inclusion of the company's under-recovered PPA charges in the computation of the new unbundled rates.[12]

**14.** The upward pressures on the power rates could be mitigated should the Supreme Court uphold its 15 November 2002 decision on Meralco's overcharging case.[13] Meralco has filed an appeal on the said case. Moreover, the implementation of the Special Program to Enhance Electricity Demand (SPEED) and the planned establishment of the

[10] "Order on the Generation Rate Adjustment Mechanism (GRAM) and Incremental Currency Exchange Recovery Adjustment (ICERA)," ERC Case No. 2003-44, 24 February 2003, available at http://www.erc.gov.ph

[11] The ERC released its decision on Meralco's rate unbundling petition on 20 March 2003. Although the unbundling of power rates per se is not expected to increase nor decrease the rates, the use of a new test year (FY 2000 as prescribed in the Uniform Filing Requirements) could change the existing rate levels. (Source: ERC, Unbundling of Rates, available at http://www.erc.gov.ph)

[12] In its order dated 19 December 2002, the ERC authorized Meralco to collect its under-recovered purchased power adjustment (PPA) charges amounting P5.8 billion. The ERC said that the "collection should be through the inclusion of the amortized amount as part of the unbundled generation rate schedule to be approved by the commission in ERC Case Nos. 2001-646 and 2001-900". (Source: ERC, Order on Meralco's application for the approval of the rate schedule to implement the NPC rate reduction, ERC Case No. 2001-383 (ERB Case No. 97-18), 19 December 2002, available at http://www.erc.gov.ph)

[13] In its decision issued on 15 November 2002, the Supreme Court ruled that Meralco should implement a rate adjustment of ₱0.017 per kwh (instead of the original ₱0.184 per kwh) and reimburse Meralco's customers or credit in their favor for future consumption the "overcharged" average amount of ₱0.167 per kwh with respect to Meralco's billing cycles beginning February 1994 to February 1998. (Source: Supreme Court, "Decision on G.R. No. 141314, "Republic of the Philippines represented by Energy Regulatory Board vs. Manila Electric Company, 15 November 2002," available at http://www. supremecourt.gov.ph)

Wholesale Electricity Spot Market (WESM) would also likely bring down power rates.[14]

**15.** The Manila Waterworks and Sewerage System (MWSS) approved a staggered water tariff adjustment for both Manila Water Company and Maynilad Water Services, Inc. Since 1 January 2003, Manila Water has started to implement a ₱4.25 per cubic meter increase in its weighted average all-in water tariff. The next phase of the approved water rate adjustment will be in 2005. Meanwhile, Maynilad has not yet implemented the MWSS-approved ₱5.35 per cubic meter increase in its weighted average all-in water tariff as it has already tendered a notice of early termination of its concession agreement with the government.

***The implementation of deferred cost-recovery mechanisms by ERC could limit the possibilities of over-recovery and under-recovery by energy distribution utilities. This could help temper sharp adjustments in electricity rates. Meanwhile, the implementation by Manila Water of the MWSS-approved water rate increase implies a transitory increase in the utilities component of the CPI.***

**Interest rates and interest rate differentials**

**16.** The auction rate on the 91-day T-bill rose further to 6.097 percent on 3 March 2003 from 5.672 percent a month earlier amid market concerns over the repercussions of the possible war in the Middle East. Similarly, yields for the 182-day T-bill rate and the 364-day T-bill rate increased to 6.87 percent and 7.89 percent, respectively, from 6.6 percent and 7.609 percent. Nevertheless, the auction for T-bills and T-bonds have continued to attract oversubscription in bids from banks, indicating ample liquidity in the financial system.

[14] The SPEED is a price incentive scheme for large end-users of electricity whereby discounts are provided to industrial and commercial customers for incremental use of energy above a specified base load. Meanwhile, the WESM is a spot market for the trading of electricity in which power generation companies (gencos) submit their offers to sell electricity to distribution utilities at their desired price. Distribution utilities, in turn, submit their demand requirements to a market operator who is assigned to match the supply and demand for power. The Electric Power Industry Reform Act of 2001 (R.A. 9136) requires the Department of Energy (DOE) to establish the WESM in coordination with electric power industry participants to ensure greater supply and rational pricing of electricity.

**17.** As of 3 March 2003, the differentials between the RP 91-day T-bill rate (net of withholding tax) and the 90-day LIBOR and US 90-day T-bill rate widened to 353.8 basis points and 368.8 basis points, respectively, from the 318.8 basis points and 337.4 basis points registered in 3 February 2003.[15]

**18.** The differential between the BSP's policy interest rate (overnight borrowing or RRP rate) and the US federal funds target rate was unchanged at 575 basis points as the BSP policy rates and the US federal funds target rate remained steady at their 15 March 2002 and 6 November 2002 levels, respectively.

**19.** Adjusted for the risk premium (measured by the differential between the 10-year ROP note and the 10-year US Treasury note), the differential between the BSP policy interest rate and the US federal funds target rate narrowed to 27 basis points as of 3 March 2003. This developed as the risk premium on the 10-year ROP increased while the yield of the 10-year US Treasury note declined. The increase in the 10-year ROP yield can be traced to higher risk aversion of investors from less than investment grade papers amidst the ongoing geopolitical conflict in Iraq.

***The differentials between RP and US interest rates continued to widen in March as the rising benchmark RP T-bill rate was accompanied by relatively steady foreign interest rates. The uptrend in the 91-day T-bill rate—despite ample liquidity in the system and the past interest rate easing in the BSP's policy rates—was driven largely by geopolitical uncertainties surrounding the war in Iraq.***

**20.** During the period 20-26 February 2003, the Philippines' real lending rate (based on the low-end of the range of banks' lending rates) rose anew to 5.9 percent from the 5.51 percent registered during the review period 23-29 January 2003.[16] The uptick in the RP real lending rate could be traced primarily to the rise in the lower end of the range of banks' lending rates. At 5.9 percent, the Philippines' real lending rate stayed within the midrange among a sample of Asian countries.

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[15] Review period covered in the last policy paper on the "Review of the BSP's monetary policy stance" considered by the Monetary Board on 12 February 2003

[16] Review period covered in the last policy paper on the "Review of the BSP's monetary policy stance" considered by the Monetary Board on 12 February 2003

***The Philippine real lending rate inched up but remained within midrange in the Asian region.***

**21.** The yield curve for government securities in the secondary market on 3 March 2003 shifted upward relative to that which prevailed on 3 February 2003.[17] The yields rose across all tenors reflecting the uptrend of interest rates in the primary market. Relative to selected countries in Asia, the yields for Philippine instruments for 1-10 year maturities are generally higher compared to those in Malaysia and Taiwan but are comparable with those of Indonesia.

***The upward shift in the yield curve for government securities in the secondary market mirrored the uptrend of interest rates in the primary market associated with the growing concerns over the conflict in the Middle East.***

**Domestic Liquidity and Credit Conditions**

**22.** Domestic liquidity (M3) grew by 7.7 percent year-on-year to reach ₱1.7 trillion as of end-January 2003. The sustained expansion in the net foreign assets (NFA) of the monetary system and the improvements in the levels of domestic credits of both the public and private sectors—supported by the recovery in bank lending—contributed to the rise in M3.

**23.** Growth in the total volume of outstanding loans of commercial banks (KBs) accelerated to 4.4 percent year-on-year as of end-January 2003 compared to 2.4 percent in the previous month. This reflected the fifth consecutive month of positive growth in bank lending. Moreover, the 7.7 percent year-on-year growth in bank lending to the manufacturing sector in January marked the second straight month of increase after 17 months of consecutive year-on-year contractions.

**24.** Banks continued to place funds with the BSP. The total volume of banks' placements under the RRP window reached ₱80.8 billion as of 4 March 2003, lower by ₱3.5 billion from the end-February level. Meanwhile, banks placements in SDAs as of 4 March 2003 reached ₱1.3 billion, up by ₱99.0 million from end-February level.

[17] Yield curve presented in the previous policy paper on the "Review of the BSP's monetary policy stance" considered by the Monetary Board on 11 February 2003

***Bank lending activities continued to improve. These developments provide evidence that the expansionary impact of the BSP's past monetary easing is gradually working its way into the real sector. Meanwhile, banks continued to place relatively large volume of funds with the BSP under the RRP and SDA facilities in February, an indication of ample liquidity in the system.***

**Domestic stock market developments**

**25.** Activity in the Philippine stock market remained bearish as the average PHISIX in February 2003 slipped further by 15.7 index points to 1,031 from the previous month's average of 1,046.7. Investors continued to be sidelined and opted to stay liquid as the local bourse faced a series of negative developments. In particular, uncertainties surrounding the Middle East crisis, the possible sanctions that the FATF could impose on the Philippines (prior to the passing of the amendments to the Anti-Money Laundering Act), the continuing weakness of the peso against the dollar and indications of increasing domestic interest rates have weakened investors' appetite for stocks. In addition, domestic security concerns following the spate of bombings in the Southern Philippines also weighed down on the market.

***A generally cautious environment prevailed in the local stock market due to persistent domestic and external concerns, which tended to overshadow some evidence of improvements in the domestic economy, such as the modest growth in bank lending and continued growth in consumer demand.***

**Fiscal developments**

**26.** For the month of January 2003, the budget deficit of the National Government (NG) was recorded at ₱13.9 billion, lower than the ₱15.0 billion budget gap recorded in the same month a year ago. The strict enforcement of revenue reform measures and prudent expenditure management policies during the month helped keep the fiscal deficit within target. The revenue reform measures included, among others, the strengthening of anti-graft measures at the BIR and the closure of customs bonded warehouses involved in anomalous transactions.

***The fiscal deficit was better-than-expected in January 2003 and lower than the level posted in the same period a year ago. If***

***sustained, this could provide a positive influence on the outlook for inflation and output growth.***

**Developments and outlook in the rest of the world**

**27.** Recent economic data in the advanced economies continued to point to a hesitant and uneven US-led economic recovery. The growth in industrial production has been sluggish, labor markets remained soft and other leading indicators have weakened. Output growth has decelerated as consumer and business sentiment weakened. Based on the revised data from the US Department of Commerce, US GDP grew by 1.4 percent year-on-year in real terms during the fourth quarter of 2002. This marked a deceleration from the 4.0 percent year-on-year rise in the previous quarter. Consumption expenditures, which account for about two-thirds of GDP, rose by only 1.5 percent in the fourth quarter, sharply lower than the 4.2 percent expansion registered in the previous quarter and the slowest since the third quarter of 2001 following the 11 September events.[18] Moreover, the University of Michigan's (UM) index of consumer sentiment dropped from 82.4 in January 2003 to 79.9 in February 2003, the lowest since 1993.[19] The Institute of Supply Management (ISM) index of manufacturing declined further by 3.4 percent to 50.5 percent in February from 53.9 percent in January 2003.[20] US unemployment edged up to 5.8 percent in February from 5.7 percent in the previous month. With generally benign inflation in a weak domestic and external environment, analysts are of the view that the Fed is likely to keep rates steady in the near term or even turn more accommodative.

**28.** Economic activity also remained sluggish in the euro area. Euroland real GDP grew by 1.3 percent year-on-year in the fourth quarter in 2002 from 0.9 percent in the previous quarter.[21] Geopolitical tensions and rising oil prices have continued to dampen consumer and business confidence and undermined the growth prospects in the euro area. In view of the need to provide stimulus for growth without

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[18] US Dept. of Commerce Press Release. "Gross Domestic Product Fourth Quarter 2002" 28 February 2003

[19] The Economist. "Economic and Financial Indicators", 22 February 2003

[20] Institute for Supply Management. "February Manufacturing ISM Report on Business" 3 March 2003

[21] The Bank of England. "Minutes of the Monetary Policy Committee Meeting" 5 and 6 February 2003

jeopardizing the medium-term prospects for growth and inflation, the Governing Council of the European Central Bank (ECB) voted to cut the benchmark interest rate by 25 basis points to 2.5 percent in its last meeting on 6 March 2003. The ECB Governing Council also indicated that it stands ready to cut interest rates again should economic prospects worsen.[22] Meanwhile, in the United Kingdom, the Monetary Policy Committee (MPC) of the Bank of England (BOE) kept the benchmark repo rate steady at a 48-year low of 3.75 percent during its meeting on 6 March 2003 after the 25-basis point cut a month ago. The MPC has revised downwards its outlook for growth in the UK economy over the next two years due mainly to weaker prospects for the world economy, further falls in equity prices as well as business investment.[23] Despite the growing evidence of a slowing economy and the spectre of war in Iraq, the MPC decided to maintain the key policy rate to cushion price pressures and keep inflation within the 2.5 target over the medium-term while keeping a close watch for signals that may show signs that the cooling economy could worsen."[24]

**29.** Meanwhile, data on Japan was mixed, indicating mainly that the economic recovery that had been apparent in 2002 seems to have faltered. According to the Bank of Japan (BOJ), the Japanese economy is unlikely to show clear signs of recovery for some time as business investment remains weak and as high levels of unemployment and debt persist.[25] During its monetary policy meeting held on 5 March 2003, the Policy Board of the BOJ voted unanimously to increase its current account balance target[26] to a range of 17-22 trillion yen beginning April 2003 from 15-20 trillion yen.[27]

**30.** In general, the major economies have pursued an accommodative monetary policy stance to support domestic economic activity as the

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[22] Reuters, "Update 6-ECB cuts rates modest quarter point, ready for more", 6 March 2003, available at http://www.reuters.com

[23] Bank of England, "Inflation Report Press Conference by Mervyn King" 12 February 2003, available at http://www.bankofengland.co.uk

[24] Reuters, "Update 2-BOE leaves UK rates steady, pressure builds up for cut." 6 March 2003, available at http://www.reuters.com

[25] Ibid.

[26] Current accounts are reserves set aside by private financial institutions to meet withdrawals from customer deposits, among others. The BOJ's current accounts serve as an indicator of the amount of funds circulating in the financial markets.

[27] Bank of Japan, Monetary Policy, Monetary Policy Meetings, 5 March 2003, available at http://www.boj.jp/en

balanced of risks weighed heavily on the weakness in their respective domestic economies combined with heightened geopolitical uncertainties. Despite some price pressures, the BOE and the ECB have eased monetary policy, recognizing that such pressures emanating the recent upturn in oil prices may be temporary. Both central banks noted that the current easing are consistent with the medium-term objectives for growth and inflation. In the other Asian economies, the Monetary Policy Committees of the Bank of Thailand (BOT) and the Bank of Korea (BOK) decided to maintain their policy rates during their respective meetings on 3 and 6 March 2003.[28] Despite higher crude oil prices which are exerting some pressures on consumer prices, the BOK decided to keep its benchmark overnight call rate at 4.25 percent to support economic activity as investors' sentiment have weakened and geopolitical developments have reduced the prospects of early recovery in the global economy. Similarly, the BOT maintained the 14-day repurchase rate at 1.75 percent to keep the momentum for economic growth in Thailand given the external uncertainties with respect to the recovery of industrial economies, higher oil prices and increased volatility in the financial markets.[29]

***Weakness in domestic demand conditions in the world's major economies amid geopolitical developments continued to weigh down on the pace of the global economic recovery. A weak global environment, in turn, could dampen prospects for a sustained recovery in the country's external demand and growth outlook. The presence of downside external risks could limit the impact of the BSP's previous monetary policy easing in supporting growth.***

**II. Review of the Monetary Policy Stance**

**31.** During the Monetary Board's discussion on the appropriate monetary policy stance, the members of the Monetary Board shared the view that the continuing evidence of a generally subdued inflation environment going forward underlie expectations that average inflation in 2003 will be broadly in line with the government's full-year target of 4.5–5.5 percent. They pointed out that the recent movements in

[28] Bank of Korea, Monetary Policy Decision, 6 March 2003, available at http://www.bok.or.kr

[29] Bank of Thailand, Press Release on the Current Monetary Policy, 3 March 2003, available at http://www.bot.or.th

headline inflation have remained largely confined to specific components of the CPI basket—notably food and fuel, which suggests the predominance of supply-side factors in current price movements. In addition, they noted that the relative absence of broad price changes across commodity groups implies that present demand conditions remain consistent with a benign inflation setting for the future. Moreover, an examination of the major risks to future inflation by the members of the Monetary Board pointed mainly to cost-push influences, such as those arising from the impact on farm prices of the El Niño phenomenon and the escalation in world oil prices due to Middle East geopolitical developments. These risks are for the most part expected to be transitory.

**32.** However, the members of the Monetary Board acknowledged that the depreciating trend of the peso against the US dollar poses risks to future inflation and inflation expectations. They shared the view that although present levels of unemployment and manufacturing capacity utilization suggest that the degree of exchange rate pass-through may be relatively low, the possibility of a sustained episode of currency depreciation in the current geopolitical environment presents a concern given its likely impact on inflation expectations. They noted that the risk of higher future inflation stemming from exchange rate movements may require a preemptive policy response to moderate the feed-through effects on consumer prices.

**33.** The members of the Monetary Board also observed that the lack of significant demand-side risks to inflation coincides with the continued presence of weak areas in domestic economic activity. They argued that the overall strength of aggregate demand remained tentative, as may be gauged from the mixed trends in various indicators of economic activity. They noted that labor market conditions remained soft, with sizeable unemployment preventing strong calls from labor groups for wage adjustments. In addition, there is still some spare capacity in manufacturing, suggesting that previous monetary stimulus still has adequate room to work its way through the real sector. They emphasized that lack of clear-cut signs of a sustained upturn in domestic demand is complicated by indications of weaker economic activity overseas, implying continued sluggishness in external demand.

**34.** Thus, abstracting from the possibility of a sustained exchange rate shock, the members of the Monetary Board stressed that the near-term risks to the inflation outlook appear to be largely contained. They likewise expressed the view that the relative absence of demand-side influences on the outlook for inflation and growth supports the arguments for ensuring that liquidity conditions remain appropriate for the domestic economy's requirements.

**35.** In light of these considerations, discussions by the Monetary Board revolved around the following policy questions:

a. Do the risks to the inflation outlook warrant an increase in policy rates in order to contain a possible build-up in price pressures?

b. Given the uncertainty in domestic and external conditions and the need to support domestic economic growth, is there scope for further monetary easing in order to sustain the stimulus to the economic activity?

c. Looking at both perspectives, should the policy stance remain cautious, one that is sufficiently accommodative by ensuring adequate liquidity to support growth while guarding firmly against the risks to the inflation outlook, and thus maintain the current monetary policy settings?

**36.** Increase in policy rates

In principle, the members of the Monetary Board noted that a tighter monetary policy stance is pursued as a preemptive action against the risks to the inflation outlook due to potential build-up of demand-side pressures. The members of the Monetary Board argued that monetary tightening may be necessary during periods of prolonged exchange market pressure, when movements in the exchange rate threaten to feed on to inflation expectations and pose a danger to the inflation target. Moreover, given the need to assure the sustainability of domestic economic growth, an increase in policy rates—which would lead to higher market interest rates—could dampen incentives for increased consumption and investments. Thus, a rise in policy rates could derail efforts to steer the economy toward a sustainable recovery path.

**37.** Reduce policy rates

The members of the Monetary Board expressed the view that a further easing of the BSP's monetary policy stance at this time, would infuse additional liquidity in the system, which already has ample liquidity. Given that monetary policy affects inflation with a lag, a more accommodative stance now could undermine the attainability of the inflation target over the policy horizon. Moreover, the members of the Monetary Board noted that the scope for reducing policy rates may be limited by the following considerations:

- There has been substantial monetary policy easing in the past– amounting to a cumulative 800 basis points for the period 4 December 2000-15 March 2002–which could limit the present scope for monetary easing.

- The relatively slow pace by which the stimulatory impact of monetary easing becomes evident can be traced to the long lags in monetary policy. This implies that sufficient time should be allowed for monetary policy actions to work its way fully to the real sector.

- Further monetary easing, either through a reduction in the BSP's policy rates or in liquidity reserve requirement would infuse more liquidity in the system, which could fan inflation. This, in turn, poses the risk of a sharp adjustment in interest rates later should inflationary pressures become evident.

- A reduction in the BSP's policy rates would narrow anew the country's interest rate differentials with foreign interest rates, which could lead to greater volatility in the exchange rate and undermine the stability of the peso. This could generate higher inflation and fuel inflationary expectations.

**38.** Maintain policy rates

The Monetary Board expressed the view that monetary policy should remain accommodative by providing a supportive environment, one that ensures the availability and sufficiency of liquidity to fuel the economy's growth requirements. At the same time, the members of the Monetary Board believed that monetary policy should remain cautious to guard against any potential build-up of price pressures that could dampen the growth momentum. The stance of the Monetary Board was based on the following considerations:

- The level of inflation remains consistent with the outlook of a generally subdued inflation environment in the near term. However, there are foreseeable risks to inflation in the months ahead in the form of cost-push pressures arising from the potential impact on the prices of agricultural products of the El Niño weather disturbance, a likely further increase in oil prices due to escalating geopolitical tensions, and an increase in electricity and water rates.

- The prospects for sustained economic growth going forward is clouded by the risks of a slower-than-expected global economic recovery and uncertainties surrounding the geopolitical developments.

- In the face of the current pressures in the peso, monetary policy would need to carefully strike a balance between stabilizing the foreign exchange market and the likely contractionary impact of higher interest rates on domestic economic activity.

## III. Monetary Policy Decision

**39.** Based on the analysis of various indicators on the macroeconomy and the financial sector that have become available since the review of the BSP's monetary policy stance by the Monetary Board on 12 February 2003 and a careful assessment of the balance of risks on inflation and inflationary expectations, the Monetary Board believed that the current monetary policy stance continued to be appropriately supportive of the economy's growth objective while ensuring price stability. For this reason, the Monetary Board, by a unanimous vote, decided to approve the following measures:

a. 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. maintain the tiering scheme on banks' placements with the BSP under the RRP and SDA windows;

c. maintain the current interest rates on the term RRPs, RPs, and SDAs; and

d. maintain the reserve requirements at their current levels given the adequate level of liquidity in the system.

**40.** However, the Monetary Board expressed growing concerns over the recent movements in the exchange rate. In particular, the members of the Monetary Board indicated their willingness in the future to resort to monetary tightening measures should conditions in the foreign exchange market continue to point to a severe depreciation of the peso which could threaten the inflation target over the policy horizon.

The next meeting of the Monetary Board to discuss the monetary policy setting was scheduled on 10 April 2003.[30]

**- The Monetary Board of the Bangko Sentral ng Pilipinas**

[30] The Monetary Board held a special meeting on monetary policy issues on 19 March 2003.