HIGHLIGHTS OF THE MEETING OF THE MONETARY BOARD ON MONETARY POLICY ISSUES HELD ON 1 AUGUST 2002[*]

Background

The Monetary Board held its eighth meeting on monetary policy issues on 1 August 2002 following the 30 July 2002 meeting of the Advisory Committee where the members discussed their assessment of the inflation outlook and macroeconomic conditions, which formed the basis for their recommendations for 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 trends in and forecasts of agricultural output, movements of the exchange rate, direction of world oil prices, possible adjustments in power and water rates, monetary conditions, demand and output indicators, fiscal developments, world economic conditions 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. Inflation in June 2002 fell to 3.0 percent, year-on-year after holding steady at 3.6 percent in the previous three months. Lower rates were recorded during the

[*] The highlights of the discussions of the 1 August 2002 Monetary Board meeting were approved by the Monetary Board during its meeting held on 5 September 2002.

[1] The Advisory Committee is composed of the Governor of the BSP as Chairman and four members, namely the Deputy Govemor for the Banking Services Sector, Research and Treasury, the Deputy Governor for Supervision and Examination Sector, the Managing Director, In-Charge of Research or the Director of the Department of Economic Research, and the Director of the Treasury Department.

month for both food and non-food items, particularly fuel, light and water (FLW). Average inflation for the first six months of the year stood at 3.5 percent. This was lower than the 6.7 percent average for the same period a year earlier and the government's revised full-year target of 4.5-5.5 percent.

2. Favorable food supply combined with broad stability in the exchange rate contributed to a well-behaved inflation picture during the first semester. Moreover, the impact of the series of oil price increases during the period on inflation was tempered by the action of transport operators to defer plans to raise fare rates and the decision of local oil companies to reduce the pump prices of petroleum products by an average of 35 centavos in the last week of June to the first week of July. Apart from positive supply-side factors, demand pressures continued to be soft, although recent data showed signs of improvement. The decline in bank lending appeared to have leveled off as loans outstanding of commercial banks contracted by 1.8 percent in May, a slight improvement from the 2.2 percent year-on-year decline in the previous month. Meanwhile, the volume and value of production index (VOPI and VAPI) of manufacturing output in May posted positive year-on-year growth rates of 8.9 percent and 10.7 percent, respectively, although these were lower compared to the month ago levels of 13.7 percent (revised) and 14.7 percent (revised), respectively. Capacity utilization in manufacturing, however, remained at the 75 percent mark (75.0 percent in May 2002 from 75.2 percent in the previous month). Furthermore, the unemployment rate rose to 13.9 percent in the second quarter from 13.3 percent in the same period a year ago.[2]

The sustained slowdown in headline inflation provides further indication that generalized price pressures have been minimal given soft demand conditions and positive supply-side factors. This supports the outlook for a tepid inflation environment for the rest of the year.

Agricultural output forecasts

3. The Department of Agriculture (DA) has projected that palay harvest for the period January-September 2002 would reach about 8 million metric tons,

[2] The unemployment rate typically exhibits a seasonal uptick in the second quarter as the number of unemployed persons rise with the entry of new college graduates into the labor force. The unemployment rate in first quarter of 2002 was registered at 10.3 percent.

slightly higher than the 7.97 million metric tons output recorded in the same period a year ago.[3]

4. Well-timed importation of rice could serve as viable safeguard against any possible supply shortage in the fourth quarter. In June, the President authorized the National Food Authority (NFA) to import 250,000 metric tons of rice on top of the total 640,000 metric tons that the NFA has already ordered for the year.[4] This move was intended to shore up the NFA's buffer stock, which stood at 446.1 thousand metric tons as of 25 June 2002—equivalent to 22 percent of the total national inventory of 2.1 million metric tons.[5] At this level, the national rice inventory would be sufficient to last for 85 days. To protect the local farmers, the NFA will bring in the bulk of rice imports before the onset of the harvest season and monitor carefully their release.[6] In practice, the NFA sells imported rice in the domestic market during lean months in order to shore up supply and temper possible pressures on rice prices.[7]

The DA's forecast of favorable palay harvest along with the timely importation of rice—aimed at shoring up the national inventory—strengthen expectations of adequate grain supply at relatively low prices.

Exchange rate developments

5. For the period 1-30 July 2002, the peso per US dollar averaged ₱50.59/US$1, weaker by 7 centavos relative to its average in June. Market concerns over the sustainability of the fiscal sector and the lack of political consensus in the Senate exerted some pressures on the currency. This was, however, cushioned partly by the actions of some banks to stay on the sidelines as the US dollar weakened following sharp declines in US share prices due to worries over corporate governance. The peso exhibited increased volatility in July as the standard deviation rose to 34 centavos compared to 20 centavos in the previous month.

[3] Department of Agriculture, "Slight rise in palay output seen in 2002 first 9 months", July 2002

[4] Department of Agriculture, "RP to use standby 250,000 tons of rice imports", 11 July 2002, www.da.gov.ph

[5] National Food Authority, press release, 25 June 2002

[6] The planting seasons in the Philippines are May/June-September (due for harvesting in October-December) and August-November (due for harvesting in January-April).

[7] The NFA's purchase prices for palay are ₱9.00 per kilo during the main cropping season (September-February) and ₱10.00 per kilo during the summer months (April-May). Meanwhile, the NFA sells rice at ₱14.15 per kilo and ₱15.16 per kilo in the wholesale and retail markets, respectively.

6. On a trade-weighted basis and in real terms, the peso appreciated relative to the basket of currencies of major trading partners by about 0.7 percent in July 2002 relative to the level in December 2001. In contrast, the peso tracked a depreciation trend vis-à-vis the currency baskets of competitor countries as reflected in the decline in the real effective exchange rate (REER) of the peso against the broad and narrow baskets of competitor currencies by about 1.0 percent and 7.8 percent, respectively during the review period.[8] Thus, the country's external competitiveness weakened slightly relative to its major trading partners' basket of currencies but strengthened slightly compared to the competitor countries' broad and narrow baskets of currencies.

Despite the recent decline, the peso remains relatively stable and continues to exert a positive influence on inflation and inflation outlook.

Oil price developments

7. The spot international price of crude oil (Dubai) increased by 3.1 percent to average US$24.66 per barrel for the period 1-19 July 2002 from the US$23.91 per barrel average price in June. Compliance with production limits set by Organization of Petroleum Exporting Countries (OPEC) as well as episodes of hostilities in the Middle East have reversed the observed moderation in world oil price movements in May and June. The uptick in world oil prices could prompt local oil companies to offset the recent cuts in local pump prices of petroleum products. It may be recalled that during the last week of June up to the first week of July, local oil companies reduced their pump prices by an average of 35 centavos per liter across all petroleum products. The net increase in domestic oil prices thus far in 2002 stood at 91 centavos per liter for gasoline, diesel and kerosene.[9]

8. In the futures market, the price of the benchmark Brent crude oil was also higher as September 2002 deliveries settled at US$26.43 per barrel.[10] For the

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[8] The broad basket 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.

[9] In 2001, pump price of petroleum products declined by ₱1.81 per liter for gasoline and ₱ 1.30 per liter for kerosene and diesel oil (Source: Department of Energy).

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

remaining months of 2002, the price of Brent crude oil in the futures market is forecasted to remain relatively stable. Market expectations indicated that world oil prices would continue to track the $22-$28 per barrel target price band of OPEC for the year, given the production limits set by the OPEC for its member countries and softer world oil demand due to concerns regarding the robustness of the US economic recovery.

9. It is estimated that an increase in domestic oil prices due to an uptick in world oil prices could raise average annual CPI inflation directly by about 0.15 percentage point. This could trigger a second round effect on the prices of other commodities estimated to be about twice that of the direct impact, which would raise the average annual inflation for 2002 by about 0.48 percentage point.[11]

The flow-on effects of an upturn in domestic oil prices could lead into a price spiral on other commodity groups as well as upward adjustments in transport fares and wages.

Petitions for upward adjustment in user charges on utilities

10. Apart from the recent reduction in power rates—as a result of the suspension of the deferred purchased power adjustment (PPA) of the Manila Electric Company (Meralco)—the Department of Energy (DOE) projected electricity rates to go down further for the remaining months of the year due to plans to pursue the establishment of the Wholesale Electricity Spot Market (WESM) and to introduce a price incentive scheme for large end-users of electricity.[12]

[11] 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 increase to $30 per barrel for the period August -December to reach an average of $25.70 per barrel in 2002.

[12] Pursuant to RA No. 9136 entitled, the Electric Power Industry Reform Act, the Power Sector Assets and Liabilities Corp. (PSALM) shall manage an orderly sale and privatization of all existing independent power producers (IPP) contracts and generation facilities of the NPC. After the sale and privatization of generation companies and IPP contracts owned by the NPC, these private companies are expected to participate in retail competition under the WESM for the sale of power to distributors.

11. Under the WESM scheme, electricity will be traded at the spot market, where power generators would compete against each other to supply power to distributors. The creation of the WESM is aimed at ensuring efficiency and transparency in power generation charges. Based on DOE's estimates, the operation of the proposed WESM could reduce further the cost of electricity by about 40 centavos per kwh. The DOE also planned to introduce a "declining block" rate structure for large end-users of power, which would offer discounts for incremental energy consumption over a specified base load.

12. Meanwhile, the Energy Regulatory Commission (ERC) has yet to decide on the proposed graduated power rate adjustments by the Manila Electric Company (Meralco) as embodied in its petition for the "unbundling" of power rates submitted on 2 April 2002. The proposed rates could raise the cost of electric power consumption by an average of ₱0.65 per kwh or about 10.3 percent across all residential users.[13] Meanwhile, the proposed power rate increases for commercial and industrial establishments will be moderate, estimated at about 2.7 percent and 3.2 percent, respectively. The reduction in the PPA combined with the unbundling of power rates could result in a net increase in the cost of electricity by about 15 centavos per kwh, or an increase of about 2.4 percent.

13. The Manila Waterworks and Sewerage System (MWSS) Board announced its decision to freeze temporarily water rate hikes this year. The proposed increase in water rates could instead be implemented in 2003. The decision of the MWSS to defer action on the petitions for water rate hikes was prompted by the resubmission of revised computations of the appropriate rate of increase by the two water concessionaires (Maynilad Water Services Inc. and Manila Water Company), which would entail a review of the revised numbers. Given the relatively small share of water to the CPI basket of 0.7 percent, the proposed increase in water rates was estimated to result in an increase in the CPI inflation by 0.1 percentage point in 2003.[14]

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[13] According to Meralco, the unbundling of power rates is not expected to result in any power rate increase for residential users at the lowest consumption bracket. (Source: Meralco, Press Release entitled, "Meralco Submits New Alternative on Rate Unbundling," 2 April 2002)

[14] Based on analysis using input-output (I-O) tables published by the National Statistical Coordination Board (NSCB)

User charges for utilities could be expected to remain low for the rest of the year. Electricity rates could go down further with the reduction in the PPA, the planned implementation of WESM and the introduction of the price-incentive scheme for large-end users. Similarly, water rates will remain at current levels as the MWSS has decided to put on hold action on the petitions for water rate hikes until next year.

Interest rates and interest rate differentials

14. Nominal differentials between RP interest rates and foreign interest rates continued to widen in July 2002 relative to the levels in April-June as the RP benchmark interest rate remained steady while US interest rates generally trended downward. The average 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 period 1-22 July 2002 rose to 2.0 and 2.1 percent, respectively, from the previous month's average differentials of 1.9 percent and 2.1 percent**.**

15. 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. On its two-day meeting on 26-27 June 2002, the Fed kept the federal funds target rate unchanged at 1.75 percent, given the ongoing weakness in unemployment, business investment and the equity market in the US.

16. However, adjusted for the risk premium—as 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 continued to narrow in July at an average of about 110 basis points, as the risk premium rose to an average of 415 basis points in July.

17. In the domestic market, the RP 91-day T-bill rate for the month of June remained generally steady at its 5 June 2002 auction rate of 4.778 percent, as the Bureau of the Treasury (BTr) rejected bids across all maturities during the 25 June and 9 July 2002 auction. This developed as banks were reported to have sought excessively high yields, fueled mainly by market expectations of higher interest rates due to concerns over the higher-than-target fiscal deficit figure for January-June 2002. During the 22 July auction, however, the RP 91-day T-bill rate declined slightly to 4.77 percent as ample system liquidity prompted banks to lower their bids.

The country's average nominal interest rate differentials with the US continued to widen in July as the RP benchmark market interest rate remained steady while US interest rates trended downward. However, adjusted for risk premium, the differentials have narrowed down, indicating the need to watch closely the possible impact on market expectations.

18. The spread of the RP lending rate over the benchmark 91-day T-bill rate for the period 11-17 July 2002 rose slightly to 317 basis points from 312 basis points posted during the period 17-21 June 2002[15] due mainly to the rise in the low-end of bank lending rates (by about 4 basis points). This differential was below the average of 361 basis points for a sample of countries.

19. The Philippines' real lending rate (based on the low-end of the range of banks' lending rates) for the period 11-17 July 2002 increased to 4.9 percent from the 4.3 percent registered during the review period 17-21 June 2002[16]. This was due mainly to the increase in the low-end in banks' lending rates which was accompanied by a decline in the inflation rate in June. However, the Philippines continued to register one of the lowest real lending rates in the Asian region.

Despite the slight uptick in the RP real lending rate, the Philippines continues to record one of the lowest lending rates in Asia.

20. The yield curve for government securities in the secondary market as of 22 July 2002 declined but was steeper relative to that which prevailed at the beginning of 2002 due to sizeable decline in the yields reflected in the shorter maturities. This was mainly on account of the general drop in yields of government securities, which ranged from 159-420 basis points across all maturities since 4 January 2002, with the higher decline at the short-end of the yield curve (2 years and below). Compared to 25 June 2002, the yield curve has also shifted downward, reflecting ample liquidity as well as the decline in the yields of government securities in the primary auction.[17]

[15] Review period during the Advisory Committee meeting on 2 July 2002
[16] Ibid.
[17] Yield curve presented in the last meeting of the Advisory Committee

The general steepness of the yield curve reflects the larger decline in the shorter-dated government securities in the secondary market.

Domestic stock market movements

21. The average Phisix for July 2002 dropped to 1,154 index points—the lowest level so far for the year—as investors remained cautious and opted to stay on the sidelines. Trading in the local bourse was supported mainly by bargain hunting and the recovery bids were stalled by concerns over the higher-than-programmed budget deficit, corporate equity battle over the shares of an index heavyweight firm and the absence of positive corporate news. The bearishness in the US equities market as well as the recent leadership conflict in the Senate also dampened the investors' enthusiasm.

22. Market activity remained thin as the volume of transactions for the period 1-22 July 2002 dropped to 3.7 billion shares, 32.7 percent lower than the 5.4 billion shares recorded in June while value turnover in July dipped by 19.2 percent to ₱6.5 billion from ₱8.0 billion in June 2002. Meanwhile, foreign investors appeared to shy away from the local bourse as total foreign participation slid to 38 percent in July from 62 percent (revised) in the previous month and as foreign selling exceeded foreign buying by ₱396.3 million.[18]

Trading in the local bourse remains tentative as the market awaits for positive economic and corporate news. The recovery of the local bourse would also depend on the pace of the strengthening of the US and other major economies.

Monetary aggregates and bank lending

23. Domestic liquidity (M3) grew steadily by 6.9 percent year-on-year to reach ₱1.57 trillion as of end-May 2002, a slight improvement from the 6.6 percent M3 growth as of end-April 2002. The steady growth in domestic liquidity can be attributed partly to the increase in net foreign assets (NFA) of the monetary system, arising from the decline in foreign exchange liabilities of financial institutions.

[18] Source: Philippine Stock Exchange (Figures as of 22 July 2002)

24. Commercial bank (KB) loans registered a year-on-year decline of 1.8 percent to reach ₱1.41 trillion in May 2002, a slight improvement from the 2.2 percent year-on-year contraction in the previous month. The decline in KB loans can be traced mainly to the relatively low demand for bank credit by firms despite recent signs of improvement in economic activity due to the presence of spare capacity in the manufacturing sector. At the same time, banks' lending activity has been constrained by the need for banks to contain possible build-up in their non-performing loans (NPLs), which stood at 18.4 percent in May 2002, up from 18.2 percent in April 2002.

25. Banks' excess funds 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 by ₱68.2 billion to reach ₱96.4 billion as of 19 July 2002 from ₱28.2 billion as of end-December 2001 while placements under the SDA window amounted to ₱5.6 billion from zero availments during the same period.

Banks remained cautious in extending credit due to the still high NPLs and weak demand for additional bank financing. With ample liquidity in the system, banks have preferred to channel their resources into government securities and placements with the BSP.

26. The National Government (NG) budget deficit for the first half of the year was registered at ₱119.72 billion, about 53 percent above the target for the period of ₱78.3 billion and accounted for 92 percent of the full year target. The fiscal authorities attributed the higher-than-programmed budget deficit of the NG to weaker revenues, deliberate investments in agriculture to prepare for the impact of El Niño weather phenomenon and slowdown in the growth of tax revenue sectors such as the manufacturing and trade sectors. Higher fiscal deficits could lead to higher domestic borrowings or net drawdowns in the deposits of the NG with the BSP. These alternative measures to finance the budget deficit have implications on the size and movements of domestic liquidity, which in turn could affect inflation and inflationary expectations. Moreover, an increase in domestic borrowings by the NG could also put upward pressures on domestic interest rates. However, the ample liquidity in the system, subdued inflationary environment and the favorable cash position of the Bureau of Treasury could soften the possible upward pressures on domestic interest rates.

Developments and outlook in the rest of the world

27. In the Monetary Policy Report to the US Congress on 16 July 2002, Federal Reserve Chairman Alan Greenspan reported that the US economy is expected to grow by 3.5-3.7 percent in 2002. However, Chairman Greenspan indicated that the outlook on the US economy remained uncertain amid mixed macroeconomic signals.[19] Retail sales have rebounded and firms have started to build up inventories. Industrial production also rose in June by 0.8 percent—the fastest rate of increase since August 1998. Moreover, capacity utilization rose to 76.1 percent in June—the highest since the 76.4 percent in August 2001.[20] By contrast, consumer confidence weakened further as preliminary estimates of the University of Michigan's consumer sentiment index slipped to 86.5 in July from 92.4 in June, the lowest level since the aftermath of the 11 September attacks.[21]

28. The absence of generalized price pressures in the US amid renewed concerns over the fragility of the US economic recovery has heightened investor expectations that the Fed will maintain its accommodative monetary stance by keeping the federal funds target rate steady at the 40-year low of 1.75 percent until the rest of the year. This could allow the strong fundamentals of the US economy to show through more solidly.[22]

29. In the euro zone, the European Central Bank (ECB) kept policy rates unchanged during its 6 July 2002 meeting due to weak first quarter economic growth and subdued inflation in June. First quarter growth in the 12-country euro area was revised downward to 0.2 percent, a slight rebound from the 0.3 percent decline registered in the previous quarter.[23] Recent readings indicated that real GDP could grow faster in the second quarter. However, uncertainty remained as to the strength of the recovery in the short term, especially in relation to consumer demand due to weak labor market conditions.[24] Meanwhile, in Japan, the likelihood of an improved economic environment is relatively small except in the export sector, which has contributed to improved corporate

[19] Board of Governors of the Federal Reserve System, Monetary Policy Report to the Congress, 16 July 2002
[20] CNN Money, Industrial output rises, 16 July 2002
[21] Bloomberg, Wall Street economists see chance of rate reduction (update2), 15 July 2002
[22] Bloomberg News, Greenspan says US consumers aren't pulling back, 17 July 2002
[23] European Central Bank, Monthly Bulletin, July 2002
[24] Ibid., p. 28

production and sentiment. However, the robustness of exports growth registered in the first quarter could diminish in the second quarter as the yen strengthened further against the dollar and as uncertainty over the strength of overseas markets continued.[25] With business capital spending and consumer sentiment on a standstill combined with a prolonged price deflation, the Bank of Japan's overnight call rate continued to move around zero percent. On the basis of these factors, the central banks of the euro zone and Japan have opted to uphold their accommodative monetary policy stance.

Mixed signals on the prospects for sustained global economic recovery reinforce the markets' view of continued accommodative stance by the Fed and other central banks in major economies.

II. Discussion on the Review of the Monetary Policy Stance

30. The members of the Monetary Board noted that recent indicators of demand and output showed a mixed picture. While there have been signs of improvement in economic activity, domestic demand still lacked buoyancy. Manufacturing output grew steadily for the second consecutive month, although at a slower pace. Domestic liquidity grew steadily but bank lending remained weak. The global economic recovery appeared to be underway but the pace has been uneven and somewhat tepid in the US and other major economies. In particular, the decline in consumer confidence—due to concerns about corporate governance—has contributed to a more cautious rise in aggregate demand in the US. Given the uncertainty about the timing and pace of the world economic upturn, monetary policy should thus be focused on ensuring conditions to strengthen domestic demand.

31. The members of the Monetary Board shared the view that indications of potential upside pressures on future inflation and inflationary expectations combined with the uncertainty about the strengthening of domestic demand argued for a cautious monetary policy stance, one that could be supportive of the economy's growth objective while ensuring the price pressures are well contained. The risks to the inflation and inflationary expectations are related to the uncertainty over the impact of El Niño weather

[25] Bank of Japan, Monthly Report on Recent Economic and Financial Developments, July 2002, www.boj.or.jp

on agricultural crop production in 2003, the uptrend in world oil prices, delayed but eventual adjustment in user charges and the possible shortfall in the budget deficit relative to the target in 2002.

32. The Monetary Board also discussed the implications of a further reduction in policy rates. The members of the Monetary Board shared the view that, given the lags in monetary policy, a more accommodative stance now could undermine the attainability of the target inflation in 2003. The main risk factors to inflation and inflationary expectations arising from reducing policy rates that were identified by the Monetary Board are follows:

a. The present scope for monetary easing was limited by the fact that policy rates have already been reduced to a significant extent over the past year;

b. A more accommodative stance in the BSP's policy rates at this time might call for a more drastic tightening measures in the future should inflationary pressures set in and reverse the current benign inflation picture;

c. A reduction in the BSP's policy rates would narrow down further the country's interest rate differentials with foreign interest rates, which could trigger renewed volatility in the foreign exchange market and undermine the relative stability of the peso as well as impact adversely on inflation and inflationary expectations; and

d. Concerns about the possibility that the fiscal sector would breach the target NG budget deficit.

III. Monetary Policy Decision

33. Based on the analysis of data that have become available since the last meeting of the Monetary Board on 4 July 2002 and a careful assessment of the balance of risks on inflation and inflationary expectations, the members of the Monetary Board by a unanimous vote decided as follows:

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.

The next meeting of the Monetary Board to discuss the monetary policy setting was scheduled on 29 August 2002.

- The Monetary Board of the Bangko Sentral ng Pilipinas