



**HIGHLIGHTS OF THE MEETING OF THE MONETARY BOARD ON
MONETARY POLICY ISSUES HELD ON 1 JULY 2004***

The Advisory Committee¹ submitted the following recommendations for the consideration of the Monetary Board: (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 RRP, RP, and Special Deposit Accounts (SDAs); and (3) maintain the current reserve requirement ratios.

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

The above recommendations were based on the following considerations:

- Headline inflation in May rose to 4.5 percent (1994=100) year-on-year from 4.1 percent in the previous month. The increase in May inflation was due mainly to higher prices of food items, particularly, meat, dairy products and cooking oil, which exerted the most pressure on headline inflation. The average inflation for the first five months of the year was 3.8 percent which remains lower than the Government-announced target of 4.0-5.0 percent for 2004.
- Based on the new CPI series released by the National Statistics Office (NSO) using 2000 as the reference or base year, inflation increased to 4.7 percent in May from 4.2 percent in the previous two months, bringing the average inflation for the first five months to 4.1 percent.
- Likewise, core inflation (defined as headline inflation excluding selected food and energy products) edged up to 4.7 percent in May from 4.3 percent in the previous month (1994=100). Similarly, the 2000-based core inflation rose to 5.2 percent in May from 4.7 percent in the previous month.

* The highlights of the discussions of the 1 July 2004 Monetary Board meeting were approved by the Monetary Board during its meeting held on 5 August 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 Assistant Governor, In-Charge of Research and the Director of the Treasury Department. The 1 July 2004 meeting of the Monetary Board—the 7th monetary policy meeting for 2004—followed the Advisory Committee meeting held on 28 June 2004.



- Forecasts generated by the BSP's inflation forecasting models indicated that average headline inflation is likely to track the upper end of the 4.0-5.0 percent target inflation in 2004 and could possibly rise above the target in 2005 with the full impact of the various supply-side risk factors. The uptrend in inflation in recent months was driven mainly by supply-side factors, including the rise in the prices of food products, increase in the domestic pump prices of gasoline and other oil products as well as the adjustments in transport fares and utilities charges.
- Selected indicators of demand showed improvements but there continued to be some soft spots in the economy. This underpinned the view of moderate demand-side pressures in the near term.
 - Average capacity utilization in manufacturing remained stable at 78.8 percent in April 2004 as in March, but was higher than the 77.0 percent a year ago.
 - The value of production index (VAPI) for manufacturing rose by 2.8 percent in April 2004, reversing the 5.0 percent contraction in the previous month. However, the volume of production index (VOPI) for manufacturing dipped by 5.2 percent year-on-year in April 2004 following a 10.3 percent contraction in March.
 - Exports sustained its growth at 8.9 percent in April 2004 from 7.1 percent in the previous month. This brought the January-April 2004 annual growth of exports to 6.9 percent.
 - Total merchandise imports expanded for the seventh consecutive month by 8.3 percent year-on-year in April 2004 from 4.4 percent in March. This brought the January-April 2004 annual growth of imports to 6.9 percent.
 - Passenger car sales continued to post double-digit year-on-year growth rates for eight straight months at a hefty 145.8 percent based on May 2004 report of the Chamber of Automotive Manufacturers of the Philippines (CAMPI).
 - Energy sales by the Manila Electric Company (Meralco) sustained its increase for the fourth consecutive month at 3.8 percent year-on-year in May. This was slower than the 5.2 percent annual increase in energy sales in April but was higher than the 2.7 percent growth in May 2003.
 - Based on the April 2004 Labor Force Survey conducted by the NSO, unemployment rate rose to 13.7 percent, representing an increase in the number of unemployed persons to 4.99 million in April 2004 from 4.22 million persons in April 2003.



- Supply-side factors continued to represent the major source of risk to the inflation outlook over the policy horizon. However, the favorable outlook for agricultural production, particularly, for the crops subsector, should help ensure stable food prices and provide some cushion against cost-side inflationary pressures. The potential cost-side risks to inflation could come from the adjustments in transport fares and utilities charges.
 - Continued Government programs along with forecasts of normal weather conditions suggested favorable prospects for agriculture in 2004. The observed supply shocks have been limited to a few commodities, particularly, corn, meat and fish products. Overall food supply conditions remain supportive of price stability.
 - The international price of Dubai crude oil eased slightly following the announcement of an increase in Organization of Petroleum Exporting Countries' (OPEC) production ceiling by 2.0 million barrels per day (mbd) beginning 1 July 2004, and an additional 0.5 mbd beginning 1 August 2004. In the domestic market, pump prices of gasoline and other fuel products increased following the rise in world crude oil prices in the previous month. Such increases translated into an increase in transportation costs.
 - In the utilities sector, the Energy Regulatory Commission (ERC) approved Meralco's 13.27-centavo per kwh increase in generation charge by way of the periodic generation rate adjustment mechanism (GRAM) on 2 June 2004. Similarly, the ERC has also released its decision on the National Power Corporation's (NPC) petition for an adjustment in the generation charge allowing the NPC to raise its rates by an average of 25.05 centavos per kwh.
- In the financial sector, domestic liquidity accelerated in April while bank lending increased slightly. Meanwhile, nominal RP interest rates rose in June relative to the previous month. This led to the widening of spreads between RP and foreign interest rates.
 - The growth in domestic liquidity (M3) in April accelerated to 6.5 percent year-on-year from 4.8 percent in the previous month.
 - The loans outstanding of commercial banks (KBs) grew modestly by 0.9 percent year-on-year to reach ₱1.5 trillion as of end-April 2004, following the 0.8 percent annual growth registered as of end-March.
 - The bellwether 91-day T-bill rate rose during the 21 June 2004 auction of the Bureau of the Treasury relative to that registered in



May reflecting market's concerns over the perceived weakening of fiscal position of the National Government (NG), the anticipated increase in the US federal funds target rate as well as the risk premium associated with the then protracted canvassing of presidential and vice-presidential election results in Congress.

- The peso weakened in June, weighed down by concerns over the hike in US interest rate, the increase in the country's unemployment rate and news reports regarding the NG's plan to absorb the debt of the NPC.
- In the fiscal sector, the NG budget deficit in May 2004 widened to ₱12.7 billion from ₱7.8 billion in April as the growth in revenues was outpaced by that of expenditures on account of election-related spending. This brought the NG deficit to ₱77.4 billion for the first five months of the year, only ₱2.2 billion away from the target for the semester.
- Recent developments in the world economy continued to point to a well-established and broader-based recovery, as evidenced by robust industrial production alongside sustained improvements in consumer demand and strong rebound in global trade in most regions. Overall, the conditions for sustaining the global economic recovery over the medium term remained in place. However, the sustained economic expansion in the US and the UK along with declining spare capacity could exert further pressures on inflation.
 - US economy continued to strengthen. Labor market conditions improved further while the manufacturing sector sustained its robust performance in May. However, consumer prices continued to accelerate due to the steep rise in energy and food prices.
 - The recovery of real economic activity in the euro area has strengthened in recent months supported by gradual improvements in private consumption and robust export performance. Inflation has remained in line with price stability although recent oil developments exerted upward pressures on consumer prices.
 - The UK economy continued to exhibit resilient growth. Against a backdrop of increased consumer spending and rising consumer prices, coupled with the gradual tightening of the labor market, inflationary pressures continued to mount in the UK.
 - Japan's economic recovery gained further momentum on the back of strong export performance as well as sustained improvements in business fixed investment and corporate profits. However, deflation continued to persist.



- Amid continued indications of robust expansion of global economic activity, monetary authorities in Japan and the euro area remained cautious and kept their monetary policy settings unchanged during their latest policy meetings. However, the US Fed and the Bank of England (BOE) raised their policy rates to ease the underlying pressures on consumer prices as their economies continued to strengthen. The US FOMC voted to raise federal funds target rate by 25 basis points to 1.25 percent during the 29-30 June 2004 meeting while the BOE raised its key repo rate by 25 basis points to 4.5 percent during its 10 June 2004.

II. Review of the Monetary Policy Stance

- Based on the latest information and inflation forecasts provided by the Advisory Committee, the members of the Monetary Board noted that the inflation outlook is likely to trend upward over the policy horizon. Inflation is likely to track the upper end of the 4-5 percent target for 2004 and could possibly rise above the target in 2005.
- The Monetary Board noted that the inflation environment in the months ahead does not warrant a shift towards a monetary tightening bias. The recent uptrend in inflation could be traced to relative price changes involving selected CPI components and, therefore, is not broad-based. Potential for demand-side pressures on consumer prices are likely to be tempered by the presence of resource slack as evidenced by double-digit unemployment, continued spare capacity in manufacturing as well as subdued activity in lending and investments.
- In addition, the members of the Monetary Board believed that the possibility of an above-target headline inflation rate in 2005 are largely tied to supply-side developments particularly, higher energy prices, which are also driving wage and transport cost adjustments, in addition to utility charge increases. The members of the Monetary Board were of the view that the impact of these supply-side factors on inflation is likely to be transitory and thus, is not likely to be curbed by monetary action.
- The members of the Monetary Board agreed that there is a need to exercise gradual caution in the path of monetary policy action in responding to unforeseen developments in the economy. This is in line with enhancing credibility in setting the stance of monetary policy.
- The Monetary Board recognized that the risk of sentiment-driven exchange market volatility remained present. They noted that the prospect of tighter monetary policy in the major economies—with its implications for interest differentials and exchange market stability that could, in turn, fuel inflationary expectations—could raise the possibility



that limited monetary tightening may become necessary in the near future.

- Overall, the members of the Monetary Board shared the view that the current policy settings remained appropriate for the macroeconomic environment given the outlook for inflation. However, the Monetary Board underscored the need to monitor closely the emerging risks to the inflation outlook over the policy horizon.

III. Monetary Policy Decision

- After an assessment of the balance of risks to inflation and the evidence that have been made available since the last meeting on monetary policy on 3 June 2004 as presented by the Advisory Committee, the Monetary Board approved unanimously 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 RRP, RP, and SDAs; and
 - c. Maintain the current reserve requirement ratios.

The next meeting of the Monetary Board to discuss the monetary policy setting was scheduled on 29 July 2004.