HIGHLIGHTS OF THE MEETING OF THE MONETARY BOARD ON MONETARY POLICY ISSUES HELD ON 14 MARCH 2002*

Background

The Monetary Board held its third meeting for the year on monetary policy issues on 14 March 2002. This followed the meeting of the Advisory Committee on 12 March 2002 where the members discussed the assessment of the inflation outlook and macroeconomic conditions as the basis for the formulation of recommendations on the appropriate monetary policy stance.[1] The Advisory Committee submitted, for the consideration of the Monetary Board, a policy paper and various information relevant to the deliberations on monetary policy. In particular, the Monetary Board discussed inflation developments and expectations—notably the uptrend in oil prices, possible power rate adjustments and the impact of the El Niño weather phenomenon on food supply in 2002 and 2003—monetary conditions, external developments and the global economic outlook, demand and output indicators and the implications of these factors on monetary policy.

I. Considerations in the Formulation of the Monetary Policy Stance

Current inflation and the inflation outlook

1. Inflation in February 2002 decelerated to a two-year low of 3.4 percent from 3.8 percent in January 2002. This reflected a sustained decline in inflation for the past seven months and brought the average inflation for 2002 to 3.6 percent. February's inflation performance was marked by the continued slowdown in price increases across all commodity groups. Similarly, the various measures of core inflation tracked a continued downtrend since August 2001.

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* The highlights of the discussions of the 14 March 2002 Monetary Board meeting were approved by the Monetary Board during its meeting held on 25 April 2002.

[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 Director of the Department of Economic Research, and the Director of the Treasury Department

2. Continued restraint in demand and indications of good food supply conditions in 2002 are expected to exert a favorable influence on the general price levels during the year. Still weak demand means that firms have little pricing power. Average capacity utilization in the manufacturing sector remained broadly steady at 76.9 percent in December 2001 from 76.6 percent in the previous month. In addition, the unemployment rate—at 9.8 percent—as of October 2001 was still high, suggesting that labor costs are not expected to rise sharply.[2]

3. Based on the latest macroeconomic assumptions on output growth, money supply, Treasury bill rates, the government's fiscal position, the exchange rate, domestic oil prices and prices of non-oil imports and the expected yearly increase in wages, future inflation is expected to track broadly the inflation target for 2002. Inflation, however, could trend upward in the first half of 2003 due to the possible impact of the El Niño weather disturbance on food prices and the expected wage adjustments in the latter part of 2002.[3]

The sustained slowdown in headline and core inflation affirms further the broad outlook of a benign inflation environment for 2002 due, in part, to the inertial component of price movements. Based on the latest forecast of the BSP, an uptick in inflation would likely be manifested in the latter part of 2002 heading through 2003. This can be traced to the expected annual wage adjustments and as the full impact of the expected El Niño weather phenomenon is felt in 2003. The average inflation rates for 2002 and 2003, however, are expected to track broadly the targets set by the Government for the period.

Impact of the El Niño weather disturbance on future inflation

4. The Department of Agriculture (DA) noted that the expected El Niño weather phenomenon in 2002 would likely manifest itself in a weak form in the second half of the year. This is thus expected to have a minimal impact on agricultural production in the last half of 2002. Meanwhile, the DA has implemented various measures to mitigate the impact of the expected dry spell, particularly the construction and upgrading of irrigation systems as well as rehabilitation of shallow tube wells in order to provide adequate water facilities

[2] Sources: NSO, Report on the Quarterly Labor Force Survey as of October 2001 and Report on the Monthly Integrated Survey of Selected Industries (MISSI) as of November 2001

[3] Based on the results of the single equation and multi-equation inflation forecasting models of the BSP as of 11 February 2002

to farmlands across the country. However, the DA expressed caution that "unless adequate water provision and water-saving measures are instituted for the dry season from December 2002-May 2003, agricultural production could fall below target in 2003."[4]

The weak form of the expected El Niño weather disturbance and timely implementation of mitigating measures by the DA would likely contribute to generally favorable agricultural production conditions in 2002 but agricultural output could fall below target in 2003.

Exchange rate

5. The peso-dollar rate appreciated steadily to reach ₱50.951 as of 8 March 2002. This brought the average peso-dollar rate to ₱51.109 for the period 1-8 March 2002 from ₱51.41 in December 2001. The steady improvement in the peso-dollar rate can be traced to increased inflows from the proceeds of the recent bond issuances by the government and private corporations as well as remittances by overseas Filipino workers (OFWs). Moreover, the exchange rate was broadly stable as measured by the standard deviation, which remained at about 10.5 centavos during the period 1-8 March 2002. This was a significant drop in volatility from 17.6 centavos in January 2002 and 31 centavos in December 2001. The steady improvement in the peso-dollar rate also mirrored the increasing market confidence amidst brighter prospects for sustained economic recovery.

The broad stability of the peso—both in terms of levels and variance—is expected to have a favorable influence on inflationary expectations and the inflation outlook.

Oil prices

6. As of 5 March 2002, the world price of crude oil (Dubai) rose to US$21.72 per barrel, an uptrend from the US$17.83 per barrel in December 2001.[5] In the futures market, the price of crude oil (Brent) for April-December 2002 was quoted at an average of US$21.61 (as of 1 March 2002), up from US$19.55 per barrel (as of 28 January 2002). Because of the uptrend in oil prices

[4] Source: Press Release entitled, "DA Bares Mitigating Measures for El Niño," Department of Agriculture (DA) website, 4 March 2002
[5] Source: Department of Energy

in the world market, domestic oil companies announced plans to increase pump oil prices before the end-March 2002.

7. Meanwhile, the American Petroleum Institute reported a decline in crude oil inventories by about 4 million barrels in February 2002, the first time this year because of declining oil imports.[6] Concerns over the outcome of the meeting of OPEC member countries in March—where additional production cuts are part of the agenda—also contributed to the observed uptick in oil prices in the world market. In addition, apprehensions over the news that the US may turn its attention toward Iraq in its ongoing battle against global terrorism contributed to the increasing price quotes in the futures oil market. However, some analysts consider compliance with the agreed production cuts among OPEC members to be weak as stocks remained relatively high. Demand has also been constrained by the unusually warm weather and weakness in global economic conditions. At the same time, observers say that Russia—the biggest non-OPEC oil exporter—could potentially raise its output countering the objective of supporting oil prices by tightening supply conditions. While petroleum and other energy-related products account for 4.62 percent of the total CPI basket, an increase in petroleum prices could have a cascading impact over a broad range of other commodities.

Despite adequate supply, world oil prices have trended up, indicating uncertainty in the direction of prices over the long run. A sharp rise in oil prices could lead to upward pressures in the general price level.

Petitions for an upward adjustment in power rates

8. The current petition for the "unbundling" of power rates by the Manila Electric Company (Meralco)—which would also entail updating its asset valuation using 2000 as the base year from the current 1993 base year—could raise the cost of electric power consumption in Metro Manila and nearby provinces by an estimated average of ₱1.10 per kilowatt-hour (kwh) consumption. According to the Energy Regulatory Commission (ERC), the proposed rate increase by Meralco is equivalent to about 19.3 percent hike from the current rate of ₱5.70 per kwh consumption. While light accounts for only 2.7 percent of the CPI basket, the flow-on effects of increased power rates could lead to a price spiral in the general price level.

[6] Source: Global Markets Monitor, 21 February 2002

The possible increase in power rates could raise inflationary expectations as the expected flow-on effects of power adjustments could feed through the prices of other commodities.

Domestic interest rates and interest rate differentials

9. Interest rate differentials (adjusted for taxes) with the US continued to narrow in January and February 2002, but still remained considerable at 3.9-4.0 percent in February. As of 4 March 2002, the interest rate differential between the RP 91-day T-bill rate (net of RP withholding tax) and the 90-day LIBOR stood at 3.627 percent while the interest rate differential between the RP 91-day (net of RP withholding tax) and the US 90-day T-bills reached 3.757 percentage points.

10. The differential between the BSP's policy interest rate (overnight borrowing or RRP rate) and the US target federal funds rate declined further to 550 basis points following the latest 25 basis-point cut in the BSP's RRP rate effective 15 February 2002. This differential was lower than the average differential in 2001 of about 5.9 percentage points, but higher than the differential that prevailed for the most part in 2000, which averaged at about 4.8 percentage points. Meanwhile, 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 target federal funds rate posted an uptrend, due mainly to the declining risk premium for the Philippine debt papers.

11. As of 6 March 2002, the spread of the Philippine lending rate over the benchmark T-bill rate stood at about 322 basis points. This differential compared favorably with the spreads for a sampling of Asian countries during the period. The highest spread observed was that for Taiwan at 524 basis points, while the lowest was that for Indonesia at 66 basis points. Meanwhile, the margin between the Philippine lending rate and the benchmark 91-day T-bill rate continued to decline from its peak level of about 5.7 percentage points in October 2000. The observed narrowing in differential between the lending rates and the 91-day T-bill rate suggested that the impact of the monetary easing measures of the BSP have already started to gradually work its way to the real economy and the financial sector.

12. The country's real lending rate—measured as the difference between the low-end of the range of banks' lending rates and the inflation rate—dropped to

6.7 percent during the period 28 February-6 March 2002 due to sustained declines in the lending rate, which were greater than the declines in the inflation rate. However, with the exception of Taiwan and Hong Kong—which have real lending rates of 9.2 percent and 8.7 percent, respectively during the same reference period due to deflationary pressures—the Philippines' real lending rate remained one of the highest relative to other countries in the region.

Interest rate differentials with other countries have narrowed but remained high relative to historical trends and to other countries in the region. As the interest margins remained comfortable, the broad stability of the peso would not be endangered.

13. The yield curve for government securities in the secondary market as of 4 March 2002 showed a downward shift relative to that which prevailed at the start of 2002, but remained steep at the longer-term maturities (5-10 years). This indicated higher inflationary expectations over the long term.

The steeper long end of the yield curve indicates higher inflationary expectations over the long run.

Domestic stock market movements

14. The domestic stock market remained buoyant in February 2002, continuing the rally that began in January 2002. Market sentiment was spurred mainly by recent positive economic data, particularly lower-than-expected inflation in January and February 2002, favorable market sentiment toward Philippine bonds and improved refinancing possibilities of private companies. Investors' optimism about the economy's growth outlook translated into steady foreign demand for local stocks. Foreign participation in the domestic stock market remained considerable at about 42 percent of total transactions in January and February 2002 from 45 percent in 2001. In terms of value, net foreign buying of domestic stocks reached ₱10.43 billion in January and February 2002, a significant increase compared to the ₱2.33 billion recorded in the same period a year ago. Stronger activity in the equity market was also attributed, in part, to the sustained drop in market interest rates which led to a shift in investors' preference from fixed-yielding instruments to equities. In addition, the local bourse was positively affected by the better-than-expected US manufacturing data.

The strengthening performance of the domestic stock market amid active foreign participation points to favorable market sentiment and positive outlook on the country's economic growth. Encouraging signs of growth, in turn, could make the case for an accommodative monetary stance less compelling.

Monetary aggregates and bank lending

15. The year-on-year growth of domestic liquidity or M3 slowed down further to 5.3 percent in January 2002, from the 6.8 percent growth in December 2001. The deceleration in liquidity growth could be traced partly to banks' cautious lending stance amidst restrained credit demand by the corporate sector. The volume of outstanding loans of commercial banks dropped further by 3.2 percent in January 2002 from the level a year ago, as bank lending to most sectors registered declines. While this is a slight improvement from the 3.6 percent year-on-year decline in December 2001, the January 2002 contraction marked the sixth month of successive decline in bank lending since August 2001 due to constraints posed by banks' persistently high non-performing loans (NPLs). Thus, despite the observed downtrend in lending rates, bank lending has remained sluggish. Corporate demand for fresh loans has also been held back, in part, by the need to manage cash flows to finance maturing obligations rather than to undertake expansion plans given that external demand remains weak in the near term.

16. Meanwhile, based on data from the BSP and the National Government (NG), banks continue to place their excess funds in government securities and placements with the BSP under the RRP and SDA facilities. Excess liquidity in the system was also evident in the continued oversubscriptions and aggressive bidding by banks during the auctions for T-bills and bonds, which contributed to the downtrend in the T-bill yields. As of 4 March 2002, banks' placements under the RRP and SDA windows rose to ₱43.2 billion and ₱31.9 billion from ₱28.2 billion and ₱12.6 billion as of end-December 2001. Using seasonally adjusted data, the levels of RRPs and SDAs in February 2002 rose by 28.7 percent and 30.1 percent, month-on-month, respectively, compared to the 1.3 percent growth and 27.8 percent contraction recorded a year ago. Thus, both the seasonally adjusted and non-seasonally adjusted data on RRPs and SDAs in February 2002 showed reflows of banks' excess liquidity into the BSP.

Bank lending continued to be sluggish, in part due to high NPLs and weak corporate demand. At the same time, banks continue to place their excess funds in government securities and placements with the BSP under the RRP and SDA facilities.

External developments and outlook

17. There have been encouraging signs that a turning point in the business cycle has been reached and that the global economy is poised for a faster-than-expected recovery. In particular, recent data showed that the US economy grew positively in the fourth quarter—a steep recovery from the contraction in the previous quarter. There were also improvements in the unemployment rate and jobless numbers. In addition, the Institute of Supply Management reported that the index of manufacturing activity reached 54.7 index points in February, exceeding the benchmark level of 50 index points, which implies rising manufacturing activity.

18. A stronger and earlier-than-expected US recovery buoyed up expectations of an increase in the US federal funds target rate toward the second half of 2002. A survey of the US federal funds futures contract showed that the US federal funds target rate was expected to rise by 25 basis points by July and by a cumulative 100 basis points by December 2002 from the current level of 1.75 percent.[7] Some market analysts, however, believe that the US could raise policy interest rates even ahead of the May meeting of the Fed.

19. Signs of a US rebound have raised expectations in Europe and Asia as well. In the Euro area, business confidence has perked up due to the positive turnout of the most recent European leading indicators led by an increase in manufacturing output. Meanwhile, in the Asian region, technology-driven economies such as Korea, Malaysia, Singapore and Taiwan showed improved export numbers, reduced inventory stockpiles and rising consumer confidence due mainly to the perceived bottoming-out of the slump in the electronics sector. Growing expectations of recovery have also been particularly apparent in financial markets across the globe. Currency and equity markets in the US, Europe, Asia—and even Japan—continued to post gains. Most economists believed that these developments indicate that the monetary easing cycles across the globe were nearing their end.

[7] Based on the summary of implied Fed Funds rate contract at the Chicago Board of Trade as of 5 March 2002 as quoted from the Bloomberg News, 6 March 2002

20. In his recent testimony before the US Congress on the economic outlook, US Fed Chairman Alan Greenspan noted that while the recovery of the US economy has kicked off, the bounce back will be milder than past recoveries. This indicates that the economic rebound may not match the quick resurgences from previous recessions. Some analysts maintain that, while there are clearer signs of recovery in the US, there is uncertainty on the depth or magnitude of the recovery. Greenspan has suggested that the Fed is likely to proceed with caution in setting the monetary policy stance in the months ahead.[8]

Signs that the monetary easing cycle of major economies have bottomed out and that recovery is gaining strength could limit scope for further monetary easing.

II. Discussion on the Review of the Monetary Policy Stance

21. Majority of the Monetary Board members were of the view that the generally subdued inflation outlook for the year—given expectations of favorable food supply conditions and continued stability in the exchange rate—suggested a case for further monetary easing. They supported the position that, in an environment marked by continued softness in domestic demand and excess capacity in the manufacturing sector, monetary policy should continue to be supportive of growth. Recognizing, however, that there are risks to the inflation outlook, majority of the Monetary Board members expressed support for a modest cut in the BSP's policy rates.

22. A further cut in the BSP's policy rates could be interpreted by the market as growth spurring. A 25-basis point cut in the BSP's policy rates—to 7.0 percent for the overnight RRP rate and 9.25 percent for the overnight RP rate—would help create conditions for promoting increased bank lending activities and propelling domestic demand to support the country's growth objectives. The last time the overnight RRP rate reached 7.0 percent was in May 1992.

23. With continued low capacity utilization in manufacturing, some members of the Monetary Board believed that there is some leeway for a further cut in the BSP's policy rates. This would influence a further decline in domestic

[8] Reuters, "Greenspan hints at a rate hike without major tremors", 12 March 2002

interest rates, which would translate into lower cost of capital. This, in turn, would help stimulate investment spending.

24. Majority of the members of the Monetary Board also noted that the current interest rate differentials remained comfortable, suggesting a case for further monetary easing without raising concerns on a possible adverse impact in the foreign exchange market.

25. Meanwhile, majority of the members of the Monetary Board noted that while bank lending rates have declined by more than the magnitude of the policy rate cuts—by 856 basis points against 775 basis points for the period December 2000-February 2002—banks' lending activity continued to be sluggish due to persistently high NPLs of the banking system and weak corporate demand. The members of the Monetary Board underscored the need to pursue structural reforms that would address banks' NPLs, particularly, the passage of the legislation on the creation of Special Purpose Asset Vehicles (SPAVs).

26. A further cut in the BSP's policy rates could pave the way for a further decline in the benchmark 91-day T-bill rates and bank lending rates, which would be supportive of the fiscal position of the National Government and enhance the repayment capabilities of corporates. Easier repayment terms, in turn, would help ease pressures on banks' NPLs and create conditions for renewed bank lending activity. As the impact of the rate easing works its way in the real sector, the resulting favorable environment—one that fosters consumer spending and increased investments—would help restore confidence in the market. Meanwhile, the impact on inflation of a 25-basis point cut in the BSP's policy rates is estimated to be minimal, i.e., a one-basis-point increase in the average annual inflation.[9]

27. To complement the monetary easing measures undertaken by the BSP, some members of the Monetary Board underscored the need to encourage wider availments of loan guarantees for small enterprises under the Small Business Guaranty Fund Corporation (SBGFC).

28. Some members of the Monetary Board noted that a further reduction in the BSP's policy rates combined with the rationalization of the tiering scheme would discourage banks from placing large volume of excess funds with the BSP. This move would encourage banks to invest in longer-dated government securities

[9] Based on the DER's multiple-equation VAR forecasting model as of 11 February 2002

such as the 5-year and 10-year Treasury bonds, which carry more attractive yields. Over time, this would also compel banks to resume active lending to the private sector for productive purposes.

29. Meanwhile, the possibility that the monetary easing cycle of advanced economies has ended would limit the case for a further policy rate cut in the future. Majority of the members of the Monetary Board, therefore, shared the view that a modest cut in the policy rates now would be warranted given that the US Fed has not yet shifted to a monetary policy tightening mode.

30. Some members of the Monetary Board, however, raised the observation that monetary policy is not the only factor influencing the growth in credit, noting that prevailing generally weak business conditions have continued to restrain domestic demand .

31. Some members of the Monetary Board raised the following issues in connection with a further cut in the BSP's policy rates:

a. There are downside risks to the inflation outlook posed by the uncertainty over the impact of El Niño weather phenomenon on agricultural crop production in 2003, the uptrend in oil prices and the possible adjustment in power rates. Maintaining a strong bias against inflationary risks could reinforce expectations of continued price stability in the long run, thus, providing an anchor for certainty in investment and business decisions.

b. Given strong indications that the monetary easing cycles of major economies have reached their troughs, a further cut in the BSP's policy rates could imply the need for a more dramatic tightening of monetary policy by the BSP should the major industrial economies shift to monetary tightening mode.

c. Raising interest rates in the Philippines would not be as easy as in other countries, particularly under conditions of still weak demand and high NPLs. These concerns reinforce the need for a cautious monetary policy stance.

d. While results from the inflation forecasting model show that average inflation would track the targets for 2002 and 2003, the observed uptrend beginning in the latter part of 2002 argues for a cautious monetary policy stance.

32. Going forward, the members of the Monetary Board agreed that monetary policy should proceed with greater caution. Specifically, monetary authorities should continue to monitor carefully the potential risks to future inflation, particularly the direction of oil prices as well as power rates and the impact of the El Niño phenomenon on agricultural output in 2003 in order to ensure a pre-emptive response to any possible threat to the BSP's primary objective of maintaining price stability.

III. Monetary Policy Decision

34. Based on the weight of evidence and assessment of the balance of risks on inflation and inflationary expectations, particularly as they relate to the inflation outlook, the members of the Monetary Board approved the following measures:

a. Reduction in the BSP's policy rates by 25 basis points each to 7.0 percent for the overnight RRP (borrowing) rate and 9.25 percent for the overnight RP (lending) rate effective 15 March 2002.

b. Adjustment in the interest rates on banks' overnight RRP placements with the BSP under the tiering system as follows: 7.0 percent for placements of up to ₱5 billion, 4.0 percent for the next ₱5 billion, and 1.0 percent for placements in excess of ₱10 billion.

The next meeting of the Monetary Board to discuss the monetary policy setting will be held on 11 April 2002.

— The Monetary Board of the Bangko Sentral ng Pilipinas

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