HIGHLIGHTS OF THE MEETING OF THE MONETARY BOARD ON MONETARY POLICY ISSUES HELD ON 18 DECEMBER 2003*

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

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

These recommendations were based on the following considerations:

- Inflation continued to be benign as headline inflation fell in line with forecasts for November. Year-on-year headline inflation rose to 3.3 percent in November 2003 from 3.1 percent in the previous month. The higher inflation in November was traced mainly to the increase in the prices of food, beverage and tobacco products as well as upward adjustments in energy prices. Nevertheless, the November inflation was well within the staff's inflation forecast of 3.1-3.5 percent for the month. Meanwhile, core inflation estimates by the BSP showed a gradual rising trend in recent months due to the higher inflation rates for services, particularly education, housing and health services. The BSP's main measure of core inflation (CPI excluding food and energy) was recorded at 3.6 percent in November, a slight uptick compared to the previous month's 3.5 percent.

* The highlights of the discussions of the 18 December 2003 Monetary Board meeting were approved by the Monetary Board during its meeting held on 15 January 2004.

[1] The Advisory Committee is composed of the Governor of the BSP as Chairman and four members, namely the Deputy Governor for the Banking Services Sector, Research and Treasury, the Deputy Governor for Supervision and Examination Sector, the Managing Director, In-Charge of Research and the Director of the Treasury Department. The 18 December 2003 meeting of the Monetary Board—the 13th meeting for the year to discuss monetary policy issues—followed the Advisory Committee meeting held on 15 December 2003.

- Prevailing cyclical conditions continued to support a benign path for inflation over the policy horizon. Average annual headline inflation should see a moderate increase from around 3 percent in 2003 to 4-5 percent for 2004-2005, consistent with the Government's inflation targets, as output growth strengthens, aggregate demand conditions improve, and supply-side factors provide a modest cost-push impact on consumer prices.

- The pace and strength of domestic economic activity have shown some improvements but remained uneven across indicators. This suggests generally manageable demand-side price pressures over the near term.

  - Private consumption spending grew by 4.9 percent in real terms during the third quarter of 2003, slightly lower than the 5.2 percent growth reported in the second quarter of 2003. Real GDP and real GNP rose by 4.4 percent and 5.9 percent, respectively, during the quarter. The growth performance in the first three quarters strengthened expectations that the full-year real GDP target of 4.2-5.2 percent will be achieved.

  - The volume of production index (VOPI) for manufacturing fell by 3.7 percent year-on-year in September 2003 after a 4.7 year-on-year increase in August 2003. Meanwhile, the growth in the value of production index (VAPI) for manufacturing slowed down to 3.1 percent year-on-year in September following an 11.2 percent rise in the previous month.

  - Average capacity utilization in manufacturing fell slightly to 77.5 percent in September 2003 from 78.6 percent in the previous month.

  - External trade activity remained generally weak. Total imports showed an 8.5 percent and 4.5 percent year-on-year decline in August and September 2003, following a 1.3 percent increase in July. Growth in exports improved for the second straight month, rising by about 6.3 percent in October 2003. On a cumulative basis, however, imports rose by only 4.8 percent in the first nine months while exports grew by only 1 percent in the first ten months of 2003.

  - Car sales registered a sizeable increase of 81.9 percent year-on-year in units of passenger cars sold in October 2003 following a 2.7 percent decrease in the previous month. This can be traced to the recent adjustment in excise taxes, which effectively reduced the price of certain passenger cars.

- Registered energy sales by the Manila Electric Company (Meralco) continued to slow down at 0.3 percent year-on-year in October from 0.4 percent annual rise posted in September.

- Conditions in the food and energy sectors suggest generally manageable supply-side risks to prices going forward. The outlook for food prices remained positive given the continued favorable performance of the agricultural sector, particularly in palay production. Meanwhile, the international price of crude oil softened in November owing to stable OPEC production, although domestic prices saw another increase in late November.

  - The strong performance in palay production in the third quarter boosts the outlook of the overall agricultural output in 2003. Thus, expectations of favorable farm output given continued government support should help keep prices relatively stable in the near term.

  - The international spot price of Dubai crude oil eased to US$27.47 per barrel for the period 1-9 December 2003 from the US$27.66 per barrel average in November 2003. The decision by the Organization of Petroleum Exporting Countries' (OPEC) to maintain its current production ceilings eased market concerns over possible tighter oil supply in the world market.[2] By contrast, the domestic prices of major petroleum products were raised during the last week of November. These included the prices of gasoline, kerosene and diesel, rising by an average of 30 centavos relative to their prices as of 8 November 2003. Meanwhile, prices of liquefied petroleum gas (LPG) was adjusted by 83 centavos during the first week of December 2003 from its level as of 8 November 2003. The price increases reflected the sustained increase in the international prices of crude and finished oil products in the previous month.

  - The Energy Regulatory Commission granted the Manila Electric Company (Meralco) a provisional rate increase amounting to an average of 12 centavos per kwh effective January 2004. The approved adjustment will be reflected in increases in the distribution charge, supply charge and metering charge components of Meralco's unbundled bill.

- Demand for money and credit slowed down while nominal and real interest rates continued to trend upward. The increase in interest rates

[2] OPEC, Press Release No. 16/2003, 4 December 2003;, available online at http://www.opec.org

reflected an increase in the risk premia as market concerns over political noise persisted.

- Domestic liquidity (M3) growth eased to 2.5 percent year-on-year as of end-October 2003 from 3.4 percent in September.

- The total volume of commercial bank (KB) loans grew by 0.8 percent year-on-year to ₱1.43 trillion as of end-October 2003. The increase was slower than the 3.9 percent annual increase in the previous month.

- Treasury bill (T-bill) rates rose steadily in November due to concerns over the domestic political front. During the 24 November 2003 T-bill auction, the average yield on the benchmark 91-day T-bill went up by 27 basis points relative to the previous auction on 10 November 2003 to settle at 6.532 percent, the highest since the 26 May 2003 auction.

- The Philippine peso maintained its relative stability during the review period. During the period 1-10 December 2003, the peso was relatively steady at its November 2003 average level of ₱55.39/US$1 as the year-end influx of overseas Filipino workers' remittances offset the impact of persistent market concerns over political developments relating to the forthcoming May 2004 elections. The peso was also less volatile, with the standard deviation dipping to an average of ₱0.10 in 1-10 December 2003 compared to ₱0.17 registered in November 2003.

- The National Government (NG) posted a below-target budget deficit of ₱163.9 billion for the period January-October 2003, lower than the program level for the period by ₱7.9 billion. This reinforced expectations that the 2003 target deficit will be achieved, which has positive implications for inflation expectations.

- In the external sector, key indicators pointed to a moderate to strong economic recovery for the world's major economies. Prospects for external demand consequently appeared to be firmer. Stronger economic performance has been particularly evident in the United States, where recovery has been accelerating on the basis of record growth in output in the third quarter. Gains in performance in the euro area and Japan have been equally encouraging although slightly less brisk.

  - Output growth in the US was even stronger than earlier announced, owing to strong improvements in private consumption and business fixed investment. Manufacturing activity also enjoyed a better performance in recent months, although the unemployment rate remained largely unchanged. Nevertheless, news of stronger economic activity helped prop up consumer confidence and dispelled fears of deflationary pressures.

- Output performance in the euro area improved in the third quarter. The European Central Bank (ECB) noted that indicators pointed increasingly to a gradual improvement in economic activity, suggesting that the euro area economy would likely post a slow but gradual recovery. However, the recent appreciation of the euro against the dollar poses downside risks to the Eurozone's export performance, which in turn could dampen the growth prospects of the region.

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

- Japan's economy has shown steady signs of recovery owing to robust exports and production, despite lingering weakness in other components of final demand, notably private consumption, housing investment and public investment. Most observers agree that the country's recovery prospects remained intact, but weakness in the above areas has put a drag on overall growth.

- Amid increased evidence of stronger economic activity in major economies, central banks generally took a wait-and-see attitude and opted to leave their monetary policy settings unchanged. The US Federal Open Market Committee (FOMC), the European Central Bank (ECB), the Bank of England (BOE) and the Bank of Japan (BOJ) have all opted to keep their monetary policy settings unchanged during their respective monetary policy meetings in December 2003.

II. Review of the Monetary Policy Stance

- The members of the Monetary Board were of the view that the balance of risks for consumer prices has not changed significantly during the inter-meeting period in the context of the review of the BSP's monetary policy stance. They pointed out that present cyclical conditions continue to support a moderate, on-target path for headline inflation over the policy horizon. In addition, expected cost-push risks to consumer prices appeared not to pose a major threat to the inflation objective.

- However, the members of the Monetary Board also noted that the observed slowdown in money and credit demand and the restrained pace of bank lending and the generally uneven character of the trends in other economic indicators tend to suggest downside risks for the overall strength of economic activity.

- Taken together, the Monetary Board believed that the benign inflation outlook and subdued domestic demand conditions over the next several quarters support the argument for maintaining the policy stimulus without any undue risk of demand-pull inflation. The monetary policy stance should therefore continue to recognize the liquidity needs of economic growth against a backdrop of manageable inflation. The Monetary Board also highlighted the need to ensure that the macroeconomic environment remains conducive to credit demand and investment activity.

- Based on the information presented by the Advisory Committee, the Monetary Board considered the following monetary policy options:

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

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

  - Further easing of the monetary policy stance:

    The members of the Monetary Board shared the view that the principal argument for further easing is to stimulate economic activity and guard against the downside risks stemming from the slowdown in the demand for money and credit as well as the uneven conditions of other indicators of aggregate demand. However, some members of the Monetary Board argued that easing the BSP's monetary stance is premised on the assumption that the continuing economic weaknesses can be addressed mainly by monetary policy. They clarified that in addition to the still sizable level of spare capacity, the large NPLs of the banks contributed also to the observed weakness in credit. In addition, monetary easing could also add pressure on the foreign exchange market.

Members of the Monetary Board argued that the possibility of disorderly adjustments in the foreign exchange market due to political developments and shifts in market sentiment suggest the need for caution in formulating the monetary policy stance. On the other hand, it was also noted that the present pass-through impact of exchange rate movements on consumer prices is likely to be low given indications of a negative output gap—such as the high unemployment rate and relatively large spare capacity—so that a monetary response may indeed not be warranted.

In addition, a member of the Monetary Board expressed the view that easing the current monetary policy stance through a reduction in the policy rates may contribute to even higher demand for public sector credit, which could eventually constrain the sustainability of the NG's fiscal position.

- Maintaining current monetary policy stance:

The members of the Monetary Board noted that the alternative to active stimulus is one that emphasizes caution in the face of uncertainty and involves keeping policy interest rates unchanged. The following arguments were raised by the members of the Monetary Board in favor of a cautious stance:

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

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

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

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

III. Monetary Policy Decision

- After a careful assessment of the balance of risks on inflation and inflationary expectations and the evolving domestic and external conditions as presented by the Advisory Committee, the Monetary Board, by a unanimous vote, approved the following policy measures:

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

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

  c. Maintain the current reserve requirement ratios given the adequate level of liquidity in the system.

The next meeting of the Monetary Board to discuss the monetary policy setting was scheduled on 15 January 2004.