Bangko Sentral ng Pilipinas

HIGHLIGHTS OF THE MEETING OF THE MONETARY BOARD ON MONETARY POLICY ISSUES HELD ON 21 OCTOBER 2004*

The Advisory Committee[1] submitted the following recommendations for the consideration of the Monetary Board:

1) Maintain the current monetary policy settings as follows:

   (a) Maintain the BSP's policy rates at the current uniform rates of 6.75 percent for the overnight RRP (borrowing) rate and 9.0 percent for the overnight RP (lending) rate;

   (b) Maintain the current interest rates on the term RRPs, RPs, and Special Deposit Accounts (SDAs); and

   (c) Maintain the current reserve requirement ratios.

2) Continue to strengthen support for the use of non-monetary measures to address supply-side risks, particularly those relating to food supply, by strengthening the BSP's representation and coordination with various government agencies.

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

The above recommendations were based on the following considerations:

- Year-on-year headline inflation (1994=100) edged up to 6.9 percent September from 6.3 percent in the previous month. As in the previous months, the acceleration in September inflation was driven mainly by price pressures on selected food and energy-related CPI components, as well as items classified under services, particularly transport and communications. The average inflation for the period January to September 2004 was 4.8 percent, which was still within the 4-5 percent target for the year.

* The highlights of the discussions of the 21 October 2004 Monetary Board meeting were approved by the Monetary Board during its meeting held on 25 November 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 2000-based headline inflation rate likewise trended up in September to 7.2 percent from 6.8 percent in August, for a year-to-date average inflation 5.2 percent.

- Both the 1994– and 2000–based core inflation rate (defined as headline inflation excluding selected food and energy products) rose to 6.6 percent in September from 6.2 percent and 6.4 percent, respectively.

- Latest forecasts generated by the BSP inflation forecasting models indicated that inflation could continue to rise over the next year or so, and may exceed the 4-5 percent inflation target for 2004 and 2005. However, average inflation is expected to revert to 4-5 percent in 2006 in the absence of any further adverse supply-side shocks.

- Domestic demand indicators showed positive trends. However, some soft spots in the domestic economy remained as other demand-side indicators continued to post modest and uneven improvements.

  - Average capacity utilization in manufacturing has remained at close to 80 percent in recent months. Data for July showed average capacity utilization at 79.7 percent, a slight deceleration from the 79.8 percent in June. This level was higher than the 78.7 percent registered for the same month a year ago.

  - The value of production index (VAPI) for manufacturing rose by 7.7 percent (revised) in July 2004 following a 9.7 percent (revised) annual growth in the previous month. On the contrary, the volume of production index (VOPI) for manufacturing dipped by 0.2 percent (revised) in July 2004 following a 2.0 percent rise in June.

  - Export growth increased by 13.7 percent year-on-year in August 2004 from 3.2 percent in July. This brought the January to August 2004 annual export growth to 8.5 percent.

  - Total merchandise imports increased by 5.6 percent year-on-year in July 2004, a marked slowdown from the 18.0 percent growth in the previous month. For the January to July 2004 period, the cumulative annual growth of imports was 6.9 percent.

  - Passenger car sales posted an 80.1 percent year-on-year growth in August, a considerable acceleration from the 8.2 percent posted in the previous month. Meanwhile, the combined truck and bus sales continued to decline by 11.3 percent year-on-year in August, lower than the 55.7 percent decline reported in the previous month.

  - Energy sales by the Manila Electric Company (Meralco) increased by 3.0 percent year-on-year in August, slightly higher than the 2.9

percent growth in July 2004. However, this was lower than the 6.7 percent increase in August 2003.

- Unemployment rate remained high at 11.7 percent, although this was lower than the 12.6 percent registered in the previous year. Despite the improvement, this level remains considerably higher than 7.4 percent, the lowest unemployment rate recorded during the peak growth years 1993-1996.

- Supply-side factors continued to dominate the risks to the inflation outlook. These risk factors include primarily the rise in world oil prices, which will impact on the cost of producing other goods and services. Nonetheless, the favorable outlook for agricultural output for the rest of the year is expected to provide some cushion for food prices.

  - The agriculture sector showed robust performance in the first semester of 2004. However, a warm episode—which may develop into a weak El Niño—may affect domestic supply of agricultural products and could pose upside pressures to food prices in the first quarter of 2005.

  - The international price of Dubai crude oil rose anew in October after easing in the previous month. This was due to supply disruptions, geopolitical concerns among major oil producers and the anticipated rise in demand for heating fuel in the coming winter season in the Northern Hemisphere. In the domestic oil market, retail prices of kerosene, diesel and LPG also increased, reflecting the recent uptrend in world oil prices.

- In the financial sector, the demand for money and credit continued to post a modest growth. Meanwhile, nominal RP interest rates increased during the 11 October 2004 auction of the Bureau of the Treasury (BTr) from September 2004 levels.

  - Domestic liquidity (M3) continued to grow by 6.1 percent year-on-year in August 2004, a slight deceleration from the 6.7 percent rise posted in the previous month. At 6.1 percent, however, the growth in M3 remained significantly below the double-digit levels posted in the growth years during the pre-Asian crisis period of 1993-1996.

  - Commercial bank lending expanded by 5.5 percent year-on-year to ₱1.51 trillion as of end-August 2004. This was higher than the 3.6 percent growth registered in the previous month, but a sharp decline relative to the double-digit growth rates registered during the pre-Asian crisis period of 1993-1996.

  - Reference T-bill yields rose during the first regular auction of the BTr in October relative to those recorded in September, reflecting market concerns over the rising inflation, early passage of tax measures in Congress and warnings of possible downgrade in the country's credit rating.

- The peso weakened against the US dollar in October due to continuing market concerns over the uptrend in inflation, the sustainability of the country's fiscal position as well as the rising corporate demand for dollars to fund the higher cost of oil and other key imports.

- In the fiscal sector, data showed that NG budget deficit for August 2004 of ₱11.7 billion was well below the deficit level of ₱18.2 billion posted in August 2003. This brought the January to August 2004 deficit level to ₱111.1 billion, slightly lower than the ₱114.5 billion deficit recorded in the same period last year.

- Recent developments in the global economy continued to show signs of firming up, underpinned by robust industrial production and rising corporate profitability. These developments were accompanied by gradual improvements in consumer demand and tightening of labor market conditions in most regions. On the price front, the medium-term outlook remains favorable although stronger inflationary pressures are expected to persist over the short term.

  - US economic activity remained on track as indicated by better employment conditions, improved consumer spending, and the uptrend in business investment.

  - Recovery of real economic activity in the euro area continued with the upturn in private consumption, rise in business investment, and robust export performance.

  - UK's economic expansion continued, underpinned by strong manufacturing output, buoyant private investment, and steady growth in household spending.

  - Japan's economic recovery remained on course as evidenced by robust export performance, increase in industrial production, and uptrend in business fixed investment.

- The US Federal Reserve (Fed) raised its policy rates by 25 basis points at its 21 September 2004 meeting. Other central banks which have tightened their policy rates were Canada, Thailand, and New Zealand. The main reasons cited by these central banks for raising policy rates were rising inflationary pressures due to robust domestic demand, and tight labor market conditions.

- Meanwhile, the Bank of England (BOE), Bank of Japan (BOJ), and the European Central Bank (ECB) remained cautious and kept their monetary policy settings unchanged during their policy meetings on 6-7 October 2004, 12-13 October 2004 and 7 October 2004, respectively. Other central banks which have kept their monetary policy settings were Australia and South Korea. These decisions were generally based on output concerns, given the sluggish growth in private consumption and investments, and softening labor market conditions.

II. Review of the Monetary Policy Stance

- Recognizing the time lag required for monetary policy decisions to take full effect (currently estimated at 15–21 months), the Monetary Board noted that monetary actions undertaken at this point will primarily affect inflation in 2006 and may only have a minimal impact in 2004-2005 inflation. The members of the Monetary Board, therefore, agreed that prospective decisions should be oriented toward safeguarding the 2006 inflation target.

- The members of the Monetary Board also noted that the expected path of headline inflation over the near term remains hump-shaped, with average inflation expected to exceed the 4-5 percent target in 2004-2005 but will revert toward the same range target by 2006. The members of the Monetary Board believe that supply-side pressures driving the projected uptrend in inflation cannot be addressed appropriately by monetary policy, which restrains inflation pressures mainly by curbing demand for goods and services.

- In particular, the members of the Monetary Board pointed out that three main developments must be looked at before changing monetary policy course, as follows:

  1) Indications of demand pressures building up;
  2) Evidence of second round effects from the ongoing supply shocks in inflation; and
  3) Risks of possible volatility in the foreign exchange market driven by possible narrowing of interest rate differentials with potential impact on inflation and inflation expectations.

- The Monetary Board noted that indications of sustained price pressures from the seasonally-adjusted CPI data are outweighed by the presence of relatively high unemployment and moderate credit activity in the economy. Such conditions point to the conclusion that the current inflation uptrend is originating mainly from the supply side rather than the demand side.

- Furthermore, the members of the Monetary Board were of the view that given the absence of clear evidence of demand-side effects of supply shocks or mounting demand-side inflationary pressures, the balance tilts in favor of maintaining the present neutral stance of monetary policy. With the dominant role of supply-side developments in the inflation outlook, the members of the Monetary Board believed that inflation can be best mitigated by appropriate supply-side (which are non-monetary) policy measures.

- Nonetheless, the Monetary Board recognized the risk of a sustained period of rising oil prices, which could lead to a reduction in domestic demand and self-sustaining inflation pressures reinforced by public expectations of persistently high inflation. Monetary action will thus become necessary when the available evidence begins to point more strongly to inflation pressures that are over and above those generated by ongoing supply shocks, or to emerging demand-side pressures on prices.

- The members of the Monetary Board likewise recognized the risk of exchange market pressures that may be caused by narrowing nominal interest differentials, ample liquidity among banks, and negative market sentiment that could feed into inflation and inflation expectations.

- At the same time, the members of the Monetary Board acknowledged the need for the BSP to continue assessing economic and financial developments for indications of potential threats to the inflation target and, if necessary, undertake a well-timed policy adjustment.

- On the basis of the preceding discussion, the members of the Monetary Board agreed unanimously to maintain current monetary policy settings. However, the Monetary Board members emphasized that the monetary authority is prepared to respond to the potential second-order inflationary effects of ongoing supply shocks and other conditions that could generate persistent price pressures.

III. Monetary Policy Decision

- Upon assessment of the balance of risks to inflation and the evidence that has become available since its previous meeting on monetary policy, the Monetary Board approved unanimously the following measures:

  1) Maintain the current monetary policy settings as follows:

     (a) Maintain the BSP's policy rates at the current uniform rates of 6.75 percent for the overnight RRP (borrowing) rate and 9.0 percent for the overnight RP (lending) rate;

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

(c) Maintain the current reserve requirement ratios.

2) Continue to strengthen support for the use of non-monetary measures to address supply-side risks, particularly those relating to food supply, by strengthening the BSP's representation and coordination with various government agencies.

The next meeting of the Monetary Board to discuss the monetary policy setting is scheduled on 18 November 2004.

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