HIGHLIGHTS OF THE MEETING OF THE MONETARY BOARD ON MONETARY POLICY ISSUES HELD ON 3 JUNE 2004*

The Advisory Committee[1] 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 RRPs, RPs, 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 April rose to 4.1 percent year-on-year from 3.8 percent in the previous month using the 1994-based series for consumer price index (CPI). The increase in April inflation was due mainly to higher prices of selected food items, gasoline and other oil products, selected construction materials and the adjustment in transport fares. The average inflation for the first four months of the year was 3.7 percent, lower than the Government-announced target of 4.0-5.0 percent.

- Based on the new CPI series released by the National Statistics Office (NSO) using 2000 as the reference or base year, inflation remained at 4.2 percent in April 2004, bringing the average inflation for the first four months to 4.1 percent.

- Meanwhile, core inflation (defined as headline inflation excluding selected food and energy products) increased to 4.3 percent in April from 4.0 percent in the previous month (1994=100). Similarly, the

* The highlights of the discussions of the 3 June 2004 Monetary Board meeting were approved by the Monetary Board during its meeting held on 23 June 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 3 June 2004 meeting of the Monetary Board—the 6th monetary policy meeting for 2004—followed the Advisory Committee meeting held on 31 May 2004.

2000-based core inflation edged up to 4.7 percent in April from 4.6 percent in March.

- Forecasts generated by the BSP inflation forecasting models indicated that the baseline average headline inflation is likely to trend higher but will continue to track the 4-5 percent target for 2004-2005. However, the recent transport fare adjustments and possible increase in utilities charges could threaten the inflation target over the policy horizon. The uptrend in inflation can also be attributed to expectations of improving aggregate demand conditions and emerging supply-side risks.

- For the first quarter of 2004, GDP rose at a robust pace of 6.4 percent, while real GNP grew by 6.2 percent from the year-ago level. The economic expansion was broad-based with all the major production sectors (supply-side) posting higher growth rates. On the demand-side, private consumption continued to be the major driver of growth along with the strong rebound in both investments and exports.

- Selected indicators of demand indicated continuing presence of some soft spots in the economy as evidenced by the double-digit unemployment rate and fairly sizable level of spare capacity in manufacturing.

  - Average capacity utilization in manufacturing remained relatively steady at 78.6 percent in March 2004 from 78.4 percent in February, but was lower than the 80.1 percent a year ago.

  - Exports sustained its growth at a slower pace of 7.1 percent growth in March 2004 from 7.6 percent in the previous month. This brought the January-March 2004 exports annual growth to 6.3 percent.

  - Total merchandise imports continued to expand for the sixth consecutive month but at a decelerated pace of 4.4 percent in March 2004 from 6.3 percent in February 2004 and from 11.6 percent a year ago.

  - Passenger car sales continued to post double-digit year-on-year growth rates for seven straight months at 119.1 percent based on April 2004 report of the Chamber of Automotive Manufacturers of the Philippines.

  - Energy sales by the Manila Electric Company (Meralco) increased by 7.8 percent year-on year in March 2004 from 6.2 percent in February.

- The favorable outlook for agricultural production 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 observed uptrend in world oil prices, increase in transport fares and the possible adjustments in user charges in the utility sector.

  - The agriculture sector grew by a strong 8.2 percent in the first quarter of 2004, the sector's highest expansion in 15 years and more than twice the 3.6 percent growth registered in the same quarter a year ago. Both *palay* and corn production performed better-than-forecasted, and benefited from favorable weather conditions as well as better irrigation facilities and the use of high-yielding seeds. Forecasts of robust rice and corn production are expected to be sustained over the next quarters of 2004 which should help keep prices stable over the near-term.

  - The international price of Dubai crude oil continued to trend up due mainly to the strong demand for oil from US and China as well as the prospects of lower US crude inventory and continued hostilities in the Middle East which could threaten the stability of global supply. 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. These developments prompted regulators to allow an increase in the minimum transport fare.

  - There are anticipated price increases in the utilities sector, given pending petitions by the Meralco and the National Power Corporation (NPC) with the Energy Regulatory Commission (ERC) for a 27-centavo increase in generation rate and 12-centavo increase in distribution, metering and supply charge.

- In the financial sector, domestic liquidity accelerated in April while bank lending increased slightly. Meanwhile, nominal RP interest rates eased in May relative to the previous month. This, combined with the increase in foreign interest rates, has led to the narrowing of spreads between RP and foreign interest rates.

  - The growth in domestic liquidity (M3) in April accelerated to 6.4 percent year-on-year from 4.8 percent in the previous month.

  - The loans outstanding of commercial banks (KBs) registered a modest 0.8 percent year-on-year growth to reach ₱1.47 trillion as of end-March 2004. This was, however, an improvement from the 1.5 percent contraction in KB loans in the previous month.

  - The bellwether 91-day T-bill rate eased during the 24 May auction of the Bureau of the Treasury relative to that registered in April as political uncertainties began to simmer. However, the 24 May 2004 auction rate was higher relative to the yield posted during the 11 May auction due to concerns over rising oil prices and market's expectation of an imminent rise in the US federal funds target rate.

- The peso continued to recover against the US dollar for the second consecutive month to average ₱55.84/US$1 for the period 1-31 May 2004 from its April 2004 average of ₱55.89/US$1 due mainly to easing political concerns after the 10 May 2004 elections and higher inflows from remittances of overseas Filipino workers in time for the school opening in June.

- In the fiscal sector, the budget deficit of the National Government (NG) for April 2004 stood at ₱7.8 billion, the lowest monthly deficit since June 2003. However, this level of deficit was 18.8 percent higher than the ₱6.6 billion deficit recorded in April 2003. This brought the cumulative level of deficit for the January to April 2004 period to ₱64.7 billion, 1.2 percent lower than the cumulative deficit for the comparable period in 2003 and was 81.3 percent of the 2004 first semester target of ₱79.6 billion.

- The expansion of the global economy, led by the US has been proceeding robustly. Growth in most regions has been driven mainly by industrial production and business investment, accompanied by growing consumer demand. However, economic expansion in the US and UK alongside rising consumer prices, declining spare capacity and surging world oil prices suggested rising inflationary pressures, which could pose risks to the sustainability of world economic recovery.

  - The strong pick up of the US economy has gained further momentum in the first quarter of 2004. The labor market continued to strengthen while the manufacturing sector returned to fairly solid growth in April. Consumer prices, on the other hand, continued to accelerate due to higher food and fuel prices.

  - The recovery of real economic activity in the euro area continued, albeit at a modest pace. The robust global economic recovery has provided a favorable external environment while modest growth in retail sales signaled improving consumer demand. While these factors pointed to an overall positive outlook for the economy, uncertainties related to the tepid investment climate and sluggish labor market conditions indicate continued weak spots in the euro economy.

- The UK economy continued to show strong growth, backed by robust consumption and solid investment performance. Latest economic indicators also supported the prospect of sustained economic growth going forward.

- Japan's economic recovery continued to gain momentum, boosted by strong export performance and growing business fixed investments. Industrial production trended up while private consumption showed some positive movements as labor market conditions improved.

- Amid continued indications of robust expansion of global economic activity, monetary authorities in the US, Japan and the euro area remained cautious as they kept their monetary policy settings unchanged during their latest policy meetings. However, the Bank of England (BOE) raised its policy rate by 25 basis points on 19 May 2004 in order to contain the underlying inflationary pressures.

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.

- The outlook for 2004 inflation continued to track the 4-5 percent target for the year with a possibility of a further increase above the 4-5 percent target in 2005.

- Supply-side factors dominate the sources of risks to the inflation outlook, which could threaten the inflation target over the policy horizon. These risks include the rising oil prices, increase in transport fares and the planned adjustments in utilities charges. The expected inflationary pressures are transitory in nature and do not appear to represent a permanent shift in the long-run price path. These supply-side risk factors are outside the sphere of monetary policy and, thus, a monetary policy response may not be warranted. However, careful monitoring should be sustained of the possible second round effects of these supply pressures on the demand side.

- Meanwhile, the possible adjustments in wages could also exert demand-side pressures on future inflation. However, the overall likelihood of significant demand-driven pressure on consumer prices developing in the near term remained low given continued evidence of double-digit unemployment, spare manufacturing capacity and modest bank loan growth.

- The Advisory Committee presented estimates of the impact of the various cost-side risks to the average annual inflation in 2004 and 2005.

- The Monetary Board argued that there is need to exercise cautious gradualism in considering any possible adjustments in policy rates in the future. This is in line with the need to sustain price stability with the flexibility of accommodating economic growth.

- The Monetary Board recognized that, in the short run, inflation risks could still emanate from volatile movements in the nominal exchange rate. They noted that the risk of exchange market volatility is linked mainly to negative market sentiment concerning the medium-term prospects for fiscal consolidation as well as the expected narrowing of foreign interest differentials as a result of cyclical monetary tightening in the major economies, particularly the US.

- Overall, the members of the Monetary Board were of the view that the current policy settings remain 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 6 May 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 RRPs, RPs, 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 1 July 2004.