HIGHLIGHTS OF THE MEETING OF THE MONETARY BOARD ON MONETARY POLICY ISSUES HELD ON 23 OCTOBER 2002*

Background

The Monetary Board held its eleventh meeting on monetary policy issues on 23 October 2002. This followed the 22 October 2002 meeting of the Advisory Committee.[1] The Advisory Committee submitted, for the Monetary Board's consideration, a policy paper along with a comprehensive set of economic and financial indicators relevant for the deliberation on monetary policy. In particular, the policy paper prepared by the Advisory Committee contained the committee's assessment of the macroeconomic conditions and inflation outlook, which formed the basis for its recommendations on the appropriate monetary policy stance. During the meeting, the Monetary Board discussed the factors that could affect inflation and inflation expectations, including the forecasts of agricultural production, movements of the exchange rate, direction of world oil prices, possible adjustments in power and water rates, monetary conditions, demand and output indicators, fiscal developments, world economic conditions and outlook, and the implications of these factors on the BSP's monetary policy stance.

I. Considerations in the Formulation of the Monetary Policy Stance

Domestic Price Developments and Outlook

1. Despite pressures coming from the recent uptick in international oil prices, year-on-year headline inflation in September 2002 remained stable at 2.9 percent, the same rate posted a month earlier. Month-on-month headline inflation slowed

* The highlights of the discussions of the 23 October 2002 Monetary Board meeting were approved by the Monetary Board during its meeting held on 21 November 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 Managing Director, In-Charge of Research or the Director of the Department of Economic Research, and the Director of the Treasury Department.

down to 0.2 percent in September after a brief pick-up to 0.5 percent in August. The reduced electricity costs since June 2002 coupled with generally lower food prices muted the impact of higher prices for other consumer items such as gasoline products, clothing and related products, as well as housing and repairs. The nine-month average inflation of 3.3 percent was more than a full percentage point lower than the 2002 target.[2]

2. Despite continued signs of improvement, aggregate demand for the most part remained relatively soft. Exports rose by 14.8 percent in August but this represents a slowdown from the 23 percent expansion in the previous month. Spare capacity in manufacturing also remained sizeable at about a quarter of firms' total output capacity. Credit conditions have remained relatively weak despite some improvements in August. Energy sales by Meralco declined by 1.6 percent in August, after rising by 3.7 percent year-on-year in July. In addition, the unemployment rate rose to 11.2 percent in July 2002 from 10.1 percent in the same period a year ago. These developments signaled that demand-side price pressures on inflation would remain relatively tamed in the near term.

Domestic price conditions remain generally favorable despite the presence of cost-side pressures on inflation emanating from the recent increases in world oil prices. The current subdued inflation environment is expected to continue for the remainder of 2002 with the full-year average inflation rate falling below the government's target of 4.5-5.5 percent.

Developments in Agriculture

3. According to PAGASA, there is a 65 percent likelihood of a mild to moderate El Niño episode relative to the 1997-98 occurrence.[3] This would have an initial impact in the form of water shortages and droughts beginning in the fourth quarter of 2002 in Mindanao and other regions in the country, which would extend up to the first half of 2003.

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[2] The government's revised inflation target for 2002 is 4.5-5.5 percent.

[3] Climatology and Agrometeorology Branch PAGASA, "Update on El Niño Advisory", Press Release October 4, 2002 in www.dost.gov.ph/pagasa

4. The dry spell in some parts of the country combined with the delayed planting season during the second quarter would likely reduce agricultural production in the third quarter. Hence, total palay and corn production for the year were estimated to decline by 2.1 percent and 4.0 percent, respectively, from their year-ago levels. However, timely importation as well as gains in the production of other crops, livestock and poultry could cushion the impact of lower production in rice and corn production for the year. The entire agricultural sector was expected to grow by 2.7-3.6 percent in 2002 from the 3.9 percent in the previous year. [4]

5. In addition to the support under the Agriculture and Fisheries Modernization Act (AFMA), the government's rice import program could also help to mitigate the adverse impact of El Niño on food supply and rice prices. As of 11 October 2002, the total rice imports of the government reached 1.045 million MT, equivalent to 92 percent of the total contracted rice importation for the period January-October 2002.[5] Moreover, as of 11 October 2002, the national rice inventory[6] of 1.3 million metric tons (MT) was sufficient to last for 51 days, much higher than the 15 days security benchmark for rice self-sufficiency. [7]

The impact of a mild episode of the El Nino weather disturbance will be complemented by the implementation of the government's mitigating measures. This could help ensure adequate food supply at relatively stable prices in the near term.

Exchange rate developments

6. The peso fell for the fifth straight month to settle at an average of ₱52.83/US$1 for the period 1-18 October 2002, down by ₱0.67 from ₱52.16/US$1 in September.[8] On 18 October 2002, the peso breached the ₱53/US$1 level, registering a daily average of ₱53.19/US$1, the lowest since 8 August 2001. Increased corporate demand for dollars combined with market fears over the heightened US-Iraq tensions and renewed threats to domestic and

[4]Source: National Economic and Development Authority, as of September 2002
[5] NFA, *Grains Situation Report as of Second Week of October 2002,* (11 October 2002)
[6] Composed of NFA palay and rice stocks, and commercial and household inventories. Commercial stock is as of 1 October 2002 while household stock is as of 1 September 2002.
[7] Based on the daily consumption of 25,700 MT of rice (Source: NFA)
[8] Based on real time foreign exchange transactions in the Philippine Dealing System (PDS)

international security following the recent bombings in Mindanao and Bali, Indonesia and recently, in Metro Manila exerted pressures on the exchange rate. In addition, the rising fiscal deficit continued to weigh down on market sentiment. However, the seasonal inflows of overseas workers' remittances toward the year-end could help mitigate possible pressures on the peso. In terms of volatility, the peso remained broadly stable as its standard deviation eased slightly to ₱0.20 for the period 1-18 October compared to ₱0.28 in September 2002.

7. Recent estimates showed that a one peso depreciation of the exchange rate would translate into an increase in the average annual rate of inflation by about 0.11 percentage point over a 12-month period.[9] On the other hand, a moderate depreciation of the peso would also help improve the country's external competitiveness. On a trade-weighted basis and in real terms, the peso depreciated relative to the basket of currencies of major trading partners by about 2.6 percent in September 2002 from its' level in December 2001. Similarly, the peso tracked a depreciation trend vis-à-vis the currency baskets of competitor countries as reflected in the decline in the real effective exchange rate (REER) of the peso against the broad and narrow baskets of competitor currencies by about 3.4 percent and 9.5 percent, respectively. These developments indicated a small but sustained improvement in the country's external price competitiveness.[10]

Market concerns over the fiscal deficit and the threat of a US-led attack against Iraq continue to weigh down on the peso. Nevertheless, the exchange rate has been relatively less volatile compared to the previous month.

Oil price developments

8. Dubai crude oil prices in the international market increased further by US$0.31 per barrel or 1.1 percent to average US$27.11 per barrel for the period 1-14 October 2002 from US$26.80 per barrel in September 2002 following the US Congress' approval of a military offensive aimed at disarming Iraq, which was

[9] Based on the BSP-DER's multi-equation inflation forecasting model as of 30 September 2002

[10] The basket of the major trading partners is composed of the currencies of the US, Japan, Germany and the United Kingdom. The broad basket is composed of the currencies of Singapore, South Korea, Taiwan, Malaysia, Thailand, Indonesia and Hong Kong while the narrow basket is composed of the currencies of Indonesia, Malaysia and Thailand only.

alleged to be maintaining biological and chemical weapons of mass destruction. The October average price was the highest level observed since November 2001.

9. Following the uptrend in world oil prices, the local pump prices of petroleum products rose by an average of ₱0.50 per liter on 9 October from their posted levels on 6 September 2002, the last time that domestic oil prices were raised. The net increase thus far in domestic oil prices for 2002 was ₱2.10 per liter for gasoline, ₱1.90 per liter for diesel and ₱2.14 per liter for kerosene.[11] Similarly, local oil companies raised the prices of their LPG products thrice—between July and October this year—by a total of ₱1.70 per liter. Apart from geopolitical risks, the recent weakness in the peso also contributed to the increases in domestic pump prices of oil.

10. In the futures market, the price of the benchmark Brent crude oil showed a modest decline as November 2002 deliveries reached US$27.99 per barrel from the US$28.55 price per barrel quoted in the previous month.[12] The existing large excess capacity of OPEC— as a result of sharp production cuts over the past few years—provided assurance that OPEC has the ability to respond to any disruption in oil supplies should the tension in the Middle East escalate into a war. In particular, Saudi Arabia has indicated that it would increase its own oil output if Iraq supplies were disrupted and would push for an OPEC production quota increase should the price of oil exceed US$28 per barrel for 20 days.[13]

11. Based on BSP's estimates, a one-percent increase in domestic oil prices would raise average inflation by about 0.05 percentage point over a 12-month period.[14] With the series of increases in the pump prices of domestic petroleum products, transport operators could soon file their petitions before the Land Transportation Fare Regulatory Board (LTFRB) for an increase in the minimum transport fare by ₱1.00 for the first 5 kms. to ₱5.00.

[11] In 2001, pump price of petroleum products declined by ₱1.81 per liter for gasoline and ₱ 1.30 per liter for kerosene and diesel oil (Source: Department of Energy).

[12] Source: Asian Wall Street Journal, 16 September 2002, The futures price for Brent crude—a close substitute for Dubai crude—is used as indicator of future world oil prices since futures data on Dubai crude are not available.

[13] IDEAglobal, Gulf War II and Asia, (4 October 2002)

[14] This is based on the assumption of a one percent increase in the price of domestic petroleum products—arising from higher world oil price—from ₱14.05 per liter in September 2002 to ₱14.35 per liter for October 2002-Novermber 2003. The total impact on inflation, which includes the feedback on other commodities and services such as transport fares is estimated at about 0.16 percentage point increase in the average annual inflation.

The recent increases in world oil prices have prompted similar adjustments in local pump prices. Since oil is a major input of production, the prospects of higher local pump prices of oil products could trigger upward adjustments in the prices of other goods and services including transport fares and wages.

Developments in the Utilities Sector

12. The Department of Energy (DOE) has assured the public that the recent increases in oil prices would not have a significant impact on electricity rates since oil accounted for only a small percentage of the country's power generation mix. The DOE reported that a 10-percent increase in the price of bunker fuel per liter could only lead to a minimal one-centavo per kwh increase in the fuel cost adjustment component of National Power Corporation's (Napocor) electricity rates in the Luzon grid while a 50-percent increase in diesel fuel will translate only to a one-centavo per kwh increase.[15] However, the Manila Electric Company (Meralco) has already announced that it would raise its purchased power adjustment (PPA) charges for October by ₱0.14 per kwh to reflect the upward adjustments in the selling rates—due mainly to fuel cost adjustment—of Meralco's suppliers.[16]

13. Meanwhile, Meralco's proposal for the unbundling of its power rates could raise the cost of electricity consumption by an average of an average of ₱1.12 per kwh.[17] The ERC has yet to reach a decision on Meralco's proposed unbundling of power rates.

14. At the same time, there are plans to establish the Wholesale Electricity Spot Market (WESM) and introduce the Special Program to Enhance Electricity Demand (SPEED). Under the WESM scheme, electricity will be traded at the spot market, where power generators would compete against each other to supply power to distributors. The creation of the WESM is aimed at ensuring efficiency and transparency in power generation charges. Based on DOE's

[15] Department of Energy: "Increases in oil prices no effect on electricity rates", 26 September 2002, http://www.doe.gov.ph

[16] Meralco Customer News: "Changes in PPA a result of adjustments in the selling rates", http://www.meralco.com.ph

[17] Source: Meralco, Application to ERC for unbundling of rates, dated 26 December 2001, as mandated under Sec. 36 of RA 9136.

estimates, the operation of the proposed WESM could reduce further the cost of electricity by about ₱0.40 per kwh. The DOE would also introduce a "declining block" rate structure for large end-users of power under the SPEED program, which would offer discounts for incremental energy consumption over a specified base load.

15. Meanwhile, the proposed adjustments in water rates would likely take effect in 2003, leaving the current water rates steady for the rest of the year. It could be recalled that the Manila Water Company (MWC) and Maynilad Water Services Inc. (MWSI) have earlier filed a petition for upward adjustments in water rates with the regulatory agency, Manila Waterworks and Sewerage System (MWSS).[18] The MWSS has decided to put on hold its decision on the said petition pending a review of the revised estimates submitted by the two water concessionaires.

User charges for utilities are likely to remain relatively steady for the rest of 2002 as the petitions for the adjustments in power and water charges are still being reviewed by the appropriate regulatory agencies.

Interest rates and interest rate differentials

16. The differentials between RP and foreign interest rates were generally on an uptrend during first half of October 2002 as RP market interest rates edged up while foreign interest rates declined. As of 14 October 2002, the differentials between the RP 91-day T-bill rate (net of withholding tax) and the 90-day LIBOR and US 90-day T-bill rate widened further to 245.5 basis points and 266.0 basis points respectively, from the 235.8 basis points and 247.2 basis points registered in 16 September 2002.[19]

17. The differential between the BSP's policy interest rate (overnight borrowing or RRP rate) and the US federal funds target rate was unchanged at 525 basis

[18] MWC services Metro Manila's east zone which covers Mandaluyong City, Pasig City, Pateros, San Juan, Taguig, and portions of Makati City, Manila City, Marikina City and Quezon City as well as Angono, Antipolo, Baras, Binangonan, Cainta, Jala-Jala, Morong, Pililia, Tanay, Teresa, Rodriguez and San Mateo, all in Rizal. MWSI services Metro Manila's west zone which covers Valenzuela, Bulacan, Malabon, Navotas, parts of Quezon City and Makati City, Manila City, Pasay City, Las Piñas, Parañaque City, Muntinlupa City and areas in Cavite.

[19] Review period covered in the last policy paper on the "Review of the BSP's monetary policy stance," considered by the Monetary Board on 26 September 2002

points as the BSP policy rates and the US federal funds target rate remained steady at their 15 March 2002 and December 2001 levels, respectively.

18. However, adjusted for the risk premium—that is, the differential between the BSP policy interest rate and the US federal funds target rate less the risk premium—the differential in the RP-US policy rates narrowed further in October by an average of 28 basis points. The narrowing trend could be attributed to the increase in the risk premium for RP bonds.[20]

19. In the domestic market, the RP 91-day T-bill rate for the first half of October rose from 5.2 percent in September to 5.288 percent at the 14 October 2002 auction. The increase in yields reflected mainly market apprehensions over the widening budget deficit and threats against domestic and international security.

The RP-US interest rate differentials sustain its uptrend in October due, in part, to the easing trend of foreign interest rates. Meanwhile, the continued rise in the risk premium for RP bonds has led to a further narrowing of the risk-adjusted RP-US interest rate differentials.

20. The Philippines' real lending rate (based on the low-end of the range of banks' lending rates) for the period 10-16 October 2002, declined slightly to 5.26 percent from the 5.28 percent registered during the review period 4-11 September 2002[21]. The country's real lending rate was the fourth lowest in a sample of Asian countries after South Korea, Malaysia, and Japan, which had real lending rates of 4.27 percent, 4.39 percent and 2.61 percent, respectively. By contrast, the highest lending rates were 8.41 percent for Hong Kong and 8.18 percent for Taiwan, a result partly of zero to negative inflation rates.

The Philippines continues to have one of the lowest real lending rates in the Asian region.

21. Based on data on bid yields, the yield curve for government securities in the secondary market as of 14 October 2002 generally shifted upward—except for

[20] The risk premium was measured as the difference between the 10-year ROP note and the 10-year US Treasury note.
[21] Review period covered in the last policy paper on the "Review of the BSP's monetary policy stance," considered by the Monetary Board on 26 September 2002

the 5-year and 20-year maturities—relative to that which prevailed on 16 September 2002.[22]

Unresolved concerns over the widening budget deficit as well as in international and domestic security push up the yields of government securities in the secondary market.

Domestic stock market movements

22. The modest gain in the composite index in September proved to be unsustainable as the PHISIX tumbled to a fresh low in October. The average PHISIX for the period 1-18 October 2002 dropped to 1,075.47—the lowest so far for the year. Moreover, the daily PHISIX closed at 1,027.67 on 18 October 2002—the lowest since 20 November 2001. Worries over the US-led offensive against Iraq, the slow upturn in the world economy, the depreciation of the peso and the increasing fiscal gap combined to dampen market sentiment. Investor confidence was also hurt by domestic security concerns following the incidence of bombings at home and overseas.

23. The soft tone of the local equities market was also reflected in the thin volume and value of transactions. For the period 1-18 October 2002, the volume of transactions settled at 2.4 billion shares, 4.0 percent lower than 2.5 billion shares recorded for the comparable period in September while value turnover dropped by 72.7 percent to ₱4.1 billion from ₱15.0 billion during the same period. Meanwhile, total foreign transactions in the domestic stock market declined by 26.6 percent from ₱4.4 billion pesos in the previous month to ₱3.2 billion pesos in the review period. Foreign investors have also maintained their net selling position with foreign selling outpacing foreign buying by ₱454 million.[23]

Most market analysts believe that the stock market will remain in a consolidation phase over the near term, with the tone of the market dictated largely by external developments. In particular, the resolution of the crisis in the Middle East is likely to be a key factor in setting the direction of the market.

[22] Yield curve presented in the previous policy paper on the "Review of the BSP's monetary policy stance," considered by the Monetary Board on 26 September 2002

[23] Source: PSE (Figures as of 11 October 2002)

Monetary aggregates and bank lending

24. Domestic liquidity (M3) growth accelerated to 7.7 percent as of end-August from the 7.1 percent year-on-year increase registered as of end-July. However, the end-August growth was still considerably below the projected year-on-year growth of M3 of about 13 percent for end-2002.

25. Loans outstanding of commercial banks (KBs) reached ₱1.376 trillion as of end-August 2002, 2.0 percent lower compared to the ₱1.404 trillion recorded during the same period in the previous year. This, however, reflected an improvement from the 2.9 percent year-on-year contraction in the previous month.

26. The volume of banks' placements under the RRP window declined by ₱5.0 billion to reach ₱99.6 billion as of 11 October 2002 from the ₱104.7 billion as of end-September 2002. Similarly, placements under the SDA declined by ₱3.0 billion to reach ₱2.4 billion. Compared to the levels as of end-December 2001, RRP and SDA placements registered an increase of ₱71.4 billion and ₱2.4 billion, respectively, from ₱28.2 billion and zero worth of placements.

Despite some improvements, credit conditions remain generally soft. The tentativeness in bank lending could be attributed, in part, to the weak corporate credit demand. Meanwhile, the increase of holdings by banks of government securities could have led to the decline in bank placements under the RRP and SDA windows of the BSP.

Fiscal developments

27. At ₱144.0 billion the NG budget deficit as of August 2002 has exceeded the target for 2002 by about ₱14 billion. However, the ₱10.9 billion deficit for the month of August was significantly lower than the average monthly deficit of ₱20 billion during the first semester. Efforts of the government to prevent a further increase in the budget deficit level were undertaken through improvements in revenue collections and restraint in spending.

28. In the short term, a breach of the budget deficit target could still be manageable given the adequate prefunding efforts of the National Government (NG). However, a further increase in the fiscal underperformance over the medium term could pose risks to macroeconomic management. In particular, large fiscal deficits could lead to domestic borrowings and withdrawals from the deposits of the NG with BSP. These alternative measures to finance the budget deficit have implications on inflation and interest rates as well as on output. However, given the low interest rate environment and the benign inflation outlook, the BSP can accommodate a moderate overrun in the deficit.

A further widening of the fiscal deficit could pose limitations to the conduct of monetary policy. However, this can be mitigated in part by the current low interest rate environment amidst ample liquidity in the system.

Developments and outlook in the rest of the world

29. A number of leading economic indicators and survey data showed that global economic recovery was proceeding weaker than expected, particularly in the US. For example, US real GDP growth in the second quarter of 2002 was recorded at 1.3 percent, slower than the 5.0 percent expansion in the first quarter. Other indicators suggested that US private consumption growth has slowed down while private business investment has not shown a rebound. The University of Michigan's preliminary consumer sentiment index fell sharply to 80.4 in October from 86.1 percent in the previous month. At this level, the index has declined for the fifth consecutive month since June to its the lowest level in 9 years.[24] This reading correlated closely with the data on US spending. In particular, the overall retail sales declined by 1.2 percent in September due mainly to the 4.8 percent drop in auto sales despite financing incentives from automakers. The pressure on consumer spending can be traced largely to the steep falls in the equity prices associated with the disclosures on corporate accounting irregularities in recent months. In addition, rising fears of a US-led military offensive against Iraq continued to weigh on consumer and business confidence. The slowdown in consumption spending has raised concerns that the consumer-driven recovery of the US could be in jeopardy. Moreover, the Institute of Supply Management's (ISM) manufacturing index fell to 49.5 in September from holding steady at 50.5 in July and August. Meanwhile, the unemployment rate showed an improvement, easing slightly to 5.6 percent in September from 5.7 percent a month ago.

[24] Finley, Ross, "Consumer sentiment hits 9-year low," in Business-Reuters (11 October 2002)

30. The US Federal Reserve kept the federal funds target rate unchanged at 1.75 percent during its meeting on 24 September 2002, citing the considerable uncertainty about the extent and timing of the expected pickup in production and employment owing in part to the heightened geopolitical risks.

31. In the euro zone, the European Central Bank (ECB) kept the key ECB interest rates unchanged during its meeting on 10 October 2002 based on its overall assessment that the risks to price stability are balanced at the moment. The ECB noted that economic activity in the euro area remained subdued and that the uncertainty surrounding the economic outlook was still high.[25] A significant degree of uncertainty has built up over the past few months, owing mainly to the sharp decline in stock prices and their potential detrimental effects on the economy, as well as to geopolitical tensions as reflected in surging oil prices.

32. Following the two-day monetary policy meetings of the Bank of Japan (BOJ) held on 10 and 11 October 2002, the BOJ noted that "it will take a while for the economy of Japan to show clear signs of recovery, as the increase in exports and production was expected to slow for the time being."[26] Signs that the US rebound was faltering could dampen Japan's prospects for a sustained upturn in exports, thereby endangering its expectations for a gradual economic recovery. In addition, the domestic economy continued to be saddled by large corporate debt and the associated high NPLs of the banking system.

The pace of the US-led global economic recovery is proceeding slower than initially expected. With increased uncertainty over the strength of the global economy, the major central banks are expected to maintain a bias towards accommodation in order to support recovery and growth.

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[25] European Central Bank, ECB Conference Introductory Statement on monetary policy decision, (10 October 2002); available at http://www.ecb.int.

[26] Bank of Japan, *Monthly Report of Economic and Financial Developments*, October 2002; downloaded from http://www.boj.or.jp.

II. Discussion on the Review of the Monetary Policy Stance

33. In their assessment of the stance of monetary policy, the members of the Monetary Board expressed the view that while the near-term risks to the inflation outlook are well under control, possible upside pressures on inflation could set in over the policy horizon. At the same time, the pace of the global economic recovery has slowed down and domestic demand conditions remain soft. Against this backdrop, discussions by the members of the Monetary Board revolved around the following policy questions:

(a) Given the risks to the inflation outlook, would an increase in policy rates be warranted?
(b) Given the uncertainty in external conditions and relative softness in domestic demand conditions, should policy rates be reduced to provide the further stimulus to perk up the economy?
(c) Looking at both perspectives, should the policy stance remain cautious, one that continues to be accommodative while at the same time guarding firmly against the risks to the inflation outlook, and maintain the current monetary policy settings?

34. The members of the Monetary Board pointed out that monetary tightening through an increase in policy rates would serve as a pre-emptive action against inflationary risks stemming from possible demand-side pressures. However, the potential risks to inflation are associated largely with supply-side factors, which include the effects of the El Niño weather disturbance as well as the possible increase in oil prices, power rates and water charges. Moreover, given the still-weak domestic demand conditions, the members of the Monetary Board agreed that an increase in interest rates could dampen consumption and investments. Higher interest rates could stifle the recovery in bank lending and hurt the domestic stock market. The members of the Monetary Board thus expressed the view that an increase in policy rates could undermine efforts to steer the economy toward a sustainable recovery path.

35. The Monetary Board also noted that a further easing of the BSP's monetary policy stance at this time would infuse additional liquidity in the system, which already has ample liquidity. Given that monetary policy affects inflation with a lag, a more accommodative stance now could undermine the attainability of the inflation target in 2003. In particular, the Monetary Board discussed the following main risk factors to inflation and inflationary expectations that could arise from a reduction in policy rates as follows:

a. The present scope for monetary easing is already limited by the fact that policy rates have already been reduced to a significant extent over the past year (amounting to a cumulative 800 basis points for the period 4 December 2000-15 March 2002, 75 basis points of which was for this year alone).

b. Further monetary easing, either through a reduction in the BSP's policy rates or in liquidity reserve requirement would infuse more liquidity in the system, which could generate inflationary pressures. This could increase the risk of a sharp correction in interest rates later should inflationary pressures become evident.

c. A reduction in the BSP's policy rates would narrow down further the country's interest rate differentials with foreign interest rates, which could trigger renewed volatility in the foreign exchange market and undermine the stability of the peso. This could impact adversely on inflation and inflationary expectations.

36. The Monetary Board likewise expressed the view that indications of potential upside pressures to future inflation and inflationary expectations combined with the relatively soft domestic demand amidst the observed slowing down in global economic activity called for a cautious monetary policy stance, one that would remain appropriately supportive of the strengthening of domestic demand while guarding firmly against price pressures. The members of the Monetary Board thus argued that maintaining policy rates at their current levels accords with the view that withdrawal of the monetary stimulus to domestic demand could hurt the economy's growth prospects. They emphasized, however, that keeping the policy rates on hold does not represent inaction by monetary authorities to the downside risks to inflation.

III. Monetary Policy Decision

37. Based on the analysis of data that have become available since the last meeting of the Monetary Board on 26 September 2002 and a careful assessment of the balance of risks on inflation and inflationary expectations, the members of the Monetary Board by a unanimous vote decided as follows:

a. maintain the BSP's policy rates at the current levels of 7.0 percent for the overnight RRP (borrowing) rate and 9.25 percent for the overnight RP (lending) rate;

b. maintain the tiering scheme on banks' placements with the BSP under the RRP and SDA windows;

c. maintain the current interest rates on the term RRPs, RPs, and SDAs; and

d. maintain the reserve requirements at their current levels 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 21 November 2002.

- The Monetary Board of the Bangko Sentral ng Pilipinas