



**HIGHLIGHTS OF THE MEETING OF THE MONETARY BOARD ON
MONETARY POLICY ISSUES HELD ON 19 DECEMBER 2002***

Background

The Monetary Board held its thirteenth meeting on monetary policy issues on 19 December 2002. This followed the 17 December 2002 meeting of the Advisory Committee.¹ The Advisory Committee prepared, for the Monetary Board's consideration, a policy paper which outlined the committee's assessment of the macroeconomic conditions and inflation outlook as well as their recommendations on the appropriate stance of monetary policy. 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. Year-on-year inflation continued to be lower than expected in November 2002 at 2.5 percent compared to 2.7 percent a month earlier. The November inflation rate also marked the lowest rate on record since June 1987. The deceleration was traced to lower food inflation and fairly stable non-food prices. Month-on-month headline inflation showed a 0.1 percent rise compared to a 0.1 percent decline in October. The eleven-month average inflation of 3.2 percent was more than a full

* The highlights of the discussions of the 19 December 2002 Monetary Board meeting were approved by the Monetary Board during its meeting held on 16 January 2003.

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.



percentage point below the 2002 target and was considerably lower than the average of 6.3 percent for the same period in 2001.

2. There were indications of strengthening demand for goods and services based on the sustained growth in real GDP in the third quarter of 2002 at 3.8 percent year-on-year, up from the 3.0 percent growth recorded during the same period last year. The third-quarter expansion was underpinned by a 3.7 percent growth in personal consumption spending, which was stronger than last year's rise of 3.5 percent and driven mainly by spending on food, transportation and communication and miscellaneous services. However, other indicators pointed to areas of weakness in domestic demand. For instance, manufacturing activity remained sluggish. Data from the Monthly Integrated Survey of Selected Industries (MISSI) published by the National Statistics Office (NSO) showed that the Value of Production Index (VAPI) of the manufacturing industry rose by a minimal 0.7 percent (revised) in September 2002 while the Volume of Production Index (VOPI) fell by 3.9 percent (revised) on an annual basis during the same month. Capacity utilization in manufacturing also remained fairly low at 75.0 percent (revised) for September 2002.

The eleven-month inflation results suggest that the full-year average headline inflation for 2002 would be significantly lower than the low-end of the target range of inflation. However, for 2003, a number of downside risks could accompany the outlook for inflation, notably the fiscal performance and cost-side factors. Nevertheless, average inflation for 2003 is expected to be in line with the government's target of 4.5-5.5 percent.

Developments in Agriculture

3. Agriculture grew by 2.3 percent during the first nine months of 2002, reflecting a deceleration from the 3.1 percent year-on-year growth in the same period a year ago.² This resulted as crop production fell by 0.4 percent for January-September 2002 compared to the level a year ago due mainly to the decline in rice and corn production by 3.6 percent and 3.1 percent, respectively. Meanwhile, the government's import program helped mitigate the upward price pressure from the low palay production in the third quarter of 2002, as the

² Source: Bureau of Agricultural Statistics, Report on the Performance of Agriculture: January to September, 2002



National Food Authority (NFA) allowed 1.2 million metric tons (MT) of rice imports from 1 January-4 December 2002.³

4. Palay production could grow by 8.9 percent year-on-year to 5.4 million MT in the fourth quarter of 2002 with the expected favorable impact of the quick turnaround scheme (QTA) and adequate rainfall brought about by the southwest monsoons.⁴ This could make up for the crop losses in the third quarter, and lead to a full-year palay production growth of 1.2 percent to 13.1 million MT. However, corn production could decline by 4.9 percent year-on-year in the fourth quarter of 2002 to 4.3 million MT, as earlier floods affected the standing crops and delayed the planting especially in the corn-growing areas in the south. In the first quarter of 2003, palay production could decline by 1.9 percent year-on-year to 3.0 million MT as irrigated rice farmers have tempered their planting activities due to apprehensions over the effect of the El Niño phenomenon. However, corn production for the first quarter of 2003 could be expected to grow by 6 percent year-on-year to 1.2 million MT.

5. Moreover, the agricultural sector was expected to gain from other government programs aimed at boosting production and mitigating the impact of the El Niño phenomenon. For the first 11 months of 2002, the Quedan and Rural Credit Guarantee Corporation (Quedancor) extended a total of ₱1.2 billion worth of loans to projects involving grains, livestock and poultry, fisheries and various agribusiness production.⁵ In addition, the Department of Budget and Management released for the period January- October 2002, a total of ₱1.3 billion for irrigation projects and other El Niño mitigating programs of the DA.⁶

³ NFA, Grains Situation Report as of the First Week of December 2002, 5 December 2002

⁴ The quick turnaround scheme (QTA) is part of the *Ginintuang Masaganang Ani* (GMA) Rice Program of the DA which aims to compensate for possible loss in rice output brought about by drought, flooding caused by typhoons, and also to mitigate the impact of El Niño weather phenomenon. Under the scheme, irrigated rice areas which had been harvested in August or early September were immediately replanted with early maturing rice varieties and certified seeds within two to three weeks to make up for the delays in planting during the second quarter. Farmer participants to the program may also avail of fertilizer on credit under the Quedancor. The program expects to produce an additional 339,598 metric tons of rice for 2002. (Source: Department of Agriculture)

⁵ "DA credit firm loan releases to hit ₱2 billion this year." 24 November 2002 at <http://www.da.gov.ph>

⁶ "Montemayor lauds DBM's release of ₱1.25 billion for El Niño preparation." 16 October 2002 at <http://www.da.gov.ph>



In the near term, food prices are expected to remain in check due to the prospect of a good harvest in the fourth quarter of 2002, helped by timely government interventions.

Exchange rate developments

6. The peso weakened slightly against the US dollar as of 19 December 2002, averaging at ₱53.54/US\$1 for the period 1-19 December 2002 compared to ₱53.33/US\$1 average in November.⁷ The domestic currency continued to be weighed down by market concerns over the government's fiscal position. In addition, the weakness of the Japanese yen exerted pressure on the peso. The seasonal foreign exchange remittances from overseas Filipino workers to their families for holiday spending, however, helped cap the depreciation of the peso against the US dollar. Thus, the peso showed relative stability during first two weeks of December, with the standard deviation at only ₱0.15 for the period 1-19 December compared to ₱0.32 registered in November 2002.

7. On a real, trade-weighted basis, the peso depreciated relative to the currencies of the major trading partners by about 5.0 percent in November 2002 from its level in December 2001, as shown in the real effective exchange rate (REER) index.⁸ The peso showed a similar depreciation trend over the same period vis-à-vis two sets of currencies of the Philippines' competitor countries. The REER for the broad and narrow baskets of competitor currencies fell by about 5.0 percent and 12.7 percent, respectively. These developments indicated the continued modest improvement in the country's external price competitiveness.

The peso was mildly weaker against the dollar in December. However, the peso remains less volatile compared to the previous month due mainly to the seasonal rise in inflow of remittances from OFWs.

⁷ Based on real-time foreign exchange transactions in the Philippine Dealing System (PDS)

⁸ The basket of the major trading partners is composed of the currencies of the US, Japan, Germany and the United Kingdom. The broad basket of competitor countries 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.



Oil price developments

8. The price of Dubai crude in the international market averaged US\$24.47 per barrel for the period 2-13 December 2002, about 5.0 percent higher than the US\$23.31 per barrel posted in November 2002. World oil prices trended upward in December following the decision of the Organization of Petroleum Exporting Countries (OPEC) to cut production quotas of members by 1 January 2003 in a move to maintain the US\$22-28 per barrel price band mechanism.⁹ In addition, the renewed threat of a US-led assault on Iraq, the general strike in Venezuela that stalled oil exports and the seasonal increase in demand for heating oil during the winter season in the Northern hemisphere have combined to push up oil prices in the world market. In the futures market, the price of the benchmark Brent crude oil tracked the rise in the spot market as January 2003 deliveries settled at US\$25.46 per barrel from US\$23.49 per barrel quoted in the previous month.¹⁰

9. Meanwhile, local oil companies reduced the pump prices of petroleum products particularly gasoline, kerosene and diesel oil by an average of 40 centavos on 9 December 2002. Despite the recent cuts, the price per liter of gasoline and other petroleum products as of 9 December 2002 were higher relative to end-December 2001 levels. The net increase in domestic oil prices in 2002 thus far, stood at ₱1.48, ₱1.75 and ₱1.84 per liter for diesel, gasoline, and kerosene, respectively.¹¹

The direction of oil prices in the near term would be dictated by potential supply shock scenarios surrounding the Middle East tensions and the Venezuela crisis interacting with the bearish demand outlook due to the tepid pace of economic recovery of the US and other major economies.

⁹ Press Release, Oil Exporting Countries, 12 December 2002 at <http://www.opec.org>

¹⁰ Source: Asian Wall Street Journal, 11 November 2002. The futures price for Brent crude oil—a substitute for Dubai crude—is used as an indicator of future world oil prices since futures data on Dubai crude are not available.

¹¹ In 2001, pump price of petroleum products declined by ₱1.32 per liter for diesel, ₱1.85 per liter for gasoline and ₱1.29 per liter for kerosene (Source: Department of Energy).



Developments in the Utilities Sector

10. In its decision issued on 15 November 2002, the Supreme Court affirmed the Energy Regulatory Board (ERB) findings and urged the Manila Electric Company (Meralco) to reduce its rates as well as to reimburse its customers the “overcharges”. It could be recalled that in January 1994, the ERB granted Meralco the provisional authority to raise its rates by ₱0.184 per kwh. However, in 1998, the ERB ruled that Meralco should have raised its rates by only ₱0.017 per kwh and ordered Meralco to refund the excess ₱0.167 per kwh it had collected since February 1994. The case was brought before the Court of Appeals, which set aside the ERB ruling. The impact of the Supreme Court’s decision to reverse the Court of Appeals ruling on Meralco’s electricity charges is still uncertain at the moment as Meralco has filed a motion for reconsideration of the said case.¹²

11. On the other hand, the Energy Regulatory Commission (ERC) has yet to reach a decision on Meralco’s proposed power rate unbundling. According to Meralco—in its submission to the ERC on 26 December 2001—its proposed new rates as contained in its petition for the unbundling of power rates could raise the cost of electric power consumption by an average of ₱1.12 per kwh.¹³ This represents an average increase of 19.6 percent from the November 2001 average tariff of ₱5.73 per kwh.¹⁴ The impact of the unbundling of the power rates would also need to be weighed against those of the Special Program to Enhance Electricity Demand (SPEED) and the planned establishment of the Wholesale Electricity Spot Market (WESM).¹⁵

¹² “Decision on G.R. No. 141314, Republic of the Philippines represented by Energy Regulatory Board vs. Manila Electric Company”, 15 November 2002, at <http://www.supremecourt.gov.ph> and “Meralco customers billed at rates approved by law”, undated, at <http://www.meralco.com.ph>

¹³ Meralco, Application to ERC for unbundling of rates, dated 26 December 2001, as mandated under Sec. 36 of RA 9136

¹⁴ Ibid.

¹⁵ The WESM is a spot market for the trading of electricity in which power generation companies (gencos) submit their offers to sell electricity to distribution utilities at their desired price. Distribution utilities, in turn, submit their demand requirements to a market operator who is assigned to match the supply and demand for power. The Electric Power Industry Reform Act of 2001 (R.A. 9136) requires the Department of Energy (DOE) to establish the WESM in coordination with electric power industry participants to ensure greater supply and rational pricing of electricity. Meanwhile, the SPEED is a price incentive scheme for large end-users of electricity whereby discounts are provided to industrial and commercial customers for incremental use of energy above a specified base load. The program is aimed at enhancing demand for electricity and ensuring that excess power capacity is fully utilized.



12. The Metropolitan Waterworks and Sewerage System (MWSS) has already approved an initial ₱4.25 per cubic meter increase in the water tariff of Manila Water Co. (MWC) beginning January 2003. This will bring the average weighted all-in water tariff of MWC to ₱14.22 per cubic meter of water from its current rate of ₱9.97 per cubic meter. The MWSS' initial estimates for MWC's rate adjustment was ₱7.03 per cubic meter. To soften the impact of the rate increase on consumers, the MWSS and MWC have agreed to implement the tariff adjustment on a staggered basis. The initial ₱4.25 per cubic meter water rate increase will take effect in January 2003 while the remaining ₱2.78 per cubic meter could be implemented in 2005. Meanwhile, the other water concessionaire in Metro Manila—Maynilad Water Services Inc. (MWSI)—also has a pending petition with MWSS for a tariff adjustment. MWSI was earlier reported to have expressed its interest to terminate its concession agreement with the government. The process of arbitration between the MWSS and MWSI has yet to be organized.

Water rates in the east zone of Metro Manila have been raised effective 1 January 2003 following the MWSS approval of a tariff hike for MWC. Meanwhile, the direction of power rates will depend on the Supreme Court's final ruling on Meralco's case and the ERC's decision on the utility firm's unbundling petition.

Interest rates and interest rate differentials

13. As of 9 December 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 declined to 271.1 basis points and 292.6 basis points, respectively, from the 286.1 basis points and 304.1 basis points registered in 11 November 2002.¹⁶

14. The differential between the BSP's policy interest rate (overnight borrowing or RRP rate) and the US federal funds target rate was unchanged at 575 basis points as the BSP policy rates and the US federal funds target rate remained steady at their 15 March 2002 and 6 November 2002 levels, respectively.

15. 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

¹⁶ Review period covered in the last policy paper on the "Review of the BSP's monetary policy stance," considered by the Monetary Board on 21 November 2002



BSP policy interest rate and the US federal funds target rate narrowed significantly in December, as the risk premium jumped to 510 basis points on 9 December from 474 basis points in end-November. The sharp rise in the premium was due mainly to fiscal deficit concerns as well as the sell-off of bonds to book profits for the year as financial institutions closed their books.¹⁷

16. The yield on the 91-day short-term government securities declined during the Bureau of Treasury's (BTr) 9 December 2002 auction—the last for the year—but the yields on the 182-day and 364-day Treasury bills rose on concerns that the government will exceed the budget deficit estimate for 2002.

The steady decline in the RP 91-day T-bill rates resulted into a narrowing of the RP-US interest rate differential in December. Likewise, the risk-adjusted RP-US interest rate differential declined in December due mainly to the uptick in the risk premium for RP bonds on fiscal worries and year-end profit-taking of investors.

17. During the period 28 November-3 December 2002, the Philippines' real lending rate (based on the low-end of the range of banks' lending rates) increased slightly to 5.6 percent from the 5.5 percent registered during the review period 4-6 November 2002¹⁸ due primarily to the decline in the inflation rate for November. However, the Philippines continued to have one of the lowest real lending rates in the Asian region. In particular, the Philippines' real lending rate together with Singapore's rank as the fifth lowest at 5.6 percent in a sample of Asian countries after Japan, South Korea, Malaysia, and Thailand, which had real lending rates of 2.5 percent, 3.9 percent, 4.4 percent, and 5.1 percent, respectively. By contrast, the highest real lending rates were 8.6 percent for Hong Kong and 7.9 percent for Taiwan, a result partly of negative inflation rates.

The Philippine real lending rate increases marginally but remains lower than the real lending rates of other Asian countries surveyed.

18. Based on data on bid yields, the yield curve for government securities in the secondary market as of 5 December 2002 remained generally unchanged

¹⁷ Bloomberg News, "Philippine dollar bonds fall to 20-week low on deficit concerns," 9 December 2002

¹⁸ Review period covered in the last policy paper on the "Review of the BSP's monetary policy stance," considered by the Monetary Board on 21 November 2002



relative to that which prevailed on 11 November 2002 as banks competed for government papers, given their excess liquidity position.¹⁹

Banks continued demand for government securities resulting from ample liquidity in the system helped keep the yield curve broadly stable.

Domestic stock market movements

19. Lack of enticing market news pushed the average PHISIX for the period 2-9 December 2002 to 1037.6 index points, down by 24.7 index points from the 1062.3 index points average PHISIX posted for the comparable period in November. Uncertainties brought about by the government's widening budget gap, the absence of positive corporate news as well as the domestic and international peace and order concerns continued to cast a shadow in the market.

20. The volume of transactions in the local bourse for the period 2-6 December 2002 rose by 1.1 billion shares to reach 1.6 billion shares from 489 million shares for the comparable period a month ago. On the other hand, value turnover declined by almost ₱300 million to ₱1.5 billion from ₱1.8 billion in the previous month as share prices declined. Foreign investors have remained reluctant to invest in the domestic stock market as indicated by the decline in total foreign transactions during the period 2-6 December 2002 by 10.4 percent compared to the level in previous month. Moreover, foreign selling exceeded foreign buying by ₱199.1 million.²⁰

Cautious trading in the local bourse is expected to persist in the near term as the market waits for fresh leads.

Domestic Liquidity and Credit Conditions

21. Domestic liquidity (M3) sustained its acceleration since July of this year as it grew by 9.7 percent (revised) year-on-year to reach ₱1.598 trillion in October 2002. The sustained rise in the net foreign assets (NFA) of the monetary system as well as the continued growth in credits to the National Government contributed to the rise in M3.

¹⁹ Yield curve presented in the previous policy paper on the "Review of the BSP's monetary policy stance," considered by the Monetary Board on 21 November 2002

²⁰ Source: Philippine Stock Exchange



22. The total volume of loans outstanding of commercial banks rose steadily by 1.1 percent in October from 1.2 percent year-on-year rise in the previous month. The sustained rise in bank credits to firms in the agricultural, community, social and personal services, and the financial institutions, real estate and business services (FIREBS) sectors—which together accounted for 46.9 percent of total KB loans—contributed to the continued, although modest, growth in bank lending activities in October.

23. The volume of banks' placements under the RRP window increased by ₱3.2 billion to ₱85.3 billion as of 4 December 2002 from the ₱82.1 billion in end-November 2002. Meanwhile, placements under the SDA facility declined by ₱24 million to reach ₱343 million. Compared to the levels as of end-December 2001, RRP and SDA placements registered an increase of ₱57.1 billion and ₱343 million, respectively, from ₱28.2 billion and zero worth of placements.

Bank lending posts second consecutive month of growth as money demand strengthens. This could signal the start of the recovery in bank lending. Meanwhile, banks continue to channel excess funds into the BSP's RRP window.

Fiscal developments

24. The deficit of the National Government (NG) for the first eleven months of 2002 was recorded at ₱200.6 billion, considerably higher than the full-year target deficit of ₱130.0 billion (3.3 percent of GDP). This was the result of the shortfall in revenue collections and higher-than-programmed expenditures.

25. The NG announced that the indicative budget deficit for 2002 was raised to 5.6 percent of GDP (₱223 billion) from the original 3.3 percent of GDP (₱130 billion).²¹ From a strictly monetary policy perspective, this level of deficit appeared manageable as market interest rates were expected to remain relatively low. The impact of the deficit on market interest rates could be muted by the ample liquidity in the system. However, a large overshoot for 2002 means that the NG will enter 2003 with fewer funds to deal with its financing requirements. The resulting tightness in government finances could thus force fiscal authorities

²¹ The ₱223 billion indicative budget deficit target was estimated using the low-end of the nominal GDP consistent with the real GDP growth of 4-4.5 percent for 2002.



to either withdraw from the NG's deposits with the BSP or increase their borrowing next year. The withdrawal of NG deposits with the BSP could imply an infusion of additional liquidity into an already-liquid financial system, which could lead to demand-related inflationary pressures. On the other hand, increased NG borrowing could push up not only interest rates on domestic government debt but also the private cost of capital as the government competes with the private sector for available funds. These factors thus imply a cost-side risk to the inflation outlook.

Continued widening of the NG's budget deficit could impact adversely on the conduct of monetary policy. However, its impact could be mitigated, in part, by the ample liquidity in the system and the current low interest rate environment.

Developments and outlook in the rest of the world

26. Despite an upturn in the third quarter real GDP growth to 4.0 percent (revised) relative to the 1.3 percent year-on-year growth in the previous quarter, the US economy continued to show signs of weakness, highlighted by high unemployment as well as the slow pace of growth in manufacturing and business investment. These prevailing signs of weakness in the US economy combined with the lack of price pressures were the major factors behind the Fed's decision to maintain its neutral monetary policy stance, keeping the federal funds target rate at a 41-year low of 1.25 percent on 10 December 2002. Some analysts, however, contend that the Fed could reconsider a shift to an easing bias if weak economic conditions continued to persist.²²

27. In the euro area, the weakness in the 12 member-countries—particularly Germany—persisted as inflation remained above the 2 percent target even as there are signs that price pressures have started to dissipate. These factors underpinned the recent decision of ECB to cut its policy rates following the meeting of its Governing Council on 5 December 2002. The benchmark interest rate on the ECB's refinancing operations was reduced by 50 basis

²² Employment Situation, November 2002, US Economic Data at http://www.bocm.com/bocmrs/Research_Fixed/usdata/employment/employment.htm



points to 2.75 percent effective 11 December 2002.²³

28. The Bank of Japan (BOJ) noted that an appreciable recovery of the Japan's economy is unlikely in the near term due to, among others, greater uncertainty regarding economic conditions overseas. Given these considerations, the BOJ, in its Monetary Policy Meeting held on 18-19 November 2002, decided to keep its policy stance aimed at maintaining the outstanding balance of current accounts²⁴ at around 15 to 20 trillion yen.²⁵

The weakness in the external environment amidst renewed uncertainty over the pace and timing of recovery suggests that global interest rates are likely to remain low so as to provide support to the economic recovery process.

II. Discussion on the Review of the Monetary Policy Stance

29. The Monetary Board's assessment of the conditions influencing future price developments pointed to a generally subdued inflation environment in 2003. The members noted that average inflation in 2003 will broadly track the 4.5-5.5 percent government target for the year. The Monetary Board also pointed out that the subdued economic activity—highlighted by the slowdown in manufacturing in the third quarter as well as continued spare capacity in manufacturing and relatively modest growth in bank lending—could help ease potential supply-side pressures on inflation. Moreover, they added that the possible supply-side or cost-push strains on prices were largely temporary in nature. They also noted that the risks to the inflation outlook were associated with the possible adverse impact on agricultural output of the El Niño weather disturbance, the lingering geopolitical tensions with potential consequences for future oil prices as well as the widening fiscal gap and its possible implications for the financial markets.

²³ The ECB also reduced the interest rate on the marginal lending facility by 50 basis points to 3.75 percent and the deposit facility rate by 50 basis points to 1.75 percent effective 6 December 2002. (Source: ECB Press Release at <http://www.ecb.int>)

²⁴ Current accounts are reserves set aside by private financial institutions to meet withdrawals from customer deposits, among others. The BOJ's current accounts serve as an indicator of the amount of funds circulating in the financial markets.

²⁵ Monetary Policy Meetings, 19 November 2002 at http://www.boj.or.jp/en/seisaku/02/seisak_f.htm



30. The Monetary Board is also of the view that continued uncertainty in the strength of the world economic recovery, areas of weakness in domestic demand and concerns about the sustainability of the fiscal position could weigh down the economy's growth prospects. They agreed that the weakness in the US economy as evidenced by lower imports from Asia, including the Philippines, could constrain prospects for growth in exports with adverse implications for the manufacturing sector. Moreover, the Monetary Board observed that the overall pattern of domestic demand remained mixed and uneven as the economy's growth path has yet to gather momentum. Meanwhile, the Monetary Board also noted that the growth in bank lending that persisted for the past two months suggested that the impact of past monetary easing actions has begun to filter into the economy, providing evidence that monetary policy acts with a lag.

31. In the course of the Monetary Board's discussion on the appropriate stance of monetary policy, the following issues were raised:

- a. Given the uncertainty over the recovery of the world economy and the softness in domestic demand conditions, should policy rates be reduced to propel the economy towards sustained economic recovery?
- b. With the potential risks to the inflation outlook, would an increase in policy rates be warranted?
- c. Should current monetary policy settings be maintained to allow previous policy rate reductions to work their way further through the system while guarding firmly against sources of potential pressures to the inflation outlook?

32. The Monetary Board identified the following arguments in favor of a policy rate reduction:

- Recent inflation readings continued to be relatively benign, thereby strengthening expectations of a manageable inflation environment over the policy horizon despite possible upside risks to consumer prices. Moreover, the expected price pressures over the policy horizon are largely supply-side and, therefore, transient in nature.



- Given a tame inflation outlook, the tentative overall pattern of domestic demand conditions suggests some room for continued domestic monetary stimulus.
- Continued uncertainty about the pace and timing of the global economic upturn also argues for further interest rate stimulus.
- A policy rate reduction is not expected to lead to significant exchange market volatility, since the interest rate differential will simply revert to levels before the US policy move on 6 November 2002 and would remain positive in favor of the peso.
- A policy rate cut could also serve to brighten confidence as this could send a strong signal to the financial markets.

33. On the other hand, the Monetary Board pointed out the considerations for raising policy rates as follows:

- An increase in policy rates could serve as a pre-emptive action against the risks to the inflation outlook, arising mainly from demand-side pressures.
- While there are looming inflationary pressures—coming from the impact of the El Niño weather phenomenon on food prices and the increase in utility charges—these are likely to be short-lived because these are supply-side factors. Thus, these would not warrant an increase in the BSP's policy rates.
- Given that the strength of the domestic economic recovery remains tentative, an increase in interest rates could dampen incentives for increased consumption and investment.

34. Finally, the Monetary Board discussed the following as arguments in favor of keeping policy rates steady:

- The significant extent of monetary easing since December 2000—through a reduction in policy rates by 800 basis points—and the resulting ample liquidity in the financial system should give the economy ample room to expand without the need for further monetary stimulus.



- The traditional transmission channels of monetary policy impulses may be weak under present conditions and that further easing could have little impact on real sector activity.
- The best approach to the problem of weak credit demand may simply be to allow sufficient time for the past monetary easing to work its way fully through the real sector. The steady growth in bank lending in September and October could be indicative of the start of a recovery in bank lending.
- In addition, the NG fiscal performance posed a significant concern for the inflation outlook.
- Maintaining the BSP policy rates at their current levels would lead to a wider interest rate differential that could allow authorities more room to maneuver in case of any possible pressures on the foreign exchange market that may arise in the near term.

III. Monetary Policy Decision

35. Based on the analysis of indicators that have become available since the review of the BSP's monetary policy stance by the Monetary Board on 21 November 2002 and a careful assessment of the balance of risks on inflation and inflationary expectations, the Monetary Board believed that the current monetary policy stance continued to be appropriately supportive of the economy's growth objective while ensuring price stability. In particular, the Monetary Board decided to approve the following measures:

- 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 RRP, RP, and SDA; and



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- 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 16 January 2003.

- The Monetary Board of the Bangko Sentral ng Pilipinas