



**HIGHLIGHTS OF THE MEETING OF THE MONETARY BOARD ON
MONETARY POLICY ISSUES HELD ON 29 JULY 2004***

The Advisory Committee¹ 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 RRP, RP, 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 June rose to 5.1 percent (1994=100) year-on-year from 4.5 percent in the previous month. The acceleration in June inflation was driven mainly by price pressures on fish and meat, as well as fuel, rentals, and services, including educational services. The average inflation for the first half of the year at 4.1 percent remained within the Government's announced target of 4.0-5.0 percent for 2004.
- ✍ Based on the new CPI series released by the National Statistics Office (NSO) using 2000 as the reference or base year, inflation increased to 5.4 percent in June from 4.7 percent in the previous month, bringing the average inflation for the first semester to 4.3 percent.
- ✍ Likewise, core inflation (defined as headline inflation excluding selected food and energy products) edged up to 5.4 percent in June from 4.7 percent in the previous month (1994=100). Similarly, the 2000-based core inflation rose to 5.5 percent in June from the revised estimate of 4.9 percent in May.

* The highlights of the discussions of the 29 July 2004 Monetary Board meeting were approved by the Monetary Board during its meeting held on 2 September 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 29 July 2004 meeting of the Monetary Board—the 8th monetary policy meeting for 2004—followed the Advisory Committee meeting held on 26 July 2004.



- ✍ Forecasts generated by the BSP inflation forecasting models indicated that the baseline average headline inflation is likely to settle at the upper end of the 4-5 percent target for 2004 with the possibility of temporarily exceeding the target in 2005, as the full impact of the supply-side risks are felt. However, in the absence of any adverse supply-side shocks, inflation is expected to decelerate to about 4-5 percent in 2006.
- ✍ Selected indicators of demand showed improvements in economic activities but remained generally mixed.
- ✍ Average capacity utilization in manufacturing remained stable at 78.8 percent in April 2004 as in March, slightly higher than the 77.0 percent registered for the same month a year ago.
- ✍ The value of production index (VAPI) for manufacturing rose by 4.9 percent (revised) in April 2004, reversing the 5.0 percent contraction in the previous month. However, the volume of production index (VOPI) for manufacturing dipped by 1.5 percent (revised) year-on-year in April 2004 following a 10.3 percent contraction in March.
- ✍ Exports growth accelerated to 15.3 percent in May from 8.9 percent in April 2004. This brought the January-May 2004 exports annual growth to 8.6 percent.
- ✍ Total merchandise imports declined by 1.6 percent year-on-year in May 2004 following an 8.3 percent growth in April. This brought the year-to-date imports annual growth to 5.1 percent.
- ✍ Passenger car sales continued to post double-digit year-on-year growth rates for nine straight months at 44.2 percent based on the June 2004 report of the Chamber of Automotive Manufacturers of the Philippines (CAMPI).
- ✍ Energy sales by the Manila Electric Company (Meralco) sustained its increase for the fourth consecutive month at 3.8 percent year-on-year in May. This was, however, slower than the 5.2 percent annual increase in energy sales in April but was higher than the 2.7 percent growth in May 2003.
- ✍ Based on the April 2004 Labor Force Survey conducted by the NSO, unemployment rate rose to 13.7 percent, representing an increase in the number of unemployed persons to 4.99 million in April 2004 from 4.22 million persons in April 2003.



- ✍ Supply-side factors continued to represent the major source of risks to the inflation outlook over the policy horizon, particularly the risks associated with volatile movements in energy prices and the corresponding adjustments in local pump prices of oil, transport fares and utility charges. There were also some observed increases in the prices of selected food commodities, but these are expected to taper off given forecasts of favorable agricultural production.
- ✍ Continued implementation of Government agriculture programs along with forecasts of normal weather conditions suggest favorable prospects for agriculture in 2004. The observed supply shocks have been limited to a few commodities, particularly, corn, meat and fish products. Such pressures should be addressed by appropriate government policies other than monetary policy. Overall food supply conditions remain supportive of price stability.
- ✍ The international price of Dubai crude oil increased further in July, driven by strong demand for oil by rapidly growing economies and concerns over the possibility of supply disruptions due to prolonged tensions in the Middle East. In the domestic market, pump prices of gasoline and other fuel products remained at their June 2004 levels with the exception of LPG, which was reduced slightly on account of the drop in the international contract price of LPG. However, the recent uptrend in world oil prices could translate to potential further adjustments in local pump prices in the near term.
- ✍ In the utilities sector, the Manila Electric Company (Meralco) began implementing the Energy Regulatory Commission (ERC)-approved 13.27-centavo per kwh increase in generation charge beginning with its July 2004 billing. Likewise, the National Power Corporation (NPC) started implementing the new ERC-approved rates beginning with its 26 May to 25 June 2004 billing cycle.
- ✍ In the financial sector, growth in money and credit demand continued to be modest. Meanwhile, nominal RP interest rates declined in July relative to the previous month.
- ✍ Domestic liquidity (M3) expanded by 6.1 percent year-on-year in May, slightly lower than the 6.5 percent posted in the previous month.
- ✍ Growth in the loans outstanding of commercial banks (KBs) improved to 1.7 percent year-on-year to reach ₱1.5 trillion as of end-May 2004, following the 0.9 percent annual growth registered as of end-April.
- ✍ The bellwether 91-day T-bill rate declined during the 19 July auction of the Bureau of the Treasury (BTr) relative to that registered in June



due to ample liquidity in the system arising from the proceeds of maturing T-bills.

- ✍ The peso recovered slightly against the dollar in July, supported mainly by inflows from export earnings and OFW remittances.
- ✍ In the fiscal sector, cumulative NG budget deficit as of June 2004 reached ₱80.1 billion, slightly above the ₱79.6 billion target for the first semester. This was lower than the market's consensus forecast of ₱85 billion deficit due to prudent fiscal spending and improved tax collections in June.
- ✍ Prospects for growth in the world's major economies have strengthened in recent months, although the pace and scope of growth in US have slightly moderated. The sustained growth of the UK economy has been driven forward by the expansion in household spending and business investments. Similarly, steady improvements in exports and industrial production in Japan as well as the gradual pick up of consumer demand in the euro area provided encouraging signs for further recovery in these economies.
- ✍ The US economy has moderated slightly compared to last year based on data on real GDP, manufacturing activity and retail sales. Nevertheless, US consumer confidence remained strong as many consumers expect economic growth to continue at a healthy pace.
- ✍ The recovery in the euro area has remained strong due to robust export performance and gradual improvements in private consumption.
- ✍ The UK economy continued to exhibit resilient growth, buoyed by strong household consumption and government expenditures alongside the pick up in business investments.
- ✍ Japan's economic recovery gained further momentum, driven by robust export performance as well as sustained improvements in industrial production and corporate profits.
- ✍ The US Federal Reserve raised its policy rate by 25 basis points following its 29-30 June 2004 meeting. Meanwhile, monetary authorities in Japan, euro area, and UK remained cautious and kept their monetary policy settings unchanged.



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 inflation is likely to trend upward over the policy horizon. Inflation is expected to lie close to the upper end of the 4-5 percent target for 2004 and could possibly rise above the target in 2005. However, it is expected to slow down to around 4-5 percent in 2006.
- ✍ The Monetary Board pointed out that prevailing conditions for output and inflation continued to argue for maintaining present monetary settings. The BSP's forecasts extending to 2006 showed a hump-shaped inflation path, reinforcing the argument that the inflation uptrend does not represent a permanent shift in the inflation path that would otherwise require monetary tightening. Moreover, the Monetary Board added that the overall conditions for aggregate demand, credit activity and investments continued to argue against monetary tightening.
- ✍ The members of the Monetary Board also recognized the need for the BSP to issue an Open Letter to the President should actual inflation in 2005 exceed the target. This is part of the operational procedures under the inflation targeting framework, and in line with the transparency practices of inflation targeting countries. The said Open Letter would explain in detail the reasons behind the deviation from the target and what course of action was taken by authorities in response to the breach.
- ✍ The Open Letter will also discuss the deviation in the context of the predefined set of circumstances of acceptable reasons for non-fulfillment of inflation target. These factors include the following: (a) movements in prices of agricultural products; (b) natural calamities; (c) movements in international oil prices; and (d) changes in government administrative measures.
- ✍ The members of Monetary Board likewise agreed that issuing a public explanation is preferable to revising the inflation target, as the former option upholds the credibility of the BSP, and is in line with international best practice in monetary policy.
- ✍ Given the expected rise in inflation, the Monetary Board pointed out that the BSP should continue to identify clearly the sources of pressures, both on current and future inflation in its press statements or press releases as well as in its public information campaign. This will help make clear to the public the limited role of monetary policy in helping contain inflation when it is driven mainly by supply-side factors. At the same time, the Monetary Board argued that the BSP shall continue to ensure that the level of liquidity in the system and the monetary policy settings are



appropriate and mindful of the need to exercise caution given the emerging price pressures.

- ✍ The Monetary Board also emphasized the importance non-monetary measures in addressing the inflation build up due to supply shocks. These include government policies and programs to ensure the timely importation of specific agricultural commodities such as corn and feedstuffs as well as continued monitoring of prices of basic commodities. Such measures can be carried out by concerned government agencies such as the Department of Agriculture and Department of Trade and Industry.
- ✍ Moreover, the members of Monetary Board likewise underscored the need for continued public information campaigns in order to explain carefully the ongoing inflationary process and the BSP's responsibility in line with the inflation targeting framework. The Monetary Board pointed out the need to clearly explain to the public in simple and layman's terms both the demand and supply dynamics of the inflation process.
- ✍ The members of the Monetary Board stressed the need to continue monitoring the evolving economic and financial developments and to assess their impact on the long-run price path, with particular focus on possible second-round effects of supply-side or cost-push factors on inflation, which may require action on the part of monetary policies in order to contain the build up in price pressures.
- ✍ At the same time, members of the Monetary Board pointed out the need to strengthen the banking system. The Monetary Board argued that despite adequate liquidity in the system, banks continued to be constrained to lend actively in an effort to preserve asset quality or to avoid a further deterioration in capital base. There is a need, therefore, to address the still high levels of banks' non-performing loans (NPLs) which constrains banks' lending ability. Efforts to strengthen further the balance sheets of the banking system would improve their capability to provide more funds to the business and industry sector.

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 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 RRP, 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 26 August 2004.