HIGHLIGHTS OF THE MEETING OF THE MONETARY BOARD ON MONETARY POLICY ISSUES HELD ON 26 AUGUST 2004*

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

1) Maintain the current monetary policy settings as follows:

   (a) Maintain the BSP's policy rates at the current levels of 6.75 percent for the overnight reverse repurchase (RRP) rate and 9.0 percent for the overnight repurchase (RP) rate;

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

   (c) Maintain the current reserve requirement ratios.

2) Enhance the communication of the monetary policy stance through the following measures:

   (a) Continue to discuss and explain to the public the expected breach of the inflation target in 2005 through press releases and other means, with specific emphasis on the driving role of supply-side factors in the inflation forecast and the notion that such factors cannot be appropriately addressed by monetary action.

   (b) In the event that the target is not met, issue an Open Letter to the President clearly outlining the role of supply-related factors in the deviation from the inflation target and making reference to the BSP's "explanation clause" under the inflation targeting framework.

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

---

* The highlights of the discussions of the 26 August 2004 Monetary Board meeting were approved by the Monetary Board during its meeting held on 30 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 26 August 2004 meeting of the Monetary Board—the 9th monetary policy meeting for 2004—followed the Advisory Committee meeting held on 23 August 2004.

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

The above recommendations were based on the following considerations:

- Headline inflation (1994=100) rose to 6.0 percent year-on-year in July from 5.1 percent in the previous month. The acceleration in July inflation was driven mainly by price pressures on food and energy-related CPI components, as well as items classified under services, including transportation and communications. The average inflation for the period January to July 2004 was 4.3 percent, still within the Government's announced target of 4-5 percent for 2004.

- The 2000-based headline inflation also edged higher in July. It increased to 6.6 percent from 5.4 percent in June to bring the average inflation for the first seven months of the year to 4.6 percent.

- Likewise, both the 1994 and 2000 based core inflation (defined as headline inflation excluding selected food and energy products) tracked a similar uptrend in July. The 1994-based headline inflation inched up to 6.0 percent in July from 5.4 percent the previous month while the 2000-based core inflation rose to 6.2 percent in July from the revised estimate of 5.3 percent in June.

- Forecasts generated by the BSP inflation forecasting models indicated that inflation could possibly exceed the upper end of the 4-5 percent inflation target for 2004 and 2005 as the full impact of the supply-side risks is felt. However, in the absence of any further adverse supply-side shocks, average inflation is expected to revert to the 4-5 percent target in 2006.

- Selected indicators of demand showed improvements in economic activities with a mild reduction in excess capacity in manufacturing.

    - Average capacity utilization in manufacturing rose to 79.4 percent in May 2004 from 78.8 percent in April, also higher than the 78.5 percent registered for the same month a year ago.

    - The value of production index (VAPI) for manufacturing rose by 3.1 percent in May 2004 following a 4.9 percent annual growth in the previous month. However, the volume of production index (VOPI) for manufacturing continued to dip by 1.6 percent year-on-year in May 2004 following a 1.5 percent contraction in April.

- Exports growth moderated to 8.2 percent in June 2004 from 15.3 percent in May. This brought the first semester annual export growth to 8.5 percent.

- Total merchandise imports increased by 18 percent year-on-year in June 2004, a reversal from the 1.7 percent contraction in the previous month for a cumulative imports annual growth for the period January to June period of 7.2 percent.

- Passenger car sales posted an 8.2 percent year-on-year growth in July, slower than the double-digit growth of 44.3 percent in the previous month, based on the report of the Chamber of Automotive Manufacturers of the Philippines (CAMPI). Meanwhile, the combined truck and bus sales continued to decline by 55.7 percent year-on-year in July following a 25.7 percent dip in the previous month.

- Energy sales by the Manila Electric Company (Meralco) sustained its increase for the fifth consecutive month at 6.8 percent year-on-year in July 2004. This was higher than the 3.8 percent annual increase in energy sales in May and the 0.5 percent rise in June 2003.

- Based on the April 2004 Labor Force Survey conducted by the NSO, the unemployment rate rose to 13.7 percent from 12.2 percent a year earlier. In a related development, wage adjustments in the form of increase in cost of living allowance (COLA) have been granted to nine regions including Metro Manila as of 16 August 2004.

- Supply-side factors continue to represent the major source of risks to the inflation outlook, particularly the risks associated with volatile movements in world oil prices and the corresponding adjustments in domestic pump prices of oil, transport fares, and utility charges. In addition, some domestic supply constraints led to the uptick in selected food prices. Nonetheless, the favorable outlook for agricultural production, along with the timely implementation of Government policies should help stabilize food prices and provide some cushion against inflationary pressures.

  - The agriculture sector posted strong growth in the first semester of 2004 boosted by the expansion in crops and fisheries production. However, the recurrence of the avian flu outbreak in other Asian countries could raise demand for country's poultry products and exert pressures on prices of local poultry products. Nevertheless, continued Government programs as well as forecasts of normal weather conditions remain supportive of the favorable prospects for agriculture in 2004. This should help ensure the broad stability of agricultural products, moving forward.

- The international price of Dubai crude oil rose in August, driven by both legitimate demand and supply concerns as well as short-term uncertainties relating to production capacity given the developments in major oil producing countries.

- Analysis of available data from the late 1980s to the present showed that, in real terms, both the current world and local prices were still below their peak levels in 1991. Moreover, past data also showed that previous experiences with oil price hikes did not necessarily lead to a contraction in output. The available data also revealed that domestic oil price inflation influence overall inflation with a lag but more recent evidence also showed that this correlation has somewhat weakened.

- In the financial sector, the demand for money and credit remained modest. Meanwhile, nominal RP interest rates declined during the 16 August 2004 auction relative to the previous month, but rose relative to the previous auction.

  - Domestic liquidity (M3) expanded by 5.7 percent year-on-year in June, slightly lower than the 6.1 percent posted in the previous month.

  - Growth in loans outstanding of commercial banks (KBs) improved to 3.8 percent year-on-year to reach ₱1.5 trillion as of end-June 2004, following the 1.7 percent annual growth registered as of end-May.

  - Yields for the 91-day T-bill rate declined during the 16 August 2004 auction of the Bureau of the Treasury (BTr) relative to those registered during the 16 July auction. Compared to the previous auction on 2 August 2004, however, T-bill yields were higher, reflecting market's expectation that the uptrend in global oil prices could push inflation higher.

- The peso strengthened further in August owing to the continued appreciation of other regional currencies against the US dollar, as well as the sustained inflows of OFW remittances.

- In the fiscal sector, preliminary data showed that the cumulative NG budget deficit as of July 2004 reached ₱99.4 billion, about ₱844 million higher than the ₱98.6 billion target for the first seven months of 2004.

- Recent developments in the world economy indicated continued broadening of the recovery process in the world's major economies. On the price front, while stronger inflationary pressures persist over the short term, the outlook remains in line with price stability over the medium term.

- The growth of the US economy moderated in the second quarter of 2004 due to higher oil prices, tepid employment growth and weak consumer spending. However, analysts expect the US economy to resume a stronger pace of expansion going forward.

- Recovery in the euro area has remained strong due to robust export performance and gradual improvements in business investments.

- The UK economy continued to exhibit resilient growth, supported by gains in the production industries and the continued rise in retail spending.

- Japan's economic recovery eased owing to the modest pick up of private consumption and business investment in the second quarter.

- The US Federal Reserve (Fed) and the Bank of England (BOE) raised their respective policy rates by 25 basis points following their 10 August 2004 and 5 August 2004 policy meetings, respectively. Meanwhile, the Bank of Japan (BOJ) and the European Central Bank (ECB) remained cautious and kept their monetary policy settings unchanged during their latest policy meetings held on 9-10 August 2004 and 5 August 2004, respectively.

II. Review of the Monetary Policy Stance

- During the Monetary Board's deliberation on the appropriate stance of monetary policy, the members of the Monetary Board noted that inflation is likely to marginally exceed the upper end of the 4-5 percent target and could continue to rise above the target in 2005. However, the overall path remains hump-shaped as average inflation is also expected to taper off to around 4-5 percent in 2006, in the absence of continued adverse supply-side shocks. The Monetary Board's assessment of the inflation outlook was based on the latest information and inflation forecasts provided by the Advisory Committee.

- The members of the Monetary Board were of the view that the prevailing conditions for inflation as well as output growth continued to argue for maintaining present monetary settings. The outlook for inflation continued to be driven largely by supply-side pressures, mainly the rise in oil prices. They believed that said price pressures are transitory in nature with no permanent long-run impact on the overall inflation path. The transient nature of the supply shocks as well as the overall conditions for aggregate demand and credit activity argue against monetary tightening at this time.

- The members of the Monetary Board also recognized the need for the BSP to continue to discuss and explain to the public the reasons behind the possible breach of the inflation target in order to promote transparency and enhance the credibility of monetary policy. They noted that communications with the public concerning the monetary stance should highlight the role of supply-side factors.

- Moreover, the members of the Monetary Board noted the need for the BSP to issue an Open Letter to the public addressed to the President, in case the inflation target is breached. This forms part of the operational procedures under the BSP's inflation targeting framework and is consistent with the transparency practices of inflation targeting countries. The members of the Monetary Board agreed that the Open Letter would include reference to "explanatory notes" in order to make clear to the public that the deviations in the inflation target are due to supply-side factors, which are beyond the sphere of influence of monetary policy. The letter should also explain in clear terms why the target was exceeded, and the policy actions, if any, taken by the monetary authorities.

- The Monetary Board noted that the Open Letter should explain carefully to the public the specific factors that caused the deviation of actual inflation from the target. The members of the Monetary Board agreed to refer to this predefined set of circumstances under which actual inflation may deviate from target inflation as the BSP's explanatory note. These factors include price pressures arising from: (a) volatility in the prices of agricultural products; (b) natural calamities or event that affect a major part of the economy; (c) volatility in the prices of oil products; and (d) changes in government administrative or policy measures that directly affect prices.

- The Monetary Board also emphasized the importance of non-monetary measures in addressing the inflation buildup due to supply shocks. Among other things, they identified the timely importation of specific agricultural commodities such as corn and feedstuffs as well as continued monitoring of prices of basic commodities as measures that could help ensure adequate supply and ease supply related price pressures.

- In addition, the members of the Monetary Board stressed further the need to continue monitoring the evolving economic and financial developments and to assess their impact on the long-run price path. The Monetary Board also pointed out the need to monitor and measure possible second-round effects of supply shocks on inflation which could lead to inflation persistence, which may require measured action on the part of monetary authorities, in order to arrest a further build up in inflationary pressures and prevent inflation persistence.

- In conclusion, the members of the Monetary Board were all in agreement that current monetary policy settings remain appropriate. They believed that monetary tightening may be unwarranted at present given that the supply-side pressures driving the current uptrend in inflation remain dominant but are expected to be transitory. The members of the Monetary Board agreed to draft a letter addressed to the President to inform Her Excellency of the dynamics behind the upward trend in headline inflation and to reassure the President and the general public of the BSP's firm commitment to delivering stable prices.

III. Monetary Policy Decision

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

  1) Maintain the current monetary policy settings as follows:

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

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

     (c) Maintain the current reserve requirement ratios.

  2) Enhance transparency of the monetary policy stance through the following measures:

     (a) Continue to discuss and explain to the public the dynamics of the inflation process and the expected breach of the inflation target through press releases, press briefings and other means, with specific emphasis on the driving role of other supply-side factors in the inflation forecast and the notion that such factors cannot be appropriately addressed through monetary action.

     (b) The BSP Officer-in-Charge to write a letter to the President of the Philippines informing her of inflation developments, the reasons behind the inflation uptrend and measures undertaken by the BSP and other Government agencies to mitigate the impact on consumer prices.

3) Continue to articulate its support for the use of non-monetary measures to address supply-side risks, particularly those relating to food supply, by strengthening representation and coordination with various government agencies.

The next meeting of the Monetary Board to discuss the monetary policy setting is scheduled on 23 September 2004.