HIGHLIGHTS OF THE MEETING OF THE MONETARY BOARD ON MONETARY POLICY ISSUES HELD ON 11 APRIL 2002*

Background

The Monetary Board held its fourth meeting for the year on monetary policy issues on 11 April 2002. This followed the meeting of the Advisory Committee on 9 April 2002 where the members discussed their assessment of the inflation outlook and macroeconomic conditions, which formed the basis for their recommendations on the appropriate monetary policy stance.[1] The Advisory Committee submitted, for the consideration of the Monetary Board, a policy paper and various information relevant for the deliberation on monetary policy. In particular, the Monetary Board discussed factors affecting inflation and inflation expectations, particularly the uptrend in global and local oil prices, possible power rate adjustments and the impact of the El Niño weather phenomenon on food supply in the latter part of 2003, monetary conditions, external developments and the global economic outlook, demand and output indicators and the implications of these factors on monetary policy.

I. Considerations in the Formulation of the Monetary Policy Stance

Current inflation and the inflation outlook

1. Inflation in March 2002 was recorded at 3.6 percent year-on-year. This was a slight increase from the level in the previous month, but well within the BSP's and the range of market expectations for the period. The uptick in March inflation was attributed to adjustments in electricity rates, higher costs for housing and repairs, and a seasonal increase in food prices due to the Lenten

* The highlights of the discussions of the 11 April 2002 Monetary Board meeting were approved by the Monetary Board during its meeting held on 16 May 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 Director of the Department of Economic Research, and the Director of the Treasury Department

season. The first quarter average inflation rate of 3.6 percent was well below the government's target of 5-6 percent for the year.

2. The various measures of core inflation have been on a downtrend since August 2001. The sustained slowdown in headline and core inflation affirms further the broad outlook of a low inflation environment for the rest of 2002, given that past and current inflation influence expectations of price movements going forward. Generally good food supply conditions are expected to exert a favorable influence on consumer prices in 2002. In addition, continued spare capacity in manufacturing (at 74.4 percent average capacity utilization in January 2002 from 76.5 percent (revised) in December 2001), relatively high unemployment (10.2 percent in January 2002 from 9.8 percent in the previous month) along with still soft domestic demand indicate broadly stable price movements in the near term.

3. Inflation readings—based on the most recent macroeconomic assumptions on economic growth, monetary aggregates, Treasury bill rates, the Government's fiscal position, the exchange rate, domestic oil prices and prices of non-oil imports and the expected yearly increase in wages—paint a benign inflation picture in 2002 and 2003, in line with the targets.

Latest forecast readings of the BSP paint a generally benign inflation picture despite some uptick beginning in the latter part of 2002.

Impact of the El Niño weather disturbance on future inflation

4. Based on the assessment of the Department of Agriculture (DA), the El Niño weather disturbance in 2002 is likely to manifest itself in a weak form in the second half of the year. However, this warming phenomenon is expected to have a muted impact on agricultural production, since it is expected to come during the rainy season. At the same time, the DA has implemented various measures to mitigate the impact of dry weather conditions, particularly through the construction and upgrading of irrigation systems as well as the rehabilitation of shallow tube wells in order to provide adequate water facilities to farmlands across the country. For the period January-June 2002, the DA has forecasted palay and corn production at 5.72 million metric tons and 2.05 million metric tons, respectively, up by 2.7 percent and 4.7 percent from the previous year's level.[2] These reflected gains from expansion in hectarage and productivity. Moreover, rice inventory rose by 5.5 percent to 2.3 million metric tons as of 1 January 2002.[3]

Forecasts of favorable food supply conditions for the rest of 2002 by the DA along with measures to mitigate the impact of the El Niño cyclical warming condition have reinforced expectations of favorable food prices for the whole year. However, the full impact of the El Niño weather disturbance in 2003 could weigh heavily on food production, leading to lower food supply unless adequate water provisions and water-saving measures are instituted promptly. Moreover, timely importation of grains, in particular of rice, will be important in meeting any domestic shortfall and mitigating upward price pressures.

Exchange rate developments

5. The peso continued to strengthen, supported by strong inflows of foreign portfolio investments and dollar remittances of overseas Filipino workers (OFWs). For the period 1-9 April 2002, the peso-dollar rate averaged at ₱51.09/US$1 from ₱51.41/US$1 in December 2001. At the same time, the exchange rate has been stable—with its standard deviation estimated at about 6 centavos during the period 1-9 April 2002, a sustained improvement from 11 centavos in the previous month, 18 centavos in January 2002 and 31 centavos in December 2001.

The sustained strength and stability of the peso is expected to have a positive influence on future inflation.

Oil price developments

6. As of 3 April 2002, the spot international price of crude oil (Dubai)—reached US$25.59 per barrel, up sharply by 43.5 percent from the US$17.83 per barrel average in December 2001.[4] Reflecting the uptrend in world oil prices, the three major oil companies—Caltex Philippines, Shell Petroleum Corporation and Petron Corporation—raised pump prices twice after the 11 September events:

[2] Department of Agriculture (DA), Rice and Corn Situation and Outlook, January 2002
[3] Source: Bureau of Agricultural Statistics (BAS)
[4] Source: Department of Energy

by 35 centavos per liter for gasoline and 30 centavos per liter for diesel and kerosene on 21 March 2002 and by an average of 50 centavos across domestic petroleum products on 6 April 2002.[5] These price hikes brought the increase in domestic oil prices to an average of about 82.5 centavos since the beginning of the year.

7. In the futures market, benchmark Brent crude oil for May 2002 deliveries were traded at a high of US$27.35 per barrel.[6] The recent spike in world oil prices was driven by fears over the impact of Iraq's oil embargo due to the escalating Israel-Palestinian conflict in the Middle East. The uptrend in world oil prices was also attributed to the decision of OPEC and non-OPEC countries to sustain production cuts to support oil prices. OPEC member-countries reduced their production by 1.5 million barrels per day while non-OPEC countries such as Russia, Mexico and Norway have cut oil production by some 500,000 barrels so far this year. Apart from the supply-side pressures, signs of a faster-than-expected US rebound also influenced the uptrend in world oil prices on expectations of increased demand for oil.

8. A simulation of the inflation impact of a possible sustained increase in Dubai crude oil from US$24.00 per barrel for the period January-March 2002 to an average of US$24.00-US$27.50 per barrel for the whole year would translate directly to an increase in the average inflation for 2002 of about 0.2-0.4 percentage points.[7] Based on the assumption that oil prices for the rest of the year would increase—to an average of US$27.50 per barrel—the indirect impact on inflation was estimated to be about twice that of the direct impact, for a total impact of 1.22 percentage points.[8]

The pass-through impact of higher oil prices is expected to translate into a generalized increase in the price level since oil is a major input in the production and delivery of a broad range of goods and services.

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[5] Source: Department of Energy

[6] IMF, Global Markets Monitor, 4 April 2002

[7] The assumptions on world oil prices were based on two scenarios: (1) oil prices would track the Brent futures prices (as of 5 April 2002) for May-December 2002 to reach an average of US$24.00 per barrel in 2002; and (2) oil prices would reach US$30.00 per barrel for the period April-December 2002 to settle at an average of US$27.50 per barrel for the whole year.

[8] Based on the simulation results using input-output (I-O) analysis and the structural inflation-forecasting model for estimating the total impact and direct impact of an oil price increase on inflation, respectively.

Petitions for upward adjustment in power rates

9. In a revised petition for the "unbundling" of power rates submitted to the Energy Regulatory Commission (ERC) on 2 April 2002, the Manila Electric Company (Meralco) proposed graduated power rate adjustments. The revised petition provided for moderate increases for residential customers consuming not over 300 kilowatt-hours (kwh) per month of electricity, which comprised about 70 percent of total residential customers. In particular, those consuming less than 50 kwh per month or the so-called "lifeline consumers" will not be affected by the planned increase. However, power costs of households consuming electricity over 300 kwh per month are expected to increase by an average of 13.0-13.7 percent depending on power usage bracket. Based on the revised petition of Meralco, the proposed rates will likely raise the cost of electric power consumption by an average of ₱0.65 per kwh or about 10 percent across all residential users.[9] Based on the input-output (I-O) analysis, a 10 percent increase in power rates would raise average inflation by about 0.48 percentage points. While light accounts for only 2.73 percent of the CPI basket, the pass-through impact of an increase in power cost could have a cascading impact on prices of other commodity groups.

The flow-on effects of possible power rate adjustments could lead to a cascading impact on the prices of other commodities.

Interest rates and interest rate differentials

10. As of 1 April 2002, the differential between the RP 91-day T-bill rate (net of RP withholding tax) and the 90-day LIBOR narrowed further to 2.11 percent while the differential between the RP 91-day (net of RP withholding tax) and the US 90-day T-bills fell to 2.37 percentage points. These differentials were the lowest since 26 March 2001 when the differentials reached 2.32 percent and 2.54 percent, respectively. The narrowing interest rate differentials between the Philippines and the US can be traced mainly to the steep decline in the benchmark RP 91-day T-bill rate, accompanied by the steady rise in the 90-day US LIBOR and US 90-day T-bill rates as markets priced expectations of future increases in US interest rates. Compared to the historical levels, the current interest rate

[9] Meralco, Press Release entitled, Meralco Submits New Alternative on Rate Unbundling," 2 April 2002

differentials with the US are lower than the 3.82-4.23 percent average recorded for the period 1995-2001.

11. The differential between the BSP's policy interest rate (overnight borrowing or RRP rate) and the US federal funds target rate declined further to 525 basis points following the 25 basis-point cut in the BSP's RRP rate effective 15 March 2002. This differential was lower than the average differential in 2001 of about 5.9 percentage points; however, it was higher than the differential that prevailed for the most part in 2000, which averaged at about 4.7 percentage points. Meanwhile, 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 BSP policy interest rate and the US federal funds target rate has been on an uptrend, as the risk premium for the Philippines continued to fall sharply in March 2002. As of 22 March 2002, the risk premium was estimated at 359 basis points, reflecting a 58 basis points decline from that recorded on 7 January 2002 level of 417 basis points.

With the sustained decline in the market interest rates, the country's interest rate differentials with the US have narrowed further. The continued drop in interest rate differentials could limit the scope for a further cut in the BSP's policy rates as this could threaten the relative stability in the foreign exchange market in case of a dramatic shift in market sentiment.

12. For the period 1-3 April 2002, the spread of the Philippine lending rate over the benchmark T-bill rate stood at about 356 basis points. This differential was slightly higher than the average of 344 basis points for a sample of countries. The highest spread observed was that for Taiwan at 526 basis points, while the lowest was that for Indonesia at 60 basis points. In general, the spread between the Philippine lending rate and the average benchmark 91-day T-bill rate continued to trend downward. Since the BSP started to ease policy rates in December 2000, the 91-day T-bill rate has dropped by 10.63 percentage points for the period November 2000-1 April 2002 while the low-end of the range of bank lending rates has declined by about 9.25 percentage points during the same period.

13. In general, the real lending rate—measured as the difference between the low-end of the range of banks' lending rates and the inflation rate—of most Asian countries declined due to the faster rate of decline in banks' lending rate relative to inflation across the region. In particular, the Philippines' real lending rate dropped further to 5.09 percent during the period 1-3 April 2002 from 6.05 percent in March 2002. Relative to other Asian countries, the Philippines' real lending rate at 5.09 percent was lower compared to most countries surveyed (Hong Kong, India, Singapore, Taiwan and Thailand and Malaysia).

Banks' lending rates in the Philippines continue to be on a downtrend, reflecting, in part, the impact of the BSP's past monetary easing.

14. The yield curve for government securities in the secondary market as of 1 April 2002 was steeper at the longer end of the curve (5-10 years) compared to that at the beginning of 2002.

The slope of the yield curve indicates higher inflationary expectations over the medium-term. Meanwhile, the sharper downward shift at the shorter end of the curve reflected the impact of monetary policy on short-term instruments.

Domestic stock market movements

15. The domestic stock market underwent a period of consolidation during the period 1-26 March 2002 as most investors opted to stay in the sidelines ahead of the Lenten season. The consolidation was expected considering the substantial appreciation that has been realized since the middle of November 2001. The PHISIX averaged 1,405.72 index points in March, up slightly by 7.25 index points from the average of 1,398 index points recorded in February 2002. The upturn in share prices in the domestic stock market was limited as investors took advantage of the opportunity to collect gains after significant increases in share prices in the last three months and as they wait for more positive fresh news on the performance of the corporate sector and the Philippine economy. However, analysts generally view the domestic stock market's overall positive tone as sustainable over the long term.

16. Foreign participation in the stock market strengthened as its share to total transactions increased slightly to 43 percent in March 2002 from 42 percent in January and February 2002. Net foreign buying rose by more than twice to about ₱862.0 million in March 2002 from ₱370.3 million in the previous month. The steady stream of portfolio investments during the month could be attributed to the steep decline in market interest rates, which prompted the shift from low-yielding fixed income instruments to local shares of stocks. With money market yields at historic lows, market analysts are of the view that stocks could outperform other types of investments.

While monetary policy is focused mainly on controlling inflation in the market for goods and services, the BSP looks at the movements of asset prices as leading indicators of underlying movements in the economy. Asset prices also contain useful incremental information about macroeconomic fundamentals. Despite consolidation in the domestic stock market in March 2002, the long-term outlook continues to be positive given active foreign participation and the steady stream of portfolio investments.

Monetary aggregates and bank lending

17. Domestic liquidity (M3) grew by a stronger 7.2 percent as of end-February 2002 from the level a year ago, reflecting an upturn from the 5.3 percent year-on-year slowdown in the previous month. Banks, however, continue to be circumspect in their lending activities as the volume of outstanding loans of commercial banks dropped by 3.2 percent in January 2002 from the level a year ago. The January 2002 contraction in bank lending marked the sixth month of successive decline in bank lending since August 2001 due to constraints posed by persistently high non-performing loans (NPLs) and the presence of spare capacity in manufacturing, which has dampened demand for new loans.

18. Meanwhile, based on data from the BSP and the National Government (NG), banks continued to place their excess funds in government securities and in the BSP's RRP and SDA facilities. As of 18 March 2002, banks' placements in the RRP window rose to ₱66.5 billion from ₱28.2 billion while placements under the SDA window amounted to ₱42.0 billion from zero as of end-December 2001. Using seasonally adjusted data, the levels of RRPs and SDAs rose by 10.5 percent and 72.8 percent, month-on-month, respectively compared to the 5.9 percent growth and 77.0 percent contraction recorded a year ago. Thus, both the seasonally adjusted and non-seasonally adjusted data on RRPs and SDAs of 18 March 2002 showed reflows of banks' excess liquidity into the BSP. It may be noted, however, that the consolidated tiering scheme had, to a certain extent, capped the volume of banks' placements with the BSP.

Despite successive monetary policy easing in the past, banks remain circumspect in lending, due in part to still relatively large NPLs and the slow pick up in corporate demand. Meanwhile, a large part of banks' excess liquidity continues to be placed in government securities and the BSP's RRP and SDA windows.

External developments and outlook

19. The US Fed shifted to a neutral monetary stance as it kept the target federal funds rate at 1.75 percent during its meeting on 19 March 2002.[10] The US Federal Open Market Committee noted that the US economy is already expanding at a significant pace, driven in part by increases in inventory investments and improving industrial production as well as continued resilience in consumer spending. US GDP data show positive growth in the fourth quarter of 2001, a sharp recovery from the contraction seen in the previous quarter. Unemployment fell to 5.5 percent in February 2002 from 5.8 percent in December, and payroll employment showed an increase in February following successive declines in the previous six months. Declining business inventory levels and evidence of expansion in US manufacturing have also improved the outlook for US consumption and external trade. These developments have given rise to expectations of an increase in the US federal funds target rate by 25-50 basis points at the Fed's next policy meeting on 7 May 2002.[11] Moreover, the Chicago Board of Trade survey on the federal funds futures contract indicates that target US federal funds target rate could increase by a cumulative 165 basis points by December 2002 from the current level.[12]

20. Strengthening economic conditions in other major countries—boosted by the upturn in employment and confidence—particularly in the Euro zone and in the UK have heightened expectations that their central banks are also poised to increase interest rates in the near term. The Reserve Bank of New Zealand and the Swedish National Bank have in fact raised their policy interest rates following the neutral monetary policy stance of the US Fed during its meeting on 19 March 2002. Market analysts believe that these developments reflect more an end to the overly accommodative monetary policy stance, particularly by the US—

[10] The US Fed was on an accommodative monetary policy stance for the period 3 January 2001 to 11 December 2001. The US Fed maintained its weakness bias until 30 January 2002 and moved to a neutral bias on 19 March 2002. (Source: www.Bloomberg.com)
[11] IMF, Global Markets Monitor, 22 March 2002
[12] Quoted from the Bloomberg News, 28 March 2002

which was a response to the abnormally weak global conditions exacerbated by the 11 September attacks—rather than genuine fears of rising inflation. News of the US rebound has raised expectations of an end to the monetary easing mode in Europe and Asia as well.

Steady signs of a US-led global economic turnaround have set the stage for possible end to the accommodative monetary policy stance and eventual increase in the US federal funds target rate to contain the possible build-up in inflationary pressures coming from stronger demand.

II. Discussion on the Review of the Monetary Policy Stance

21. The members of the Monetary Board agreed that favorable food supply conditions and continued broad stability in the exchange rate combined with still relatively weak domestic demand and the presence of spare capacity pointed to generally subdued inflation in 2002. However, uncertainty over the impact of El Niño weather phenomenon on agricultural crop production in 2003, the uptrend in oil prices, and the expected adjustment in power rates posed downside risks to the inflation outlook. The Board noted that these developments underscored the need to carefully monitor and assess underlying inflationary pressures as well as supported a case for greater caution in monetary policy settings, going forward.

22. Some members of the Monetary Board noted the latest advisory of the Department of Agriculture (DA), citing that the El Niño weather phenomenon is expected to occur during the last quarter of the year when the planting season has already been finished. In addition, the DA has also encouraged farmers to plant ahead to mitigate the possible adverse impact of the dry spell on food crops. This advisory of the DA reinforced its earlier expectations that the impact of the warming phenomenon on agricultural output would likely be minimal, indicating relative stability in food prices in the near term.

23. Given the concerns over inflationary risks posed by the upswing in world oil prices and possible power rate adjustments, a likely increase in election-related spending and indications that demand pressures would pick up as the global economic recovery strengthens, some Monetary Board members emphasized the need to monitor and assess more carefully the evolving environment, with particular focus on the impact of the current Middle East conflict on the oil market.[13]

24. The members of the Monetary Board shared the view that the monetary authorities should also monitor closely the movements in interest rate differentials. While the current interest rate margins remain comfortable and broadly supportive of the peso, such margins could be pared down in the course of the year as the cycle of monetary easing comes to an end in the world's major economies, notably the US. In turn, a further narrowing of interest rate differentials could trigger renewed volatility in the foreign exchange market as investors shift from peso-denominated assets to foreign-currency denominated assets. The possibility of excessive volatility in the exchange rate could feed into inflationary expectations and thus increase the overall price level. This also argued for greater caution in pursuing further monetary easing.

25. Moreover, the members of the Monetary Board agreed that the scope for cutting policy rates was partly limited by the fact that the overnight RRP rate has reached a decade low level, and monetary conditions have already been eased to a significant extent over the past year. As of 15 March 2002, the BSP's policy rates have declined by 800 basis points since the BSP started to ease policy rates in December 2000. The benchmark 91-day T-bill rate stood at 5.174 percent during the 1 April 2002 auction, the lowest rate recorded since the auction for T-bills started in October 1986. This has also contributed to the sharp decline in bank lending rates by about 925 basis points for the period November 2000-March 2002.

26. The members of the Monetary Board emphasized that the presence of inflationary risk factors suggested the need for greater caution in setting the monetary policy stance. In this regard, a cautious monetary stance involves allowing the cumulative interest rate cuts in the past to work their way through the economy. The Monetary Board members believed that well-calibrated monetary policy settings would preclude the need for any dramatic tightening in the near term should the economy start to recover more quickly than anticipated.

[13] The synchronized election of Sangguniang Kabataan (SK) and Barangay Officials is scheduled on 15 July 2002.

III. Monetary Policy Decision

27. Based on the above discussion, the Monetary Board decided to:

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; and

b. Maintain the current structure of the tiering scheme for the overnight RRP placements with the BSP at 7.0 percent for the first ₱5.0 billion; 4.0 percent for the next ₱5.0 billion and 1.0 percent for placements in excess of ₱10 billion.

The next meeting of the Monetary Board to discuss the monetary policy setting was scheduled on 9 May 2002.

—The Monetary Board of the Bangko Sentral ng Pilipinas

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