HIGHLIGHTS OF THE MEETING OF THE MONETARY BOARD ON MONETARY POLICY ISSUES HELD ON 26 SEPTEMBER 2002*

Background

The Monetary Board held its tenth meeting on monetary policy issues on 26 September 2002. The Advisory Committee submitted, for the consideration of the Monetary Board, a policy paper and a comprehensive set of economic and financial indicators relevant for the deliberation on monetary policy.[1] In particular, the policy paper prepared by the Advisory Committee contained the committee's assessment of the inflation outlook and macroeconomic conditions as well as their recommendations for the appropriate monetary policy stance. During the meeting, the Monetary Board discussed the factors affecting inflation and inflationary expectations, including agricultural production, movements of the exchange rate, direction of world oil prices, possible adjustments in power and water rates, monetary conditions, trends in demand and output indicators, fiscal developments, global 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

Current inflation and the inflation outlook

1. Headline inflation picked up slightly in August 2002, rising to 2.9 percent year-on-year from 2.6 percent in the previous month. The uptick was traced mainly to supply or cost-push factors, notably the seasonal movements in food prices and the adjustments in fuel prices. Higher inflation rates were reported for food items such as rice, corn and fruits and vegetables, while local fuel pump prices rose by an average of about 30 centavos in August. Month-on-month headline inflation rose to 0.5 percent in August after holding steady at 0.2 percent

* The highlights of the discussions of the 26 September 2002 Monetary Board meeting were approved by the Monetary Board during its meeting held on 30 October 2002.

[1] The Advisory Committee is composed of the Governor of the BSP as Chairman and four members, namely the Deputy Governor for the Banking Services Sector, Research and Treasury, the Deputy Governor for Supervision and Examination Sector, the Managing Director, In-Charge of Research or the Director of the Department of Economic Research, and the Director of the Treasury Department.

since March 2002. Nevertheless, the year-to-date average inflation of 3.3 percent was more than a full percentage point lower than the 2002 target.[2]

2. Despite signs of improvement in the economy, as reflected in the favorable outturn in output growth numbers for the second quarter, demand-based pressures on consumer prices remained generally weak. The Philippine economy delivered a higher-than expected performance in the second quarter, rising by 4.5 percent and 5.2 percent in terms of real GDP and GNP, respectively. Merchandise exports during the first seven months grew by 6.9 percent, with the July level showing a hefty annual increase of 23 percent. Imports in July expanded by 13.6 percent for a seven-month average growth of 5.7 percent. However, unused capacity in the economy remained fairly sizable, as indicated in the 75.9 percent manufacturing capacity utilization in June. Labor market conditions remained soft, with an 11.2 percent unemployment rate in July 2002, against 10.1 percent in the same period a year ago. Based on other indicators, overall demand also remained relatively subdued despite some strengthening in recent months. For example, bank lending was lower than a year ago, falling by 2.9 percent in July 2002, albeit a slight improvement over the 3.7 percent decline in the preceding month. Meanwhile, energy sales by Meralco rose by 3.7 percent in July, after posting a slight 0.1 percent year-on-year contraction in June. Sales of cement—an indicator of construction activity—rose by 18 percent year-on-year in May, following a 23.5 percent rise in April.

Despite the slight uptick in the August inflation rate, the inflation outturn for the first eight months of 2002 remains consistent with the BSP's assessment of a generally benign inflation environment relative to the 4.5-5.5 percent target for the whole year of 2002.

Agricultural output forecasts

3. Food supply conditions were expected to remain adequate over the near term. Overall crop production volume grew by 1.9 percent in the first half, with rice production rising by 1.9 percent, helped by favorable planting conditions such as adequate rains and reduced incidence of pests and diseases.

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

4. Agricultural output performance for the remainder of the year would depend mostly on the extent of the warm climate conditions. Although various parts of the Philippines are expected to have below normal rainfall in the last quarter of 2002 (especially in Southern Tagalog, Central Visayas and Northern Mindanao regions), much of the available evidence confirmed that the El Niño weather phenomenon would be much weaker than the 1997-1998 El Niño episode. This implied that any downturn in output could be comparatively mild.

5. The national rice inventory as of 11 September 2002 was estimated at 1.3 million metric tons (MT), sufficient to last for 52 days.[3] The rice import program of the government, through the NFA, could provide a safeguard against the possible adverse impact of the upcoming El Niño weather phenomenon on palay supply and prices.

Food supply conditions are expected to remain generally favorable over the near term. The expected occurrence of a weak El Niño weather disturbance in the last quarter of 2002 until the first half of 2003 could have a minimal impact on crop production. Moreover, the rice importation program of the government can serve as cushion against any possible adverse supply shock in 2003.

Exchange rate developments

6. The peso weakened anew for the period 2-23 September 2002, falling by ₱0.25 to average ₱52.07/US$1 from ₱51.82/US$1 in August.[4] The decline in the peso was driven by market apprehension over the fiscal underperformance and the possible escalation of the conflict in the Middle East. Pressures on other regional currencies along with the end-of-the-quarter demand for dollars by corporates also contributed to the weaker peso in September.

7. On a trade-weighted basis and in real terms, the peso depreciated against the basket of currencies of major trading partners by about 1.4 percent in August 2002 relative to the level in December 2001. Similarly, the peso tracked a depreciation trend vis-à-vis the currency baskets of competitor countries as reflected in the decline in the real effective exchange rate (REER) of the peso

[3] Estimated based on the daily consumption of 25.7 MT of rice; the security level benchmark for rice sufficiency of the NFA is 15 days (Source: NFA)
[4] Based on real time foreign exchange transactions in the Philippine Dealing System (PDS)

relative to the broad and narrow baskets of competitor currencies by about 2.8 percent and 9.0 percent, respectively. These developments indicated that the country's external price competitiveness has improved.[5]

The peso weakens further in September as it continues to move in line with the other Asian currencies. Market concerns over the rising fiscal deficit and the rising tension in the Middle East also exerted pressure on the peso. However, the peso remains broadly stable relative to the year-ago level and thus, it is not expected to undermine the inflation target for the year.

Oil price developments

8. Dubai crude oil prices in the international market climbed by US$1.34 per barrel or 5.3 percent to average US$26.58 per barrel for the period 2-16 September 2002 from US$25.24 per barrel in August 2002. The upsurge in oil prices since July was driven by heightened tension over the US-Iraq conflict as the US remained unconvinced that Iraq does not maintain biological and chemical weapons of mass destruction and thus, the US continued to prepare for a military offensive aimed at disarming Iraq. These developments continued to exert upward pressure on world oil prices.

9. With the increase in oil prices in the world market, the local pump prices of petroleum products rose by an average of ₱0.44 per liter on 6 September 2002 from their levels on 11 August 2002, the last time domestic oil prices were raised. The net increase thus far in domestic oil prices for 2002 stood at ₱1.60 per liter for gasoline, diesel and kerosene.[6] Similarly, local oil companies raised the prices of their LPG products twice since the beginning of the year—in August and September—by a total of ₱1.00 per liter. Apart from the increase in world oil prices, the recent weakening of the peso also contributed to the increase in domestic oil prices.

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

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

10. In the futures market, the price of the benchmark Brent crude oil moved slightly higher as October 2002 deliveries reached US$28.31 per barrel from the US$27.00 per barrel quoted in August 2002.[7] The extent of the impact on oil prices of a possible war in the Middle East and its repercussions on the world economy would depend on the length of the US-led offensive. A prolonged rise in oil prices arising from such eventuality could put a drag on the growth of developing economies, including the Philippines, through the following channels:

a) higher cost of production of goods and services given the increase in the prices of energy inputs, thus, reducing profit margins;
b) higher inflation for goods and services due to the need for easier monetary policy; and
c) negative direct and indirect effects on the financial markets due to higher risk aversion.[8]

11. An increase in domestic oil prices due to an uptick in world oil prices could raise average annual CPI inflation directly by about 0.15 percentage point. This could trigger a second round effect on the prices of other commodities estimated to be about twice that of the direct impact, which would raise the average annual inflation for 2002 by about 0.48 percentage point.[9]

The uptrend in the world price of crude oil poses a risk on inflation and inflationary expectations through its impact on domestic pump prices of petroleum products and the cost of other energy-related inputs of production. In turn, a further increase in local oil prices could lead to upward adjustments in the prices of basic goods and services, including wages and transport fares.

[7] Source: Asian Wall Street Journal, 16 September 2002, The futures price for Brent crude—a close substitute for Dubai crude—was used as indicator of future world oil prices since futures data on Dubai crude are not available.
[8] Ideaglobal, "Oil and Asia: Losers All Around", Asian Regional Markets, 9 September 2002
[9] These findings were 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 user charges on utilities

12. Apart from the recent reduction in electricity rates—due mainly to the reduction in the purchased power adjustment (PPA) charges—power rates could ease further in 2003 with the implementation of proposed measures to encourage competition and improve capacity utilization of energy such as the Wholesale Electricity Spot Market (WESM) and the Special Program to Enhance Electricity Demand (SPEED).

13. Under the WESM scheme, electricity will be traded at the spot market, where generators would compete against each other for the right to supply power to distributors.[10] Based on DOE's estimates, the operations of the proposed WESM could reduce further the cost of electricity by about ₱0.40 per kwh. Meanwhile, the coverage of the SPEED program continued to expand as more distribution utilities and electric cooperatives have decided to participate in the program. The SPEED is aimed at raising the demand for electricity by providing price incentives to large users.[11]

14. Meanwhile, the ERC has yet to decide on Meralco's proposed graduated power rate adjustments as contained in its petition for the "unbundling" of power rates, submitted on 2 April 2002. The proposed rates would likely raise the cost of electric power consumption by an average of ₱0.65 per kwh or about 10.3 percent across all residential users.[12] The proposed power rate increases for commercial and industrial establishments would be moderate, estimated at about 2.7 percent and 3.2 percent, respectively. It may be noted that light accounts for 2.7 percent of the total CPI basket.

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[10] The implementation of WESM would require the horizontal unbundling of the Napocor's generation assets into individual generation companies (Genco) to allow the decentralization of dispatch and pricing discretion. An IPP administrator will be assigned to each Genco. Under the WESM scheme, the Gencos are expected to engage in the competitive trade of electricity. The Genco offering the lowest price would likely receive priority dispatch of electricity into the system (Source: DOE Website, "PGMA's ways to reduce electricity rates" and " DOE promulgates WESM rules", www.doe.gov.ph)

[11] The following have signed a Memorandum of Agreement with Napocor to extend SPEED program in their areas: Angeles Electric Corp., Cabanatuan Electric Corp., Cagayan Electric Power & Light Co., Dagupan Electric Corp., Iligan Light & Power Inc., La Union Electric, Tarlac Electric Inc., San Fernando Electric Light & Power Co., Visayan Electric Co. and the Cebu Electric Cooperative Inc. (Source: DOE Press Release entitled, " Napocor Pricing Discount Program expanded to include other utilities and electric cooperatives", 12 September 2002, www.doe.gov.ph)

[12] According to Meralco, the unbundling of power rates is not expected to result in any power rate increase for residential users at the lowest consumption bracket. (Source: Meralco, Press Release entitled, "Meralco Submits New Alternative on Rate Unbundling," 2 April 2002)

15. Water rates are likely to remain at current levels for the rest of the year as the Manila Waterworks and Sewerage System (MWSS) Board has decided to temporarily defer its decision on the proposed water rate hike pending a review of the revised estimates submitted by the water concessionaires, Manila Water Company (MWC) and Maynilad Water Services Inc. (MWSI). The proposed increase in water rates could instead be implemented in 2003.[13] In an earlier petition, MWC and MWSI have applied for increases in their water rates by ₱1.00 and ₱6.00 per cubic meter, respectively, representing an average increase of 26.8 percent from current levels.[14] Given the relatively small share of water to the CPI basket of 0.7 percent, the proposed increase in water rates was estimated to result in an increase in inflation by 0.1 percentage point in 2003.[15]

The moves to defer upward adjustments in power and water charges could help cushion the impact of higher world oil prices and the depreciation of the exchange rate on user charges. These measures could, therefore, mitigate cost-side pressures on inflation for the rest of the year.

Interest rates and interest rate differentials

16. The differentials between RP and foreign interest rates widened significantly in September 2002 as RP market interest rates edged higher while foreign interest rates were relatively steady. As of 16 September 2002, the differentials between the RP 91-day T-bill rate (net of RP withholding tax) and the 90-day LIBOR and US 90-day T-bill rate widened further to 235.8 basis points and 247.2 basis points, respectively from the 221.2 basis points and 233.6 basis points registered in 19 August 2002.

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

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

[14] The MWC and MWSI have proposed increases in water rates by ₱1.00 and ₱6.00 per cubic meter or by 38.8 percent and 14.8 percent, respectively, from ₱6.75 and ₱15.46 per cubic meter, respectively, for an average increase of 26.8 percent.

[15] Based on analysis using input-output (I-O) tables published by the National Statistical Coordination Board (NSCB)

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

18. However, adjusted for the risk premium—that is, the differential between the BSP policy interest rate and the US federal funds target rate less the risk premium—the differential in the RP-US policy rates narrowed further in September by an average of 49 basis points. This was due to the increase in the risk premium, which rose to an average of 476 basis points in the same period.[16]

19. In the domestic market, the RP 91-day T-bill rate for the month of September trended upward as the yield rose from a weighted average of 4.9 percent in August to a rate of 5.223 percent at the 16 September 2002 auction.

The differentials between the RP interest rate and foreign interest rates sustain its uptrend in September. However, adjusted for the spread, the interest rate differential has narrowed down due to the rise in the risk premium for the Philippine sovereign bonds owing to fiscal as well as peace and order concerns. This development underpins the need to guard closely factors that could influence market sentiment, which has implications on inflation and inflationary expectations.

20. The spread of the RP lending rate over the benchmark 91-day T-bill rate for the period 4-11 September 2002, narrowed further to 296 basis points from 304 basis points during the period 8-14 August 2002[17] as the increase in the low-end of banks' lending rate (by about 14 basis points) was accompanied by a larger increase in the RP 91-day T-bill rate (by about 22 basis points). This differential was below the average of 368 basis points for a sample of countries, which have shown a general decline in lending rates as well as in benchmark rates during the review period.

The RP real lending rate declines in September and remains one of the lowest in the Asian region.

[16] The risk premium is measured as the difference between the 10-year ROP note and the 10-year US Treasury note.

[17] Review period covered in the policy paper entitled, "Review of the BSP's Monetary Policy Stance", which was considered by the Monetary Board on 29 August 2002

21. The yield curve for government securities in the secondary market as of 16 September 2002 generally shifted downward relative to that which prevailed on 26 August 2002.[18] Compared to 4 January 2002, the yield curve has likewise shifted downward, with the general drop in the yields on government securities ranging from 138-377 basis points across all maturities.

The decline in the yields of government securities in the secondary market reaffirms the general view that there is ample liquidity in the system.

Domestic stock market movements

22. The domestic stock market posted some modest gains in early September as the average PHISIX registered its first increase after five consecutive months of decline. Preliminary figures for September 2002 showed that the average PHISIX climbed up to 1,130.2 index points, higher by 19.4 index points from its month-ago level.[19] The improvement in investor sentiment can be traced to the release of favorable reports on economic performance, particularly, the better-than-expected second quarter GDP data and the robust performance of the exports sector. Moreover, the passage of the National Transmission Corporation franchise bill in the House of Representatives, which underpinned the government's commitment to fostering an investment-friendly environment, also helped lift investors' confidence.

23. The volume and value of transactions in the domestic stock market displayed mixed trends in September. For the period 1-16 September 2002, the volume of transactions reached 2.4 billion shares, 0.7 billion shares lower than the 3.1 billion shares posted for the comparable period a month ago. By contrast, total value turnover increased by ₱10.5 billion from ₱3.9 billion to reach ₱14.4 billion for the same period. The significant increase in value turnover could be attributed to the large block transactions involving the shares of blue chip companies. Foreign investors were, however, net buyers for the period with foreign buying exceeding foreign selling by ₱48.2 million.[20]

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[18] Yield curve presented in the in the policy paper entitled, "Review of the BSP's Monetary Policy Stance", which was considered by the Monetary Board on 29 August 2002

[19] Source: Philippine Stock Exchange (Figures as of 16 September 2002)

[20] Ibid.

The favorable second quarter developments in the domestic economy helped lift the PHISIX in September. However, market analysts have expressed caution noting that the recovery of the local stock market could be constrained by concerns over the strength of the global economy and the possibility of a US-led military strike against Iraq.

Monetary aggregates and bank lending

24. Domestic liquidity (M3) growth accelerated to 7.1 percent to reach ₱1.55 trillion as of end-July 2002. This compared favorably to the 5.1 percent year-on-year growth registered in June 2002. The acceleration in the growth of money supply could be traced partly to the improving level of net foreign assets (NFA) of the monetary system as well as the increase in the credits to the public sector.

25. Loans outstanding of commercial banks (KBs) reached ₱1.384 trillion as of end-July 2002, up by 0.7 percent from ₱1.374 trillion after posting negative month-on-month growth rates for the past two months. Relative to the level a year ago, however, bank lending declined by 2.9 percent, slower than the 3.7 percent year-on-year contraction recorded in June 2002.

26. The volume of banks' placements under the RRP window increased by about ₱4.0 billion to reach ₱98.6 billion as of 16 September 2002 from the ₱93.8 billion as of end-August 2002. This developed as the rejections during the fortnightly T-bill auctions prompted banks to shift their investments into RRP placements with the BSP.

The decline in bank lending eased in July but banks remained restrained in their lending activities in their efforts to preserve the quality their assets. Meanwhile, banks' placements with the BSP under the RRP window have increased following rejections at the Treasury bill auctions as banks shifted their excess liquidity into RRPs.

27. The National Government (NG) budget deficit for the period January-August 2002 was ₱144.0 billion, exceeding the full-year target of ₱130 billion by ₱14.0 billion. The Department of Finance (DOF) noted, however, that the August budget deficit—at ₱10.9 billion—was below the average monthly deficit of ₱19 billion for the first seven months. The DOF attributed the fall in the August budget deficit to the improvement in revenue collections and the slowdown in government expenditures. In the short-term, a breach of the target deficit should be manageable, given adequate fiscal resources, as the NG had earlier on prefunded its financing requirements. In the long run, the sustainability of the fiscal deficits and the costs they impose in terms of debt servicing could pose a constraint to macroeconomic management. However, given the prevailing low interest rate environment and the benign inflation outlook, the BSP could accommodate a moderate overrun in the fiscal deficit.

Developments and outlook in the rest of the world

28. The World Economic Outlook (WEO) noted that the global recovery was still expected to continue, albeit at a pace slower than what was earlier projected. The main risks identified in the WEO included the following: a further fall in equity markets; a delayed pick-up in investment; and the possibility of a sharp and disorderly adjustment in the US dollar given the current external imbalances among the major currency areas.[21] In particular, a sharp depreciation of the US dollar has implications on the Philippine economy in terms of capital flows, bilateral trade and intra-regional trade, external debt, foreign exchange reserves as well as the peso-dollar exchange rate.

29. The WEO also noted that the overall speed of the US economic recovery would be much slower than earlier expected. There were signs that consumer confidence was weakening in the US economy as reflected in the weakness in the stock market and the relatively slow pick-up in consumer spending. This could be attributed to the steep declines in equity prices following exposure of corporate accounting irregularities and corporate governance inadequacies. Consumer sentiment continued to be weak as the University of Michigan's consumer confidence index fell for the third consecutive month at 87.6 in August from 88.1 in July and 92.4 in June. However, other indicators pointed to brighter prospects ahead. Retail sales rose by 5.2 percent in August from 4.8 percent in the previous month, boosted by increased car sales. The jobless numbers improved as the unemployment rate declined to 5.7 percent from 5.9 percent during the same period. Given the considerable uncertainty about the extent and timing of the expected pickup in production and employment due in part to heightened geopolitical risks, the Fed kept the federal funds target rate unchanged at 1.75 percent during its meeting on 24 September 2002. The Fed noted that the current accommodative stance of monetary policy coupled with still robust

[21] IMF, World Economic Outlook, Prospects and Policy Issues (September 2002)

underlying productivity growth should be sufficient to foster improving business climate overtime.[22]

30. In the eurozone, real GDP grew by 0.6 percent in the second quarter, indicating a slight improvement from the 0.3 percent growth registered in the first quarter. However, other indicators continued to point toward a slowing down of economic activity. The growth in the euro zone's services sector slowed down in August as measured by the Reuters Eurozone Business Activity index for services, which fell to 50.8 in August, only slightly higher than the 50.0 level that divides growth from contraction.[23] Moreover, inflation in the eurozone in recent months has been hovering around the 2 percent ceiling of the European Central Bank (ECB). Inflation reached 2.1 percent in August from 1.9 percent in the previous month. Meanwhile, in Japan, output performance in the second quarter of this year was better than the market expected, helped by the better-than-anticipated performance of domestic consumption and exports, the latter attributed largely to the depreciation of the yen in the early part of the year. However, deflationary pressures continued to weigh down on recovery prospects for the Japanese economy.

The global economy is expected to recover but at a slower pace than earlier projected. Given the uncertainty over the prospects for sustained economic recovery, the Fed and other major central banks have continued to pursue an accommodative monetary policy stance in order to support economic growth.

II. Discussion on the Review of the Monetary Policy Stance

31. The members of the Monetary Board noted that while the Philippine economy posted a better-than-expected performance in the second quarter, other indicators continued to point to the softness in domestic demand. Spare capacity in manufacturing remained relatively high at about a quarter of firms' total output capacity. Credit conditions also remained weak despite a shallower decline in bank lending in July. At the same time, the Philippine economy faced external downside risks arising from the uncertainty over the robustness of the global economic recovery as well as the continuing threat of a

[22] Federal Reserve, Press Release, 24 September 2002 in www.federalreserve.gov/board/boarddocs/press
[23] Reuters.com, "Lagging Japan economy on G7 agenda-US Tsy's Taylor", 13 September 2002

US-led offensive against Iraq and its implications on world oil supply and prices. Under these conditions, the Monetary Board believed that monetary policy should continue to provide a supportive environment that would foster a sustainable recovery in domestic demand while guarding firmly against price pressures.

32. The members of the Monetary Board shared the view that inflation is likely to remain tame for the rest of the year with average inflation falling well below the 4.5-5.5 percent target range for the year. However, the members of the Monetary Board believed that there are potential upside pressures to the inflation outlook over the policy horizon. In particular, the Monetary Board cited the uncertainty over the impact of El Niño weather on agricultural crop production in 2003, sustained uptrend in world oil prices, delayed but eventual adjustment in user charges and the impact of continued fiscal underperformance as potential risk factors to inflation and inflationary expectations. Hence, the Monetary Board agreed that these indications of potential upside pressures to future inflation and inflationary expectations combined with the uncertainty about the strengthening of domestic demand called for a cautious monetary policy stance, one that remains supportive of the economy's growth objective while keeping a low and stable inflation environment.

33. Given the still soft demand conditions, the option of further easing of monetary policy settings through a reduction in the BSP's policy rates was also discussed by the members of the Monetary Board. However, the Monetary Board noted that a further easing of the BSP's monetary policy stance at this time, would infuse additional liquidity in the system, which already has ample liquidity. Given that monetary policy affects inflation with a lag, a more accommodative stance now could undermine the attainability of the inflation target in 2003. The Monetary Board identified the following main risk factors to inflation and inflationary expectations arising from a reduction in policy rates:

a. The present scope for monetary easing is already limited by the fact that policy rates have already been reduced to a significant extent over the past year;

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

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

d. Market's concerns that the budget deficit would continue to widen for the rest of the year could limit the scope for the BSP's monetary policy actions.

34. Given the downside risks to the inflation outlook over the policy horizon, the Monetary Board also discussed whether raising the BSP's policy interest rates could be an option. The members of the Monetary Board, however, noted that the growth of the domestic economy remained uneven and tentative as reflected in the mixed trends displayed by leading economic indicators. An increase in interest rates could impede measures aimed at achieving sustainable economic growth. Moreover, the potential sources of inflationary pressures would emanate largely from the supply side and, therefore, may not warrant a policy response in the form of higher policy interest rates.

III. Monetary Policy Decision

35. Based on the analysis of data that have become available since the last meeting of the Monetary Board on 29 August 2002 and a careful assessment of the balance of risks on inflation and inflationary expectations, the members of the Monetary Board—by a unanimous vote—decided to support the Advisory Committee's recommendations as follows:

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

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

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

d. maintain the reserve requirements at their current levels given the adequate level of liquidity in the system.

The next meeting of the Monetary Board to discuss the monetary policy setting was scheduled on 23 October 2002.

- The Monetary Board of the Bangko Sentral ng Pilipinas