HIGHLIGHTS OF THE MEETING OF THE MONETARY BOARD ON MONETARY POLICY ISSUES HELD ON 8 MAY 2002*

Background

The Monetary Board held its fifth meeting for the year on monetary policy issues on 8 May 2002. This came after the 7 May 2002 meeting of the Advisory Committee wherein 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 a comprehensive set of economic and financial indicators relevant for the deliberation on monetary policy. In particular, the Monetary Board discussed the factors affecting inflation and inflation expectations, including the direction of world oil prices, the subsequent uptrend in domestic oil prices, possible adjustments in power rates as well as the impact of the El Niño weather phenomenon on food supply in 2003, monetary conditions, demand and output indicators, global economic developments 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. The year-on-year inflation in April 2002 remained steady at 3.6 percent due mainly to stable prices of food, beverage and tobacco, clothing as well as services. The average inflation rate for the first four months of the year at 3.6 percent was significantly lower than the 6.8 percent average annual

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* The highlights of the discussions of the 8 May 2002 Monetary Board meeting were approved by the Monetary Board during its meeting held on 13 June 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

inflation during the same period a year ago. At 3.6 percent, the average inflation for the period January-April 2002 was also well below the government's target of 4.5-5.5 percent (revised) average for the whole year 2002. Ample supply of food products, broad stability in the exchange rate and relatively weak—though improving—domestic demand kept price pressures at bay. Despite some signs of improvement in economic activity, the presence of spare capacity at 75.4 percent (revised) in February 2002—although an increase from 74.5 percent (revised) in the previous month—and the relatively high unemployment rate at 10.3 percent in the first quarter of 2002 (lower than the 11.3 percent reported a year ago) indicated that domestic demand remained relatively soft. These factors combined to temper overall consumer price movements during the first four months of 2002.

2. Tamed inflationary pressures since August 2001 were evident in the sustained downtrend in the various measures of core inflation. Using the BSP's main definition, core inflation decelerated to an annual rate of 4.7 percent in April 2002 from 6.8 percent a year ago and 4.9 percent in the previous month.[2]

3. Using the latest assumptions on economic growth, monetary aggregates, the 91-day Treasury bill (T-bill) rates, the Government's fiscal balance, the exchange rate, domestic oil prices, prices of non-oil imports and the expected yearly increase in wages, the forecast for the average annual inflation for 2002 would likely track a broadly quiescent inflation path, in line with the target for the year.

The sustained slowdown in headline inflation reinforced expectations that the current inflation can be relied upon to deliver subdued inflation environment for the rest of 2002. This was evident in the latest readings on inflation, which point to a generally favorable inflation path over the policy horizon. In particular, the average annual inflation in 2002 is projected to remain on track with the target for the year.

[2] Excludes rice, corn, fruits and vegetables, fuel, transport and communication, which account for 25.5 percent of the CPI basket.

Agricultural output forecasts

4. The Department of Agriculture (DA) has projected that the country's unmilled rice harvest for 2002 would reach 13.3 million tons, up from 12.95 million tons in 2001 as a result of the distribution of higher-yielding seed varieties to farmers.[3] The increase in projected rice harvest also reflected gains from expansion in area of hectarage planted and improved farm productivity.

5. As part of the contingency plan against the possible adverse impact of the El Niño weather phenomenon, the government through the National Food Authority had planned to import rice from India, Pakistan, Vietnam and Thailand, estimated at 390,000 tons in May-July to beef up the country's buffer rice stock for the third quarter, the lean season in local rice harvest.[4] In addition, the DA has underscored the importance of instituting adequate water provision and water-saving measures for the dry season (December 2002-May 2003) to cushion the possible adverse impact of the El Niño weather phenomenon on agricultural production, which would help ensure adequate food supply in 2003.[5]

Adequate food supply conditions are expected to prevail for the rest of 2002 based on the forecasts of agricultural production by the DA. This, in turn, could translate into favorable food prices for the rest of the year. For 2003, adequate and timely installation of water-generating facilities and implementation of water-saving measures could cushion the possible adverse impact of the El Niño weather phenomenon on agricultural output in 2003. These measures would help ensure adequate food supply at relatively low prices.

Exchange rate developments

6. The peso has strengthened relative to the US dollar in April 2002, buoyed up by net inflows of foreign exchange from remittances of overseas Filipino workers (OFWs)—in time for the enrollment season—and relatively thin corporate demand for foreign exchange. The currency markets in most countries in the region remained stable in April 2002, as the yen gained strength against the

[3] Department of Agriculture (DA), Rice and Corn Situation and Outlook, January 2002
[4] The Philippine Star, "RP Eyes More Rice Imports Due to El Niño," by Reuters, 28 April 2002
[5] Department of Agriculture (DA) website, Press Release entitled, DA Bares Mitigating Measures for El Nino," 4 March 2002.

US dollar and as regional sentiment improved, with the increasing evidence of a global turnaround. The average peso-dollar rate gained steadily since December 2001 to reach ₱50.99 for the month of April 2002 from ₱51.79 in December 2001. In terms of variability, the peso traded within a narrow range, with its standard deviation estimated at about 10 centavos in April 2002.

7. In nominal terms, the peso appreciated by 80 centavos or 1.5 percent against the US dollar in April 2002 relative to its average level in December 2001. On an inflation-adjusted basis or in real terms, measured by the real effective exchange rate (REER), the index—corresponding to the basket of currencies of the country's major trading partners—rose by 2.9 percent to 65.03 index points in April 2002 from 63.21 index points in December 2001. Relative to the broad basket of competitor countries, the REER was stable at 110.88 index points in April 2002 compared with 111.36 index points in December 2001. Meanwhile, relative to the narrow basket of competitor countries, the REER declined by 6.3 percent to 164.01 index points in April 2002 from 174.99 index points in December 2001, suggesting an improvement in the country's external competitiveness.

The broad stability of the peso could likely exert a favorable influence on the general price level, in line with the inflation targets for 2002 and 2003.

Oil price developments

8. As of 2 May 2002, the spot international price of crude oil (Dubai) dropped slightly by 0.7 percent to reach US$24.33 per barrel from the US$24.51 per barrel average price recorded in April 2002. The softening oil prices was a reversal of the month-on-month increase of 6.8 percent in April and 20.7 percent in March 2002. Relative to US$17.83 per barrel in December 2001, however, Dubai crude has increased sharply by about 36.5 percent in April 2002. Domestic oil prices reflected the uptrend in world oil prices, rising by three times since 7 January 2002. As of 23 April 2002, domestic oil prices went up by a total of ₱1.22 per liter for all gasoline products and ₱1.17 centavos per liter for diesel and kerosene.[6]

[6] Source: Department of Energy

9. In the futures market, the price of benchmark Brent crude oil for June 2002 deliveries settled at $27.11 per barrel.[7] For the period June-December 2002, the price of Brent crude oil in the futures market showed gradual softening and settled at an average of $26.21 per barrel. Market analysts believed that the increase in oil prices—that was triggered mainly by the hostilities in the Middle East—could be contained, given the assurance of adequate oil supply by both OPEC and non-OPEC countries, particularly Russia and Venezuela.

10. The indirect impact of the increase in oil products could feed into the cost of transport and other commodities. However, the overall impact on consumer prices could be muted because of the relatively low share of energy-related components in total CPI basket, estimated at only 4.6 percent. Moreover, the country's dependence on imported oil accounted for only 39.0 percent of the total energy requirement for 2002. The direct impact on inflation of an increase in world oil prices was estimated at 0.4 percentage points while the indirect impact was estimated at about twice that of the direct impact, for a total impact of 1.22 percentage points.[8]

The flow-on effects of higher oil prices to other commodity groups could pose upside pressures on inflation and inflation expectations.

Petitions for upward adjustment in power rates

11. The Manila Electric Company (Meralco) proposed graduated power rate adjustments under its revised petition for the "unbundling" of power rates submitted to the Energy Regulatory Commission (ERC) dated 2 April 2002. Under this proposal, Meralco explained that there would be no likely power rate increase for residential users at the lowest consumption bracket while that for all other residential customers would increase moderately. On average, the

[7] Source: Asian Wall Street Journal, 29 April 2002, The futures price for Brent crude—a close substitute for Dubai crude—is used as indicator of future world oil prices since futures data on Dubai crude are not available.

[8] This was based on the assumption that world oil prices for the rest of 2002 would increase to average $27.50 per barrel. The estimated direct and indirect effects on inflation were based on the simulation results using the 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.

proposed rates were estimated to raise the cost of electric power consumption by about ₱0.65 per kwh or 10.3 percent across all residential users.

12. While light accounts for only 2.7 percent of the CPI basket, the flow-on effect of an increase in power cost could have a cascading impact on prices of other commodity groups. Using an I-O analysis, a 10 percent increase in power rates could raise average annual inflation by about 0.48 percentage points.

The unbundling of power rates by Meralco is expected to have a ripple effect on the prices of other commodity groups, which could lead to a generalized increase in the consumer price level.

Interest rates and interest rate differentials

13. The average differentials between the RP 91-day T-bill rate and the US 90-day LIBOR and the 90-day US T-bill rate in April 2002 declined to 1.8 percent and 2.1 percent, respectively, the lowest interest rate differentials since January 2001. The narrowing interest rate differentials were due to the sharp decline in the 91-day T-bill rate in April by about 168 basis points from the previous month's average rate, accompanied by relatively steady 90-day US LIBOR and US 90-day T-bill rates. Apart from the recent monetary easing measures by the BSP, the significant decline in the RP 91-day T-bill rate can be attributed, in part to excess liquidity in the system, as banks continued to be circumspect in their lending activity. In turn, banks' excess funds have flowed to the government securities market, which contributed to a downward pressure on the RP T-bill rates. In addition, the shift from the weekly to the fortnightly auction of T-bills have prompted banks to bid aggressively during the T-bill auctions, leading to the sharp decline in RP T-bill rates to reach new historic lows.

14. The differential between the BSP's policy interest rate—the overnight borrowing or reverse repurchase (RRP) rate—and the US federal funds target rate was unchanged at 525 basis points as the BSP policy rates and the US federal funds target rate remained at their 15 March 2002 and December 2001 levels, respectively. 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 continued to rise as the risk premium for the Philippines fell sharply in April 2002. The decline in the risk premium reflected an increase in market confidence in the Philippine economy, characterized by the continued stability in the foreign exchange market and the recovery of the domestic stock market.

As domestic interest rates trended downward, the country's interest differentials with the US narrowed further, indicating that the room for any possible further reduction in the BSP's policy rates could be limited. A narrowing interest rate differential between domestic and foreign interest rates could lead to a sharp reversal in the broad stability in the exchange rate, in case of a sudden shift in market sentiment.

15. The Philippines' banks' lending rate and the 91-day T-bill rate have dropped significantly since the BSP started to ease policy rates in December 2000. During the same period, the decline in the banks' lending rate at 1,064 basis points has matched closely that of the benchmark 91-day T-bill rate at 1,111 basis points.[9]

16. The Philippines' real lending rate dropped further to 4.1 percent for the period 25-30 April 2002 from 4.3 percent in the previous week. Relative to other Asian countries, the Philippines' real lending rate at 4.1 percent was lower compared to most countries surveyed: Hong Kong, India, Malaysia, Singapore, South Korea, Taiwan and Thailand.

Banks' lending rates in the Philippines have declined significantly relative to its historical levels and to other Asian countries. The downtrend in banks' lending rates suggests that past monetary easing measures of the BSP have gradually been working its way through the financial system.

17. The yield curve for government securities in the secondary market on 29 April 2002 shifted further downward across all maturities but was steeper compared to yield curve in the previous week. A larger decline was registered for short-term instruments as it reflected the impact of the easing of monetary policy, while yields at the longer-end indicated market expectations of higher inflationary pressures in the long-term.

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[9] The decline in banks' lending rate was measured as the difference between average of the low-end of banks' lending rate for April 2002 and that, which was recorded in November 2000. The decline in the 91-day T-bill rate was measured as the difference between the latest 91-day T-bill rate in April l 2002 auction and the average monthly 91-day T-bill rate in November 2000.

The steeper long end of the yield curve indicated higher inflation expectations given the inherent uncertainty in the long run.

Domestic stock market movements

18. The PHISIX closed at 1,375 index points on 3 May 2002, up by 28.9 index points from the average 1,346.1 index points recorded in April 2002. The rebound was boosted by a string of positive news led by the possible re-entry of the US biggest pension giant, California Public Employees' Retirement System (Calpers) into the domestic stock market,[10] the release of export performance in March 2002, showing the lowest 0.7 percent year-on-year contraction in 14 months and the peaceful Labor Day rally. The gain in the benchmark stock market index for the period 3 May-April 2002 offset partly the 57.5 index points or 4.1 percent month-on-month decline registered in April 2002.

19. Despite softening share prices, the total value of stock trading showed an upturn in April 2002. The total share value turnover in April 2002 gained by ₱7.7 billion or 64.4 percent to ₱19.6 billion compared to the value recorded in March 2002 even as the volume of transactions dropped by 11.0 percent to 10.1 billion shares from the previous month's level. Total foreign transactions in the stock market accounted for 52 percent of the total value turnover in April 2002, up from just 46 percent in the previous month. However, foreign selling dominated foreign buying by ₱663.88 million.[11]

Increasing foreign participation in the local bourse and the modest recovery in the composite index in early May following the bearish market sentiment in April reinforced the market's view that the stock market could maintain its relatively positive tone for the rest of the year.

Monetary aggregates and bank lending

20. Domestic liquidity or M3 has risen steadily since the start of the year. It accelerated to an 8.6 percent (revised) year-on-year growth, as of end-March 2002 from 7.2 percent in the previous month and 5.2 percent in January 2002 . This marked the highest year-on-year growth registered since November 2001.

[10] Following a meeting with Finance Secretary Jose Isidro Camacho, the investment staff of Calpers announced its decision to reinvest in the Philippine stock market (BridgeNews, 1 May 2002).

[11] Source: Philippine Stock Market

Meanwhile, the volume of outstanding loans of commercial banks dropped by a slight 0.6 percent, indicating the lowest year-on-year decline since September 2001. On a monthly basis, bank lending rose by 1.5 percent in February 2002, the highest growth recorded since May 2001. Loan availments of firms in the services, utilities, and mining sectors rose year-on-year to offset the continued decline in bank loans to the manufacturing, construction, transportation, storage and communication sectors. Despite some positive signs of renewed economic strength, banks continued to be generally cautious in extending new loans, as they seek to prevent any deterioration in asset quality and as they await more evidence of sustainable growth such as higher capacity utilization in the manufacturing sector and a reduction in the levels of non-performing loans (NPLs).

21. Banks' excess funds continued to be channeled to government securities and placements with the BSP. As of end-April 2002, banks' placements under the RRP window rose to ₱72.5 billion from ₱28.2 billion while placements under the special deposit accounts (SDA) window amounted to ₱30.5 billion from zero as of end-December 2001. Using seasonally adjusted data, the levels of RRPs and SDAs rose by 76.3 percent and 1.5 percent, month-on-month, respectively compared to the 5.9 percent.

Despite some improvements, banks remained circumspect in their lending activities due to the still high NPLs and the presence of spare capacity in the manufacturing sector, which has constrained demand for additional bank financing. With ample liquidity, some banks have continued to place their excess funds in government securities as well as in the RRPs and SDA facilities of the BSP.

Developments and outlook in the rest of the world

22. Recent economic data showed that strong productivity gains and a low-inflation environment in the US have helped, to a large extent, ensure that the recovery in the world's largest economy would gain strength gradually. The US economy grew at an annual rate of 5.6 percent (revised) in the first quarter of 2002, marking the fastest pace of growth since the fourth quarter of 1999. The first quarter performance of the US economy was driven mainly by robust consumption spending, particularly in the housing market and the slowdown in the pace of inventory liquidation following a sharp drawdown in the previous quarter.

23. While the overall picture of the US economy has been improving, market analysts believed that there were still areas of continued weakness, casting doubts on the strength of the US recovery. Businesses continued to cut spending on new plants and equipment during the quarter by 5.8 percent in the first quarter. This was in addition to the deep 13.8 percent contraction in capital spending in the fourth quarter. US manufacturing output in April expanded less than expected, as the Institute for Supply Management's factory index slipped to 53.9 index points in April from 55.6 index points in March, reflecting the slowdown in orders and employment. As a result, the U.S. unemployment rate rose sharply to 6.0 percent in April 2002 from 5.7 percent in March 2002, marking the highest unemployment rate since August 1994. In a testimony before Congress in April 2002, Fed Chairman Alan Greenspan said that an upturn in business investment is needed for the US economy to stage a sustained recovery. Meanwhile, US inflation rose at a marginal 0.6 percent in the first quarter, indicating that price pressures have been virtually non-existent.

24. Markets' assessment of the various economic indicators in the US reinforced the view that the US Federal Reserve will likely maintain a neutral monetary policy stance until there are firmer signs of a sustained and balanced economic expansion from both the supply and the demand sides in the absence of wage and price pressures. Some analysts believed that a clear improvement in the path of the unemployment rate would be crucial in the timing of the Fed's initial tightening move.[12]

25. The strong growth posted by the US economy in the first quarter of 2002 has to a large extent, helped other major economies recover. The UK manufacturing index rose to 53.4 index points in April from 50.6 index points in the previous month, signaling the fastest expansion in two-and-a half years. In Asia, Malaysian exports grew unexpectedly by 4 percent in March, from an expected 7.6 percent decline, boosted by an increase in new orders of semiconductor and electronic goods by US semiconductor assemblers. Similarly, Thai business sentiment index rose to 53.5 points in March from 49.9 points in February, as the rebound in exports fueled expectations that sales and profits would likewise increase. In Japan, there were indications that the economic recession has been bottoming out, with the slow but continuing gains in the currency and equity markets. Market optimism over the rebound of the Japanese economy was boosted by export-

[12] CNN News website, " US unemployment jumps to 6 percent, " 3 May 2002

led gains in industrial production and sustained current account surplus in February 2002.[13]

Uncertainties over the sustainability of the recovery in the US economy and the absence of price pressures underpin the likely neutral policy stance of the US Fed in the near term.

II. Discussion on the Review of the Monetary Policy Stance

26. The members of the Monetary Board shared the view that the favorable food supply conditions and continued stability in the exchange rate combined with still relatively weak domestic demand and the continued presence of spare capacity point to generally subdued inflation in 2002. However, uncertainty over the full impact of El Niño weather phenomenon on agricultural crop production in 2003, the uptrend in domestic oil prices and the expected adjustment in power rates indicate upward pressures on inflation.

27. Given these considerations, the members of the Monetary Board noted that the key challenge for monetary authorities is to ensure that the policy response is appropriately timed and well calibrated such that the current growth stimulus is not withdrawn too early, which could dampen the increasing signs of improving domestic demand, nor delayed such that the price stability objective of the BSP is threatened.

28. Meanwhile, the members of the Monetary Board noted that the scope for a further reduction in the BSP's policy rates has been partly limited by the fact that the overnight RRP rate was already at a decade low, 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 dropped further to 4.299 percent during the 29 April 2002 auction. This has also contributed to the sharp decline in bank lending rates by 1,064 basis points or 10.6 percentage points in April 2002 since the BSP started to ease policy rates in December 2000. There were also signs of renewed strength in economic activity such as the increase in the average capacity utilization in manufacturing to 75.4 percent (revised) in February 2002 from 74.5 percent (revised) in the previous

[13] SG Weekly Economist, 6 May 2002

month; the increase in the annual growth rates of the volume and value of production indices (VOPI and VAPI) by 3.3 percent (revised) and 0.7` percent (revised), year-on-year, respectively, in February 2002; as well as the improvement in exports given the highest month-on-month growth of 8.4 percent or lowest year-on-year decline of 0.7 percent in March 2002.

29. Some members of the Monetary Board pointed out that the observed lag in the pass-through of the BSP's monetary easing measures on bank lending should not be interpreted as a weakness of past monetary easing measures of the BSP. The members of the Monetary Board noted that the monetary easing measures implemented by the BSP in the past were aimed at providing an enabling environment to support the economy's growth objective while maintaining price stability. They pointed out that the response of market agents such as banks, business sector and consumers, however, ultimately determines the impact of the BSP's monetary policy actions.

30. In discussing the effectiveness of monetary policy, some members of the Monetary Board expressed the view that if the BSP's policy rates have not been reduced, the scenario could have been different since it would have been more difficult to increase bank lending. It could have also posed a drag on expectations, which could have dented the country's economic growth prospects.

31. At the same time, the members of the Monetary Board underscored the need for continued caution in setting the monetary policy stance. A cautious monetary stance involves allowing for the cumulative interest rate cuts in the past to feed through the economy, and waiting for increased evidence of sustainable growth while guarding against any possible build up of inflationary pressures.

32. In conclusion, the members of the Monetary Board were of the view that an increase in policy rates would not be advisable at the moment given the following considerations:

a. inflationary pressures are well contained;
b. the likely neutral stance of the US Fed provides scope for the BSP to maintain policy rates; and
c. an increase in the BSP's policy rates could dent improving market sentiment and the economy's growth prospects.

III. Monetary Policy Decision

33. Based on the weight of evidence and discussions, the members of the Monetary Board by an unanimous vote 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 levels of the reserve requirements at 9 percent `for the regular reserve and 7 percent for the liquidity reserve.

The next meeting of the Monetary Board to discuss the monetary policy setting was scheduled on 6 June 2002.

- The Monetary Board of the Bangko Sentral ng Pilipinas

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