Bangko Sentral ng Pilipinas

HIGHLIGHTS OF THE MEETING OF THE MONETARY BOARD ON MONETARY POLICY ISSUES HELD ON 31 JULY 2003[*]

Background

On 31 July 2003, the Monetary Board held its ninth meeting for the year on monetary policy issues. At the meeting, the Advisory Committee[1] presented its recommendations to the Monetary Board on the stance of monetary policy of the BSP, based on the Committee's assessment of the outlook for inflation, the economy's growth prospects, and the emerging trends in key macroeconomic and financial indicators. The recommendations served as basis for the Monetary Board's discussion on the appropriate course of action for monetary policy.

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

The Advisory Committee recommended the following measures to the Monetary Board: (1) maintain the BSP's policy rates at the current levels of 6.75 percent as the borrowing rate under the overnight reverse repurchase (RRP) facility and 9.0 percent as the lending rate under the overnight repurchase (RP) facility; (2) maintain the tiering scheme on banks' placements with the BSP under the RRP and Special Deposit Account (SDA) windows; (3) maintain the current interest rates on the term RRPs, RPs, and SDAs; and (4) maintain the reserve requirements at their current levels given the adequate level of liquidity in the system. These recommendations were based on the following considerations:

- Headline inflation rose to its highest level for the year at 3.4 percent in June 2003 from 2.7 percent in the previous month and 2.9 percent a year earlier. This was due mainly to the temporary increase in food prices in Metro Manila brought about by the series of typhoons that caused heavy

[*] The highlights of the discussions of the 31 July 2003 Monetary Board meeting were approved by the Monetary Board during its meeting held on 4 September 2003.
[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 and the Director for the Treasury Department.

rains and flooding. Moreover, increased charges for electricity consumption in Metro Manila in June as well as higher tuition fees and prices of school supplies and other commodities coinciding with the opening of the school year also exerted upside pressures on prices. Core inflation also picked up during the month to 3.0 percent from 2.4 percent in May.

- Abstracting from temporary price hikes and seasonal effects, inflation continued to be relatively low. This mainly reflected the continued absence of significant demand-pull pressures on consumer prices as well as the positive impact of supply-side factors. The outlook for inflation for the remainder of the year thus continued to be benign.

- The strength of domestic demand remained moderate. The tentativeness of the pace and strength of a pick-up in domestic demand reinforced expectations of limited demand-side influences on prices.

  - The growth in the volume of production index (VOPI) for manufacturing accelerated to 2.6 percent year-on-year in May from 1.2 percent (revised) in the previous month. Similarly, the increase in the value of production index (VAPI) for manufacturing improved to 10.7 percent in May from 8.6 percent (revised) in April.

  - Average capacity utilization in the manufacturing sector rose to 78.4 percent in May from 77.5 percent in the previous month.

  - The pace of bank lending remained modest, with outstanding loans of commercial banks rising by 3.4 percent year-on-year in May 2003. This rate of increase was an improvement from the 3.0 percent growth recorded in the previous month.

  - Import demand improved. Total merchandise imports recorded by the National Statistics Office (NSO) showed a 12.2 percent year-on-year rise in May 2003, following a 7.6 percent decline in April and an 11.4 percent increase in March.

  - Meanwhile, demand for Philippine exports weakened further. Merchandise exports fell by 4.0 percent year-on-year in May following a 1.8 percent decline in April. This reflected the downside impact of the continued softness in global market conditions.

  - Other demand indicators displayed similar signs of weakness. The number of car sold registered a 4 percent year-on-year decline in June 2003 following a steep 40 percent decrease in the previous month. Meanwhile, growth in sales of electricity by Manila Electric Company (Meralco) slowed down to 2.7 percent in May from 5.4 percent in the previous month.

- Positive supply-side developments reaffirm expectations of a benign inflation setting, going forward.

  - Increased agricultural production due to government programs, the end of the El Niño weather disturbance and normal rainfall conditions are expected to temper food prices.

  - Tighter supply conditions in the world market brought about by lower production by the Organization of Petroleum Exporting Countries (OPEC) combined with delays in Iraqi exports led to higher international oil prices in July. In spite of this, domestic oil prices were stable during the month due to large inventory levels of local oil companies.

  - The ERC-approved new generation charges for NPC are relatively lower than those applied for by the NPC. This helped support expectations of a benign impact of power rates on future inflation. Meanwhile, the continued implementation of Meralco's refund scheme could support a favorable outlook on consumer sentiment.

- The benchmark 91-day T-bill rate continued its downtrend in July's average yield falling by about 16 basis points to 5.17 percent at the BTr auction on 21 July 2003. The BSP's monetary easing stance, improved fiscal performance and continued presence of ample liquidity in the system have contributed to the easing of interest rates. Meanwhile, interest rate differentials were narrower for the early part of July following the BSP's policy rate cut by 25 basis points.

- Growth in the demand for money improved in May relative to the previous month's level. Domestic liquidity grew by 4.0 percent year-on-year in May 2003 from 2.5 percent in the previous month. The continued oversubscriptions of offerings of T-bills and T-bonds and sizable placements in government securities by banks also indicated the presence of ample liquidity in the system.

- The peso was relatively stable against the US dollar for most of July, but exhibited some volatility in the fourth week as domestic peace and order concerns were reignited following the escape from prison of a suspected international terrorist and 27 July 2003 failed mutiny. Meanwhile, on a real and trade-weighted basis, the peso weakened against the basket of currencies of the country's major trading partners and competitor countries. This suggested an improvement in the country's external price competitiveness.

- The fiscal gap narrowed by about a third in the first half of 2003 to ₱79.6 billion relative to its year-ago level and by about 22 percent relative to the January-June 2003 target. The narrowing gap reflected the gains from stronger revenue collection performance and the strict enforcement of tax laws and measures to increase collection efficiency along with tight spending policy.

- Global economic recovery remained generally hesitant as a result of uneven and tentative improvements in macroeconomic conditions in the major economies.

  - Recent signs pointed to a firming up of the US economy as consumer spending continued to hold up and financial conditions showed marked improvement following a rebound in the stock market. However, there were still elements of fragility owing to continued weakness in labor market conditions, relatively high spare capacity and the external downside risks posed by the softness in major trading partners' economies.

  - In the euro zone, the latest data pointed to a continued subdued economic activity and lack of confidence. Recent economic indicators suggested broadly that conditions have stabilized but there were no clear signs yet of the underlying strength in production and market confidence.[2]

  - In the UK, output growth has recently been below trend due in part to slower consumer demand and subdued private investment along with the decline in exports which have offset the impact of higher public spending.[3]

  - In Japan, the overall economic activity has remained virtually flat due to weak consumer spending and housing investment combined with

[2] European Central Bank, "ECB Press Conference, Introductory statement of ECB President Willem F. Duisenberg," 10 July 2003; available online at http://www.ecb.int/index.html
[3] Bank of England, News Release, "Bank of England reduces interest rates by 0.25% to 3.5%," 10 July 2003; available online at http://www.bankofengland.co.uk/Links/setframe.html

the decline in public investments. Meanwhile, the recovery in Japanese exports has also stalled.[4]

- In the prevailing environment, the major central banks continued to maintain a supportive monetary policy stance by reducing policy rates to help sustain economic recovery. In the case of the US, the easing was also aimed at guarding against the possibility—although remote—of a substantial further disinflation.[5] Following the 25-basis point reduction in the federal funds target rate by the US Fed on 25 June 2003, the Bank of England, the Swedish central bank—Riksbank, the Bank of Canada, the Bank of Thailand and the Bank of Korea reduced their key policy rates.

II. Review of the Monetary Policy Stance

- Based on the information presented by the Advisory Committee, the members of the Monetary Board agreed that the outlook for inflation has not significantly changed since the previous review of the monetary policy stance on 2 July 2003. In particular, they expressed the view that the assessment of various indicators of demand and supply conditions suggested that price dynamics will continue to be benign going forward.

- The members of the Monetary Board emphasized that the prospect for subdued inflation combined with moderate growth in domestic demand and downside risks to external demand pointed to the need for the monetary policy stance to continue to help establish a firmer footing for economic activity.

- The members of the Monetary Board recognized, however, that the need to provide monetary impetus to growth should be balanced with the need to guard against excessive easing as well as the need to maintain operational latitude in preserving the inflation target from potential pressures.

- Most of the members of the Monetary Board were of the view that the current monetary stance would help check any possible build-up of vulnerabilities in the economy that could arise from renewed volatility in the foreign exchange market, excessive debt accumulation by both the

[4] Bank of Japan, Monthly Report of Recent Economic and Financial Developments July 2003 (The Bank's View), 16 July 2003; available at http://www.boj.or.jp/en/seisaku/03/seisak_f.htm
[5] The Federal Reserve Board, Testimony of Chairman Alan Greenspan before the Committee on Financial Services, US House of Representatives, 16 July 2003

private and public sectors and the possibility of incipient rise in asset price inflation.

- In light of these considerations, the members of the Monetary Board considered the following monetary policy options:

    - Ease monetary policy stance; or
    - Maintain current monetary policy stance.

- The considerations on easing monetary policy stance were as follows:

  The members of the Monetary Board noted that a further easing of the monetary policy settings would infuse more liquidity into the financial system, which already has ample liquidity.[6] The majority of the members of the Monetary Board shared the view that given that monetary policy affects inflation with a lag, the recent 25-basis point cut in the policy rates should be given sufficient time to work its way through the system.

- The considerations for maintaining current monetary policy stance were as follows:

  The Monetary Board's assessment was that the current monetary policy stance remained supportive of the economy's growth path given subdued inflationary expectations. They emphasized that while there is room for more easing, this should be weighed against the need to remain cautious and vigilant against any possible resurgence of inflationary threats. A member of the Monetary Board also noted that there may not be a need to ease the monetary settings at the moment since there is already ample liquidity in the system as evidenced by the downtrend in the benchmark 91-day T-bill rate and the oversubscriptions of T-bill offerings. The Monetary Board concluded, therefore, that maintaining the current monetary settings would help preserve the BSP's operational latitude in maintaining price stability.

- The Monetary Board also briefly discussed the possible implications of the 27 July 2003 coup attempt on the domestic economy. The members of the Monetary Board reviewed the economic impact of past coup attempts, particularly the 1989 coup attempt, on key demand indicators. They noted that the 1989 coup attempt did not have an independent impact on inflation and that, based on simulations, the main channel of

[6] Based on estimates, a one-percentage point reduction in the reserve requirement would release additional liquidity of about ₱14.4 billion.This was estimated as one percent of the sum of deposits and deposit substitute liabilities of commercial banks amounting to ₱1.435 trillion as of end-May 2003.

impact of the 1989 coup on the economy appeared to come in the form of higher risk premium. The resulting higher interest rates along with coup's impact on market sentiment and expectations led to a reduction in private investment. However, the Monetary Board stressed that the economic impact of the 27 July 2003 mutiny is likely to be considerably less, since the mutiny was confined to a particular area, did not result in bloodshed and was resolved quickly.

III. Monetary Policy Decision

- After a careful assessment of the balance of risks on inflation and inflationary expectations and the evolving domestic demand conditions, the Monetary Board, by a unanimous vote, decided to:

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

For banks' placements with the BSP under the overnight RRP window, the interest rates shall be maintained at the following rates:

(1) First ₱5 billion	-	6.75 percent;
(2) Over ₱5 billion-₱10 billion	-	3.75 percent; and
(3) Over ₱10 billion	-	0.75 percent.

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 28 August 2003.