Bangko Sentral ng Pilipinas

HIGHLIGHTS OF THE MEETING OF THE MONETARY BOARD ON MONETARY POLICY ISSUES HELD ON 2 JULY 2003*

Background

The Monetary Board held its eighth meeting for the year on monetary policy issues on 2 July 2003. This was preceded by the meeting of the Advisory Committee[1] on 1 July 2003. Given the information presented by the Advisory Committee during the meeting, the members of the Monetary Board deliberated on the merits of the various policy options available to the BSP. The Monetary Board's monetary policy decision was based on their assessment on the implications of macroeconomic and financial developments on the country's inflation outlook and growth prospects.

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

- Headline inflation decelerated to 2.7 percent in May 2003 from 2.8 percent in the previous month and 3.6 percent in the same month a year ago. This reflected the continued absence of significant demand-pull pressures on prices as well as the impact of positive supply-side factors particularly, the pass through effect of lower fuel prices. Similarly, the BSP's measure of core inflation slowed down in May to 2.4 percent from the previous month's 2.5 percent, reflecting the lack of demand pressures on consumer prices.

- Going forward, the Monetary Board maintains its view that both demand and supply factors point to subdued price conditions. For 2003, the average annual inflation is expected to be way below the Government's target of 4.5-5.5 percent. For 2004, average inflation is expected to be broadly in line with the 4-5 percent target.

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* The highlights of the discussions of the 2 July 2003 Monetary Board meeting were approved by the Monetary Board during its meeting held on 7 August 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 of the Treasury Department.

- Latest available indicators of economic activity generally pointed to overall sluggishness in aggregate demand conditions. This supports the view that demand-side influences on prices are likely to remain tamed.

  - The growth in the volume of production index (VOPI) for manufacturing slowed down to 1.2 percent (revised) year-on-year in April from a 6.9 percent (revised) increase in the previous month. Similarly, the increase in the value of production index (VAPI) for manufacturing decelerated to 8.6 percent (revised) in April from 17.8 percent (revised) a month ago.

  - Average capacity utilization in manufacturing for April declined to 77.5 percent from 80.1 percent (revised) in the previous month.

  - External demand for Philippine goods likewise appeared to be moderate. Merchandise exports fell by 1.8 percent in April following an 8.6 percent increase in March.

  - Improvements in the demand for credit continued but at a slower pace. Commercial bank lending rose for the eighth consecutive month, rising by 3.0 percent year-on-year in April 2003. This was, however, a deceleration from the 3.2-percent increase in the previous month.

  - Other indicators for demand showed similar signs of weakness. For instance, electricity sales by Meralco slowed to 5.4 percent year-on-year in April from a 10.8 percent-growth in the previous month. Passenger car sales declined sharply by 37.7 percent year-on-year in May 2003 following an increase of 8.6 percent in the preceding month.

- The supply-side risks to inflation have weakened significantly with the end of the El Niño weather phenomenon and the decline in international crude oil prices relative to pre-US-Iraq war levels.

  - Food prices remained stable given that the El Niño has receded along with the onset of the rainy season. The risk of the possible entry of the La Niña weather disturbance was still being assessed.

  - Despite the uptick in world crude oil prices due to production cut by OPEC, domestic pump prices of petroleum products remained unchanged from their end-May levels. Moreover, the domestic oil industry inventory level remained substantial at around 68 days[2] of supply. This was a carry over of the large reserves build-up by domestic oil companies in compliance with the government's oil contingency plan during the pre-Iraq war episode.

- Recent developments in the electric power sector—particularly, the relatively small increase in Meralco's unbundled selling rate as well as the reduction in rates by several electric cooperatives—implied an evident but minimal impact on inflation. Meanwhile, the implementation of a refund by Meralco could help ease inflation expectations.

- Treasury bill (T-bill) rates continued to decline. During the Bureau of Treasury's (BTr) 23 June 2003 auction, the benchmark 91-day T-bill rate fell to 5.498 percent from 5.666 percent in the previous auction. This resulted into narrower RP-US interest rate differentials as US interest rates were generally steady for the review period until the Fed cut its key target rate by 25 basis points on 24-25 June 2003.

- There was continued excess liquidity in the system as indicated by oversubscriptions of T-bill offerings, decline in Interbank Call Loan (IBCL) rates and higher bank placements with the BSP. The bids for T-bills have been oversubscribed by an average of ₱4.6 billion per auction for the period January-May 2003. Meanwhile, financial and banking institutions have been net lenders in the interbank market since January 2003. In June, the average number of lenders was 9 compared to the average number of borrowers, which stood at 6. The average IBCL rate also declined further in June. From a high of 7.1947 percent in April, the average IBCL rate continued to fall to reach 7.0625 percent in the second week of June. Moreover, bank placements with the BSP have continued to expand in June relative to their levels in May. Preliminary estimate of domestic liquidity growth in May also showed an improvement to 4.0 percent from the 2.5 percent annual rise in April.

- On a nominal basis, the peso depreciated against the US dollar in June due to increased corporate demand and weakening regional currencies. Similarly, on a real and trade-weighted basis, the peso also weakened against the basket of currencies of our competitor countries, implying an improvement in the country's external competitiveness.

[2] As of 23 June 2003

- The National Government (NG) deficit for the January-May period at ₱75.4 billion was 29.9 percent lower compared to the ₱107.5 billion deficit posted for the same period last year. The better-than-expected developments put fiscal performance well on track and generated positive sentiment in the financial market. This should augur well for growth and price conditions, going forward.

- World economic activity remained subdued. The US economy has yet to exhibit sustainable growth while economic conditions in other major economies suggested that the pace of a global recovery may still be sluggish.

  - In the US, there have been some signs of economic improvements particularly, in business sentiment. Retail trade and food services sales for May increased by 0.1 percent from the previous month and was up by 5.1 percent from its year-ago level. Likewise, manufacturing activity displayed an improvement in May as indicated by the rise in ISM manufacturing index to 49.5 in May from 45.4 the previous month. However, there were indications that consumer sentiment in the US was still relatively weak. The Conference Board's Consumer Confidence Index remained relatively stable at 83.5 in June after a moderate improvement in May to 83.6 from 81.0 in April.[3] Meanwhile, the closely-watched University of Michigan sentiment index slipped to 87.2 in June from 92.1 in the previous month after rising in the past two months.[4] Moreover, despite the positive news on retail sales and manufacturing, US unemployment rate edged up in May to 6.1 percent from 6.0 percent in the previous month.

  - In the Euro zone, the overall economic activity remained restrained. The European Central Bank (ECB) noted that economic growth in the first half of 2003 was likely to be very weak and that expectations for growth for the whole year of 2003 as well as for 2004 continued to be subdued.[5]

  - The UK economy slowed down in the first quarter as household spending decelerated and investment declined. This could be

[3] The Consumer Confidence Survey is a monthly survey based on a representative sample of 5,000 U.S. households. The survey is conducted for The Conference Board by NFO WorldGroup, a member of The Interpublic Group of Companies (NYSE: IPG).
[4] Bohan, C., *"Consumers' Worries Grow, Prices Fall,"* in Business-Reuters, 13 June 2003, available at http://www.story. news.yahoo.com/news
[5] ECB Press Conference Introductory Statement of President Willem F. Duisenberg, 5 June 2003, available at http://www.ecb.int

attributed, in part, to the slowdown in real disposable income and incipient cooling of the housing market.

- In Japan, the quarter-on-quarter growth of real GDP was virtually flat at 0.1 percent in the first quarter of 2003 following a 0.5 percent rise in the fourth quarter of 2002. Deflationary conditions remained as the fall in consumer prices has been sustained in the last 6 years since April 1998.

- With a generally favorable outlook on inflation, the recent monetary policy actions of the major central banks have remained stimulative to spur sustainable economic recovery. During their respective June 2003 monetary policy meetings, the US Fed and the ECB have decided to ease their stance by reducing their key target rates.[6] Meanwhile, both the Bank of England and the Bank of Japan have maintained their monetary policy guidelines.

II. Review of the Monetary Policy Stance

- During the Monetary Board's discussion on the implication for the BSP's monetary policy stance of the prevailing macroeconomic and price environment, the members of the Monetary Board highlighted the following points:

  - Going forward, both demand and supply factors point to subdued price conditions.

  - The main inflationary risks that were considered in setting the targets for 2003 and 2004 have diminished significantly.

  - The current monetary conditions and other economic developments as well as continued easing in foreign interest rates led by the 25-basis point cut in the federal funds target rate by the US provided added flexibility for the BSP to ease the stance while remaining cautious of possible resurgence of inflationary threats.

  - Easing further the current monetary policy settings would help build up momentum for economic activity. By contrast, a further delay in easing monetary policy settings may risk the prospects for a sustained upturn in economic activity such that later monetary easing moves

[6] In the case of the US Fed, the interest rate cut was also intended to head off deflationary risks.

might be less able to support growth. However, the members of the Monetary Board underscored the need for caution against excessive easing which may not lead to an appreciable improvement in credit growth and economic activity.

- Based on these observations, the Monetary Board evaluated several alternative monetary policy moves. In particular, the members of the Monetary Board deliberated on the advantages and disadvantages of the following options:

  - Maintaining the current monetary policy settings;
  - Reducing the BSP's key policy rates by 25 basis points;
  - Reducing the regular reserve requirement by one-percentage point; or
  - Reducing the liquidity reserve requirement by one-percentage point.

- Maintaining the current monetary policy settings

  Some members of the Monetary Board noted that maintaining the current monetary policy settings could help preserve the relative stability in the foreign exchange market. However, given evidence of weakness in domestic demand conditions and benign inflationary setting, some members of the Monetary Board also noted that current monetary policy stance might risk being too tight. Holding the key rates steady could delay the stimulatory impact toward a sustainable growth path.

- Reducing the BSP's key policy rates by 25 basis points

  Based on BSP's estimate, a reduction in the BSP's policy rates by 25 basis points could lower intermediation cost by about 3.7 basis points. Majority of the seven-member Monetary Board were of the view that a policy rate cut could ease further the market interest rates, which in turn, could help enhance credit demand to support economic activity. All members of the Monetary Board shared the view that a reduction in the key policy rates would provide a clear-cut sign to the market that the BSP would like to see lower interest rates. Relative to a reduction in banks' reserve requirements (either regular or liquidity reserves), the members of the Monetary Board pointed out that a reduction in the BSP's policy rates would not necessarily translate into an unwarranted expansion in liquidity in the system. In addition, they also stressed that this measure was not expected to lead to capital outflows as interest rate differentials would just be maintained.

- Reducing the regular reserve requirement by one-percentage point

  The Monetary Board noted that a one-percentage point reduction in the regular reserve requirement could lead into higher savings for banks as this could reduce intermediation cost estimated at 6.5 basis points. However, all the members of the Monetary Board pointed out that reducing the reserve requirement would infuse additional liquidity into a system, which already has ample liquidity. They expressed concern over the possibility that the excess liquidity could find its way into the foreign exchange market. This could induce some volatility in the exchange rate, which in turn, could lead to a build-up of inflationary pressures. Moreover, it would be costly on the part of the BSP to mop up the resulting excess liquidity.

- Reducing the liquidity reserve requirement by one-percentage point

  The members of the Monetary Board explored the possibility of a reduction in the liquidity reserve requirement. They argued that a reduction in the liquidity reserve requirement could lower intermediation cost by about 1.8 basis point. Relative to a reduction in the regular reserve requirement, the Monetary Board also noted that it would be less costly for the BSP to mop up the excess liquidity that could result from this policy move since reserve-eligible government securities that would be purchased back by the BSP earn market interest rates.

- Other comments raised by the Monetary Board members:

  - All members of the Monetary Board noted that the implementation of any of the above policy easing options should not translate into a breach of the inflation targets over the policy horizon. This was based on the estimates presented by the Advisory Committee.

  - Given a benign inflationary setting, all members of the Monetary Board were of the view that the BSP has the flexibility to ease further the monetary settings to help spur domestic economic activity.

  - All members of the Monetary Board shared the view that the current reserve requirements should be maintained. The members of the Monetary Board agreed that a reduction in either the regular or liquidity reserve requirement could lead to unnecessary infusion of additional liquidity into the market.

  - Some members of the Monetary Board initially raised concerns over the possible implications on the exchange rate of lowering the

BSP's policy rates which could translate into increased inflation expectations. However, following a discussion of the possible exchange rate pass-through, the members recognized that a 25 basis point-cut in the BSP's policy rates would only have minimal impact on the peso-dollar rate. This is inasmuch as the interest rate differentials with the US can be maintained since the proposed policy rate reduction would match exactly the 25 basis cut in the federal funds target rate following the meeting of the US Fed on 24-25 June 2003.

- Moreover, a member of the Monetary Board emphasized that there is room to ease policy rates given a subdued inflationary conditions, consistent with the framework of inflation targeting.

- A member of the Monetary Board noted that the key policy rates have remained relatively stable since the establishment of the BSP in 1993. A reduction of the overnight reverse repurchase (RRP) rate by 25 basis point to 6.75 percent would thus bring the overnight RRP rate to its lowest level since May 1992.

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 reduce the BSP's overnight reverse repurchase (RRP) rate and overnight repurchase (RP) rate by 25 basis points to 6.75 percent and 9.0 percent, respectively. For banks' placements with the BSP under the overnight RRP window, the interest rates were set as follows:

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

The next meeting of the Monetary Board to discuss the monetary policy setting was scheduled on 31 July 2003.

- The Monetary Board of the Bangko Sentral ng Pilipinas