HIGHLIGHTS OF THE MEETING OF THE MONETARY BOARD ON MONETARY POLICY ISSUES HELD ON 5 JUNE 2003[*]

Background

The Monetary Board held its seventh meeting for the year on monetary policy issues on 5 June 2003. This was preceded by the Advisory Committee[1] meeting on 3 June 2003. During the Monetary Board's meeting, the discussions by the Monetary Board members revolved around the presentation of the Advisory Committee focusing on a comprehensive assessment of key economic and financial indicators relevant for the Monetary Board's deliberation. The results of the discussions of the Advisory Committee as well as their recommendations on the appropriate stance of monetary policy were also presented to the Monetary Board. These served as inputs for the Monetary Board's review of the BSP's monetary policy stance.

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

- Headline inflation slowed down to 2.7 percent year-on-year in May 2003 from the previous month's 2.8 percent. Similarly, the BSP's measure of core inflation decelerated to 2.4 percent in May from 2.5 percent in April 2003.
- Average inflation for the whole year of 2003 would likely fall significantly below the Government's target of 4.5-5.5 percent. This was based on the Monetary Board's assessment which showed that:
  - The continuing mixed trends in aggregate demand conditions support a benign inflation environment going forward; and

[*] The highlights of the discussions of the 5 June 2003 Monetary Board meeting were approved by the Monetary Board during its meeting held on 10 July 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.

- Supply-side risks to inflation have shown evident signs of tapering off, particularly with the abatement of the El Niño phenomenon and the downtrend in international oil prices with the conclusion of the US-Iraq war.

- For 2004, inflation is expected to rise but remain within the Government's target range of 4-5 percent. This outlook stemmed from the following factors:

  - Stronger pace of economic activity underpinned by robust consumption and improved agricultural output;

  - Stronger growth in domestic liquidity, underpinned by improving demand for credit based on expectations of a continued supportive monetary policy stance;

  - Influence of cost-push factors such as one-off price adjustments in utility charges; and

  - Possible minimum wage adjustments to reflect increases in the cost of living.

- Indicators of domestic demand showed improvement, particularly in terms of stronger consumption spending and manufacturing activities. However, the pace of credit demand remained modest with a mild slowdown observed in March. The overall strength of aggregate demand thus remained generally moderate.

  - The Philippine economy grew strongly in the first quarter as real GDP rose by 4.5 percent, which is the upper end of the Government's forecast of 4.0-4.5 percent. Similarly, real GNP increased significantly in the first quarter by 5.6 percent, exceeding the Government's forecast of 4.3-4.8 percent.

  - Consumer spending remained robust. Private consumption spending grew by 4.9 percent in real terms during the first quarter of 2003, driven mainly by spending on food, transport and cellular phone services, and utilities. This growth was stronger than the 3.5 percent increase reported a year earlier and was the highest growth rate recorded since the fourth quarter of 1998.

  - The year-on-year rise in the volume of production index (VOPI) grew by 6.4 percent (revised) in March 2003, a marked turnaround from the 1.1 percent (revised) decline in the previous month.

Meanwhile, the growth in value of production index (VAPI) strengthened to 17.4 percent (revised) during the month from 10.0 percent (revised) in February.

- Average capacity utilization in manufacturing continued to improve, rising to 80.0 percent (revised) in March from 76.7 percent (revised) in the previous month.

- Commercial bank lending continued to rise for the seventh consecutive month, rising by 3.2 percent year-on-year in March 2003. However, this was a deceleration from the 4.4-percent growth registered in the previous month.

- Passenger vehicle sales declined further by 31.5 percent year-on-year in April 2003 following a similar decline of 18.0 percent in the preceding month.

- The main risks to future inflation associated with cost-push influences, have shown some signs of weakening. Weather conditions are expected to normalize indicating continued favorable food production in the near term. Meanwhile, prices of fuel products softened in May.

  - Agricultural output growth slowed down to 2.8 percent in the first quarter from the 5.2 percent gain posted for the same period last year due mainly to the El Niño weather disturbance. However, food production for the remainder of 2003 should be normal with dissipating dry weather conditions, the onset of the rainy season, and continuing government measures to support farmers. These factors should help tame food inflation for the rest of the year.

  - Pump prices of domestic petroleum products continued to trend downward as world oil prices softened and domestic supply remained relatively high. Compared with the end-April 2003 levels, prices per liter of gasoline products, diesel oil, kerosene and liquefied petroleum gas (LPG) as of 30 May 2003 were reduced cumulatively by ₱1.20, ₱0.90, ₱0.60 and ₱0.56 respectively. Meanwhile, as of 26 May 2003, the oil industry inventory level was estimated at 72 days of supply, well above the required minimum inventory level of 7-15 days.

  - In the utilities sector, the Energy Regulatory Commission (ERC) has already approved Phase 1 of Meralco's refund scheme. On a separate decision issued on 30 May 2003, the ERC issued its Order on Meralco's motion for reconsideration of the ERC's decision on the utility's rate unbundling case. The Order authorized Meralco to implement a ₱0.17 per kwh average increase over Meralco's average May selling rate.

- Treasury bill (T-bill) yields began to decline in May. The general softening of the yields was due mainly to the improved fiscal performance in April 2003 as well as the presence of ample liquidity in the system. During the 26 May 2003 auction of the Bureau of the Treasury, the average yield on the benchmark 91-day T-bill fell to 6.302 percent, 54 basis points lower than the 6.842 percent yield recorded in the previous auction. This was the lowest level registered since the 17 March 2003 auction. The steady downtrend in the benchmark RP rates was accompanied by relatively steady foreign interest rates, which in turn translated into narrower interest rate differentials in May. Meanwhile, the growth in domestic liquidity slowed down further in April 2003 due in part to the increase in the liquidity reserve requirement for commercial and universal banks as well as the removal of the tiering scheme on RRP placements.

- The peso further strengthened against the US dollar by 22 centavos to average ₱52.54/US$1 in May 2003 compared to the ₱52.76/US$1 average in April 2003 due to the sustained inflow of remittances from overseas Filipino workers (OFWs), the strengthening of regional currencies vis-à-vis the US dollar and receipts from export dollar sales. Meanwhile, on a real, trade-weighted basis, the peso depreciated relative to the currencies of the major trading partners. The peso also tracked a similar depreciating trend vis-à-vis the broad and narrow baskets of competitor currencies. These developments indicated some improvement in the country's external price competitiveness.[2]

- For the period January-April, the National Government (NG) budget deficit stood at ₱65.5 billion, lower by 21.1 percent compared to the level registered in the same period a year ago. The favorable fiscal performance was influenced largely by the strong growth in revenue collections, reflecting partly the seasonal impact of quarterly/annual tax payments, reform measures instituted by the primary collecting agencies as well as the tight rein in public spending. The improvement in the NG fiscal performance in April buoyed up expectations that the fiscal sector could achieve its target budget deficit for the whole year.

[2] The basket of the major trading partners is composed of the currencies of the US, Japan, the Euro area and the United Kingdom. The broad basket of competitor countries 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 only.

This should provide a positive influence on expectations on future inflation and output growth.

- Although the uncertainties associated with the US-Iraq war were lifted, the timing and extent of global recovery remain uncertain as significant geopolitical, economic and policy risks remained in the major economies. The risks over the pace of global economic recovery remained predominantly on the downside.

  - In the US, recent economic indicators showed mixed signs of improvement but the overall picture indicated softness in domestic demand over the near term.[3] US real GDP growth in the first quarter of 2003 grew steadily by 1.4 percent (revised) as in the previous quarter. Consumer sentiment continued to rise in May as the University of Michigan's consumer sentiment index increased further to 92.1 (revised) from April's reading of 86.0.[4] Similarly, the Conference Board's Consumer Confidence Index—another closely watched gauge of consumer confidence—rose to 83.8 in May, the highest in six months since November 2002.[5] However, the US unemployment rate remained high at 6.0 percent in April while the manufacturing sector remained weak as reflected in the decline of the Institute for Supply Management's (ISM) manufacturing index to 45.4 percent in April compared to 46.2 in March.

  - In the Euro area, initial estimates indicated that the Euro zone posted a nil quarter-on-quarter GDP growth in the first quarter.[6] While the appreciation in the euro would help ease further inflationary pressures in the short term, it could also dampen exports, which have been relied upon as the driver of economic growth in the Euro area.

  - In the UK, estimates of the Office of National Statistics (ONS) showed that the first quarter real GDP grew by only 0.2 percent, quarter-on-quarter or by 2.2 percent from the level a year ago. The key uncertainty in the UK economy was the overall pressure on the

[3] The Federal Reserve Board, Assessing Prospects for Economic Growth in the United States, Remarks by Governor Mark W. Olson before the Chambers of Commerce of Bloomington, Eden Prairie and Edina, Bloomington, Minnesota, 22 May 2003

[4] Business-AP, "Consumer sentiment improves in May," 30 May 2003 available at http:// story.news.yahoo.com/news

[5] The Michigan survey is based on a telephone poll of around 250 respondents, and is valued for its quick read on where sentiment stands. The Conference Board's consumer confidence index is based on a mail-in survey of 5,000 households, and is more focused on labor-market conditions.

[6] ECB Monthly Outlook at fxstreet.com, The Forex Market, 28 May 2003, available at http://www.fxstreet.com/nou/content

demand side, reflecting the balance between the pick-up in government spending and the prospective improvement in net trade and ultimately investment on one hand and the slowdown in consumption, on the other.[7]

- Economic activity in Japan in the first quarter remained flat and there is greater uncertainty about the economic outlook, stoking fears that the economy would slip back into a shallow recession.

- While the main risk surrounding the US-Iraq war has been lifted, the risks on the global economic recovery have been predominantly on the downside. The US Fed, the European Central Bank and the Bank of England maintained their policy rates during their last meetings on monetary policy in May. Meanwhile, the Bank of Japan (BOJ) continued to ease liquidity conditions as it raised further the target for the current account balance of banks held at the BOJ to 27-30 trillion yen from 22-27 trillion yen during their monetary policy meeting held on 19-20 May 2003. The BOJ also signaled its readiness to provide more liquidity irrespective of the target should there be a risk to the stability of the financial markets in case of a surge in liquidity demand.[8]

II. Review of the Monetary Policy Stance

- The members of the Monetary Board agreed that the current demand and supply conditions continued to point to a subdued inflation environment going forward. For 2003, the Monetary Board expects the average annual inflation to fall significantly below the Government's target of 4.5-5.5 percent. For 2004, the Monetary Board expressed confidence that the average annual inflation would remain broadly in line with the 4.0-5.0 percent target. Based on its assessment, the Monetary Board believed that the near-term risks to inflation have diminished. In particular, deliberations by the Monetary Board showed that:

  - Despite the observed improvements in some areas of domestic demand—such as the robust growth in consumption spending and improvements in manufacturing—there is still lack of clear-cut evidence of a sustained pick-up in domestic economic activity.

[7] Bank of England, Minutes of Monetary Policy Meeting, 7 and 8 May 2003, 21 May 2003, available at www.bankofengland.co.uk

[8] Bank of Japan, Monthly Report of Recent Economic and Financial Developments, May 2003 (The Bank's View), available at www.boj.or.jp/en

The lack of momentum for a pick-up in credit demand as well as continued restraint in bank lending stance—in part motivated by banks' need to preserve asset quality—have contributed to the lack of price pressures.

- The supply-side risks to inflation have recently shown evident signs of tapering off, particularly with the abatement of the El Niño phenomenon and the downtrend in international oil prices with the conclusion of the US-Iraq war.

- The exchange rate has reversed its decline since mid-March and has remained relatively stable indicating that the risk to the inflation outlook coming from a possible sustained depreciation of the currency—which coincided with the war uncertainties—has dissipated.

- Slower M3 growth in April relative to March indicated that the demand for money remained moderate despite ample liquidity in the system.

- In the external sector, the members of the Monetary Board observed that the balance of risks on the global economic outlook remained on the downside even as the uncertainty surrounding the war has been removed. A slowdown in the pace of global recovery could impact adversely on the demand for Philippine exports. The members of the Monetary Board noted that this could weigh down on the growth prospects of the Philippine economy.

- Based on these observations, the Monetary Board evaluated two alternative policy moves. In particular, the members of the Monetary Board deliberated on the merits of maintaining the current monetary policy settings and the possibility of further easing the current monetary policy stance.

- Maintaining monetary policy settings

  Against a backdrop of favorable inflation environment and relatively subdued demand conditions, the members of the Monetary Board noted that current monetary policy stance could be maintained to provide sufficient liquidity to fuel the economy's growth requirements while guarding against the resurgence of price pressures that could dampen the growth momentum.

- Easing the monetary policy stance

  - The Monetary Board argued that the lack of momentum for a sustained build-up in aggregate domestic demand and the downside risks in the external environment along with the quiescent inflation path highlighted the need for a supportive monetary policy setting, going forward. They expressed the view that recent monetary conditions and other economic developments provided added flexibility for the BSP to ease the stance while remaining cautious against potential inflationary threats given that the main risks to the inflation outlook have largely dissipated.

  - The Monetary Board considered the option of restoring the tiering scheme on banks' placements with the BSP. They noted that based on the staff's estimates, the possible impact on inflation of the restoration of the tiering scheme on banks' placements with the BSP under the RRP and SDA facilities would only be minimal and would not lead to a breach of the Government's inflation targets over the BSP's policy horizon. They also stressed that easing the monetary policy setting—through the restoration of the tiering scheme—could help build up momentum for economic activity and consumer confidence without endangering the inflation goals. They also noted that the restoration of the tiering scheme would help compel banks to increase their lending activities for productive purposes instead of parking their excess funds with the BSP.

- The members of the Monetary Board also underscored that the BSP would remain watchful of the evolving economic and financial developments, including the policy moves by other central banks such as the US Fed.

III. Monetary Policy Decision

- After a careful assessment of the balance of risks on inflation and inflationary expectations on one hand and the evolving domestic demand conditions, on the other hand, the Monetary Board, by a unanimous vote, approved to restore the tiering scheme on banks' placements with the BSP under the RRP and SDA windows. In particular, banks' placements with the BSP under the overnight RRP window would be subject to the following interest rates:

  (1) First ₱5 billion - 7 percent;
  (2) Over ₱5 billion-₱10 billion - 4 percent; and

(3) Over ₱10 billion - 1 percent.

The next meeting of the Monetary Board to discuss the monetary policy setting was scheduled on 2 July 2003.

- **The Monetary Board of the Bangko Sentral ng Pilipinas**