Bangko Sentral ng Pilipinas

HIGHLIGHTS OF THE MEETING OF THE MONETARY BOARD ON MONETARY POLICY ISSUES HELD ON 23 OCTOBER 2003*

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

The Advisory Committee[1] submitted for the consideration of the Monetary Board the following recommendations: (1) 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; (2) maintain the current interest rates on the term RRPs, RPs, and Special Deposit Account (SDAs); and (3) maintain the current reserve requirement ratios given the adequate level of liquidity in the system. These recommendations were based on the following considerations:

- Domestic price conditions remained subdued as headline inflation decelerated anew to 2.9 percent in September from 3.0 percent in the previous month. The deceleration was traced mainly to lower year-on-year inflation rates for food items, including rice, fruits and vegetables. Meanwhile, estimates of core inflation registered marginal increases during the month but remained relatively low. The BSP's main measure of core inflation rose slightly to 3.5 percent year-on-year in September 2003 from 3.4 percent in the previous month.

- The near-term outlook for inflation remained essentially unchanged. Abstracting from any adverse shock, the current benign inflation environment could be expected to continue over the policy horizon. For the year, average annual inflation is expected to fall below the Government's target of 4.5-5.5 percent. For 2004, inflation is expected to track broadly the 4-5 percent target for the year.

* The highlights of the discussions of the 23 October 2003 Monetary Board meeting were approved by the Monetary Board during its meeting held on 20 November 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. The 23 October 2003 meeting of the Monetary Board—the eleventh meeting for the year to discuss monetary policy issues—followed the Advisory Committee meeting held on 20 October 2003.

- The strength of aggregate demand remained moderate. However, other demand-side indicators continued to show signs of weakness, particularly exports. The current modest pace of domestic economic activity underpinned expectations of limited demand-side influence on prices.

    - Production in the manufacturing sector improved in July 2003 as the volume of production index (VOPI) rose by 4.4 percent year-on-year in July after falling by 1.5 percent (revised) in the previous month. Meanwhile, the increase in the value of production index (VAPI) accelerated to 12.9 percent year-on-year in July from 6.6 percent in June.

    - Average capacity utilization of the manufacturing sector was almost unchanged at 78.8 percent in July from its month ago level of 78.5 percent.

    - Demand for Philippine exports weakened anew in August. However, the decline in merchandise exports was slower at 2.2 percent year-on-year in August as against the 7.9 percent contraction in the previous month.

    - Other demand indicators also showed mixed trends. Car sales continued to drop in September, although at a slower pace. The contraction in the number of passenger cars sold eased to 2.7 percent year-on-year in September from 30.7 percent in August. Meanwhile, power sales by Meralco increased by 6.7 percent year-on-year in August after a 4.5 percent annual rise in July.

- Supply-side or cost-push factors were expected to remain manageable, going forward. Food prices should remain stable given improving weather conditions and government efforts to boost agricultural production. Meanwhile, the adequate level of inventory maintained by the domestic oil industry should provide cushion against the pass-through impact of higher world oil prices.

    - The first semester agriculture output growth of 2.4 percent, normalizing weather conditions as well as government measures to boost agricultural production and address supply bottlenecks supported a positive outlook for food supply that could help stabilize prices.

    - World oil prices inched up in early October following the Organization of Petroleum Exporting Countries' (OPEC) decision to cut its production ceiling by 900,000 barrels per day effective 1 November

2003. On the local front, pump prices of petroleum followed a similar uptrend to reflect the higher world oil prices as well as the peso's depreciation.

- There continued to be evidence of adequate liquidity in the system. Growth in the demand for money improved slightly, accompanied by consistent—although still modest—expansion in commercial bank lending. Moreover, the Treasury bill (T-bill) offerings in October were oversubscribed while banks continued to park excess funds under the BSP's RRP and SDA windows.

  - Domestic liquidity growth (M3) accelerated slightly to 3.8 percent year-on-year as of end-August 2003 from 3.6 percent in July.

  - Loans outstanding of commercial banks rose for the twelfth consecutive month in August. Commercial bank lending grew by 3.8 percent in August, a slight improvement from the 3.7 percent annual rise in the previous month.

  - Despite ample liquidity in the system, T-bill rates rose further in October, fueled by concerns over the country's fiscal position and political uncertainties. During the Bureau of the Treasury's (BTr) T-bill auction held on 13 October 2003, the yield on the benchmark 91-day T-bill rate went up by 12.3 basis points relative to the previous auction on 29 September 2003 to settle at 5.629 percent.

- Despite Moody's downgrade on the outlook for the country's debt ratings, the peso strengthened against the US dollar in the first half of October, buoyed by the strength of regional currencies and expectations of inflows of dollar remittances for the holiday season.

- The National Government's (NG) budget deficit in September was recorded at ₱29.1 billion, higher than the ₱22.0 billion programmed for the month as fiscal stimulus was maintained while revenue performance of major tax collecting agencies softened. However, the NG budget deficit for the first nine months remained below the program and the level posted a year earlier as the NG remains committed to fiscal discipline.

- The global economy has shown encouraging signs of recovery in recent months, led mainly by the upturn in the US economy. The near-term downside risks to the world economic activity appeared to have receded in the past month. However, the signs of recovery continued to be tentative and uneven across the major economies. There have been signs of improving prospects for economic growth in Japan but economic growth in the euro area remained subdued. Meanwhile, the structural imbalances and vulnerabilities across major countries and the rest of the world continued to pose a challenge to the sustainability of recent gains in global economic activity.

- The recovery in the United States has recently been gaining momentum as consumer spending advanced strongly and business investment picked up in the second quarter. However, these gains have yet to feed through fully through the economy, in terms of absorbing excess capacity and creating new jobs. In addition, the large deficits in the federal budget and the current account—estimated at about 3.8 percent and 4.6 percent of GDP, respectively—continued to pose a challenge to the sustainability of the recovery process.[2] This, in turn, could impact adversely on the strength of the US dollar relative to other currencies. A weakening of the US dollar relative to other major currencies such as the euro and the Japanese yen could dampen the growth prospects of the global economy.

- In the euro area, economic activity was weaker than anticipated in the second quarter of 2003. However, the European Central Bank (ECB) noted that the latest data and information were consistent with a moderate pick-up in activity in the second half of the year. The ECB reported that recent confidence surveys and leading indicators pointed to some pick up in manufacturing activity and improving business confidence.[3] However, the continued weakness in labor market conditions, highlighted by the significantly high levels of unemployment in the major member-economies such as Germany and France, could dampen the growth prospects in the eurozone.

- In the United Kingdom (UK), the quarter-on-quarter GDP growth was revised up to 0.6 percent from the earlier estimate of 0.3 percent on the strength of construction activity and manufacturing.[4] Based on its assessment, the Bank of England (BOE) noted the risks to the achievement of the inflation target over the medium-term posed by the apparent strength in consumption demand that was accompanied by

[2] Source of data: Bloomberg, "Global Economy Watch: GDP, Inflation, Deficit, Jobs" 8 October 2003
[3] European Commission Directorate General for Economic and Financial Affairs, Quarterly Report on the Euro Area, 30 September 2003, available at http://europa.eu.int
[4] Source of data: Reuters, Update 1-BOE's Bean not surprise by upward UK GDP revision." 1 October 2003

a rapid accumulation of debt.[5] These developments highlighted the need to restore balance in consumers' financial position and the corporate balance sheets as these could cap the growth in business investments.

- In Japan, the foundation for a gradual recovery of the economy has been laid with improvements in exports and business sentiment, although the pace of said improvements have been quite modest. The Bank of Japan (BOJ) noted that exports and production will likely increase in the near-term, which in turn, would gather momentum gradually towards a sustained economic recovery in Japan. However, the Bank indicated that it could still take some time before a self-sustaining recovery in domestic demand could gain momentum, given the existence of persistent structural problems, such as the huge debt profile and the slack in the labor market.[6]

- While global growth prospects have improved, the overall global economic outlook continued to be tentative. Major imbalances remained across major economies, which could pose a risk to the sustainability of the economic recovery process. In response to these challenges, major central banks have remained broadly supportive. This was aimed at strengthening the still fragile global economic upturn.

II. Review of the Monetary Policy Stance

- Based on the information presented by the Advisory Committee, the members of the Monetary Board noted that the economic and financial environment has not changed significantly since the last review of the monetary policy stance held on 2 October 2003. The Monetary Board's assessment of current conditions continued to point to a benign inflation setting combined with moderate improvements in domestic economic activity. Their expectations of subdued price conditions were based on subdued improvements in aggregate demand, particularly credit demand, soft labor market conditions, the moderate influence of cost-push factors such as energy prices, and broad stability in foreign exchange market conditions.

[5] Bank of England, Minutes of the Monetary Policy Meeting, 3-4 September 2003, 17 September 2003, available online at http://www.bankofengland.co.uk
[6] Bank of Japan, Monetary Policy Meetings, 10 October 2003, available at http://www.boj.or.jp

- While upside pressures to the inflation outlook have diminished, the members of the Monetary Board stressed that there could still be some adverse cost-side developments and disorderly adjustments in the foreign exchange market arising from sentiment reversal. This, in turn, could impact negatively on public expectations about future prices. Thus, the members of the Monetary Board shared the view that these factors highlight the need for monetary authorities to assess continuously the evolving macroeconomic environment to be able to respond well ahead and in measured fashion to any potential risk to the inflation outlook.

- Based on these considerations, the Monetary Board discussed the following courses of monetary policy action presented by the Advisory Committee:

  a. An active approach through further monetary easing to increase the stimulus to economic activity and respond to lingering weakness in overall demand; and

  b. Cautious optimism in the form of maintaining the current monetary policy settings to preserve the ongoing stimulus to the real sector.

  - Further easing of the monetary policy stance:

    The principal argument raised by the members of the Monetary Board for further monetary easing was the observation that aggregate demand conditions continued to be modest and have yet to show evidence of sustained, robust improvement. An easing of the monetary policy settings, they argued, could help build up momentum for economic activity and support the observed improvement in consumer confidence. However, the members of the Monetary Board shared the view that there is need for monetary authorities to guard against excessive easing, particularly given the ample liquidity in the system. Moreover, they also noted some ambiguity on whether further relaxation of monetary and credit conditions would translate to a significant improvement in credit growth and aggregate demand.

  - Maintaining current monetary policy stance:

    The following arguments were raised by the members of the Monetary Board in favor of maintaining the current monetary policy stance: (a) the outlook for 2004 inflation suggests average inflation will be in line with the target, implying that monetary tightening may not be necessary; (b) there continues to be evidence of sufficient liquidity to fuel the economy's growth requirements, hence, further easing may not be necessary; (c) the monetary policy stance needed to be sufficiently cautious to guard against any possible renewed price pressures that may emerge over the near term; and (d) the present relatively low interest rate environment should contribute to a recovery in investment.

- In conclusion, the members of the Monetary Board agreed that the decision to maintain the current monetary policy settings would help guard against future price risks while ensuring adequate liquidity to support growth in domestic demand.

III. Monetary Policy Decision

- After a careful assessment of the balance of risks on inflation and inflationary expectations and the evolving domestic and external 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 RRP rate and 9.0 percent for the overnight RP rate;

  b. Maintain the current interest rates on the term RRPs, RPs, and SDAs; and

  c. Maintain the current reserve requirement ratios 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 20 November 2003.

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