Bangko Sentral ng Pilipinas

HIGHLIGHTS OF THE MEETING OF THE MONETARY BOARD ON MONETARY POLICY ISSUES HELD ON 10 MARCH 2005*

The Advisory Committee[1] submitted the following recommendations for the consideration of the Monetary Board:

1) Maintain the current monetary policy settings as follows:

   (a) Maintain the BSP's policy rates at the current uniform rates of 6.75 percent for the overnight RRP (borrowing) rate and 9.0 percent for the overnight RP (lending) rate;

   (b) Maintain the current interest rates on the term RRPs, RPs, and Special Deposit Accounts (SDAs); and

   (c) Maintain the current reserve requirement ratios.

2) Continue to articulate support for the use of non-monetary measures to address supply-side risks, particularly those relating to food supply, by strengthening the BSP's representation and coordination with various government agencies.

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

The above recommendations were based on the following considerations:

- In line with expectations, headline inflation increased slightly to 8.5 percent year-on-year in February 2005 from 8.4 percent in January. This was due to the higher inflation for food, beverage and tobacco (FBT), housing and repairs (H&R) and miscellaneous items.

- Core inflation (defined as headline inflation excluding selected food and energy products) likewise rose to 8.1 percent in February 2005 from 7.9 percent in the previous month.

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* The highlights of the discussions of the 10 March 2005 Monetary Board meeting were approved by the Monetary Board during its meeting held on 14 April 2005.

[1] The Advisory Committee is composed of the Governor of the BSP as Chairman and four members, namely: the Deputy Governor for the Monetary Stability Sector, the Deputy Governor for Supervision and Examination Sector, the Assistant Governor, Monetary Policy Sub-Sector and the Acting Managing Director of the Treasury Department.

- The risks to the inflation outlook continue to be linked primarily to supply-side factors particularly the volatile movements in world crude oil prices, which could feed into the prices of other goods and services. However, forecasts generated by the BSP's inflation forecasting models indicated that inflation will decelerate in the coming months and settle at around 5.0 percent by the fourth quarter of 2005. Average inflation is still expected to exceed the full year target of 5.0-6.0 percent in 2005 but is projected to fall within the target range of 4.0-5.0 percent in 2006.

- Selected indicators suggested improvements in domestic demand but some evidence of resource slack remained. This supported the argument that potential demand-side pressures on prices may still be limited at present.

  - Average capacity utilization in manufacturing remained relatively steady at 79.9 percent in December 2004 from 80.0 percent (revised) in November. This was also higher than the 78.4 percent posted in December 2003.

  - The growth in value of production index (VAPI) for manufacturing decelerated slightly to 17.0 percent in December 2004 from 18.7 percent (revised) growth in the previous month. Likewise, the growth in volume of production index (VOPI) for manufacturing slowed to 5.7 percent in December following an 8.1 percent (revised) increase in November.

  - Exports grew by 2.9 percent year-on-year in December 2004, the slowest since November 2003. This also brought 2004 export growth to 9.3 percent, lower than the 10.0 percent export growth target for the year.

  - Merchandise imports fell slightly by 0.9 percent year-on-year in December 2004, the first decline in imports recorded in seven months. Total merchandise imports for 2004 posted a 7.5 percent increase from 2003.

  - Passenger car sales registered a marginal growth of 0.1 percent year-on-year in January 2005 following a 9.7 percent decline in the previous month. Sales of trucks and buses, meanwhile, fell further by 31.1 percent year-on-year in January from 4.6 percent in the previous month.

  - Energy sales by the Manila Electric Company (Meralco) increased by 7.2 percent year-on-year in January 2005 from a slight decline of 0.2 percent in the previous month. This was also a reversal from the 7.6 percent contraction in same month last year.

- The unemployment rate remained relatively sizeable at 10.9 percent in October 2004 compared to the 10.2 percent registered for the same period in 2003. The October unemployment rate, however, was lower than the 11.7 percent posted in the preceding quarter.

- In the financial sector, the growth in domestic liquidity accelerated. Bank lending, however, remained sluggish. Meanwhile, Treasury bill rates eased during the 28 February compared to their 31 January auction rates.

  - Domestic liquidity (M3) grew by 9.2 percent (revised) year-on-year in December 2004 from the 6.9 percent (revised) increase in the previous month. Preliminary data for January 2005 showed that M3 based the Depository Corporations Survey (DCS) rose by 10.8 percent from 9.1 percent in the previous month.[2]

  - The total volume of commercial bank (KB) loans grew by 2.6 percent year-on-year as of end-December 2004, slower than the 3.6 percent growth recorded in the previous month.

  - T-bill rates eased across all tenors during the 28 February 2005 auction compared to their 31 January 2005 auction rates. The downtrend was traced to the presence of ample liquidity in the system amid improving market sentiment following the Financial Action Task Force (FATF) decision to remove the Philippines from its list of non-cooperative countries and territories (NCCTs) in the global fight against money laundering.

- Supply-side factors, notably price fluctuations in the world oil market and weather-induced pressures on agricultural food prices were expected to remain the central influence on the path of inflation.

  - Total agricultural production in 2004 accelerated despite the damages on output caused by typhoons in the last two months of the year. For 2005, crop production is expected to be weak in the first quarter due to the impact of the ongoing El Niño weather pattern but a rebound is expected in the second quarter. This highlights the need for government measures to prevent supply shortages.

  - International oil prices again surged to new highs in early March as the continued low temperature in the Northern Hemisphere fueled stronger demand for heating oil. Similarly, domestic oil companies

[2] The new M3 series refers to the stock of broad money based on data on the Depository Corporations Survey (DCS). The DCS, which replaces the Monetary Survey (MS) as the basis for measuring domestic liquidity, features an expanded list of surveyed institutions that includes the BSP, commercial banks, thrift banks, rural banks, non-stock savings and loan associations and non-banks with quasi-banking functions.

raised pump prices of petroleum products during the last week of February.

- The peso extended gains against the US dollar, spurred by continued inflows from overseas Filipino workers (OFWs) remittances and offshore investments as well as generally positive outlook on the domestic economy

- In the fiscal sector, the National Government's (NG) budget deficit in January 2005 widened slightly by 2.4 percent to reach ₱16.5 billion, from ₱16.1 billion in the same month last year owing to the 35 percent surge in interest expenses. However, the actual deficit is only about a fifth of the government's ₱77.8 billion target for the first quarter, indicating that the government forecast remained on track.

- Global economic expansion remained broadly on course in the fourth quarter of 2004, supported by sustained gains in investment spending and gradual improvements in labor market conditions. Industrial production and export gains, however, appeared to have slowed down in most economies, reflecting both a return to more sustainable pace of expansion and the adverse impact of higher oil prices.

  - Prospects for the US economy continued to look firmer but not altogether risk-free given the uncertainty over the direction of world oil prices, mounting budget and current account deficits, and uneven gains in employment and earnings.

  - Available information pointed to ongoing moderate growth in the euro area in the fourth quarter of 2004. Labor market conditions remained broadly stable while investment is expected to remain strong, boosted by favorable financing conditions and improved corporate earnings.

  - The UK economy grew at close to trend, boosted by the growth in services and manufacturing in the fourth quarter of 2004. This was further accompanied by solid growth in investment and public consumption alongside a strong net trade position.

  - The Japanese economy slid into recession as the economy contracted further in the last three months of 2004 due to weak industrial production and export growth, and subdued consumer spending.

- The US Federal Open Market Committee (FOMC), the Reserve Bank of Australia (RBA) and the Bank of Thailand (BOT) raised policy rates by 25 basis points, citing uptrend in inflation and tight labor market conditions. Meanwhile, the other major central banks kept their policy settings unchanged during their respective monetary policy meetings.

II. Review of the Monetary Policy Stance

- The members of the Monetary Board noted that the outlook for inflation continued to support the maintenance of present policy settings given that inflation is expected to decline towards the target by 2006. Moreover, expected price pressures over the two-year policy horizon continued to be linked primarily to supply-side influences, particularly price fluctuations in the world oil market and weather-induced pressures on agricultural food prices.

- The members of the Monetary Board also noted that demand conditions continued to indicate that the economy remains below full-employment or full capacity. This is implied by the fact that credit demand remains moderate despite its recent improvement, while the unemployment rate remains well above its cyclical low of about 8 percent in the mid-1990s.

- The members of the Monetary Board were of the view that the main policy concern for the near term will be the impact of continued supply-side pressures—such as expectations of imported oil prices to remain high, and potential impact of new tax measures—on wage- and price-setting behavior.

? The Monetary Board likewise recognized that the possibility of exchange market pressures arising from narrowing interest rate differentials and other sources may also pose a threat to inflation and inflation expectations. However, the prospect of a weak US dollar should provide a countervailing influence on import prices.

? The Monetary Board pointed out that the BSP can guide the public's inflation expectations down without resorting to monetary tightening by (1) disclosing its decelerating outlook for inflation; (2) pointing out the muted evidence of second-round effects from supply shocks; and (3) carefully explaining the basis for all policy decisions.

- In sum, the members of the Monetary Board agreed that present monetary policy settings should be kept unchanged for the time being. The necessity of monetary action remains low at present given the prevailing outlook, but this may change depending on developments in wages, cost-side variables, and any possible adverse movements in the foreign exchange market.

- Nonetheless, the Monetary Board emphasized that should policy actions indeed become necessary, such actions will be fairly restrained in order to minimize the potential output consequences, and will be geared more toward nudging inflation expectations in the right direction rather than dampening demand-side impulses.

III. Monetary Policy Decision

- Upon assessment of the balance of risks to inflation and the evidence that has become available since its previous meeting on monetary policy, the Monetary Board approved unanimously the following measures:

1) Maintain the current monetary policy settings as follows:

   (a) Maintain the BSP's policy rates at the current uniform rates of 6.75 percent for the overnight RRP (borrowing) rate and 9.0 percent for the overnight RP (lending) rate;

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

   (c) Maintain the current reserve requirement ratios.

2) Continue to articulate support for the use of non-monetary measures to address supply-side risks, particularly those relating to food supply, by strengthening the BSP's representation and coordination with various government agencies.

The next meeting of the Monetary Board to discuss the monetary policy setting is scheduled on 7 April 2005.

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