HIGHLIGHTS OF THE MEETING OF THE MONETARY BOARD ON MONETARY POLICY ISSUES HELD ON 12 FEBRUARY 2004*

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.

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

The above recommendations took the following into consideration:

- Headline inflation in January 2004 was slightly higher at 3.4 percent year-on-year compared to 3.1 percent in the previous month using the 1994-based series for consumer price index (CPI). The uptick in January inflation can be traced mainly to the movements in food (notably, meat and poultry products) and fuel-related components of the CPI.

- Based on the new CPI series released by the National Statistics Office (NSO) using 2000 as the reference or base year, inflation picked up slightly to 4.1 percent in January 2004 from 3.9 percent in December 2003. The new 2000-based CPI series was derived from an updated basket of goods and services that captures the current spending patterns and preferences of Filipino consumers. Preliminary analysis

* The highlights of the discussions of the 12 February 2004 Monetary Board meeting were approved by the Monetary Board during its meeting held on 11 March 2004.

[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 12 February 2004 meeting of the Monetary Board—the 2nd monetary policy meeting for 2004—followed the Advisory Committee meeting held on 9 February 2004.

nevertheless, showed that the historical trends of the two CPI series are broadly parallel.[2]

- Official core inflation statistics (both 1994- and 2000-based) released by the NSO continued to show a moderate uptrend but remained essentially close to their headline rates. Based on the 1994-series, the core inflation rate trended up to 3.6 percent in January 2004 from 3.4 percent in December. Similarly, core inflation increased modestly to 4.0 percent year-on-year in January 2004 from 3.8 percent a month ago based on the 2000-series.

- Looking ahead, the average annual headline inflation is expected to track generally the 4.0-5.0 percent target over the policy horizon. Headline inflation is expected to rise moderately over the coming year or so, in accordance with improving aggregate demand conditions, but should continue to be broadly in line with Government target of 4-5 percent for both 2004 and 2005. However, the recent volatility in the foreign exchange market could pose upside risks to the inflation outlook.

- Recent data on domestic demand indicators showed improvements but continued to be mixed. There continued to be soft spots in domestic demand, which indicate downside risks to aggregate demand moving forward.

  - The country's real Gross Domestic Product (GDP) grew by 4.5 percent in the fourth quarter, driven by the sustained improvement in private consumption and modest growth of non-public sector forms of investments such as private construction and durable equipment. The full year real GDP growth (4.5 percent) was well within the Government's target for the year while real GNP growth (5.5 percent) was higher than the target.

  - The value of production index (VAPI) for manufacturing declined by 0.4 percent in November 2003 following the 3.2 percent (revised) and 3.7 percent growth in October and September 2003,

[2] On 5 February 2004, the National Statistics Office (NSO) started releasing the 2000-based CPI-series and official core inflation series alongside the 1994-based CPI series. The 2000 and 1994 headline and core inflation series will continue to be published until June 2004, after which, only the 2000–based CPI headline and core inflation data will be reported.

respectively. Meanwhile, the volume of production index (VOPI) for manufacturing dipped further by 8.4 percent year-on-year (revised) in November, following a 5.1 percent (revised) decline in October and a 3.1 percent drop in September.

- Average capacity utilization in the manufacturing sector declined slightly in November 2003 at 78.2 percent (revised) from 78.6 percent in October 2003 but was higher than the 75.7 percent recorded a year ago.

- Revised data on Philippine exports from NSO showed that exports grew by 9.0 percent year-on-year in December 2003 as against the 0.6 percent decline in November (revised from -4.6 percent). The full year 2003 export growth was registered at 1.5 percent.

- Total merchandise imports reported by the NSO showed a 7.1 percent (revised) year-on-year increase in October 2003, reversing the past two consecutive months of declines.

- Registered energy sales by the Manila Electric Company (Meralco) accelerated by 3.9 percent year-on-year in December 2003, following an increase of 3.6 percent in November 2003. Total energy sales of Meralco for 2003 grew by 4.4 percent from the year ago.

- The growth of car sales doubled to 109.7 percent year-on-year in December 2003 from 53.3 percent in November. This brought the growth of car sales at 11.9 percent in 2003.

- The near-term outlook on the supply side continued to be favorable, boosted by the on-target output growth of the agricultural sector in 2003 as well as forecasts of robust production in the first semester. These factors could help cushion the risks to inflation arising from potential demand-pull pressures.

  - The agriculture sector grew by 3.8 percent in 2003, well within the 3.0-4.0 percent target growth of the Government for the year. Expectations of higher yields due to favorable weather conditions and continued Government support foster conditions for stable food prices going forward.

- The international price of Dubai crude oil trended higher in January due to continued demand for heating fuel in the Northeastern countries—as the cold spell persisted—and higher demand for oil in growing Asian economies. In turn, local oil companies raised pump prices of gasoline and other oil products in January and in the first week of February to reflect the higher cost of imported crude oil.

- There continued to be evidence of ample liquidity in the domestic financial market despite the slower growth in M3. Meanwhile, the rise in nominal interest rates in January mirrored the market's response to the downgrade of the country's credit ratings by Moody's Investors Service and the continuing concerns over political developments in the run-up to May elections.

  - Domestic liquidity (M3) grew by a slower 3.3 percent (revised) year-on-year in December 2003 from 4.9 percent in November.

  - The total volume of commercial bank (KB) loans increased by 4.3 percent year-on-year to reach ₱1.49 trillion as of end-November 2003, reflecting 14 straight months of sustained expansion. The increase in bank lending also represents an improvement from the 0.8 percent annual rise in the previous month.

  - The benchmark 91-day Treasury bill rate inched up during the 2 February 2004 auction, reflecting the negative market sentiment over the credit rating downgrade by Moody's Investors Service and uncertainties relating to the current political landscape. The average yield on the bellwether 91-day T-bill rose to 6.216 percent from the 6.16 percent registered during the 19 January 2004 auction.

- The peso weakened in January and early February due to increasing political noise ahead of the May elections and the downgrade of the country's credit rating by Moody's Investors Service combined with higher corporate demand for US dollars and the seasonally lean post-holiday inflows from OFW remittances.

- The National Government posted a fiscal deficit of ₱199.9 billion in 2003, slightly lower than the ₱202.0 billion target for the year. This can be traced largely to higher–than-programmed revenue collections of major revenue offices during the year. The favorable fiscal outturn should contribute to positive inflationary expectations.

- Global economic recovery continued to show signs of firming up. This was most evident in the United States with indications of sustained growth in productivity and output, improving labor conditions and buoyant consumer optimism. Activity in the major economies has picked up in the course of the second half of 2003. However, overall growth remains largely unbalanced, with the euro area and Japan experiencing more modest upturns. Moreover, the projected recovery may be hampered by rising oil prices and, in the case of the euro area, by sharp effective exchange rate appreciation. These developments suggest a moderate improvement in external demand in the Philippines.

  - Output in the US has expanded briskly, buoyed by the recovery in manufacturing and also by stronger consumer optimism. Although new hiring remains subdued, other indicators suggested some improvement in the labor market. Increases in headline and core consumer prices continued to be muted.

  - In the euro area, the revival of activity has been more modest. While manufacturing activity is staging a comeback, domestic demand has remained generally sluggish. Fixed investment continued to decline while household consumption remained subdued. However, the sizeable appreciation of the euro since late 2003 could impact adversely on exports growth which could dampen the prospects for growth.

  - The UK economy has been picking up strongly. Strong GDP growth was recorded in the fourth quarter of 2003, fueled by strong retail sales and record consumer borrowing, against a backdrop of steady inflation.

  - Japan's economy has been recovering gradually. Investments and exports have picked up—largely as a result of stronger activity in China—which has supported the recovery in industrial production. Deflation showed signs of easing, but consumers remained largely cautious about spending.

- Amid increasing signs of stronger economic activity in major economies, the US Federal Reserve and the European Central Bank opted to leave their monetary policy settings unchanged during their respective monetary policy meetings. Meanwhile, the Bank of England decided to raise the Bank's key repo rate by 0.25 percentage point to 4.0 percent on 5 February 2004 while the Bank of Japan decided to raise the target balance of current accounts held at the Bank from "around 27 to 32 trillion yen" to "around 30 to 35 trillion yen" on 20 January 2004.

II. Review of the Monetary Policy Stance

- Based on the assessment of the information presented by the Advisory Committee, the members of the Monetary Board believed that the outlook for consumer prices over the policy horizon continued to be manageable. They also shared the view that the modest pace of money and credit demand continued to suggest downside risks for the overall strength of economic activity. They noted that future monetary policy actions should continue to recognize the liquidity needs of economic growth against a backdrop of manageable inflation and ensure that the macroeconomic environment remains conducive to credit demand and investment activity.

- However, the members of the Monetary Board also noted that the recent pressures on the peso have again raised concerns of a possible sustained episode of currency depreciation, with adverse implications for inflation and inflation expectations. Thus, in a pre-emptive move to address the potential inflationary impact of the volatility in the foreign exchange market, the Monetary Board raised the liquidity reserve requirement by two percentage points to 10 percent effective 6 February 2004.

- The members of the Monetary Board agreed that prospective monetary policy decisions must take place within the larger setting of an inflation targeting regime, which focuses mainly on the outlook for inflation to guide monetary policy actions.

- Given these considerations, the Advisory Committee presented the following monetary policy options to the Monetary Board:

  (a) policy changes geared toward preventing further nominal depreciation and its potential inflationary impact, through

     (i) increasing policy interest rates
     (ii) other active measures; and

  (b) maintaining the current monetary policy settings.

  - The members of the Monetary Board noted that monetary tightening may be resorted to during periods of significant and prolonged exchange market pressure, when movements in the exchange rate threaten the inflation target. However, the members of the Monetary Board believed that an increase in policy rates would lead to higher market interest rates, which could dampen incentives for increased consumption and investments, the expected drivers of growth in 2004 and 2005. Moreover, the Monetary Board also pointed out that the movements in the exchange rate were, in large part driven by political noise and therefore, were neither structural nor persistent in nature. Under these circumstances, the Monetary Board believed that countermeasures to offset these shocks through an increase in the BSP's policy rates could be costly to the economy.

  - The members of the Monetary Board recognized that other active measures can be undertaken to help temper a further depreciation of the peso. In particular, the BSP could tighten further the regulations on the foreign exchange transactions of banks.

  - The Monetary Board's main argument in favor of maintaining the monetary policy stance centered around the notion that increases in domestic interest rates are likely to hamper the available stimulus to the real sector. Moreover, the degree of exchange rate pass through on inflation could be mitigated by the continued presence of output gap, as evidenced by spare capacity in manufacturing and the unemployment rate. In addition, the members of the Monetary Board noted that the impact of currency depreciation on oil and non-oil imports may also be mitigated by the fact that current import demand is relatively low and the country has actually reduced its dependence on imported crude oil over the last few years. Thus, the decision to maintain current monetary policy settings reflected the Monetary Board's belief that the current monetary policy stance is appropriately supportive of the price stability objective and is consistent with the need to ensure sufficient liquidity to sustain domestic demand.

III. Mone tary Policy Decision

- After an assessment of the balance of risks to inflation and the available data on domestic and external conditions presented by the Advisory Committee, the Monetary Board, by a unanimous vote, approved the following policy measures:

  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 11 March 2004.