HIGHLIGHTS OF THE MEETING OF THE MONETARY BOARD ON MONETARY POLICY ISSUES HELD ON 23 SEPTEMBER 2004*

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 the BSP's support for the use of non-monetary measures to address supply-side risks, particularly those relating to food supply, by strengthening 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:

- Headline inflation (1994=100) rose to 6.3 percent year-on-year in August from 6.0 percent in the previous month. The acceleration in August inflation was driven mainly by price pressures on food and energy-related CPI components, as well as items classified under services, particularly transport and communications. The average inflation for the period January to August 2004 was 4.5 percent which was still within the 4-5 percent target for the year.

* The highlights of the discussions of the 23 September 2004 Monetary Board meeting were approved by the Monetary Board during its meeting held on 28 October 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 Assistant Governor, In-Charge of Research and the Director of the Treasury Department.

- The 2000-based headline inflation also edged up in August to 6.8 percent from 6.6 percent in July, bringing the average inflation for the first eight months of the year to 4.9 percent.

- Likewise, both the 1994 and 2000 based core inflation (defined as headline inflation excluding selected food and energy products) tracked a rising trend in August. The 1994-based headline inflation moved higher to 6.2 percent in August from 6.0 percent the previous month while the 2000-based core inflation rose to 6.4 percent in August from 6.2 percent in July.

- Forecasts generated by the BSP inflation forecasting models indicated that inflation could continue to rise over the next year or so, and may exceed the 4-5 percent inflation target for 2004 and 2005. Nonetheless, average inflation is expected to slow down to 4-5 percent in 2006 in the absence of any further adverse supply-side shocks.

- On the whole, there have been some encouraging developments in domestic economic activity as indicated in the expansion in both the real gross domestic product (GDP) and gross national product (GNP). Nevertheless, some soft spots in the domestic economy remained as other demand-side indicators continued to post modest and uneven improvements.

  - In the second quarter of 2004, the country's real GDP grew at a robust pace of 6.2 percent, while real GNP expanded by 5.7 percent from the year-ago level. The economic expansion was broad-based with all the major production sectors posting higher growth rates. On the demand-side, the economic growth was boosted by the continued increase in private consumption along with the strong rebound in both investments and exports.

  - Average capacity utilization in manufacturing rose to 79.8 percent (revised) in June 2004 from 79.5 percent in May. This level was higher than the 78.6 percent registered for the same month a year ago.

  - The value of production index (VAPI) for manufacturing rose by 9.7 percent (revised) in June 2004 following a 4.0 percent (revised) annual growth in the previous month. Likewise, the volume of production index (VOPI) for manufacturing increased by 2.0 percent (revised) in June 2004 following a 3.0 percent (revised) contraction in May.

  - Export growth moderated to 3.2 percent year-on-year in July 2004 from 8.2 percent in June. This brought the January to July 2004 annual export growth to 7.7 percent.

- ✍ Total merchandise imports increased by 5.6 percent year-on-year in July 2004, a marked slowdown from the 18.0 percent growth in the previous month for a cumulative imports annual growth for the January to July 2004 period of 6.9 percent.

- ✍ Passenger car sales posted an 8.2 percent year-on-year growth in July, slower than the double-digit growth of 44.3 percent in the previous month. Meanwhile, the combined truck and bus sales continued to decline by 55.7 percent year-on-year in July following a 25.7 percent dip in the previous month.

- ✍ Energy sales by the Manila Electric Company (Meralco) increased by 2.9 percent year-on-year in July, slower than the 6.8 percent growth in June 2004. This was also lower than the 4.5 percent annual increase in July 2003.

- ✍ Unemployment rate eased to 11.7 percent from 12.6 percent a year earlier. In a related development, wage adjustments in the form of increase in cost of living allowance (COLA) have been granted to 13 regions including Metro Manila as of 13 September 2004.

✍ Supply-side factors continued to be the principal source of risks to the inflation outlook, particularly those associated with the rise in both global and domestic oil prices as well as some domestic supply constraints that led to higher prices of specific food items.

- ✍ The agriculture sector posted strong growth in the first semester of 2004 boosted by the expansion in crops and fisheries production. However, the recurrence of the avian flu in other Asian countries could raise demand for country's poultry products and exert pressures on prices of local poultry products.

- ✍ The international price of Dubai crude oil eased slightly in September following the reassurance from the Organization of Petroleum Exporting Countries (OPEC) that it is prepared to increase production to meet higher demand for oil. In the domestic oil market retail prices increased three times in August and once during the first week of September, reflecting the recent uptrend in world oil prices.

- ✍ In the utilities sector, the Energy Regulatory Commission (ERC) issued provisional authority to the National Power Corporation (NPC) to increase its rates by an average of ₱0.9798 per kwh effective 26 September 2004. Similarly, the ERC granted Meralco authority to raise rates by ₱0.1737 per kwh effective September 2004.

✍ In the financial sector, the demand for money and credit continued to rise moderately. Meanwhile, nominal RP interest rates increased during the

13 September 2004 auction of the Bureau of the Treasury (BTr) from August 2004 levels leading to wider spreads between the RP and foreign interest rates.

- Domestic liquidity (M3) grew by 6.7 percent year-on-year in July 2004, up from 5.6 percent rise recorded in the previous month.

- Commercial bank lending expanded by 3.6 percent year-on-year to ₱1.49 trillion as of end-July 2004. This is slightly lower than the 3.8 percent growth posted in the previous month.

- Reference T-bill yields rose during the first regular auction of the BTr in September relative to those registered in August, reflecting continued market uncertainty over the government's fiscal position and uptrend in inflation due to higher oil prices.

- The peso weakened in September due to continuing concerns over the country's fiscal position as well as the increase in corporate demand for the dollar due to the rising bill for oil imports and the growth in overall imports.

- In the fiscal sector, preliminary data showed that NG budget deficit for August 2004 of ₱11.7 billion was well below the deficit level of ₱18.2 billion posted in August 2003. This brought the January to August 2004 deficit level to ₱111.0 billion, slightly lower than the ₱114.5 billion deficit recorded in the same period last year.

- Recent developments in the world economy indicated robust and broad-based global economic recovery despite some observed weak spots in the US and Japan. Growth in most regions has been supported by strong industrial production and rising corporate profitability, accompanied by steadily improving consumer demand. On the price front, the outlook remains in line with price stability although stronger inflationary pressures persist in the near term.

  - Despite observed weak spots, the US economic activity regained strength as indicated by better employment conditions, improved consumer spending and uptrend in business investment.

  - Recovery of real economic activity in the euro area has remained on track, underpinned by robust export performance and gradual improvements in domestic demand.

  - The UK output expansion continued, sustained by buoyant public consumption and private investment alongside the steady growth in household spending.

  - Japan's economy continued to recover but at a slower pace given the full impact of the steep rise in world oil prices and reduced government spending.

- The US Federal Reserve (Fed) raised its policy rates by 25 basis points during its 21 September 2004 meeting. Similarly, the central banks of Canada, Thailand and New Zealand raised their policy rates recently. The main considerations behind the monetary tightening actions of these central banks is the sustained pressures on current and future inflation, driven by demand pressures arising from robust expansion of their domestic economies, tighter labor market conditions and declining spare capacity.

- Meanwhile, the Bank of England (BOE), Bank of Japan (BOJ), Bank of Korea, the European Central Bank (ECB) and the Reserve Bank of Australia (RBA) remained cautious and kept their monetary policy settings unchanged during their policy meetings in September 2004. Easing inflationary pressures accompanied by moderation in consumption demand, easing housing market and declining labor costs underpinned the decisions of these central banks to maintain their monetary policy settings.

II. Review of the Monetary Policy Stance

- During the Monetary Board's deliberation on the appropriate stance of monetary policy, the members of the Monetary Board noted the staff's projections indicating that inflation would maintain its upward trend until mid-2005, to exceed the 4-5 percent inflation target for 2004 and 2005. However, in the absence of further adverse supply shocks, the average annual inflation is expected to taper off to 4-5 percent in 2006.

- The members of the Monetary Board believed that the price and output conditions have not materially changed since the last review of the monetary policy stance. The Monetary Board members were of the view that current conditions continued to argue against monetary tightening as the ongoing inflationary process continued to be dominated by supply-side pressures, which are transitory in nature, and that the expected path of inflation over the policy horizon remains hump-shaped.

- The members of the Monetary Board also discussed the possible channels of influence of the 25 basis point increase in the US federal funds target rate on domestic inflation and the exchange rate. They noted that based on the Advisory Committee's presentation the said increase in the US federal funds target rate is not likely to have a considerable impact on both the inflation and the exchange rate. Estimates using the BSP's inflation models showed that the increase in the fed funds target rate could translate to a slight depreciation of the peso and a marginal increase in inflation in 2005 and 2006. These considerations strengthened further the view of the Monetary Board against the need to tighten the BSP's monetary policy stance.

- The Monetary Board also noted that the BSP's press statements on monetary policy and inflation developments have helped raise the public's understanding of the reasons behind the current monetary policy stance. These transparency mechanisms have been very beneficial in terms of enhancing the public's understanding and appreciation of the monetary authorities' view that given the cost-push nature of the ongoing inflation process and future inflation path, such price pressures cannot be addressed properly by monetary action.

- At the same time, the members of the Monetary Board acknowledged the need for the BSP to continue assessing economic and financial developments which may require a change in the monetary policy settings in the future. In particular, monetary action will become necessary when the available evidence begins to point more strongly to the following conditions: (1) emerging demand-side pressures on consumer prices; (2) inflationary pressures that are over and above those generated by ongoing supply shocks; and (3) risk of possible prolonged exchange rate market pressures arising from a narrowing interest rate differentials which could feed into inflation and inflation expectations. The members of the Monetary Board shared the view that if necessary, the BSP will undertake a well-timed adjustment in monetary policy settings to arrest the buildup in inflation expectations and prevent inflation persistence.

- Furthermore, the members of the Monetary Board emphasized the need for the BSP to complement the current stance of monetary policy with continued and stronger support for non-monetary measures to address supply-side risks to consumer prices. This is to be carried out by the BSP through greater representation and closer coordination with concerned government agencies such as the Department of Agriculture (DA) and Department of Trade and Industry (DTI) in order to facilitate timely distribution and delivery of basic commodities to the final consumers.

- In summary, the members of the Monetary Board reaffirmed its commitment to delivering stable prices conducive to a balanced and sustainable economic growth. At present, monetary authorities believed that there is no compelling reason to modify monetary settings given the cost-push and transitory nature of the inflationary pressures. Nevertheless, monetary authorities stand ready to respond to the potential second-order inflationary effects of ongoing supply shocks and other conditions that could generate persistent price pressures.

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

The next meeting of the Monetary Board to discuss the monetary policy setting is scheduled on 21 October 2004.