Bangko Sentral ng Pilipinas

HIGHLIGHTS OF THE MEETING OF THE MONETARY BOARD ON MONETARY POLICY ISSUES HELD ON 28 AUGUST 2003[*]

Background

On 28 August 2003, the Monetary Board held its tenth meeting for the year on monetary policy issues. At the meeting, the Advisory Committee[1] presented the Committee's assessment of the developments in key macroeconomic and financial indicators, their outlook for inflation and the economy's growth prospects as well as their recommendations for monetary policy stance. The information provided by the Committee served as basis for the Monetary Board's deliberation on the appropriate course of action for monetary policy.

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

In formulating its decision on monetary policy, the Monetary Board made an assessment of price conditions and cost factors, demand and output, money and credit, financial market conditions, world economy and other considerations as these factors relate to the outlook for inflation and the economy's growth prospects. The key considerations are as follows:

- Recent economic conditions continued to be characterized by subdued inflation and moderate demand. Headline inflation edged down in July to 3.3 percent from the previous month's 3.4 percent as food supply conditions normalized in the aftermath of recent typhoons. Core inflation rose slightly to 3.2 percent in July from 3.0 percent in June.

- The near-term outlook for inflation was essentially unchanged since the last meeting of the Monetary Board on monetary policy held on 31 July 2003. Available evidence on demand and supply conditions continued to

[*] The highlights of the discussions of the 28 August 2003 Monetary Board meeting were approved by the Monetary Board during its meeting held on 22 September 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 for the Treasury Department.

suggest that price dynamics would remain benign over the policy horizon. However, the observed weakening of the peso could also pose a concern for monetary authorities as it could impact on inflation expectations.

- Domestic demand has shown some encouraging signs of improvement as evidenced by the gradual pick-up in most leading indicators. Nevertheless, the overall strength of aggregate demand continued to be generally moderate.

  - The increase in the volume of production index (VOPI) for manufacturing improved to 2.6 percent year-on-year in May from the 1.2 percent annual rise in April. Similarly, the growth in the value of production index (VAPI) for manufacturing accelerated to 10.7 percent in May from 8.6 percent in the previous month.

  - The manufacturing sector's average capacity utilization inched up to 78.4 percent in May 2003 from 77.5 percent in the previous month.

  - Bank lending sustained its growth for the tenth straight month as loans outstanding of commercial banks expanded by 5.1 percent year-on-year in June from 3.4 percent in May.

  - Total merchandise exports increased by 4.2 percent year-on-year in June, a reversal of the 4.0 percent contraction in the previous month.

  - Passenger car sales rose sharply by 41.2 percent year-on-year in July, a turnaround from the 40.9 percent and 4.0 percent contractions registered in May and June, respectively. The surge in car sales could be traced, in part, to the planned imposition of a new excise tax on light commercial vehicles, which triggered a wave of forward buying by consumers.

  - Meanwhile, registered energy sales by the Manila Electric Company (Meralco) grew by a marginal 0.5 percent year-on-year in June 2003. This was slower than the 2.7 percent annual rise posted in the previous month.

- Supply-side or cost-push influences on inflation remained generally favorable.

  - Despite slower agricultural production in the first semester of 2003, neutral weather conditions in the second half are expected to support food production, which should help temper food prices.

- Domestic pump prices of oil products edged higher in August 2002 owing to the uptrend in international crude prices and the depreciation of the peso.

- Meanwhile, the continued implementation of the Meralco's refund scheme should help support a positive consumer sentiment outlook.

- Monetary conditions remained accommodative given ample liquidity and improvements in the demand for money.

  - Domestic liquidity growth accelerated to 6.0 percent year-on-year in June from the 3.9 percent in May 2003.

  - Moreover, the continued increase in banks' placements under the BSP's reverse repurchase (RRP) facility as well as the oversubscriptions of Treasury bill (T-bill) offerings by the Bureau of Treasury (BTr) indicated presence of ample liquidity in the system.

  - The T-bill rates rose in August as political developments raised the risk premium on government debt papers. At the 18 August 2003 auction of the Bureau of Treasury (BTr), the average yield on the benchmark 91-day T-bill rose for the first time in four months to 5.225 percent from the previous auction's yield of 5.168 percent.

  - Meanwhile, the differentials between the country's interest rates and those of the US—particularly the spread between dollar and deposit rates—have declined slightly in July from its month-ago level. However, the differentials have remained relatively high compared to the levels registered for most of 2002 until the first quarter of 2003.

- In the foreign exchange market, the peso weakened further against the US dollar in August. The recent pressures on the peso have been driven both by economic and non-economic factors. The economic factors can be traced to the seasonal increase in demand for foreign exchange arising from the onset of the import season combined with the traditional lean season for Overseas Filipino Workers (OFW) remittances; corporates' end-of-month covering for their dollar requirements; as well as the observed strengthening of the US dollar on the back of improving outlook on the US economy. At the same time, the overall market uncertainty triggered by the recent wave of political developments and concerns over peace and order conditions have contributed to the volatility in the foreign exchange market.

- The National Government (NG) fiscal deficit narrowed by more than a quarter in the first seven months of 2003 relative to the level posted for the comparable period in the previous year. This supported market expectations that the full-year fiscal target could be achieved.

- Global economic growth showed signs of picking up after months of slow and uneven recovery. Evidence of an economic upturn appeared to be strongest in the United States, with milder improvements seen in the euro area and Japan. Stronger economic activity overseas should contribute to improved demand for Philippine exports going forward. The welcome developments in the US economy, in part, has contributed to the strengthening of the US dollar relative to other currencies.

  - The US economic recovery appeared to be gathering steam. Evidences pointed to a revival in output growth in the US, driven by retail and defense spending and aided by monetary stimulus. Data releases indicated stronger output growth, robust retail spending and improved industrial production activity. Nevertheless, output growth remained below potential and capacity utilization continued to be below historical levels. Employment also remained sluggish as payroll employment continued to decline, which could dampen expectations of a lift in consumer sentiment. Meanwhile, recent price trends helped dispel deflation concerns without fueling inflation fears.

  - In the euro area, economic activity has remained subdued in the first half of 2003, broadly in line with market expectations. However, the European Central Bank sees "increasing reason to expect that economic activity will recover gradually in the second half of 2003 and strengthen further in the course of 2004.[2]

  - In the UK, the Bank of England noted that recent business surveys painted a mixed picture but, on balance, suggested an improving outlook going into the second half of this year.

  - In Japan, economic activity saw some improvements but remained generally sluggish, according to the latest assessment of the Bank of Japan.[3]

- Against this global economic backdrop, major central banks have exercised cautious optimism, leaving key policy interest rates unchanged

[2] ECB Monthly Bulletin, August 2003, available online at http://www.ecb.int
[3] Bank of Japan Monthly Report of Recent Economic and Financial Developments, August 2003, released 12 August 2003, available online at http://www.boj.or.jp/en/seisaku/03/pb/data/gp0308.pdf

and allowing the observed improvements in economic activity to take hold.

II. Review of the Monetary Policy Stance

Based on the various developments on key economic and financial indicators as well as global economic conditions, the Monetary Board discussed the various implications for monetary policy as follows:

- The members of the Monetary Board noted that the relative absence of significant inflation risks coupled with moderately improving economic activity provide room for a continued accommodative monetary stance to help spur the economy towards sustainable growth.

- At the same time, however, the members of the Monetary Board also recognized that the recent daily large movements in the bilateral nominal exchange rate have raised concerns over their possible implications on the inflation target. They noted that there could potentially be some cause for concern if prolonged political uncertainty contributes to significant nominal depreciation over an extended period of time.

- Given a generally subdued inflation outlook, on one hand and the uncertainty posed by the potential prolonged volatility in the foreign exchange market, the Monetary Board members looked at the following possible courses of action:

  a. Further monetary easing to increase the stimulus to economic activity;

  b. A preemptive increase in the policy rates to contain the potential inflationary risks from pressures in the foreign exchange market; and

  c. Maintaining current monetary policy settings to preserve the ongoing stimulus to the real sector.

- The argument for a further easing was not very persuasive given the need for a more cautious approach in the presence of potential risks to the inflation outlook posed by the observed weakening of the peso. The discussions of the Monetary Board, thus focused more on the possible implications of the weakening trend of the peso on the inflation outlook.

- Some members of the Monetary Board pointed out that the current movements in the bilateral exchange rate do not represent a permanent shock to the exchange rate as these have largely been the result of transitory factors such as the seasonal rise in demand to cover import requirements, relatively thin inflows of OFW remittances, and the overall market uncertainty triggered by the recent wave of political developments.

- Moreover, some members of the Monetary Board were also of the view that the pass-through impact of the recent weakening trend of the peso is likely to be relatively low given present levels of unemployment and manufacturing capacity utilization.

- However, a member of the Monetary Board noted that some tightening of the BSP's monetary policy stance may be warranted to help temper further volatility in the exchange rate and limit its flow-on effects on inflation expectations. Another member of the Monetary Board argued that raising the BSP's policy interest rates may not be warranted as this could lead to higher market interest rates, which in turn could dampen the ongoing stimulus for consumption and investment spending.

- Another member of the Monetary Board noted that the country's interest rate differentials with other countries remained significant as presented by the Advisory Committee. As such, there may be no need for influencing a further increase in domestic interest rates in order to attract foreign funds into the country. He pointed out that the domestic sources of uncertainty that are presently driving changes in the exchange rate are sentiment-driven and are likely to be temporary. It should subside, as political uncertainties are gradually resolved. However, he also argued that persistent daily large movements in the exchange rate could serve to raise the public's inflation expectations. He expressed the view that as a pre-emptive measure to prevent adverse changes in inflation expectations, the Monetary Board could consider lifting the tiering scheme on banks' placements with the BSP under the RRP and Special Deposit Account (SDA) windows.

III. Monetary Policy Decision

- After a careful assessment of the balance of risks on inflation and inflation expectations and the evolving domestic demand 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. Remove the tiering scheme on banks' placements with the BSP under the RRP and SDA windows;

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

d. Maintain the reserve requirements at their current levels 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 2 October 2003.