HIGHLIGHTS OF THE MEETING OF THE MONETARY BOARD ON MONETARY POLICY ISSUES HELD ON 14 FEBRUARY 2002[*]

Background

The Monetary Board held its second meeting for the year on monetary policy issues on 14 February 2002. Earlier, on 12 February 2002, the Advisory Committee[1] met and formulated its recommendations regarding the appropriate monetary policy settings. The Advisory Committee submitted, for the consideration of the Monetary Board, a policy paper and various information relevant for the deliberation on monetary policy. In particular, the Monetary Board discussed inflation developments and expectations—particularly, the trend in oil prices, power rates and the impact of the El Niño weather phenomenon on food supply in the latter part of 2003—monetary conditions, external developments and the global economic outlook, demand and output indicators and the implications of these factors on monetary policy.

I. Considerations in Setting the Monetary Policy Stance

Current inflation and the inflation outlook

1. Inflation for January 2002—at 3.8 percent—provides early indications of a generally favorable inflation environment for 2002. The sustained gains in agricultural production—on account of the bumper harvest in 2001 and expectations of good harvests in the first half of the year—are expected to translate into lower prices of food and other agricultural products in the coming months. With unemployment (at 9.8 percent as of October 2001) still high and spare capacity (average capacity utilization was at 76.6 percent for November 2001) still substantial, labor costs are not expected to rise sharply.[2] In addition, the sustained slowdown in the various measures of core inflation since

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[*] The highlights of the discussions of the 14 February 2002 Monetary Board meeting were approved by the Monetary Board during its meeting held on 21 March 2002.
[1] 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 Director of the Department of Economic Research, and the Director of the Treasury Department
[2] Sources: NSO, Report on the Quarterly Labor Force Survey for October 2001 and Report on the Monthly Integrated Survey of Selected Industries (MISSI) for November 2001

August 2001 supports the continued favorable inflation outlook. These factors should exert a favorable influence on the level of consumer prices.

2. Based on the results of the DER's inflation forecasting models, the monthly inflation path for inflation in 2002 is expected to be relatively subdued for the period February to September 2002, with an uptick expected in November and December 2002 due to the assumed wage increase effective November 2002. However, the average annual inflation rates are expected to be in line with the targets set for 2002 and 2003. [3]

The downtrend in January inflation and the sustained slowdown in the various measures of core inflation since August 2001 support the continued favorable inflation outlook over the policy horizon, which is in line with the inflation targets for 2002 and 2003.

Inflation impact of cyclical weather pattern

3. Based on the movements of the Southern Oscillation Index (SOI), the Philippine Atmospheric Geophysical and Astronomical Services Administration (PAGASA) has forecasted generally normal weather conditions for 2002.[4]

Expectations of a brief episode of a weak El Niño (warm) weather condition in the last quarter of 2002 would have a minimal impact on agricultural production and, consequently, on prices of food and other agricultural products in the latter part of the year. [5]

Exchange rate

4. Along with major Asian currencies, the movements of the peso-dollar rate narrowed to a range of ₱51.20-₱51.72 for January 2002, an improvement from the ₱51.15-₱52.06 range recorded in December 2001. Increased confidence in the Philippine economy contributed to higher foreign inflows as expectations of

[3] Based on the results of the single equation and multi-equation inflation forecasting models of the BSP

[4] A key indicator of weather conditions in the South Pacific is the Southern Oscillation Index (SOI). The SOI shows the monthly or seasonal fluctuations in the air pressure difference between the central Pacific and Indian oceans. Sustained negative values of the SOI are usually accompanied by sustained warming of the central and eastern tropical Pacific Ocean and often indicate El Niño episodes (Source: Australian Bureau of Meteorology website).

[5] PAGASA, " Seasonal Outlook for 2002", 8 December 2001

recovery in the Asian economies gained strength. In addition, continued inflows of overseas workers' remittances contributed to the relative stability of the exchange rate. This was reflected in the decline in the volatility of the peso-dollar rate to about 5 centavos from 18 centavos in January 2002 and 31 centavos in December 2001.

Continued broad stability in the exchange rate is expected to have a favorable influence on inflationary expectations and the inflation outlook.

Oil prices

5. The world oil price (Dubai crude) rose to $19.45 per barrel in January 2002 from $17.83 per barrel in December 2001, reflecting the seasonal uptick in crude oil prices in the winter season. At this level, however, the price of crude oil has declined from the peak of about $26.70 per barrel in June 2001. In the futures market, world oil prices (Brent crude) are generally stable with prices quoted at a close range of $19.37-$19.70 per barrel for the period March-December 2002.[6]

6. Despite the recent downtrend in prices, a reversal in world oil prices could arise if the OPEC is able to negotiate successfully agreements with other non-member oil producing countries (including Russia) to support oil prices through coordinated production cuts. However, according to industry experts, a near-term abrupt rise in oil prices is not considered likely inasmuch as oil stocks have been running at their highest levels since August 1999 as mild winter in the Northern Hemisphere and weak global conditions have reduced fuel demand. While fuel—which include petroleum products—accounts for only about 2.3 percent of the Filipino consumer basket, it is important to note that its pass-on effects invariably move the prices of almost all goods and services sold domestically.

The current and futures prices suggest broadly stable world oil prices in the near term.

[6] Futures price of Brent crude per barrel as of 28 January 2002 (Source: Asian Wall Street Journal)

Petitions for upward adjustment in power rates

7. The "unbundling" of power rates by the Manila Electric Company (Meralco) —which would entail updating of the firm's asset valuation using 2000 as the base year from the current 1993 base year—is expected to raise the cost of electric power to households and industrial users by an estimated minimum amount of about ₱38.00 per 100 kwh usage of electricity.[7] While electric power consumption accounts for only less than 3 percent of the CPI basket, the second round effects of the increase in power rates could lead to a generalized increase in the prices of other commodities.

The increase in power rates could cause an uptick in consumer prices.

Interest rates and interest rate differentials

8. As of 4 February 2002, the interest rate differential between the RP 91-day T-bill rate (net of RP withholding tax) and the 90-day LIBOR stood at 4.117 percent while the interest rate differential between the RP 91-day (net of RP withholding tax) and the US 90-day T-bills reached 4.270 percentage points. The differentials are higher relative to the levels in 2000, which averaged at about 2 percent and for the most part of 2001 (29-January to 6 August 2001), which averaged at 3.531 percent.

9. The differential between the BSP's policy interest rate (overnight borrowing or RRP rate) and the US federal funds target rate declined slightly to 575 basis points following the latest 25 basis-point cut in the BSP's RRP rates effective 18 January 2002. This differential was about the same as the average differential in 2001 of about 5.7 percent and is higher than the differential that prevailed for the most part of 2000, which averaged at about 4.7 percent.

10. As of end-January 2002, the spread of the Philippine lending rate over the benchmark T-bill rate stood at about 355 basis points. This differential was within the range of spreads for a sampling of Asian countries.

[7] The unbundling of power rates is prescribed under Republic Act (RA No.) 9136 or the Electricity Industry Reform Act issued on 8 June 2000.

11. However, the Philippines' real lending rate at 7.25 percent for the period 24-30 January 2002 remained high compared to those in other countries in the region, which ranged at 2.9-6.6 percent.

The margin between domestic interest rates and foreign interest rates provides some room for further monetary easing given that the outlook for inflation remains favorable and given that there is broad stability in the foreign exchange market. Monetary easing could help reduce further the real lending rate, which remains high relative to other countries in the region, thus exerting a positive effect on the competitiveness of domestic enterprises.

12. While the yield curve for government securities in the secondary market as of 4 February 2002 showed a downward shift relative to that which prevailed at the start of 2002, it was also steeper at the longer-term maturities (5-10 years.

Steeper yield curve at the long end indicates higher inflationary expectations in the long run.

Domestic stock market movements

13. The domestic stock market has been gaining strength of late, boosted by the string of positive news, particularly the stronger-than-expected growth numbers in 2001, reining in of the Government's fiscal position close to target, relative stability in the exchange rate and the downtrend in market interest rates. The recent inflows of foreign funds contributed to briskier trading activity in the domestic stock market. Data from the Philippine Stock Exchange (PSE) show that foreign investors were net buyers of stocks in 2001 as the total amount of foreign buying transactions exceeded foreign selling transactions by ₱4.5 billion. This trend has continued in 2002 as foreign investors continued to be net buyers in the domestic stock market, with net purchase amounting to ₱1.7 billion in January. There was also a marked increase in the participation of foreign funds as the share of foreign transactions to the total value turnover rose to about 45 percent in 2001 from only 31.6 percent in the previous year. The strong foreign interest in the market is anchored on brighter economic prospects in 2002.

14. There are also indications that sustained growth is firming up. GDP numbers show stronger economic performance in the fourth quarter relative to the third quarter on the back of the strong agriculture and services sectors. A recovery in the industrial sector should further strengthen the economy's growth prospects.

Recent gains in the bourse and strong economic performance in the fourth quarter of 2001 could signal an acceleration in the growth momentum, and thus making the case for large rate cuts less compelling.

Monetary aggregates and bank lending

15. Reserve money (RM) declined to reach ₱277.8 billion as of 6 February 2002 from ₱312.9 billion as of end-December 2001. The contraction in RM developed as banks' liquidity flowed back to the BSP—as placements under the reverse repurchase (RRP) and special deposit accounts (SDA) facilities—instead of being channeled to the private sector in the form of loans. The contraction in bank lending has been sustained for the fifth consecutive month in December 2001—as loans outstanding of commercial banks declined further by 3.6 percent year-on-year—due in large part to the persistently high NPLs of the banking system—which has constrained lending activity—and weak demand for credit by corporates.

Despite the downtrend in bank lending rates, banks' lending activity has been constrained in part by the high NPLs of the banking system and weak corporate demand.

External developments and outlook

16. Recent indicators on the US economy suggest that the recession has bottomed out and that the forces of recovery are in place. There are signs that weakness in demand has abated and economic activity has been firming; these signs included increased profits, lower unemployment and stronger consumer expenditures on new homes, automobiles and durables. This earlier-than-expected recovery could pose near term upside risks to the US economy, and this underpinned the decision to keep the US federal funds target rate unchanged at the last FOMC meeting on 29-30 January 2002. In addition, a survey of the federal funds futures contract indicates that the US federal funds target rate is expected to increase by 50-100 basis points in the second half of 2002.[8] There are also early signs of economic recovery in the euro zone, which could mean that the interest rate easing cycle of the European Central Bank (ECB) would come to an end soon.

Increasing signs of a US-led recovery have raised market expectations that the US and Europe would start tightening monetary policy in the second half. This, in turn, could limit the scope for further monetary easing by the BSP.

II. Discussion on the Review of the Monetary Policy Stance

17. Majority of the Monetary Board members supported the view that the generally favorable inflation outlook for the year—given expectations of good food supply conditions and stable oil prices—provide scope for further easing of policy rates. In addition, the differential between domestic and foreign interest rates—which would remain comfortable even with a 25-basis point cut—and the broadly stable foreign exchange market provides additional room for monetary easing. They expressed the view that a further 25-basis point cut in the BSP's policy rates would continue to support the country's growth objective without endangering the inflation target for 2002. The members of the Monetary Board argued that this policy stance is in line with the primary objective of the BSP of "maintaining price stability consistent with a balanced and sustainable economic growth," as embodied under its Charter.[9] A lower interest rate environment, in turn, could also help ease debt servicing costs of corporates and the National Government, and set the conditions for a briskier lending activity.

18. The majority of the Monetary Board members noted that a 25-basis point cut in policy rates is not likely to pose an upsurge in the average inflation above the target set for 2002. They noted the preliminary estimates of the Department of Economic Research, which showed that a 25-basis point cut in the BSP's overnight RRP rate will raise inflation by only a minimal 1 basis point.

[8] Based on the summary of implied US federal funds rate contracts at the Chicago Board of Trade as of 11 February 2002 as quoted from the Bloomberg News, 12 February 2002

[9] Republic Act (R.A.) No. 7653, effective 3 July 1993

19. However, some members of the Monetary Board expressed reservations on a further policy rate cut, based on the following considerations:

a. There are risks to the inflation outlook—given the likely uptrend in inflation forecasts for 2003 and the possible resumption of the monetary tightening stance of the US Fed and the ECB;

b. Firmer indications of the recovery of the Philippine economy point to a case where another or a further rate cut is less compelling; and

c. A further reduction in the BSP's policy rates may not likely translate promptly into increased bank lending due to continued structural problems facing the banking system, particularly the high levels of NPLs.

20. In support of a policy rate cut, a member of the Monetary Board also expressed the view that, while there are clearer signs of economic recovery in the US, Fed Chairman Alan Greenspan still expressed concern that such recovery could still be at risk. In particular, the increase in US retail sales in December 2001 was still relatively weak. Thus, a further cut in the BSP's policy rate –given a benign inflation outlook—would continue to be supportive of the economy's growth efforts. Moreover, it was noted that further easing can be done now before the US Fed and the ECB resume monetary policy tightening as viewed by market analysts.

21. Cognizant of the risks to the inflation outlook, the members of the Monetary Board highlighted the need to continuously monitor economic and financial developments in order to guard against potential inflationary pressures. A member of the Monetary Board pointed out that, even with the shift in inflation targeting, the movements of monetary aggregates—particularly the various indicators of money demand and the level of domestic liquidity in the system—should continue to be monitored very closely.

22. The members of the Monetary Board underscored the need to temper banks' propensity to park excess funds with the BSP through the continued application of the tiering scheme on successively higher volume of banks placements with the BSP on a consolidated basis.

23. All the Monetary Board members shared the view that, going forward, monetary policy should proceed on a cautious footing. The BSP should monitor carefully incipient risks factors. While the risks to the inflation outlook have lessened, they are still present, as indicated by the uptrend in the inflation forecast path in the last quarter of 2002 to 2003.

III. Monetary Policy Decision

24. Based on the assessment of the balance of risks on inflation and inflationary expectations—indicating that various factors are weighed heavily toward providing some room for monetary easing—the members of the Monetary Board approved the following measures:

a. Reduction in the BSP's policy rates by 25 basis points each to 7.25 percent for the overnight RRP (borrowing) rate and 9.5 percent for the overnight RP (lending) rate effective 15 February 2002. (At 7.25 percent, the BSP's overnight RRP rate is the lowest since 25 August 1995);

b. Adjustment in the interest rates on banks' overnight RRP placements with the BSP under the tiering system as follows: 7.25 percent for placements of up to ₱5 billion, 4.25 percent for the next ₱5 billion, and 1.25 percent for placements in excess of ₱10 billion.

The next meeting of the Monetary Board to discuss the monetary policy setting was scheduled on 14 March 2002.

—The Monetary Board of the Bangko Sentral ng Pilipinas

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