HIGHLIGHTS OF THE MEETING OF THE MONETARY BOARD ON MONETARY POLICY ISSUES HELD ON 12 FEBRUARY 2003[*]

Background

The Monetary Board held its second meeting on monetary policy issues for the year on 12 February 2003. This followed the Advisory Committee meeting held on 11 February 2003.[1] The Advisory Committee prepared for the Monetary Board's consideration a policy paper focusing on the latest readings on the movements of various economic and financial indicators and the developments in the world economy that could influence the Philippines' inflation outlook and growth prospects. This served as the basis for the Monetary Board's discussion and assessment for the appropriate monetary policy stance.

I. Considerations in the Formulation of the Monetary Policy Stance

Domestic Price Developments and Outlook

1. Year-on-year inflation rose slightly in January 2003 to 2.7 percent from 2.6 percent a month earlier. However, inflation in January was lower than the year-ago inflation of 3.8 percent. Month-on-month headline inflation in January 2003 was also higher at 0.5 percent compared to 0.4 percent in December 2002. The increases in the prices of domestic fuel products, medicines, unregulated bus transport fares, personal services, as well as water and electricity charges contributed to the upward movement of consumer prices in January 2003.[2] Meanwhile, the BSP estimates of core inflation, which take out the effects

[*] The highlights of the discussions of the 12 February 2003 Monetary Board meeting were approved by the Monetary Board during its meeting held on 20 March 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 or the Director of the Department of Economic Research, and the Director of the Treasury Department.

[2] National Statistics Office, "Summary Inflation Report, Consumer Price Index, January 2002", 5 February 2003

of temporary disturbances on headline CPI by excluding food and fuel components, slowed down to 2.6 percent in January 2003 from 2.7 percent in the previous month. This suggested that the slight uptick in headline inflation was influenced mainly by cost-push factors, particularly, the increase in fuel prices.

2. Various indicators show continuing signs of improvement in economic activity. Gross Domestic Product (GDP) grew by 4.6 percent in 2002, with growth in all production sectors surpassing expectations. In particular, domestic demand rose significantly by 5.7 percent, year-on-year in the fourth quarter of 2002 bringing the full year growth to 2.9 percent.[3] The growth in domestic demand was boosted mainly by robust consumption spending and the sustained increase in government spending. Power consumption expanded by 6.4 percent in November from only 0.9 percent in the previous month. Nevertheless, other data pointed to weak spots in domestic demand. For example, car sales dropped by 14.8 percent, year-on-year in December 2002. Bank lending posted positive though small year-on-year growth rates for four consecutive months until December 2002. Capacity utilization in manufacturing also continued to be fairly low at 75.2 percent for November 2002. Moreover, unemployment rose to 10.2 percent in the fourth quarter of 2002 as against 9.8 percent in the same period a year ago. The presence of spare manufacturing, soft labor market conditions and other indications of weak areas in overall demand suggest relatively mild demand-side pressures on consumer prices in the near term.

Despite the presence of cost-side risks, inflation is expected to stay broadly in line with the government's target range for 2003 of 4.5-5.5 percent and thus, remain supportive of the economy's growth objectives.

Developments in Agriculture

3. The agriculture sector grew by 3.7 percent in 2002 despite the dry spell experienced in some parts of the country in the fourth quarter with the onset of the El Niño weather phenomenon. This performance exceeded the projected 3.1-3.5 percent growth for 2002 by the Bureau of Agricultural Statistics (BAS).

[3] Domestic demand refers to the sum of personal consumption expenditures, government consumption and capital formation or investments.

4. For 2003, agriculture is expected to grow by 3.0-4.0 percent despite an anticipated drop in rice production in the second semester due to farmers' expectations of the lingering effect of the El Niño weather disturbance. The favorable weather during the last quarter of 2002 is expected to generate a 4.9 percent increase in palay production and a 21.4 percent growth in corn production during the first quarter of 2003. However, the current natural conditions pointed to continuing warming conditions over the next two to four months, and some parts of the country are likely to continue to experience below normal rainfall. Farmers' planting intentions indicated that the expected harvests during the second quarter of 2003 could drop by 8.6 percent for palay and 9.3 percent for corn. Meanwhile, the livestock and other crop subsectors were expected to sustain the good production figures into 2003.[4]

5. With the rehabilitation and upgrading of existing irrigation systems as well as the timely delivery of high-yielding seed varieties, total rice production could reach 14.2 million metric tons (MT) in 2003.[5] The government's rice importation program could also cushion the adverse impact of the El Niño phenomenon on domestic supply. Meanwhile, the national rice inventory[6] of 2.8 million MT as of 26 January 2003 would last for 105 days. Of this stock, the share of the National Food Authority (NFA) amounting to 829.3 thousand MT (about 30 percent) is sufficient to last for 31 days.

6. The agricultural sector is also expected to gain from other government programs aimed at boosting production and mitigating the impact of the El Niño phenomenon. These programs include the ₱1.2 billion worth of loans extended by the Quedan and Rural Credit Guarantee Corporation (Quedancor) for grains, livestock and poultry, fisheries and various agribusiness production during the first eleven months of 2002[7] as well as the ₱1.3 billion released by the Department of Budget and Management (DBM) for irrigation projects and other

[4] Source: Bureau of Agricultural Statistics, Selected Tables on Crop Forecasts, 6 November 2002

[5] "Agriculture sector expands 3.69% in '02", available at http://www.da.gov.ph

[6] The national rice inventory consists of NFA palay and rice stocks as well as commercial and household inventories. Rice self sufficiency is estimated based on the daily consumption of 25.7 thousand MT of rice. (Source: NFA)

[7] "DA credit firm loan releases to hit ₱2 billion this year", 24 November 2002, available at http://www.da.gov.ph

El Niño-mitigating projects of the Department of Agriculture (DA)[8] and the ₱50 million for the seven-year Coconut Development Zone Program.[9]

With the aid of timely government intervention, the agricultural sector should overcome the possible adverse effect of the El Niño weather disturbance and sustain its favorable performance into 2003. This, in turn, would help ensure relative stability in food prices during the year.

Exchange rate developments

7. The peso weakened against the US dollar, averaging at ₱53.95/US$1 for the period 1-11 February 2003 compared to the ₱53.59/US$1 average in January 2003 due mainly to rising fears over the impending outbreak of hostilities in the Middle East and the associated risks of disruptions in oil supply.[10] The increase in the demand for US dollars by oil companies to fund their inventory build-up also exerted pressure on the peso. This was in compliance with the government's directive to maintain a minimum oil inventory level equivalent to 15-30 days of consumption as part of the country's oil contingency plan.[11] However, the peso was less volatile for the period in review with the standard deviation in the daily exchange rate averaging at ₱0.05 from ₱0.13 registered in January 2003.

8. On a real, trade-weighted basis, the peso depreciated relative to the currencies of the major trading partners by 2.3 percent in January 2003 from its level in December 2002, as measured by the real effective exchange rate (REER) index.[12] The peso similarly depreciated vis-à-vis the two baskets of currencies of the Philippines' competitor countries. The REER for the broad and narrow baskets of competitor currencies fell by about 0.7 percent and 0.8 percent, respectively in

[8] "Montemayor lauds DBM's release of ₱1.25 billion for El Niño preparation", 16 October 2002, available at http://www.da.gov.ph

[9] "DA launches ₱50-M coconut development zone program", 9 December 2002, available at http://www.da.gov.ph

[10] Based on real-time foreign exchange transactions in the Philippine Dealing System (PDS)

[11] As per Department of Energy's Circular No. DC 2003-01-001 (issued 20 January 2003), refiners are required to maintain an inventory of petroleum crude oil and refined petroleum products equivalent to 30 days of consumption while other oil companies are required to maintain 15 days supply of petroleum products excluding liquefied petroleum gas (LPG), which shall be maintained at 7 days supply.

[12] The basket of the major trading partners is composed of the currencies of the US, Japan, the euro area and the United Kingdom. The broad basket of competitor countries is composed of the currencies of Singapore, South Korea, Taiwan, Malaysia, Thailand, Indonesia and Hong Kong while the narrow basket is composed of the currencies of Indonesia, Malaysia and Thailand only.

January 2003 relative to their December 2002 levels. These developments indicated a slight improvement in the country's external price competitiveness.

The peso weakens against the US dollar in February as demand by oil companies and other corporations for foreign exchange rose amidst escalating tensions in the Middle East. Some of the pressures on the domestic currency, however, could ease with the resolution of the US-Iraq crisis.

Oil price developments

9. The price of Dubai crude in the international market climbed to US$29.59 per barrel as of 7 February 2003, about 5.6 percent higher than the US$28.02 per barrel posted in January 2003. The uptrend in world oil prices was driven mainly by increased world demand arising from heightened tensions in the Middle East which has prompted countries to build up their oil inventory levels. At the same time, tighter supply in the world oil market due to the decline in US crude inventory to its lowest level in five years and the impact of the 65-day general strike in Venezuela exerted pressure on oil prices.[13]

10. Meanwhile, local oil companies and dealers continued to pass on to consumers the higher costs of crude oil imports to the retail pump prices of petroleum products in the first week of February 2003, when local oil prices were increased for the third time this year. The prices of kerosene, gasoline, and diesel oil were raised by ₱0.26 per liter, ₱0.39 per liter and ₱0.45 per liter, respectively, while that of liquefied petroleum gas (LPG) was raised by ₱0.95 per liter.[14] To ensure adequate domestic supply in the light of near-term supply bottlenecks, domestic oil companies have built up their inventory levels in compliance with a directive of the government. As of end-January 2003, the estimated oil inventory level of domestic oil companies is equivalent to about 50-60 days sufficiency.[15] This was more than the 15-30 days required oil inventory level.

The prospect of war in the Middle East poses a risk to the inflation outlook as this could lead to a disruption of oil supply and consequent

[13] Market analysts observed that there are indications that the Venezuelan opposition strike is nearing an end as negotiations between the workers and the government continue. (Source: IDEAGlobal, "Oil Market Running on Empty", 5 February 2003)
[14] Source: Department of Energy
[15] Ibid.

increase in prices of crude products. The resulting increases in the price of domestic oil products could trigger similar upward adjustments in the prices of other commodity groups including wages and transport fares.

Developments in the Utilities Sector

11. In its advisory dated 20 January 2003, the Department of Energy (DOE) informed the public of higher electricity charges for January in areas serviced by the Manila Electric Co. (Meralco). The purchased power adjustment (PPA) component of electricity bill rose by ₱0.13 to ₱2.74 per kilowatt hour (kwh) in January 2003 from ₱2.61 per kwh in December 2002. The increase in Meralco's PPA charges could be attributed to higher selling rates of power producers and the lower consumption of electricity during the colder month of December.[16] It could be noted that the PPA has been on the uptrend since October 2002.[17]

12. In the near term, the direction of power rates would depend on several factors. In particular, the outcome of Meralco's rate unbundling petition with the Energy Regulatory Commission (ERC) and the Supreme Court's final decision on Meralco's "overcharging" case would be key factors in determining the direction of power rates. In addition, the Special Program to Enhance Electricity Demand (SPEED) and the planned establishment of the Wholesale Electricity Spot Market (WESM) would also likely influence power rates.[18]

13. Meanwhile, the water services regulatory agency, Manila Waterworks and Sewerage System (MWSS), approved a ₱5.35 per cubic meter increase in the weighted average all-in water tariff of utility company Maynilad Water Services,

[16] "Expect higher power costs in Metro Manila-DOE alerts consumers", 20 January 2003, available at http://www.doe.gov.ph

[17] Meralco's PPA increased by another ₱0.04 per kwh to ₱2.78 per kwh in February 2003 from January's level of ₱2.74 per kwh.

[18] The WESM is a spot market for the trading of electricity in which power generation companies (gencos) submit their offers to sell electricity to distribution utilities at their desired price. Distribution utilities, in turn, submit their demand requirements to a market operator who is assigned to match the supply and demand for power. The Electric Power Industry Reform Act of 2001 (R.A. 9136) requires the Department of Energy (DOE) to establish the WESM in coordination with electric power industry participants to ensure greater supply and rational pricing of electricity. Meanwhile, the SPEED is a price incentive scheme for large end-users of electricity whereby discounts are provided to industrial and commercial customers for incremental use of energy above a specified base load. The program is aimed at enhancing demand for electricity and ensuring that excess power capacity is fully utilized.

Inc. (MWSI). This should bring the weighted average all-in water tariff of MWSI to ₱29.79 per cubic meter of water from the current rate of ₱24.44 per cubic meter. However, MWSI has not yet implemented the MWSS-approved rates as the company has tendered a notice of early termination of its concession agreement with the government. Meanwhile, Manila Water Company (MWC) has started to implement the MWSS-approved rebased rates since 1 January 2003, raising the MWC's water tariff by ₱4.25 per cubic meter to ₱14.23 per cubic meter from ₱9.97 per cubic meter.

The outlook for power rates remains uncertain at present. The ERC's decision on the Meralco's rate unbundling petition and the Supreme Court's final ruling on the "overcharging" case would determine the direction of Meralco's power rates in the near term. Meanwhile, the higher water rates in Metro Manila could exert a transitory cost-push pressure on inflation.

Interest rates and interest rate differentials

14. Domestic interest rates are on the rise. The benchmark 91-day T-bill rate rose to 5.672 percent during the Bureau of Treasury's (BTr) 3 February 2003 auction from 5.248 percent during the previous auction a fortnight ago, amid concerns over the impact on Philippine domestic borrowings of a possible war in the Middle East. Similarly, yields for the 182-day T-bill rate and the 364-day T-bill rate increased to 6.6 percent and 7.609 percent, respectively, from 6.277 percent and 7.201 percent. The auction was oversubscribed, with bids reaching ₱10.5 billion pesos, a tenth more than the government's offered amount of ₱9.5 billion, indicating continued ample liquidity in the system. The government, however, awarded ₱7.86 billion only in order to cap the rise in interest rates.

15. As of 3 February 2003, the differentials between the RP 91-day T-bill rate (net of withholding tax) and the 90-day LIBOR and US 90-day T-bill rate widened to 318.8 basis points and 336.8 basis points, respectively, from the 270.7 basis points and 288.2 basis points registered in 6 January 2003.[19] The differentials between RP and foreign interest rates trended upward as the rising benchmark RP rate was accompanied by falling foreign interest rates.

[19] Review period covered in the last policy paper on the "Review of the BSP's monetary policy stance" considered by the Monetary Board on 16 January 2003

16. The differential between the BSP's policy interest rate (overnight borrowing or RRP rate) and the US federal funds target rate was unchanged at 575 basis points as the BSP policy rates and the US federal funds target rate remained unchanged from their 15 March 2002 and 6 November 2002 levels, respectively.

17. Adjusted for the risk premium—as measured by the differential between the 10-year ROP note and the 10-year US Treasury note—the differential between the BSP policy interest rate and the US federal funds target rate widened to 63 basis points as of 3 February 2003 from 55 basis points as of end-December 2002.[20] This developed as the risk premium dropped to 512 basis points from 520 basis points on 30 December 2002. Both the yields on the 10-year ROP and the 10-year US Treasury note increased, with the yields on the latter rising by a larger magnitude due to higher risk aversion on concerns over the Middle East tensions.

The spread between RP and US interest rates widens in early February relative to January levels as concerns over the impact on the domestic financial market of a possible war in the Middle East pushed up the RP benchmark rates. Likewise, the risk-adjusted RP-US interest rate margin widens for the period in review.

18. During the period 23-29 January 2003, the Philippines' real lending rate (based on the low-end of the range of banks' lending rates) eased further to 5.51 percent from the 5.54 percent registered during the review period 23-27 January 2003 due primarily to the marginal decline in the low-end of the range of banks' lending rates. [21] At 5.51 percent, the Philippines' real lending rate was within the midrange among a sample of countries in the Asian region.

The Philippine real lending rate declines slightly and is within midrange in the Asian region.

19. The yield curve for government securities in the secondary market on 3 February 2003 shifted upward relative to that which prevailed on 7 January

[20] Review period covered in the last policy paper on the "Review of the BSP's monetary policy stance" considered by the Monetary Board on 16 January 2003
[21] Ibid.

2003.[22] The yields rose across all tenors, reflecting market concerns over the increasing tensions in the Middle East.

Impending outbreak of hostilities in the Middle East exerts pressure on yields of government securities in the secondary market.

Domestic Liquidity and Credit Conditions

20. Domestic liquidity (M3) growth accelerated by 9.5 percent year-on-year to reach ₱1.7 trillion in December 2002, mainly on account of the seasonal inflow of dollars from OFW remittances and the strong demand from banks for government securities.

21. At the same time, the total volume of outstanding loans of commercial banks (KBs) grew by 2.4 percent year-on-year to reach ₱1.4 trillion as end-December 2002. At this level, the growth of bank lending accelerated from the 1.4 percent year-on-year growth in the previous month. This was the fourth consecutive month of growth in bank lending and marked the upturn in bank lending to the manufacturing sector, which rose by 1.7 percent after 17 months of consecutive year-on-year contractions.

22. Relative to the end-January 2003 levels, the total volume of banks' placements under the RRP window and the SDA facility declined by ₱12.9 billion and ₱58 million to reach ₱74.9 billion and ₱1.4 billion, respectively, as of 5 February 2003 as banks continued to reallocate portfolios following the large withdrawals from their placements with the BSP in December 2002.

The steady improvement in domestic liquidity was accompanied by continued improvements in bank lending activities. The acceleration in bank lending growth in December provides encouraging signs of a recovery in the demand for credit.

[22] Yield curve presented in the previous policy paper on the "Review of the BSP's monetary policy stance" considered by the Monetary Board on 16 January 2003

Domestic stock market movements

23. The average Philippine Stock Exchange Composite Index (PHISIX) advanced by 25.2 index points to 1,046.7 index points in January 2003 from 1,021.5 index points in December 2002. The PHISIX averaged higher in the first month of the year on account of market optimism following the signing into law of the Special Purpose Asset Vehicle (SPV) bill as well as higher foreign participation in the local bourse. However, the PHISIX dropped anew in February as market concerns over an imminent US-led assault on Iraq persisted. As of 11 February, the PHISIX declined slightly by 2.0 index points to 1,044.7 index points from the January average level.

The equities market continues to be sluggish and may remain so over the near term due to lingering geopolitical uncertainties. Most market analysts are of the view that the unfolding of events in the Middle East would dictate the movements in the domestic equities market.

Fiscal developments

24. The deficit of the National Government (NG) stood at ₱212.7 billion for the year 2002. This was lower than the government's revised ceiling of ₱223.0 billion but wider than the ₱147.0 billion budget gap in 2001. The deficit was equivalent to 5.3 percent of GDP, less than the 5.6-percent cap earlier set by the government. The impact of the higher NG deficit in 2002 on financial markets appeared to have been significantly muted by the ample liquidity in the system. This was reflected in the downtrend in the average 91-day T-bill rate to 5.5 percent in 2002 from 8.9 percent recorded a year ago.

25. For 2003, the NG expects the fiscal deficit to be around 4.7 percent of GDP (approximately ₱202 billion), with total revenues amounting to ₱854.1 billion and expenditures amounting to ₱786.1 billion. The financing mix in 2003 would consist of about 48 percent foreign borrowing and 52 percent domestic borrowing compared to the 41 percent and 59 percent domestic-foreign financing mix in 2002. This implies that the NG would have to borrow more heavily from the domestic market. This could put some pressure on domestic interest rates and increase financing costs, which, in turn, could pose downside risks to the outlook for inflation.

The fiscal position and its possible implications on inflation remain a concern for monetary authorities.

Developments and outlook in the rest of the world

26. Latest indicators in the major economies showed that the growth of industrial production has been sluggish, labor markets remained soft and leading economic indicators have weakened. In the US, for example, recent data showed that the recovery has not taken a firm hold. Growth in the US economy slowed down sharply in the fourth quarter of 2002, with GDP rising by 1.4 percent as consumers reined in their spending in the face of persistent worries over the possible war against Iraq, the volatility of the stock market and the large number of unemployed. Consumption expenditures, which account for about two-thirds of the GDP, rose only by one percent in the fourth quarter, the weakest growth since 1993 and sharply lower than the 4.2 percent expansion registered in the previous quarter.[23] During its meeting on 28-29 January 2003, the Federal Open Market Committee (FOMC) unanimously voted to keep the federal funds target rate at a four-decade low of 1.25 percent. The FOMC believed that an accommodative stance of monetary policy, coupled with sustained growth in productivity, would support an improving economic climate over time.[24]

27. In the euro area, economic growth has been sluggish, with GDP rising by only 0.8 percent year-on-year in the third quarter in 2002 from 0.7 percent in the previous quarter. Economic recovery has been delayed given that the outlook for economic activity has remained broadly unchanged. The weakness in the overall domestic demand conditions in the euro zone was driven mainly by the marked slowdown of the German economy, which is the largest in Europe. Moreover, the appreciation of the euro relative to the US dollar could also slow down the growth in net exports which could limit the main source of growth in the region. During its meeting on 6 February 2003, the Governing Council of the European Central Bank (ECB) maintained the benchmark interest rate at 2.75 percent.[25] Despite the uncertainties posed by geopolitical developments on the

[23] Somerville, G., “Expansion slowed sharply as 2002 ended”, Reuters-Top Stories, available at http://www.reuters.com
[24] Federal Reserve Release, Press Release, 29 January 2003, available at http://www.federalreserve.gov/boarddocs/press/ monetary/20030129
[25] ECB Press Release, “Monetary policy decisions”, 6 February 2003, available at http://www.ecb.int

euro area and the world economy in general, the ECB opted to "wait-and-see" noting that the current interest rates are appropriate to maintain price stability.[26] Meanwhile, the Monetary Policy Committee (MPC) of the Bank of England (BOE) reduced the Bank's repo rate by 25 basis points to 3.75 percent on 6 February 2003. The MPC believed that the policy rate reduction was necessary to support the UK economy while keeping inflation on track over the medium term.[27]

28. In Japan, the recovery which began early last year on the back of increased consumer spending and an upturn in exports has stalled. In its latest assessment, the Bank of Japan (BOJ) believed that "a noticeable recovery is unlikely for the time being due to, among other factors, substantial uncertainty regarding conditions overseas."[28] During its monetary policy meeting on 21-22 January 2003, the Policy Board of the BOJ decided to maintain the guidelines for its open market operations, aimed at keeping the outstanding balance of current accounts of banks with the BOJ at 15-20 trillion yen.[29]

The prospects for global economic recovery continue to be clouded by rising fears of a US-led war against Iraq and the risk of weaker domestic demand conditions in the major economies.

II. Discussion on the Review of the Monetary Policy Stance

29. In their deliberation on the appropriate stance of monetary policy, the members of the Monetary Board shared the view that the inflation path remained consistent with the outlook of a generally subdued inflation environment in the near term. Despite foreseeable risks to the inflation outlook—arising from the potential impact on the prices of agricultural products of the El Niño weather disturbance, a likely further increase in oil prices due to escalating tensions in the Middle East as well as the possible further adjustments in user charges—the

[26] Dawson, S., "Update 4-ECB rates steady but war fears up chances for rate cut", 6 February 2003, available at http://www.reuters.com

[27] Bank of England, News Release, "Bank of England reduces interest rates by 0.25 percent to 3.75 percent." 6 February 2003, available at http://www.bankofengland.co.uk/press release/2003

[28] Bank of Japan, "Monthly Report of Economic and Financial Developments in January 2003 (The Bank's View)", 23 January 2003, available at http://www.boj.jp/en

[29] Bank of Japan, Monetary Policy, Monetary Policy Meetings, 22 January 2003, available at http://www.boj.jp/en

Monetary Board remained confident that the average inflation in 2003 would broadly track the government's full-year target of 4.5–5.5 percent.

30. The members of the Monetary Board noted that the Philippine economy posted a better-than-expected real GDP growth for 2002, driven mainly by the upturn in consumption spending and the recovery in exports. However, they also pointed out that some weak spots remain. They observed that the pick-up in the demand for credit was still relatively slow, spare capacity in manufacturing sector continued to persist and labor market conditions remained soft. Moreover, the members of the Monetary Board added that the tepid pace of the global economic recovery and heightened uncertainty due to geopolitical events in the Middle East could threaten the prospects for sustained upturn of domestic demand.

31. The Monetary Board believed that while the near-term risks to the inflation outlook are well contained, possible upside pressures on prices could set in over the 2-year policy horizon. They recognized the implications on the domestic economy of the growing downside risks to the global economic outlook due to rising tensions in the Middle East that continued to dampen business and consumer sentiment in the major economies. Under these conditions, the discussion of the members of the Monetary Board focused on the following policy questions:

a. Do the risks to the inflation outlook warrant an increase in policy rates in order to contain a possible build-up in price pressures?

b. Given the uncertainty in external conditions and the need to sustain economic growth, is there scope for a reduction in policy rates in order to preserve the stimulus to the economy?

c. Looking at both perspectives, should the policy stance remain cautious, one that is sufficiently accommodative by ensuring adequate liquidity to support growth while guarding firmly against the risks to the inflation outlook, and thus maintain the current monetary policy settings?

32. Increase policy rates

In principle, the Monetary Board pointed out that a tighter monetary policy stance may be adopted as a pre-emptive action against the risks to the inflation outlook due to potential build-up of demand-side pressures. In the case of the Philippines, the members of the Monetary Board noted that the risks to future inflation appear to come mainly from supply-side or cost-push factors such as higher food prices associated with the impact of the El Niño weather disturbance and the increase in oil prices, power rates as well as water charges. Given the need to assure the sustainability of economic growth, the members of the Monetary Board were of the view that an increase in policy rates—which would lead to higher market interest rates—could dampen incentives for increased consumption and investments. Moreover, a high-interest rate environment would hurt further the domestic stock market, increase the debt service burden of firms and the NG and stifle the observed recovery in bank lending.

33. Reduce policy rates

The members of the Monetary Board noted that a further easing of the BSP's monetary policy stance at this time would infuse additional liquidity in the system, which already has ample liquidity at present. Given that monetary policy affects inflation with a lag, the Monetary Board expressed the view that a more accommodative stance now could undermine the attainability of the inflation target over the policy horizon. Moreover, the Monetary Board argued that the scope for reducing policy rates may be limited by the following considerations:

- There has been substantial monetary policy easing in the past two years. Given ample liquidity in the system, further monetary easing may not necessarily contribute to an improvement in credit growth.

- The relatively slow pace by which the stimulatory impact of monetary easing becomes evident can be traced to the long lags in monetary policy. This implies that sufficient time should be allowed for monetary policy actions to work its way fully to the real sector.

- Further monetary easing, either through a reduction in the BSP's policy rates or in the liquidity reserve requirement, would infuse more liquidity in the system, which could fan inflation.

- A reduction in the BSP's policy rates would narrow down the country's interest rate differentials with foreign interest rates, which could lead to greater volatility in the exchange rate and undermine the stability of the peso. This could generate higher inflation and fuel inflationary expectations.

34. Maintain policy rates

The Monetary Board's assessment of the domestic economy showed that the present path of inflation remained consistent with the outlook of a generally subdued inflation environment in the near term, despite foreseeable risks to inflation in the months ahead in the form of cost-push pressures. At the same time, the members of the Monetary Board noted that the prospects for sustained economic growth going forward is clouded by the risks of a slower-than-expected global economic recovery and uncertainties over geopolitical events. Against this backdrop, the members of the Monetary Board expressed the view that monetary policy should remain accommodative by providing a supportive environment that would ensure sufficient liquidity to fuel the economy's growth requirements. The Monetary Board also stressed that monetary policy should remain cautious to guard against any potential build-up of price pressures that would dampen the growth momentum.

III. Monetary Policy Decision

35. Based on the analysis of various indicators on the macroeconomy and the financial sector that have become available since the review of the BSP's monetary policy stance by the Monetary Board on 16 January 2003 and a careful assessment of the balance of risks on inflation and inflationary expectations, the Monetary Board believes that the current monetary policy stance continues to be appropriately supportive of the economy's growth objective while ensuring price stability. For this reason, the Monetary Board, by a unanimous vote, decided to approve the following measures:

a. maintain the BSP's policy rates at the current levels of 7.0 percent for the overnight RRP (borrowing) rate and 9.25 percent for the overnight RP (lending) rate;

b. maintain 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 13 March 2003.

- The Monetary Board of the Bangko Sentral ng Pilipinas