



**HIGHLIGHTS OF THE MEETING OF THE MONETARY BOARD ON
MONETARY POLICY ISSUES HELD ON 16 JANUARY 2003***

Background

The Monetary Board held its first meeting on monetary policy issues for 2003 on 16 January 2003, two days after the Advisory Committee meeting on 14 January 2003.¹ The Advisory Committee presented to the Monetary Board a policy paper containing the committee's assessment of the macroeconomic conditions and their implications on the inflation outlook as well as their recommendations on the appropriate stance of monetary policy. The Advisory Committee also submitted a comprehensive set of economic and financial indicators relevant for the Monetary Board's deliberation on monetary policy issues. The Monetary Board's discussion on the developments in the factors that affect inflation and inflation expectations—in particular, the trends and forecasts in agricultural production, movements of the exchange rate, direction of world oil prices, adjustments in power rates and water tariff, monetary conditions, trend in demand and output indicators, fiscal position, world economic conditions and outlook—served as the basis for Monetary Board's decision on the appropriate monetary policy stance of the BSP.

I. Considerations in the Formulation of the Monetary Policy Stance

Domestic Price Developments and Outlook

1. Year-on-year inflation rose slightly in December 2002 to 2.6 percent compared to 2.5 percent a month earlier. Month-on-month headline inflation in December was also higher at 0.4 percent compared to 0.1 percent in November. Specifically,

* The highlights of the discussions of the 16 January 2003 Monetary Board meeting were approved by the Monetary Board during its meeting held on 20 February 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.



the increases in the prices of fuel products, medicines, selected construction materials (which raised the inflation rate for housing and repairs) and personal services, as well as higher purchased power adjustment (PPA) and the currency rate adjustment (CERA) for electricity in the National Capital Region (NCR) contributed to the upward movement in consumer prices in December 2002.² Average headline inflation for 2002 was 3.1 percent, more than a full percentage point below the low end of the 2002 target range and lower than the average of 6.1 percent in 2001. Similarly, BSP estimates of core inflation, which weed out the effects of temporary disturbances on headline CPI by excluding food and fuel components, showed a slight increase during the month. The BSP's main measure of core inflation rose to 2.7 percent in December from 2.6 percent in the previous month, and averaged 3.8 percent in 2002. Nevertheless, this represented a downtrend from the average core inflation rate of 6.5 percent in 2001.

2. The benign trend in core inflation suggested muted demand-side influences on future inflation as the continuing mixed signals concerning domestic demand translate into limited pricing power on the part of producers. Indications of strengthening demand for goods and services may be gleaned from data on passenger car sales, which registered a modest turnaround from a 17.4 percent year-on-year decline in October to a 2.7 percent rise in November. Similarly, power consumption expanded by 6.4 percent in November from only 0.9 percent in the previous month. However, data on manufacturing activity based on the Monthly Integrated Survey of Selected Industries (MISSI) published by the National Statistics Office (NSO) suggested weakness in domestic demand. The Value of Production Index (VAPI) of the manufacturing industry in October 2002 rose by 2.2 percent (revised) from its year-ago value, slower than the 2.4 percent (revised) rise in September. Meanwhile, the Volume of Production Index (VOPI) continued to decline in October, falling by 3.0 percent (revised) year-on-year compared to 2.5 percent in the previous month. This was the sixth consecutive month of decline in the volume of manufacturing output since May 2002. Meanwhile, capacity utilization in manufacturing also continued to be fairly low at 76.0 percent for October 2002.

The full-year average inflation of 3.1 percent for 2002—the lowest since 1988—is significantly lower than the government's target range of 4.5-

² National Statistics Office, "Summary Inflation Report, Consumer Price Index, December and November 2002", 6 January 2002



5.5 percent. Price pressures are kept at bay as demand-side influences on prices remained muted while supply-side factors are generally favorable. This strengthens expectations of a subdued inflation environment in the near term. In particular, the average inflation for 2003-2004 is expected to be broadly in line with the government's target of 4.5-5.5 percent.

Developments in Agriculture

3. The production of palay in the fourth quarter was expected to benefit from the rainfall brought about by the southwest monsoons and the government's programs to raise agricultural output such as the Department of Agriculture's (DA) quick turnaround (QTA) planting scheme³ and the promotion of the hybrid rice technology.⁴ Thus, palay production was expected to grow by 8.9 percent year-on-year to 5.4 million metric tons (MT) in the fourth quarter of 2002. This could make up for the crop losses in the third quarter, and lead to a full-year palay production growth of 1.2 percent to 13.1 million MT. This production level could help achieve a 3.1-3.5 percent target growth of the agriculture sector in 2002.⁵

4. In the first quarter of 2003, palay production could decline by 1.9 percent year-on-year to 3.0 million MT as irrigated rice farmers have tempered their planting activities due to apprehensions over the effect of the El Niño phenomenon.⁶

5. The government's rice import program has helped mitigate the upward price pressure from the low palay production in the third quarter of 2002, as the National Food Authority (NFA) allowed 1.2 million MT of rice imports from 1

³ The quick turnaround scheme (QTA) is part of the *Ginintuang Masaganang Ani* (GMA) Rice Program of the DA, which aims to compensate for possible losses in rice output brought about by drought, flooding caused by typhoons, and also to mitigate the impact of El Niño. Under the scheme, irrigated rice areas which had been harvested in August or early September were immediately replanted with early maturing rice varieties and certified seeds within two to three weeks to make up for the delays in planting during the second quarter. Farmer participants to the program may also avail of fertilizer on credit under the Quedancor. The program expects to produce an additional 339,598 metric tons of rice for 2002. (Source: DA)

⁴ President Arroyo signed Administrative Order (AO) No. 25 last December 2001, directing the DA, the Department of Trade and Industry (DTI), the NFA and their respective allied agencies to promote the large-scale use of the hybrid rice technology. This is expected to be a major technological option to achieve rice sufficiency, increase by at least threefold the average yield of palay, and generate jobs. Available at <http://www.da.gov.ph>

⁵ "Montemayor: Agriculture is in the heart and mind", 9 December 2002, available at <http://www.da.gov.ph>; The agriculture sector grew by 3.7 percent in 2001. (Source: National Income Accounts)

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



January-22 December 2002. As of 22 December 2002, the national rice inventory stood at 2.7 million MT, equivalent to 105 days of rice sufficiency.⁷

6. In addition to the rice import program, the agricultural sector could also gain from other government programs aimed at boosting production and mitigating the impact of the El Niño phenomenon. These programs included 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 2002⁸ as well as the ₱1.3 billion released by the Department of Budget and Management (DBM) for irrigation projects and other El Niño-mitigating projects of the DA⁹ and the ₱50 million for the seven-year Coconut Development Zone Program.¹⁰

Government programs could help boost agricultural production and contribute to mitigating the possible cost-push pressures on food prices arising from the impact of the El Niño weather disturbance.

Exchange rate developments

7. The peso strengthened slightly against the US dollar as of 9 January 2003, averaging at ₱53.48/US\$1 for the period 2-9 January 2003 compared to the ₱53.50/US\$1 average in December 2002.¹¹ Foreign currency inflows due mainly to remittances from overseas Filipino workers helped boost the peso. However, some pressure on the peso could be expected as post-holiday inflows of foreign exchange were likely to taper off. For the first six trading days of the year, the volatility of the peso averaged ₱0.04, an improvement compared to the ₱0.18 registered for the whole month of December 2002.

⁷ 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).

⁸ “DA credit firm loan releases to hit ₱2 billion this year”, 24 November 2002, available at <http://www.da.gov.ph>

⁹ “Montemayor lauds DBM’s release of ₱1.25 billion for El Niño preparation”, 16 October 2002, available at <http://www.da.gov.ph>

¹⁰ “DA launches ₱50-M coconut development zone program”, 9 December 2002, available at <http://www.da.gov.ph>

¹¹ Based on real-time foreign exchange transactions in the Philippine Dealing System (PDS)



8. On a real, trade-weighted basis, the peso depreciated relative to the currencies of the major trading partners by about 7.6 percent in December 2002 from its level a year ago, as shown in the real effective exchange rate (REER) index.¹² The peso showed a similar depreciation trend over the same period vis-à-vis the broad and narrow baskets of competitor currencies falling by about 5.0 percent and 13.8 percent, respectively. These developments indicated the continued improvement in the country's external price competitiveness.

The peso was slightly stronger against the dollar in January. However, some pressure on the exchange rate remains as inflows of foreign currency remittances are likely to slow down from their holiday levels.

Oil price developments

9. As of 10 January 2003, the price of Dubai crude oil settled at US\$27 per barrel, significantly higher than the average price of US\$25.73 per barrel in December 2002. In the futures market, the price of benchmark Brent crude oil for February 2003 deliveries also rose significantly to US\$30.77 per barrel from US\$25.19 per barrel quoted in the previous month.¹³ The political crisis in Venezuela, which is the fifth largest oil exporter in the world; the looming war in Iraq; and the higher demand for heating oil during the winter season in the Northern Hemisphere have combined to push up oil prices. However, in a move to temper the rise in oil prices within the US\$22-US\$28 per barrel band target, the Organization of Petroleum Exporting Countries' (OPEC) raised the production quota of members by 1.5 million barrels per day to 24.5 million barrels per day following its meeting on 12 January 2003 in Vienna, Austria.¹⁴

10. In the local front, local oil companies and dealers raised the pump prices of petroleum products during the first week of January 2003. In particular, the prices of gasoline and diesel oil were raised by an average of 35 centavos while

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.

¹³ Source: Asian Wall Street Journal, 11 November 2002. The futures price for Brent crude oil—a substitute for Dubai crude—is used as an indicator of future world oil prices since futures data on Dubai crude are not available.

¹⁴ Mackey, P. and E. Tzortzi, "OPEC lifts production to tame oil prices", 12 January 2003, available at <http://www.Reuters.com/Latest/Financial/News/Full/News/Coverage>



the prices of kerosene and liquefied petroleum gas (LPG) were raised by an average of 32 centavos and 56 centavos, respectively.¹⁵

The threat of a US-led offensive against Iraq remains a major concern for the country's inflation outlook. The possible war in the Middle East could have repercussions on world oil supply and prices, which could impact adversely on the country's oil supply, domestic oil prices and consequently, on consumer prices.

Developments in the Utilities Sector

11. In its order dated 19 December 2002, the Energy Regulatory Commission (ERC) allowed the Manila Electric Company (Meralco) to collect its under-recovered purchased power adjustment (PPA) charges amounting to ₱5.8 billion. The ERC said that the “collection should be through the inclusion of the amortized amount as part of the unbundled generation rate schedule to be approved by the ERC in Case Nos. 2001-646 and 2001-900”.¹⁶

12. The ERC is also expected to release soon its decision on Meralco's rate unbundling petition. The use of a new test year in computing the utility's revenue requirements and the inclusion of Meralco's under-recovered PPA charges in the computation of the new unbundled rates could eventually lead to higher power rates. According to Meralco—in its submission to the ERC on 26 December 2001—its proposed new rates as contained in its petition for the unbundling of power rates could raise the cost of electric power consumption by an average of ₱1.12 per kwh or an average increase of 19.6 percent from the November 2001 average tariff of ₱5.73 per kwh.¹⁷ The impact of the unbundling of the power rates would also need to be weighed against those of the Special Program to Enhance Electricity Demand (SPEED) and the planned establishment of the Wholesale Electricity Spot Market (WESM).¹⁸

¹⁵ Source: Department of Energy

¹⁶ ERC, “Order on Meralco's application for the approval of the rate schedule to implement the NPC rate reduction, ERC Case No. 2001-383 (ERB Case No. 97-18)”, 19 December 2002, available at <http://www.erc.gov.ph>

¹⁷ Meralco, “Application for approval of revised rate schedules in compliance with section 36 of Republic Act No. 36 and ERC Order dated 30 October 2001, and for approval of appraisal of properties, with prayer for provisional authority, ERC Case No. 2001-900”, 26 December 2001

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



13. The ultimate impact on inflation of any power rate increase could be mitigated should there be a possible reimbursement of “overcharges” made by Meralco. However, the impact on power rates of the Supreme Court’s decision—which ruled that Meralco should “implement a rate adjustment of ₱0.017 per kwh (instead of the original ₱0.184 per kwh) and reimburse Meralco’s customers or credit in their favor for future consumption the overcharged average amount of ₱0.167 per kwh with respect to Meralco’s billing cycles beginning February 1994 to February 1998”—is still uncertain as Meralco has filed a motion for reconsideration on the said case.¹⁹

14. Meanwhile, the Manila Water Company (MWC) has started to implement a ₱4.25 per cubic meter tariff rate hike in Manila’s east zone effective 1 January 2003.²⁰ This would bring the average weighted all-in water tariff of MWC to ₱14.22 per cubic meter of water from its current rate of ₱9.97 per cubic meter. Further rate adjustments could be implemented in 2005 as MWSS’ initial estimates for MWC’s rate adjustment showed that the rates could be revised up to ₱7.03 per cubic meter.²¹ Meanwhile, MWSS has also approved a ₱5.35 per cubic meter increase in the weighted average all-in water tariff of Maynilad Water Services Inc. (MWSI).²² The approved rate increase would bring MWSI’s current weighted average all-in water tariff of ₱24.44 per cubic meter to ₱29.79 per cubic meter. However, it is still uncertain if MWSI will implement the revised rates as it has already expressed its interest for an early termination of its concession agreement with the government.

(suppliers), 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.

¹⁹ Supreme Court, “Decision on G.R. No. 141314, Republic of the Philippines represented by Energy Regulatory Board vs. Manila Electric Company”, 15 November 2002, available at www.supremecourt.gov.ph

²⁰ MWC services Metro Manila’s east zone which covers Mandaluyong City, Pasig City, Pateros, San Juan, Taguig, and portions of Makati City, Manila City, Marikina City and Quezon City as well as Angono, Antipolo, Baras, Binangonan, Cainta, Jala-Jala, Morong, Pililia, Tanay, Teresa, Rodriguez and San Mateo, all in Rizal.

²¹ Source: Manila Water Company

²² MWSI services Metro Manila’s west zone which covers Valenzuela, Bulacan, Malabon, Navotas, parts of Quezon City and Makati City, Manila City, Pasay City, Las Piñas, Parañaque City, Muntinlupa City and areas in Cavite.



The direction of Meralco power rates in the near term would depend on the ERC's decision on the utility's rate unbundling petition and the Supreme Court's final ruling on the "overcharging" case. Meanwhile, water rates in the Manila area are now higher as the MWSS has approved a staggered water rate adjustment scheme for both water concessionaires.

Interest rates and interest rate differentials

15. The yield on the 91-day, 182-day and 364-day government securities declined during the Bureau of Treasury's (BTr) 6 January 2002 auction—the first for the year—indicating a huge market appetite for government debt papers. The demand for government securities surged during the 6 January 2003 auction, as reflected by the size of tenders amounting to ₱17.2 billion, which was about double the size of the ₱9.5 billion T-bill offering. The auction was fully awarded.

16. Following the results of the 6 January 2003 auction, 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 narrowed to 270.7 basis points and 288.2 basis points, respectively, from 271.1 basis points and 292.6 basis points registered on 9 December 2002.²³

17. 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 rate and the US federal funds target rate remained steady at their 15 March 2002 and 6 November 2002 levels, respectively.

18. 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 narrowed to 55 basis points as of end-December 2002. This developed as the risk premium rose to 520 basis points on 30 December 2002 from 474 basis points a month earlier. The sharp rise in the premium was due mainly to fiscal deficit concerns, particularly on news that the government would sell more yen-and euro-denominated bonds for 2003.²⁴

²³ Review period covered in the last policy paper on the "Review of the BSP's monetary policy stance" considered by the Monetary Board on 19 December 2002

²⁴ Bloomberg News, "Philippine dollar bonds fall on deficit concerns", 7 January 2003



The margin between RP and US interest rates is narrower in early January compared to its December level as competition among banks during the first auction of the year resulted into lower RP T-bill rates. Similarly, the risk-adjusted RP-US interest rate differential is also narrower as fiscal worries led to a sharp rise in the risk premium for RP bonds.

19. During the period 2-8 January 2003, the Philippines' real lending rate (based on the low-end of the range of banks' lending rates) eased slightly to 5.54 percent from the 5.61 percent registered during the review period 28 November-3 December 2002 due primarily to the marginal increase in the inflation rate for December.²⁵ At 5.54 percent, the Philippines' real lending rate was within the midrange among a sample of Asian countries.

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

20. The yield curve for government securities in the secondary market shifted downward relative to that which prevailed on 5 December 2002²⁶ as rates dropped across all tenors on 10 January 2003. The decline in yields was due to banks' competition for government papers, supported by ample liquidity in the system.

The yield curve shifts downward as ample system liquidity led to lower yields for government securities in the secondary market.

Domestic Liquidity and Credit Conditions

21. Domestic liquidity (M3) growth rose by 9.3 percent year-on-year to reach ₱1.603 trillion as of end-November 2002. The higher level of net foreign assets (NFA) of the monetary system as well as the increase in credits to the National Government contributed to the rise in M3.

²⁵ Review period covered in the last policy paper on the "Review of the BSP's monetary policy stance" considered by the Monetary Board on 19 December 2002

²⁶ Yield curve presented in the previous policy paper on the "Review of the BSP's monetary policy stance" considered by the Monetary Board on 19 December 2002



22. The total volume of loans outstanding of commercial banks rose steadily by 1.4 percent in November 2002 from the 1.1 percent year-on-year rise posted in the previous month. This was the third consecutive month of growth after five months of year-on-year declines. Meanwhile, lending by thrift banks—which are engaged traditionally on lending for housing as well as small-and medium-sized enterprises—showed a steady improvement, rising by 10.6 percent year-on-year in August 2002 from 10.5 percent in the previous month.

23. Relative to the end-December 2002 levels, the total volume of banks' placements under the RRP window and the SDA facility increased by ₱29.4 billion and ₱156 million to reach ₱81.7 billion and ₱220 million, respectively, as of 6 January 2003. The increase in banks' placements under the RRP and the SDA facilities reflected a post-holiday phenomenon as banks started to re-invest their excess liquidity with the BSP, which have been withdrawn in December 2002 to finance the seasonal increase in demand for liquidity during the holiday season.

Loans outstanding of commercial banks post third consecutive month of growth, providing further indications of a recovery in bank lending. Meanwhile, banks re-invest excess funds with the BSP under the RRP and SDA facilities following large withdrawals in December, in anticipation of increased demand for liquidity for the holidays.

Domestic stock market movements

24. The expected year-end rally failed to materialize in December 2002 as the average PHISIX settled at 1021.5 index points, lower by 30 index points than the November 2002 average level of 1051.1 index points. However, trading activities improved slightly during the first week of January 2003. As of 8 January, the PHISIX closed at 1042.4 index points as investors took advantage of low share prices. Trading activity in the domestic stock market have been generally subdued in 2002 as uncertainties weighed down investor sentiment. In particular, worries over the burgeoning government budget deficit, the slow pace of global economic growth, domestic and international security concerns as well as the absence of positive corporate developments kept market appetite low.

Market analysts expect investors in the local bourse to maintain their cautious stance as the aforementioned concerns could persist in 2003. In particular, geopolitical developments in the Middle East would remain a key



factor in setting the market's direction. Most market analysts, however, are of the view that bargain hunting of select issues should provide some boost to the market.

Fiscal developments

25. The deficit of the National Government (NG) stood at ₱200.6 billion for the period January-November 2002, considerably higher than the full-year target deficit of ₱130.0 billion (3.3 percent of GDP). This resulted from the shortfall in revenue collections and the higher-than-programmed expenditures.

26. For 2003, the NG expects the fiscal deficit to be around 4.7 percent of GDP (approximately ₱202 billion) from total revenues of ₱584.1 billion and expenditure of ₱786.1 billion. The financing mix is expected to consist of about 48 percent foreign borrowing and 52 percent domestic borrowing.²⁷ The primary challenge for the fiscal authorities is to ensure that the measures put in place to enhance revenue collections particularly, in the BIR and the BOC, would continue to be promoted vigorously along with maintaining prudence in government spending. This is in line with the thrust toward achieving fiscal consolidation over the medium term, consistent with the macroeconomic goals of price stability and sustained economic growth.

While the impact on inflation of the large deficit in 2002 appears to have been muted by ample liquidity in the financial system, a continued shortfall in the programmed fiscal deficit in 2003 could dampen market expectations and pose risks to the inflation outlook.

Developments and outlook in the rest of the world

27. The US economy expanded briskly in the third quarter, accelerating by 4.0 percent (revised) from 1.3 percent in the previous quarter. However, economic developments during the fourth quarter showed a mixed picture. On the positive side, the Institute for Supply Management (ISM) index of manufacturing activity jumped to 54.7 in December 2003 from 49.2 a month earlier.²⁸ Some

²⁷ Source: Press Statement by Department of Budget and Management Secretary Emilia T. Boncodin on 21 November 2002 at the Department of Finance

²⁸ Despeignes, P., "US manufacturing report beats expectations", 2 January 2003 in <http://www.FT.com/World/US>



analysts considered the rise in the ISM index as a sign that the manufacturing sector could be on the recovery path following a period of prolonged weakness. Moreover, consumer confidence improved as reflected by the rise in the University of Michigan index of consumer sentiment to 86.7 in December 2002 from 84.2 in November and 80.6 in October. Meanwhile, labor market conditions remained soft. Analysts believed that the unemployment could still rise further.²⁹ Consumers continued to be concerned about the prospects for renewed growth in jobs and wages as economic recovery could proceed at a slow pace.³⁰ This could be traced to intensifying risks over geopolitical events in the Middle East as well the month-long Venezuela strife with potential consequence for oil prices; the recent tension between the US and North Korea over the latter's nuclear weapons program; and the slow recovery of the stock market. Meanwhile, market analysts were of the view that the US Fed will likely keep the federal funds target rate steady for some time in 2003.³¹

28. In the eurozone, economic growth remained subdued, as GDP rose slightly by 0.8 percent (revised) in the third quarter of 2002 from the 0.6 percent growth in the previous quarter. The 12-member countries face the twin challenges of fiscal correction and structural rigidities in a weak economic environment. Investment contracted in 2002 as companies suffered from declining consumer demand and lower share prices.³² Given the weak external and domestic conditions and signs of easing inflationary pressures, the European Central Bank cut its policy rates by 50 basis points during the last meeting of its Governing Council on 5 December 2002.

29. In Japan, private consumption continued to be weak, housing investment remained sluggish and public investment continued to decline. Based on the view of the Bank of Japan (BOJ), the economy was unlikely to show clear signs of recovery in the near term since exports and production were expected to be virtually unchanged for some time. Based on these considerations, the BOJ have opted to maintain an accommodative policy stance. In its Monetary Policy Meeting held on 16-17 December 2002, the BOJ decided to keep its policy

²⁹ Brice, S., "The New Standard Chartered Daily", 6 January 2003

³⁰ Surveys of Consumers, University of Michigan, "Consumer confidence improves despite dark cloud of war", December 2002, available at <http://www.umich.edu/~umsurvey>

³¹ O'Donnell K., "Wrap-up 1-Fed officials offer message of hope on US economy", 3 January 2003, available at www.Reuters.com

³² IDEAglobal, Asian Regional Markets, Eurozone 2003 Outlook, 31 December 2002



stance aimed at maintaining the outstanding balance of current accounts at around ₱15-₱20 trillion.

Uncertainties over geopolitical risks along with weak domestic demand in the US and other advanced economies continue to cloud prospects for a sustained world economic recovery.

II. Discussion on the Review of the Monetary Policy Stance

30. The members of the Monetary Board were of the view that the outlook for inflation suggested generally manageable price conditions over the BSP's policy horizon, despite foreseeable cost-side risks. The Monetary Board noted that the average annual inflation is expected to move broadly in line with the government's target for 2003. They pointed out that there are still areas of weakness in overall demand conditions, which implied that demand-side factors are likely to continue to exert a muted influence on consumer prices.

31. Meanwhile, the members of the Monetary Board also noted that the potential upside pressures arising from supply-side or cost-push factors were likely to be temporary. However, the Monetary Board also acknowledged that inflationary risks from the impact of a Middle East war on oil prices and the uncertainty over the fiscal performance have a significant bearing on the inflation outlook and would, therefore, continue to inform prospective monetary decisions.

32. The members of the Monetary Board were of the view that the mixed signals concerning the strength of domestic demand accompanied by a greater risk of tepid global economic activity could likely translate into a muted export demand which could add to the existing real sector weakness, particularly in manufacturing activity.

33. In their assessment of the appropriate stance of monetary policy, the members of the Monetary Board addressed the following issues:

- a. With the potential risks to the inflation outlook, would an increase in policy rates be warranted?
- b. Given the uncertainties in external conditions—posed by heightened risks in geopolitical events and the tepid pace of global economic recovery—



combined with areas of weakness in domestic demand, should policy rates be eased in order to provide greater stimulus to the environment?

- c. Looking at both perspectives, should the policy stance remain cautious—one that continues to be accommodative while at the same time watching closely the risks to the inflation outlook—and should authorities maintain the current monetary policy settings?

34. Increase policy rates

The Monetary Board noted that the main argument for tighter monetary policy through an increase in policy rates was that the rate hike would serve as a pre-emptive action against the risks to the inflation outlook arising mainly from demand-side pressures. In the case of the Philippines, the Monetary Board stressed that the potential risks to inflation would likely emanate largely from supply-side factors such as the El Niño weather disturbance and the increase in oil prices, power rates as well as water charges. Given that the signs of strength of the domestic economic recovery remained tentative, the members of the Monetary Board agreed that an increase in interest rates could dampen incentives for increased consumption and investments. The members of the Monetary Board, however, recognize that a neutral monetary policy stance could provide traction as economic growth recovers.

35. Reduce policy rates

The Monetary Board pointed out that a further easing of the BSP's monetary policy stance at this time would infuse additional liquidity in the system, which is already very liquid. Given that monetary policy actions affect the economy with some lag, the Monetary Board believed that reducing interest rates now could undermine the attainability of the inflation target over the policy horizon. In particular, the Monetary Board discussed the following main risk factors to inflation and inflation expectations arising from a reduction in policy rates:

- The present scope for monetary easing is limited by the fact that policy rates have already been reduced to a significant extent over the past year (amounting to a cumulative 800 basis points for the period 4 December 2000-15 March 2002).



- The significant extent of monetary easing since December 2000 and the resulting ample liquidity in the financial system should give the economy ample room to expand without the need for further monetary stimulus.
- The traditional transmission channels of monetary policy impulses may be weak under present conditions and that further easing could have little impact on real sector activity. This could be attributed to structural constraints such as the still relatively large level of NPLs of the banking system—although there are signs of improvement—which drives banks' cautious lending stance.³³
- The best approach to the problem of weak credit demand may simply be to allow sufficient time for the past monetary easing to work its way fully through the real sector.
- In addition, the NG fiscal performance poses a significant concern for the inflation outlook.
- Further monetary easing, either through a reduction in the BSP's policy rates or in liquidity reserves, would infuse more liquidity in the system, which could generate inflationary pressures.
- A reduction in the BSP's policy rates would narrow down further the country's interest rate differentials with foreign interest rates, which could trigger renewed volatility in the foreign exchange market and impact adversely on inflation and inflation expectations.

36. Maintain policy rates

The members of the Monetary Board were of the view that a combination of a manageable inflation outlook, uneven domestic demand conditions, and the prospect of weaker economic activity overseas underscored the need for policymakers to focus on ensuring that monetary policy settings would remain supportive of the liquidity requirements of a growing economy. To strengthen further this argument, the members of the Monetary Board pointed out that the

³³ As of end-September 2002, the ratio of commercial banks' NPL to total loan portfolio fell to 16.4 percent from 17.6 percent in the previous month.



previous monetary easing moves of the BSP have started to show a favorable impact on the private sector credit demand and capital spending. This could, in turn, signal a sustained rise in bank lending and economic activity. Nevertheless, the Monetary Board also noted that the continuing presence of cost-side inflationary risks, including those from movements in food and oil prices as well as the fiscal performance, require a cautious monetary policy stance going forward.

37. In summing up, the Monetary Board emphasized that the overall assessment for future inflation and output supported continued caution on the part of monetary authorities, with greater recognition of the lags in monetary policy in order to gain a firmer indication of the extent to which monetary impulses have begun to support real sector activity.

III. Monetary Policy Decision

38. 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 19 December 2002 and a careful assessment of the balance of risks on inflation and inflationary expectations, the Monetary Board believed that the current monetary policy stance continued to be appropriately supportive of the economy's growth objective while ensuring price stability. In particular, the Monetary Board 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 RRP, RP, and SDAs; and
- d. maintain the reserve requirements at their current levels given the adequate level of liquidity in the system.



Bangko Sentral ng Pilipinas

The next meeting of the Monetary Board to discuss the monetary policy setting was scheduled on 12 February 2003.

- The Monetary Board of the Bangko Sentral ng Pilipinas