HIGHLIGHTS OF THE SPECIAL MEETING OF THE MONETARY BOARD ON MONETARY POLICY ISSUES HELD ON 19 MARCH 2003*

Background

The Monetary Board held a special meeting on 19 March 2003 to assess the current monetary policy stance in the light of the developments in the foreign exchange market. The said meeting was the fourth meeting for the year by the Monetary Board on matters concerning monetary policy. During the meeting, the Monetary Board's discussion focused on the pass-through impact of the volatility in exchange rate on inflation and inflation expectations.

I. Developments in the Foreign Exchange Market

- The peso-dollar rate was relatively stable in December 2002 until early 2003 due to the strength of OFW remittances and the generally favorable macroeconomic environment.
- In January 2003, however, the peso weakened against the US dollar by an average of 10 centavos from the December 2002 level. The average peso per US dollar weakened further to a low of ₱55.075/US$ on 12 March 2003 but it recovered slightly to settle at an average of ₱55.04/US$ on 18 March 2003.
- For the period end-December 2002-18 March 2003, other Asian currencies also depreciated relative to the US dollar, notably the South Korean won, the Singaporean dollar and the Indonesian rupiah.

* The highlights of the discussions of the 19 March 2003 Monetary Board meeting were approved by the Monetary Board during its meeting held on 24 April 2003.

- By contrast, the Taiwan dollar, the Thai baht and the Japanese yen appreciated slightly against the US dollar as of 18 March relative to end-2002.

Along with other Asian currencies, the peso depreciated in nominal terms against the dollar during the period January-March 2003.

II. Factors Behind the Peso-Dollar Rate Movement

The observed volatility in the exchange rate in January-March 2003 can be traced to the following factors:

- Surrounding uncertainties before and during the US-led war in Iraq and regional tensions involving North Korea;
- Lingering concerns over the country's budget deficit as of an offshoot of last year's fiscal performance and the outlook rating downgrade by Standard & Poor's and Fitch;
- Domestic security concerns in Mindanao;
- Possible imposition of sanctions by the Financial Action Task Force (prior to the passage of the amendments to the Anti-Money Laundering Law);
- Relatively low domestic interest rates which have contributed to the pressure on the peso; and
- Declining interest rate differentials; for example, the differentials between the peso time deposit rates and US dollar time deposit rates have narrowed down from 5.9 percent in January 2002 to 2.2 percent in February 2003.

The weakness in the peso during the period end-December 2002 up to the third week of March 2003 can be attributed to various factors such as the uncertainties surrounding the US-Iraq war, domestic security concerns in Mindanao, lingering concerns over the ability of the National Government to contain the budget

deficit within the target and the relatively low domestic interest rate environment.

III. Assessment of Prevailing Economic Conditions and Outlook

- There continues to be evidence of a subdued inflation environment going forward. Recent movements in headline inflation have remained largely confined to specific components of the CPI basket—notably food and fuel, which implied the predominance of supply-side factors in current price movements.

- The relative absence of broad price changes across commodity groups suggests that present demand conditions remained consistent with a benign inflation setting for the future.

- The major risks to future inflation consist mainly of cost-push influences, such as the impact on farm prices of the El Niño phenomenon and the possible sustained escalation in world oil prices due to the war in Iraq. These risks, however, are expected to be transitory. All these factors underlie the BSP's expectations that average inflation in 2003 would be broadly in line with the government's full-year target of 4.5–5.5 percent.

- The possibility of a sustained episode of currency depreciation given the prevailing geopolitical environment poses a concern for monetary authorities because of its potential impact on inflation and inflation expectations. However, the members of the Monetary Board noted that given present levels of unemployment and manufacturing capacity utilization, the degree of exchange rate pass-through to inflation is likely to be relatively low.

- There continue to be weak areas in domestic economic activity, which support arguments concerning the lack of significant demand-side risks to inflation. Labor market conditions remain soft, and spare capacity continued to prevail in key areas, particularly in manufacturing.

- There are also indications of weaker economic conditions overseas, implying continued sluggishness in demand for exports.

Demand-pull influences on prices continued to be muted as the strength of aggregate demand remained tentative. Meanwhile, cost-push pressures on inflation—particularly those emanating from the higher oil prices and the impact of the El Niño on food prices —are expected to be transitory.

IV. Implications for Monetary Policy

- On the basis of the assessment of prevailing economic conditions and the outlook, the members of the Monetary Board evaluated the following monetary policy options:

  a. <u>Increase in the BSP's Policy Rates</u>

  - The members of the Monetary Board noted that monetary tightening may be resorted to during periods of significant and prolonged foreign exchange market pressure, when the movements in the exchange rate threaten to feed into inflation expectations and pose a danger to the inflation target.

  - <u>The Monetary Board members also expressed the view that an increase in the BSP's policy rates and other monetary tightening measures during periods of exchange market pressure should be used with considerable caution as these could also introduce greater uncertainty in an environment already marked by geopolitical tensions from the US-Iraq war and generalized weakness in global economic activity</u>. Moreover, given the need to assure the sustainability of domestic economic growth, they argued that an increase in policy rates would lead to higher market interest rates, which could dampen incentives for increased consumption and investments. They shared the view that a high-interest rate environment would hurt further the domestic stock market, increase the debt service burden of firms and stifle the observed recovery in bank lending. Thus, they believed that a rise in policy rates could derail efforts to steer the economy toward a sustainable recovery path.

  - <u>The members of the Monetary Board pointed out that small, open economies such as the Philippines typically face the difficult question of how best to respond to movements in the exchange rate, since they affect not only inflation through import</u>

prices but also inflationary expectations and output. They emphasized that depending on the shock, exchange rate changes may have very different implications for monetary conditions and hence for the setting of the monetary policy stance. In this regard, the Monetary Board's view was that the recent shocks in the exchange rate were largely temporary. They believed that the movements are not structural and therefore, are not persistent in nature. Rather, these shocks have been caused by reduced foreign exchange inflows, increased demand for dollars arising largely from negative market sentiment and to some extent, excess peso liquidity finding its way to the foreign exchange market. Under these circumstances, the members of the Monetary Board stressed that countering the effects of these largely supply-side shocks may not necessarily be desirable. Likewise, they argued that if their impact on inflation is only temporary, countermeasures through adjustments in interest rates could only inject more uncertainty on real economic activity.

b. Lifting the Tiering Scheme on Banks' Placements with the BSP

- As a preemptive move to address the potential adverse impact on consumer prices arising from sustained pressure on the peso, the Monetary Board was of the view that the tiering scheme could be lifted. This could also help temper speculative demand for foreign exchange arising from excess liquidity in the system. In particular, this measure would slow down the observed unwinding of banks' placements with the BSP under the RRP window, which could be used to fund speculative demand for foreign exchange. This measure was also adopted by the BSP in August 2001 to help quell the speculative pressures on the peso.

c. Adjustment in the Liquidity Reserve Requirement

- The members of the Monetary Board expressed the view that an increase in liquidity reserves could help mitigate the pressure against the peso coming from peso borrowings to fund foreign exchange acquisitions. They pointed out that such a measure is not expected to significantly affect banks' lending rates since liquidity reserves are paid market interest rates. The members of the Monetary Board noted that this measure was adopted during the height of the Asia currency crisis as the liquidity reserves were raised to 8 percent on 29 August 1997 from only 2 percent on 4 July 1997. This was aimed at tempering the extreme volatility of the domestic currency during the period. The Monetary Board also noted that changes in the level of the liquidity reserves should be reviewed and adjusted as soon as conditions in the foreign exchange market normalize.

- The members of the Monetary Board highlighted that, in line with the BSP's shift to inflation targeting, adjustments in policy rates are not aimed at stabilizing the exchange rate *per se* but at addressing emerging inflationary pressures arising from sustained exchange rate depreciation. Given that the near-term risks to the inflation outlook appear to be largely contained and that the expected inflation pass-through appears to be relatively low at present, the Monetary Board decided that an outright increase in the BSP's policy rates does not appear to be warranted at present. At the same time, they noted the relative absence of demand-side influences on the outlook for inflation and growth supported the arguments for ensuring that liquidity conditions remained appropriate for the domestic economy's requirements. Likewise, they expressed the view that the combination of a subdued outlook for future inflation and the lack of clear-cut signs of a sustained upturn in domestic demand implied that the balance of risks in the current economic environment was weighed towards economic weakness rather than a sustained rise in inflation.

- Overall, the members of the Monetary Board believe that monetary policy should remain cautious and continue to provide a supportive environment that ensures available and sufficient liquidity to fuel the economy's growth requirements.

V. Monetary Policy Decision

- Based on all these considerations, the Monetary Board believed that a preemptive monetary policy action would be warranted to help contain a possible build-up of inflationary pressures arising from a sustained depreciation in the exchange rate**.** Thus, the Monetary Board decided to adopt 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. Lift the tiering scheme on banks placements with the BSP under the RRP and SDA windows; and

    c. Increase the liquidity reserve requirement by one percentage point to 8 percent.

The next meeting of the Monetary Board to discuss the monetary policy setting was scheduled on 10 April 2003.

- The Monetary Board of the Bangko Sentral ng Pilipinas

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