INFLATION REPORT

Fourth Quarter 2001

Bangko Sentral ng Pilipinas

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I. Overview

The inflation environment in 2001 has been mostly subdued due to favorable supply-side trends and moderate growth in domestic liquidity and aggregate demand. Although external demand weakened due to the ongoing global slowdown, domestic demand took up the slack, driven by consumption and investments. The agriculture and services sectors performed well, but growth in economic activity in the industrial sector was relatively weak.

Monetary conditions reflected the impact of a carefully considered and balanced monetary policy. Monetary policy—which has brought current and prospective inflation in line with the targets—has appropriately eased interest rates as the economy slowed. As a result, market interest rates have generally declined. However, lending by banks has continued to be restrained as banks adopted a cautious lending stance in order to preserve asset quality and as spare capacity in the manufacturing sector limited firms' need for bank credits.

Our assessment of various indicators support a generally benign outlook for inflation in 2002. This is based on expectations of favorable supply-side influences on prices, notably decelerating international oil prices, a broadly stable exchange rate, and stable food prices. The relative absence of significant supply-side cost pressures, along with the generally soft labor market, also limits the scope for sizable nominal wage adjustments going forward. Demand-pull inflationary pressures are likewise expected to be restrained, given the presence of weak external demand, excess capacity and moderating liquidity growth. We, therefore, expect inflation to remain low well into the first four months of 2002, with a slightly increasing trend toward the end of the year. The full-year average is expected to decelerate slightly from the low end of the 6-7 percent target in 2001 to the low end of the 5-6 percent inflation target for 2002.

The prospect of tame inflationary pressures going forward creates room for a continued growth-supportive monetary stance, although certain risks remain, particularly from the external sector. The sluggishness in external demand raises the likelihood of weaker foreign exchange earnings from exports and tourism, and could contribute to renewed volatility in the peso. Moreover, oil prices could reverse their current trend should the OPEC intensify its plans to restrict supply. For these reasons, monetary policy will continue to be on a cautious footing, but with some scope for easing to support growth in the domestic economy amid the risks of the present global slowdown.

II. Recent Developments in Inflation and Economic Conditions

TRENDS IN PRICES

The inflation environment was relatively subdued in 2001. This was due mainly to favorable supply-side factors, notably lower prices for food and oil products as well as the continued prudence of monetary policy. Declining prices for major food items such as rice and corn provided a stabilizing influence on the overall inflation rate. At the same time, reductions in domestic oil prices caused a deceleration in headline inflation beginning in the third quarter.[1] Estimated core or underlying inflation (see box article on BSP estimates of core inflation) showed a similar path as headline inflation, registering a brief uptrend in the first half but decelerating in the third quarter.[2]

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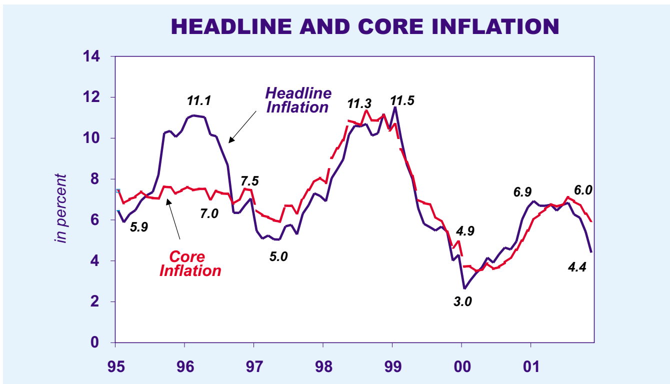
[1] *Headline inflation, or the rate of change in the consumer price index (CPI) for all items in the basket of goods published by the National Statistics Office, measures the overall movement in consumer prices in the economy.*

[2] *Core or underlying inflation is an alternative measure of inflation that eliminates the transitory effects on the CPI. Core inflation removes certain components of the CPI basket that are subject to volatile price movements such as food and energy.*

Headline and Core Inflation

Monthly headline inflation was relatively stable in the first half of 2001 due to the effect of declining prices of major food items, particularly rice and corn, which offset movements in other commodity prices. Generally favorable weather conditions during the year contributed to strong agricultural performance, thereby ensuring ample food supply. Reductions in the prices of domestic oil products beginning in the third quarter also contributed to lower headline inflation. Average inflation for 2001 reached 6.0 percent, higher than the 4.4 percent average in 2000 but at the low end of the Philippine government's inflation target of 6-7 percent for the entire year. The inflation rate for food, beverages and tobacco (FBT) averaged at 3.9 percent for the year, while non-food inflation averaged at 8.4 percent.



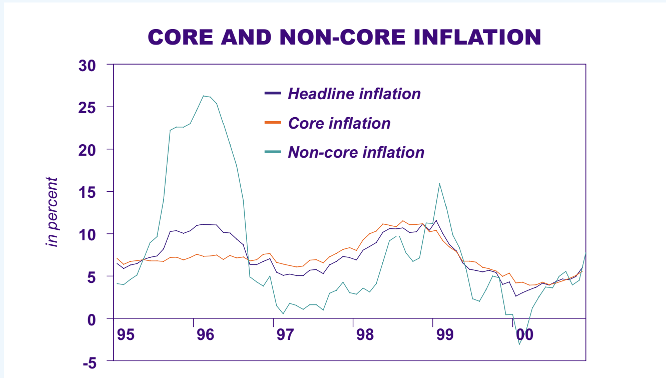
Various indicators of underlying or core inflation estimated by the BSP show an uptrend in the early part of 2001 followed by a deceleration beginning in August. The BSP's definition of core inflation (which excludes food and energy items that together comprise 25.5 percent of the CPI basket) reached a high of 7.1 percent in July but fell in succeeding months to end at 6.0 percent in November. Average core inflation for 2001 was 6.5 percent. Alternative measures of underlying inflation used by the BSP showed a broadly similar path during the period. The trimmed mean, weighted median, and net of volatile items measures peaked in July but began to decelerate in the succeeding months. For the year, the trimmed mean, weighted median, and net of volatile items measures averaged at 3.9 percent, 5.5 percent, and 4.9 percent, respectively.

Box 1. ESTIMATING CORE INFLATION

Why Measure Core Inflation?

'Headline' inflation, or the rate of change in the consumer price index (CPI) for all items in the basket of goods published by the National Statistics Office (NSO), measures the overall movement in consumer prices in the economy. In a policy context, this serves as an anchor for monetary policy and a guide to inflationary expectations.

However, the headline inflation rate in the Philippines has tended to be historically volatile because of the frequency of temporary shocks or disturbances in the economy that affect prices of major commodities. These shocks include shortages in agricultural food supply and increases in international oil prices, which feed through other commodity prices. The volatility in headline inflation makes it difficult for policymakers to forecast inflation and plan their policy actions as the basis of this variable alone. From a policy standpoint, therefore, it would be better to also use a measure of inflation that is less prone to disturbances and, therefore, relatively easier to predict. Such a measure of "core" inflation, which removes the influence of temporary shocks on the headline inflation rate, provides a more accurate gauge of the broader or underlying movements in commodity prices.



BSP Measures of Core Inflation

The economic literature cites a number of methods for estimating core inflation. Statistical approaches, for example, attempt to capture the central tendency of inflation by "trimming" the all-items CPI each month to exclude those components with large price changes, both positive and negative. The most common examples are the trimmed mean and weighted median methods. The most popular method among central banks, however, is the exclusion method, since it is the easiest to compute and explain to the public. This method excludes a fixed, pre-specified list of volatile CPI components each month, usually food and energy items. The idea behind excluding food and energy stems from the fact that the markets related with these products reflect supply shocks that are considered independent of monetary policy. Other methods rely on econometric techniques and directly link inflation to other variables in the economy.[1] This is more consistent with

[1] *For example, Quah and Vahey (1995) link inflation with real output using a vector autoregression (VAR) model.*

accepted economic theory, but is more difficult to explain to the public, requires a lot of economic data, and may be subject to frequent revisions each time new data are added to the model.

The BSP currently uses four measures of core inflation as a guide to policy actions.[2] These include two exclusion-based measures: a CPI Net of Volatile Items measure that excludes about 37.7 percent of the total basket, and a CPI Net of Food and Energy measure that excludes about 25 percent of the basket. The Net of Volatile Items measure excludes several CPI components based on their volatility, while the Net of Food and Energy measure eliminates a narrower set of commodities, mostly food and oil-related. In addition, the BSP also uses two statistically derived measures, namely a 70 percent trimmed mean measure and weighted median measure. These measures enable the BSP to examine the overall trend in consumer prices after removing the impact of temporary and exogenous shocks that are considered outside the control of monetary authorities.

These measures are computed as follows:

- **Trimmed Mean.** The BSP uses a 70-percent (15 percent on each tail) trimmed mean measure to estimate core inflation. Year-on-year inflation rates for each CPI sub-component in a given month are ranked from lowest to highest. On each side of the distribution, a subset of inflation rates corresponding to a cumulative CPI weight of 15 percent is removed. The weighted average of the remaining middle 70 percent of the distribution is then used as the core inflation rate.

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[2] *See Adamos and Fernandez (1995) for a discussion on how these four measures were originally constructed.*

- **Weighted Median.** The weighted median measure uses a lowest-to-highest ranking of year-on-year inflation rates similar to the trimmed mean. The median inflation rate (which corresponds to a cumulative CPI weight of 50 percent) is then used as the core inflation measure.

- **CPI Net of Volatile Items.** The net of volatile items approach is identical to the exclusion method. It derives underlying inflation by removing from the core CPI computation a fixed, pre-defined subset of CPI components. It assumes that, in general, price shocks to the CPI originate from these components. The excluded items, shown below, comprise about 37.2 percent of the CPI basket.

Excluded CPI Components: Net of Volatile Items	
Rice	11.8
Corn	1.2
Fruits and vegetables	5.4
Rentals	13.7
Educational services	2.9
Personal services	1.7
Recreational services	0.4
Total	37.2

- **CPI Net of Food and Energy.** As part of the preparations for the shift to inflation targeting, the BSP-DER staff came up with an exclusion-based definition for core inflation that could provide the basis for an officially published measure. This new measure is fairly similar to the BSP's existing Net of Volatile Items measure, but narrows down the excluded items list and exclude only those items that are explicitly linked to supply-side factors. Excluded CPI components are mainly food and energy items, drawn from a ranking of the most historically volatile items in the CPI basket. The excluded non-core items comprised 25.5 percent of the CPI basket, shown below:

EXCLUDED ITEMS: CORE INFLATION *CPI data at the subgroup (2-digit) level*	
Rice	11.82
Corn	1.23
Fruits & Vegetables	5.35
Fuel	2.27
Transport and Communication	4.81
Total Non-Core Weights	25.47

At present, the NSO does not publish an official measure of core inflation. In time, however, the BSP hopes to eventually use an officially defined and publicly recognized measure of core inflation in its assessments of the inflation outlook. There is already some inter-agency technical work being done toward constructing an official definition, although no final consensus has been reached. Nevertheless, the exclusion method appears to be the preferable approach for an official measure of core inflation in the Philippines, for the following reasons: ease of computation; understandability by the general public; easy replication and verification by others; increased accountability and transparency of measurement; and timeliness. This approach also accords with the practice in most countries, where core inflation is defined in terms of an exclusion-based method.

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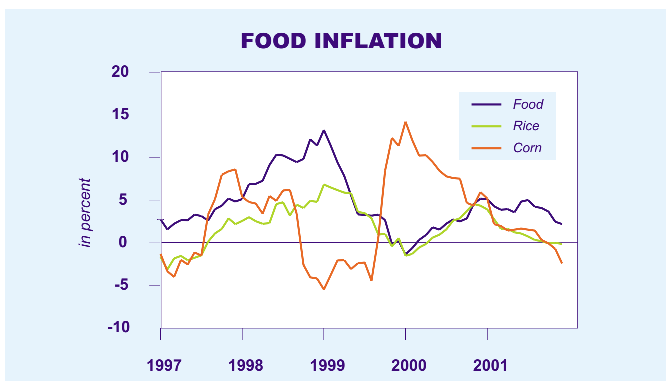
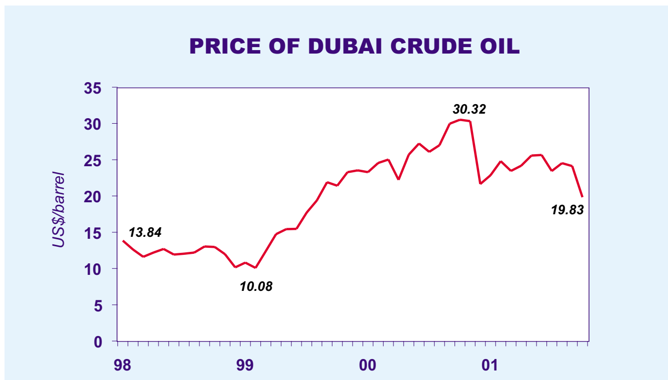
Food Prices and Weather Conditions

Declining food prices contributed in large part to the decelerating trend of overall inflation. The drop in prices was due mainly to favorable food supply conditions, particularly for major agriculture crops such as rice and corn, owing to good production performance. Data from the Bureau of Agricultural Statistics (BAS) show that average farmgate prices of major crops in the first nine months of 2001 fell by 8.4 percent compared to the same period a year earlier. In particular, the average farmgate price of palay (unmilled rice) fell by 5.0 percent during the same period. This translated into lower retail prices. The weekly National Food Authority (NFA) survey of rice prices showed that as of 5 December, retail prices of well-milled and regular-milled rice fell by 44 centavos and 48 centavos, respectively, from their January levels.



Weather conditions were also better than expected in 2001. Warmer temperatures leading to an El Niño episode were earlier predicted to occur in the latter half of the year. However, the resulting dry spell was milder than expected as rainfall conditions were only slightly below normal levels. BAS data show that from April to September this year, the country received an accumulated rainfall of 19,948 millimeters, which was only 9.4 percent less than the level a year ago and 6.6 percent below the normal level.

As a result, agricultural crop production remained relatively strong despite the dry weather. Estimates by the BAS indicate that palay production will again reach a record level of 13.0 million metric tons (MT) in 2001, or 4.6 percent more than the 12.39 million MT production in 2000. Similarly, the BAS also reported that corn production is expected to increase by 1.7 percent to 4.58 million MT this year from the 4.51 million MT registered in 2000. The production data suggest continued favorable food supply conditions in 2002, and therefore generally stable food prices.



Oil Prices

International oil prices generally softened in 2001 due to improved global supply conditions and weaker demand in the international crude oil market. Although there was a brief uptick immediately following the US September 11 attacks, the average price per barrel of Dubai crude oil, the international benchmark for Asian oil prices, has fallen for most of the year, from US$28.43 per barrel for 2000 to US$23.26 per barrel for the period January-November 2001. Prices fell further in December 2001, settling at US$17.01 per barrel at the end of the first week. The sustained downtrend in world oil prices has translated into a series of reductions in local pump prices as early as 20 July 2001. As of end-November 2001, the domestic prices of gasoline and other oil products have declined by an average of about 75 centavos compared to the end-December 2000 levels

Box 2. FACTORS AFFECTING INFLATION IN THE PHILIPPINES

Historically high inflation in the Philippines has often been linked to shocks or disturbances in various areas of the economy, notably the external (which relates to the balance of payments), real (which relates to output or production), and monetary sectors. The effect of external and real sector shocks has been noted in the economic literature. Debelle and Lim (1998), for example, observe that traditionally, inflation in the Philippines has tended to be consistently higher and more variable than in other Asian countries for the following reasons:[1] (a) fluctuations in the exchange rate, which feed directly into domestic prices; and (b) supply shocks.

External Sector Shocks

In the past, sharp swings in the exchange rate were often linked to shocks in the external sector, such as balance of payments crises. These crises often trace their origin to such factors as a sudden massive outflow of foreign capital or an excessive rise in imports relative to export earnings, all of which lead to shortages in foreign exchange within the system. The scarcity of foreign exchange causes the peso to weaken sharply relative to foreign currencies like the US dollar. The resulting increase in the cost of imports—imported inflation—feeds into the overall level of consumer prices.

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[1] Debelle, Guy and Cheng Hoon Lim, "Preliminary Considerations of an Inflation Targeting Framework for the Philippines," IMF Working Paper No. 98-39, March 1998.

Real Sector Shocks

Food supply shortages. Real sector shocks include oil price increases and food supply shortages caused by adverse weather conditions such as severe typhoons or droughts. Recall, for example, the rice shortage in 1994-1995 caused by an extended dry season associated with the El Niño phenomenon. The ensuing upsurge in rice prices pushed up overall inflation to double-digit levels.

Oil price increases. Shocks in prices of important international commodities such as crude oil tend to be outside the control of monetary authorities because of their essentially unpredictable nature. However, their impact can be minimized. The effect of international price disturbances varies among Asian countries because of differences in their level of import dependence. For example, oil producers such as Indonesia and Malaysia would be less vulnerable to a surge in world oil prices than net oil importers such as the Philippines.

Low agricultural productivity. Meanwhile, volatile food prices are partly a result of low agricultural productivity, which makes agricultural food supply largely dependent on favorable weather conditions. Low farm productivity, in turn, is partly a result of the lack of better agricultural equipment and facilities for widespread use that would ensure ample harvests. A related problem is the absence of an efficient transportation network that would enable the timely and cost-effective distribution of agricultural goods to various parts of the country. Roads, bridges, ports need further improvements to enhance farm to market access. These concerns require a comprehensive effort to raise farm productivity.

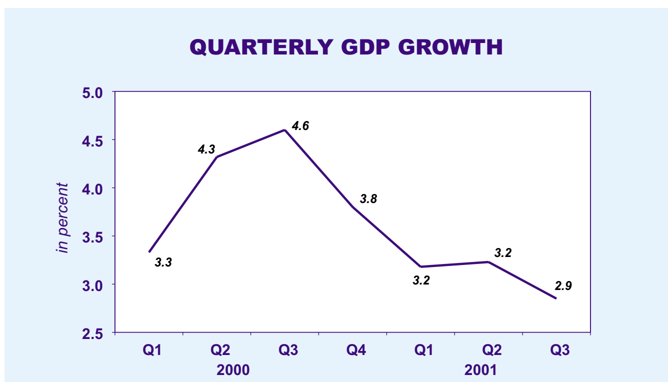
Monetary Sector Shocks

Chronic large fiscal deficits. In the monetary sector, an important source of persistently high inflation is chronic large fiscal deficits, which in the past created pressure on the old Central Bank to lend to the National Government in order to finance the fiscal deficit. This past practice monetizing the fiscal deficit created additional liquidity in the system, and led to excessive money growth and created inflationary pressures. This situation is less of a problem under the New Central Bank Act, which sets out clear limits to the amount of financial assistance that the BSP could provide to the National Government. This allows the BSP to pursue prudent monetary management without undue pressures coming from the fiscal sector.

Sharp swings in monetary policy. Debelle and Lim also cite an additional source of inflation from the monetary sector: sharp swings in monetary policy due to the pursuit of multiple objectives. This refers mainly to the case of the old Central Bank, in which the goals of price stability and exchange rate competitiveness were not always compatible. Policy swings associated with multiple objectives are no longer a problem with the explicit choice of price stability as the primary objective of monetary policy under the New Central Bank Act. In addition, the adoption of inflation targeting as a monetary policy framework is expected to help strengthen the BSP's focus on price stability.

AGGREGATE DEMAND AND OUTPUT

Domestic demand continued to grow in 2001, buoying up overall economic activity as external demand weakened due to the global economic downturn. Consumption and investment activity led the rise in domestic demand in the first three quarters of the year. Consumption was fueled by increased spending on food, transportation/communication and household operations while investment activity was driven primarily by government spending on various construction projects. Nevertheless, certain indicators suggest some weakness in domestic demand. Passenger car sales, for example, showed year-on-year contractions for all months of 2001 except in August. On a cumulative basis, passenger car sales volume recorded a contraction as of October 2001 compared to the same period last year. Meralco power sales over the same period showed weaker growth compared to a year earlier. Appliance sales, however, have started to show some recovery in October from nine consecutive months of year-on-year contractions.



Output growth in output was driven largely by agriculture performance and a resilient services sector. Industry growth slowed noticeably as manufacturing activity was dampened by reduced demand for major export products.

Domestic demand

Domestic demand in the first nine months of the year was driven mainly by consumer spending and investments. Consumer spending recorded a robust growth of 3.3 percent during the period. This was fueled by increased spending on food, transportation/communication and household operations. Meanwhile, real investments grew at a faster pace of 5.1 percent in the first nine months, from 1.2 percent in the same period last year. Spending on investments was channeled mainly into the construction sector. Construction activity gained momentum, with public construction rebounding as a result of continuing public works, transportation and Built-Operate Transfer (BOT) projects. Meanwhile, spending on durable equipment rose marginally by 0.5 percent, in contrast to the 4.5 percent growth in the same period last year.

Government spending during the first nine months continued to decline, falling by 1.1 percent. The decline in fiscal stimulus reflected in part the government's sustained cost-cutting efforts in order to keep the budget deficit within the projected level. As a result, the National Government budget deficit stood at ₱133.3 billion in the first ten months of 2001, which was within the program target of ₱137.7 billion for the period and ₱145 billion for the entire year.

Other demand indicators

Other indicators, however, suggest some weakness in overall demand. For example, the volume of passenger car sales in the first ten months of 2001 fell by 21.6 percent compared to a 11.4 percent rise in the same period a year before, based on data from car manufacturers. Similarly, the volume of appliance sales (compiled by the NSCB) declined by 9.2 percent year-on-year in January-October 2001 as against a 6.5 percent increase in the same period in 2000. Meanwhile, cumulative energy sales of the Manila Electric Co. (Meralco) increased by only 3.8 percent in the first ten months of 2001 compared to 8.0 percent for the same period in 2000.

External demand

External demand has been hampered by the weak global economy for most of the year, cutting down other countries' demand for Philippine goods. Data from the balance of payments (BOP) show that growth in the country's exports of goods fell by 14.7 percent during the first three quarters of 2001, following a 9.4 percent increase a year earlier. Electronics exports, in particular, suffered a 23.3 percent decline on account of weaker demand from the country's major export markets (the US and Japan) as well as the downturn in the global electronics business cycle. Similarly, garment exports declined by 4.4 percent during the period following an 11 percent rise a year ago.

Production and output growth

Output growth in the first nine months continued to be positive, albeit slightly lower compared to the previous year's level. GDP growth in real terms reached 3.1 percent in the first three quarters of 2001 compared to 4.1 percent in the same period a year earlier. All the three major sectors of the economy recorded positive but slower growth compared to the levels recorded a year ago. Growth in the industry sector slowed down from 3.8 percent to 2.1 percent, due mainly to the decelerating pace of activity in the manufacturing and electricity, gas and water sectors. Meanwhile, the services and agriculture sectors both experienced a deceleration, but of smaller magnitudes. The services sector decelerated to 4.0 percent from 4.6 percent during the same period last year, due to slower activity in most sub-sectors. The expansion in agriculture, fishery and forestry output during the first three quarters slowed to 2.9 percent from 3.4 percent in the same period in 2000.

Manufacturing

Manufacturing production was also dampened as businesses faced softening world demand for major export products. Growth in the Value of Production Index (VaPI) for manufacturing declined to single-digit levels, ending at a 6.4 percent in September 2001 based on preliminary results of the Monthly Integrated Survey of Selected Industries (MISSI). Similarly, the volume of production index (VoPI) registered negative growths in recent months, falling by 7.3 percent in September 2001. Manufacturers also reduced their operating capacity. The average capacity utilization rate for manufacturing in September 2001 was estimated at 77.0 percent, slightly lower than the 78.7 percent capacity utilization in August 2001.

LABOR AND EMPLOYMENT

Unemployment remained at double-digit rates but was lower compared to the level a year ago. Based on the Philippine labor force survey results for the month of July 2001, unemployment fell to 10.1 percent compared to 11.2 percent a year earlier. The number of employed workers increased by about 8.0 percent to 29.3 million in the third quarter, outpacing the 6.7 percent increase in the labor force population. Employment across all major sectors increased on a year-on-year basis, notably in the agriculture, fishery and forestry sector, which increased by 11.4 percent, and in the services sector, which rose by 6.3 percent, due mainly to the increased employment in its wholesale and retail trade subsector (19.6 percent). In the industry sector, employment increased by 6.1 percent, led by the manufacturing (8.1 percent) subsector.

Table 1: EMPLOYMENT INDICATORS, 1999-2001

Period	Labor Force Population (in '000)	Employment Rate (in %)	Unemployment Rate (in %)	Underemployment Rate (in %)
July 1999	30,440	91.5	8.5	22.0
July 2000	30,518	88.8	11.2	21.2
July 2001	32,567	89.9	10.1	17.7

Overall nominal wage adjustments during the year were moderate and limited to several regions only. Data from the National Wages and Productivity Commission (NWPC) show that as of November 2001, wage adjustments were effected in only seven regions (including Metro Manila) out of the 16 regions across the country. Increases in nominal wages compared to their end-2000 levels ranged between 2.3 percent and 6 percent for the different regions, the highest being for Metro Manila (NCR).

Table 2: NON-AGRICULTURAL NOMINAL AND REAL WAGE RATES, 2000 - 2001*

(1994 = 100) REGION	December 2000		November 2001		% Change	
	Nominal a/	Real b/	Nominal a/	Real b/	Nominal	Real
Metro Manila	250.00	150.22	265.00	154.99	6.0	3.2
CAR	178.00	115.81	185.00	118.14	3.9	2.0
I	190.00	121.32	190.00	119.26	0.0	-1.7
II	180.00	112.63	180.00	112.83	0.0	0.2
III	208.50	126.64	208.50	131.15	0.0	3.6
IV	217.00	132.66	217.00	132.41	0.0	-0.2
V	182.00	107.03	182.00	106.48	0.0	-0.5
VI	170.00	110.86	170.00	111.22	0.0	0.3
VII	180.00	107.83	190.00	109.25	5.6	1.3
VIII	173.00	105.92	177.00	106.56	2.3	0.6
IX	165.00	101.33	165.00	102.86	0.0	1.5
X	173.00	107.93	180.00	110.40	4.0	2.3
XI	170.00	109.68	180.00	114.52	5.9	4.4
XII	160.00	101.51	160.00	106.61	0.0	5.0
CARAGA 1/	166.00	104.94	173.00	108.20	4.2	3.1
ARMM 2/	140.00	83.10	140.00	77.34	0.0	-6.9

* Include COLAs
1/ Covers the provinces of Agusan del Norte, Agusan del Sur, Surigao del Norte, Surigao del Sur and the cities of Butuan, Surigao and Bislig
2/ Refers to the Autonomous Region in Muslim Mindanao
a/ Highest nominal minimum wage
b/ Average real wage using recent CPI

Source: National Wages and Productivity Commission; Department of Labor and Employment

The ₱30.00 per day for the NCR is payable in two tranches of ₱15.00 each in 5 November 2001 and in 1 February 2002. Meanwhile, estimated real wages rose in some regions (notably Region XII, by 5 percent) but declined for some (ARMM, which showed a 6.9-percent drop).

Subdued wage pressures during the year may be attributed mainly to the generally soft labor market (due to corporate downsizing and labor displacement). In addition, the relative stability of the exchange rate and the sustained decline in oil prices may have served to limit the scope for workers to press for significant cost-of-living adjustments.

FINANCIAL MARKET CONDITIONS

Stock Market

Despite initial optimism following the political developments in January 2001, trading activity in the equities market was weighed down for most the year by external and domestic factors, notably generally weak investor appetite for emerging market stocks, weak corporate earnings results, as well as domestic economic and political concerns. These factors contributed to a generally bearish mood among investors at the Philippine

Stock Exchange, and the ensuing months of 2001 saw much selling activity in the various sectors. As a result, by the end of October 2001, the average Philippine Composite Index (Phisix) had fallen by 31.4 percent to 993.35 relative to its 2 January 2001 level of 1,448.49 and 979.34 in October 24, the lowest level it reached in 2001. More recently, however, the downtrend has started to reverse in mid-November due to bargain hunting in oversold blue chip stocks and mildly improved market sentiment. Moreover, the greater liquidity in the system arising from the reduction in the liquidity reserve requirement also helped in consolidating the gains in the stock market. The main index was higher than the psychological support level of 1,000 at 1,128.47 by end-November.

Government Securities

The government securities market was characterized by continuing strong demand from banks, as indicated by oversubscription at the regular primary auctions and generally lower yields on government debt. The significant demand for government securities was due mainly to ample liquidity in the banking sector, due to the reductions in BSP policy rates and reserve requirement, as well as the generally cautious lending stance of domestic banks owing to concerns about asset quality. The prevailing weakness in demand for additional credit and weak trading activity in the local equities market also contributed to the ample liquidity in the market for debt instruments.

III. Monetary Policy Developments

The BSP's efforts to ensure a supportive environment in 2001 were centered on its primary mandate of maintaining stable prices, while broadly supporting the economy's output growth objective. This was achieved in the early part of the year with reductions in BSP policy interest rates to provide room for market interest rates to go down and thereby encourage economic activity to strengthen.

In the middle part of year, however, the movements in international oil prices and the peso-dollar rate created upside risks to inflation and inflation expectations. (Movements in exchange rates are discussed below.) These factors prompted the BSP to reassess the monetary policy stance and focus on addressing potential inflationary pressures. As a result, policy rates were held steady beginning in May 2001. The stability of the foreign exchange market became of particular concern to monetary authorities because sharp and sustained movements in the peso-dollar rate have a pass-through impact on consumer prices by raising the cost of imported inputs for production. To address potential inflationary pressures coming from a volatile exchange rate, the BSP raised the liquidity reserve requirement on deposits by a total of 4 percentage points in July and August. This was aimed at moderating liquidity growth and, at the same time, helping temper speculative activity in the foreign exchange market, as excess peso liquidity was being used to fund foreign exchange purchases. The adjustment in the liquidity reserves tempered liquidity growth, which helped reduce the potential for speculation in the foreign exchange market. It also brought overall monetary growth in line with the downscaled growth targets for 2001 to account for the weaker-than-expected economic activity. These actions, along with other BSP measures to temper currency speculation, helped pave the way for the broad stability of the exchange rate.

The benign inflation environment in the third quarter of 2001, which affirmed expectations that inflation was on a downward trajectory, as well as the benign inflation outlook for 2002 based on BSP projections, created room for a calibrated monetary easing as a means of providing broad support to the economy's growth objectives in the face of a weak external environment. Growth-supporting measures were necessary to invigorate domestic demand in the face of a weak external environment due to the expected downturn in the US economy and other global uncertainties. This was also expected to allow the economy to build upon the better-than-expected growth performance in the second quarter, which was largely consumer-driven. The advent of falling interest rates in advanced economies has also provided further leeway for the BSP to reduce rates at the time when the peso was broadly stable.

Thus, the BSP again began to implement moves toward monetary easing in October 2001, reducing policy rates several times until yearend. All in all, the BSP eased its policy rates 16 times by a cumulative 725 basis points since December 2000. The latest cut of 25 basis points on 14 December 2001 brought the BSP's overnight borrowing (RRP) and lending (RP) rates to 7.75 percent and 10.0 percent, respectivelythe lowest levels recorded since 1 September 1995. At the same time, as concerns over excess liquidity in the financial system receded, monetary authorities also reduced the liquidity reserve requirement on deposits by two percentage points on 7 December 2001.

Table 3: BSP KEY POLICY RATES

Effectivity Date	RRP Overnight	RRP Overnight	Change in RRP (in bps) From Prev. period	Change in RRP (in bps) From Yearend	Change in RP (in bps) From Prev. period	Change in RP (in bps) From Yearend
1999	8.750	12.000		-462.50		-337.50
2000	13.500	15.750		475.00		375.00
8-Jan-2001	13.000	15.250	-0.500	-0.500	-0.500	-0.500
15-Jan-2001	12.500	14.750	-0.500	-1.000	-0.500	-1.000
29-Jan-2001	12.000	14.250	-0.500	-1.500	-0.500	-1.500
5-Feb-2001	11.500	13.750	-0.500	-2.000	-0.500	-2.000
12-Feb-2001	11.000	13.250	-0.500	-2.500	-0.500	-2.500
12-Mar-2001	10.500	12.750	-0.500	-3.000	-0.500	-3.000
23-Mar-2001	10.000	12.250	-0.500	-3.500	-0.500	-3.500
20-Apr-2001	9.500	11.750	-0.500	-4.000	-0.500	-4.000
18-May-2001	9.000	11.250	-0.500	-4.500	-0.500	-4.500
5-Oct-2001	8.750	11.000	-0.250	-4.750	-0.250	-4.750
9-Nov-2001	8.250	10.500	-0.500	-5.250	-0.500	-5.250
7-Dec-2001	8.000	10.250	-0.250	-5.500	-0.250	-5.500
14-Dec-2001	7.750	10.000	-0.250	-5.750	-0.250	-5.750
Cumulative for 2001				**-575.00**		**-575.000**
Cumulative since 4 Dec. 2000				**-725.00**		

Under the three-tier pricing mechanism for RRP instruments, 7.75 percent will be paid for the first 5 billion, 5.75 percent for the next P5 billion and 3.75 percent for placements in excess of P10 billion.

Box 3. OPERATIONAL DETAILS OF INFLATION TARGETING FOR THE PHILIPPINES[1]

Operational details of inflation targeting in the Philippines

The following are the operational features of inflation targeting in the Philippines. These details have been arrived at in consultation with a broad spectrum of society including academics, the banking and business communities, and the government sector during the BSP's public briefings/discussions on the subject.

Measure of inflation. The BSP will use the CPI-based (headline) inflation rate as the target for monetary policy. This is because the CPI is the commonly used measure of inflation and is, therefore, widely known and well understood by the public. It is also published with a short time lag. However, the headline inflation rate includes the impact of transitory and exogenous disturbances such as supply-side shocks. Since some price movements are not within the control of monetary policy and as some price movements give rise to one-off effects on the price level, the BSP would also monitor closely the movements in the so-called “core inflation” for policy purposes in setting the monetary policy stance.

Core inflation removes certain components from the CPI basket that are subject to volatile price movements such as unprocessed

[1] This is an excerpt from an article to be published in the Bangko Sentral Review in January 2002

food and energy and those whose price changes are not within the control of monetary policy. The use of core inflation in the formulation of monetary policy decisions implies that the monetary authorities look at the path of the underlying inflation over a given policy horizon. Operationally, this means that monetary policy will not respond to temporary disturbances to inflation.[2]

Target for inflation. The government's inflation target will be an annual target. For 2003, the government's inflation target is 4.5-5.5 percent.

To allow for movements in inflation that are beyond the control of the BSP, the inflation target will be couched in terms of a target inflation range (e.g., 5-6 percent). This reflects the view that actual inflation will fluctuate around the target rate, and considers the presumed variability of the inflation rate as well as the imperfect control of monetary policy over the inflation rate.

Escape clauses. Escape clauses set the conditions under which any departure of actual inflation from the inflation target can be tolerated. These escape clauses—which have been identified in advance—refer to the likely causes behind significant price movements that are beyond the control of monetary policy. In effect, inasmuch as monetary policy cannot control inflation completely, there should be some mechanism by which the BSP can invoke escape clauses when actual inflation deviates from the target. The escape clauses are as follows: (a) volatility in the prices of unprocessed food; (b) volatility in the prices of oil

[2] *Monetary policy will thus accommodate the first-round effects of supply shocks. It will, however, closely monitor any second-round impact of exogenous shocks to prices, since these shocks could feed into adjustment in wages and inflationary expectations.*

products; (c) significant government policy changes that directly affect prices such as changes in the tax structure, incentives and subsidies; and (d) natural factors affecting the major part of the economy.

In using escape clauses, the BSP will have to explain carefully and clearly to the public how these factors resulted in the deviation of the inflation outcome from the target as well as discuss the actions that it will take and the length of time involved in bringing back inflation toward the target path.

Adoption of a two-year target horizon. The target horizon defines the time period over which monetary authorities commit to achieve the targeted inflation rate by calibrating monetary policy. The BSP will observe a two-year time period over which it will seek to achieve the inflation target. This will thus entail the announcement by the government of an inflation target two years in advance. This will allow sufficient scope for the BSP to respond to shocks and influence inflationary expectations. Such a gradualist approach would avoid sharp interest rate adjustments and abrupt shifts in the monetary stance, thus minimizing instability in real variables such as output and employment. The choice of a two-year target horizon is dependent on the observed lag with which monetary policy affects inflation in the Philippines.[3] Operationally, this means that the target that will be announced in January 2002 will be the target for the year 2003.[4] The 2002 inflation target (5-6 percent) set by the government will be a transitional target considering that the scope for monetary authorities' influence on the inflation outcome for 2002 is limited.

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[3] Based on vector-autoregressive (VAR) models of the BSP, the lag of monetary policy on inflation in the Philippines was estimated at about 15-21 months.

[4] This also means that sufficient time should have passed from the period of the current difficulties in the fiscal and external sectors such that monetary policy should have enough flexibility.

Strengthening the decision-making structure of monetary policy: creation of the Advisory Committee. To strengthen the monetary policy decision-making process, the Monetary Board of the BSP has created the Advisory Committee. The meetings of the Advisory Committee will serve as a forum for in-depth, comprehensive, broad-ranging and balanced assessment of monetary conditions, the economic outlook, inflationary expectations and the forecast inflation path. The main task of the Advisory Committee is to advise the Monetary Board on issues relating to the formulation and implementation of monetary policy. The Advisory Committee will meet regularly every four weeks to deliberate, discuss and make recommendations to the Monetary Board on issues relating to the formulation and implementation of monetary policy. Although the Committee may also meet in between the regular meetings—whenever it is deemed necessary—the regular schedule of meetings every four weeks signals that monetary policy is primarily focused on the medium-term outlook for inflation and not on the day-to-day gyrations in financial markets. There will be no attribution of votes to individual members in order to highlight a consensus in decision-making.

The members of the Advisory Committee are as follows:

a) BSP Governor, acting as Chairman;

b) Deputy Governor for Banking Services Sector, Research and Treasury;

c) Deputy Governor for Supervision and Examination Sector;

d) Managing Director for Research or his alternate, the Director of the Department of Economic Research; and

e) Director, Treasury Department.

Transparency and accountability mechanisms. The accountability of the BSP to the inflation target highlights the need for improved transparency. This will be achieved by reinforcing the disclosure and reporting mechanisms to help the public understand what the BSP is doing and the reasons for its monetary policy actions as well as enable the public to monitor the commitment of monetary authorities to the inflation target. Transparency regarding the BSP's monetary policy actions will also make it possible for the public to evaluate whether deviations of actual inflation from the target are acceptable or whether they are consequences of significant mistakes by the BSP. In addition to existing reports and publications (such as press releases on the stance of monetary policy), the BSP will publish a Quarterly Inflation Report, the monthly report on the balance of payments, and the highlights of the minutes of the Monetary Board meetings pertaining to discussions on monetary policy, with a lag of six (6) weeks. An additional reporting mechanism that will be adopted include the issuance by the BSP Governor of an open letter to the President explaining the reasons why actual inflation did not meet the target (if such is the case), along with the measures to be adopted to bring inflation back to target. In addition, the BSP will continue to conduct seminars and conferences to discuss monetary developments and policy issues.

Inflation forecasting. The inflation forecast is a key element of policy making under inflation targeting. This is due to the need for a forward-looking framework given the lagged impact of any monetary policy action on inflation and output. This highlights the important role of a reliable inflation forecasting model, which should provide a clear view of the transmission mechanism of monetary policy or the channels by which actions of the BSP affect prices. Cognizant of the importance of inflation forecasting models, the BSP—specifically the Department of Economic Research—continues to undertake refinements in the current short-term inflation forecasting models and is in the process of finalizing a long-term model that is capable of projecting the inflation rate further into the future.[5]

At the same time, the experience of other inflation-targeting countries has shown that inputs from other sources also provide policymakers useful information on the inflation outlook. Thus, the BSP's econometric models will be supplemented by other economic and financial indicators such as monetary aggregates, indicators of demand and production and measures of the public's inflationary expectations, including consensus inflation forecasts.

Coordination with other government agencies. It is the government—not the BSP alone—that determines the inflation target. This implies active government participation in establishing the goal of price stability and greater ownership of the government of the inflation target. This would also help ensure greater commitment of the government as a whole in achieving the inflation objective. The BSP, however, is committed—as an institution—to make the control of inflation as the primary goal of monetary policy.

The BSP has administrative and fiscal independence in the pursuit of its mandate. However, independence does not imply absence of coordination. Prudent coordination of fiscal and monetary policies is part of the process. This helps ensure that monetary policies are part of a coherent and consistent policy framework, and that the BSP's pursuit of the price stability objective does not compromise the other objectives of government. This ensures the

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[5] *The development of the BSP's long-term inflation model is supervised by Dr. Roberto S. Mariano of the University of Pennsylvania under a consultancy arrangement.*

credibility of the government's commitment to promote overall economic and social welfare and the BSP's specific commitment to price stability.

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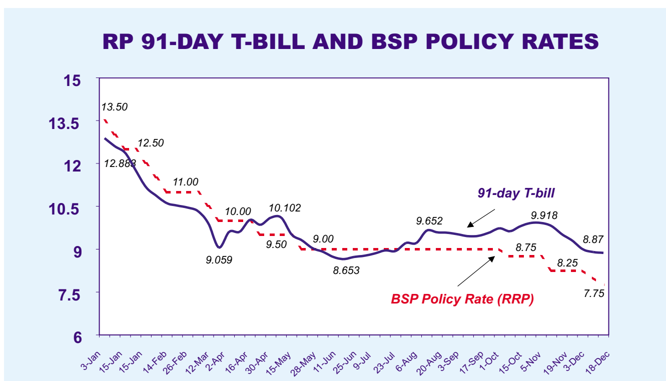
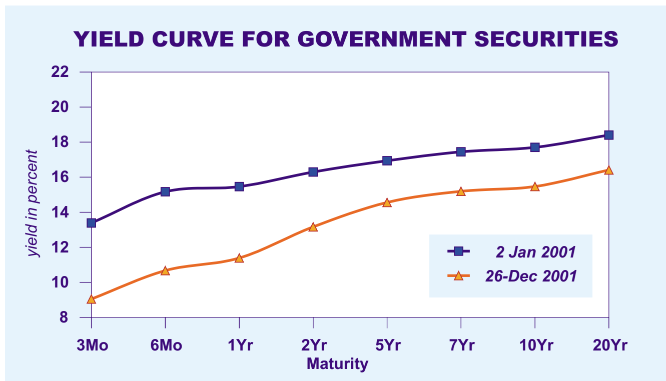
IV. Recent Monetary Conditions

INTEREST RATES

The relaxation of the monetary policy stance of the BSP contributed to the general decline in domestic interest rates in recent months. The benchmark 91-day T-bill rate averaged 8.787 percent in the latest auction on 10 December 2001. This reflected a significant drop from the levels posted in January 2001 which averaged 12.228 percent. Bank lending rates also declined appreciably to an average range of 12.99-14.57 percent for the end of November 2001 from a high of 18.86-20.82 percent in November 2000.



Likewise, the yield curve for government securities shows a downward shift compared to the start of 2001 as yields in the secondary market fell during the course of the year. The lower yields reflect the ample liquidity in the financial system as a result of monetary easing. The latest yield curve also shows a steepening relative to the start of 2001 at the longer maturities. This indicates market expectations of higher inflation over a horizon of more than one year.



However, despite the spate of policy rate reductions, there remain indications that current levels of market interest rates may still offer further room for monetary easing. For example, interest rate differentials remain wide, thus providing some scope for policy rate reduction without triggering massive portfolio shifts. The differentials between the benchmark RP 91-day T-bill rate and foreign interest rates remain considerable despite the slight narrowing in recent weeks due to the decline in the RP 91-day T-bill rate. As of 10 December 2001, the differential between the 91-day T-bill rate (net of tax) and the 90-day LIBOR reached 5.0 percentage points while the differential with the US 90-day T-bill reached 5.35 percentage points. These levels are relatively higher compared to the interest rate differentials registered for the most part of the year from mid- January to September 2001. Similarly, the rate differential between the BSP's policy rate (overnight borrowing or RRP rate) and the US target federal funds rate, while narrowing, remains substantial at 600 basis points.

Table 4: INTEREST RATE DIFFERENTIAL, PHILIPPINES VS. US, 2001

2001	RP 91-day T-bill Rate (1)	RP 91-day T-bill (net of tax) (2) = (1)-[(1)*0.20)]	90-day US LIBOR (3)	US 90-day T-bill Rate (4)	RP 91-day T-bill vs. LIBOR (5) = (2) - (3)	RP 91-day T-bill vs. US 90-day T-bill (6) = (2) - (4)
3 Jan	12.598	10.078	6.403	5.068	3.675	5.010
15	12.365	9.892	5.818	5.308	4.074	4.584
17	11.760	9.408	5.698	5.215	3.710	4.193
29	11.165	8.932	5.630	5.152	3.302	3.780
5 Feb	10.863	8.690	5.570	5.038	3.120	3.652
14	10.607	8.486	5.402	5.036	3.084	3.450
19	10.525	8.420	5.400	4.934	3.020	3.486
26	10.456	8.365	5.400	4.873	2.965	3.492
6 Mar	10.328	8.262	5.090	4.821	3.172	3.441
12	9.893	7.914	5.080	4.706	2.834	3.208
19	9.656	7.725	5.050	4.706	2.675	3.019
26	9.059	7.247	4.926	4.706	2.321	2.541
2 Apr	9.611	7.689	4.864	4.270	2.825	3.419
5	9.611	7.689	4.892	4.086	2.797	3.603
16	10.027	8.022	4.778	3.992	3.244	4.030
15 May	9.513	7.610	4.266	3.722	3.344	3.888
21	9.306	7.445	4.095	3.579	3.350	3.866
28	9.037	7.230	4.058	3.631	3.172	3.599
4 June	8.913	7.130	4.040	3.641	3.090	3.489
11	8.729	6.983	3.962	3.620	3.021	3.363
18	8.653	6.922	3.915	3.496	3.007	3.426
12 July	8.849	7.079	3.760	3.549	3.319	3.530
16	8.958	7.166	3.808	3.600	3.358	3.566
23	8.935	7.148	3.762	3.506	3.386	3.642
30	9.215	7.372	3.716	3.527	3.656	3.845
6 Aug	9.215	7.372	3.692	3.496	3.680	3.876
13	9.652	7.722	3.654	3.587	4.068	4.135
20	9.590	7.672	3.592	3.443	4.080	4.229
27	9.576	7.661	3.546	3.486	4.115	4.175
3 Sep	9.521	7.617	3.520	3.384	4.097	4.233
10	9.454	7.563	3.478	3.239	4.085	4.324
17	9.467	7.574	3.450	2.745	4.124	4.829
24	9.577	7.662	3.106	2.242	4.556	5.420
1 Oct	9.730	7.784	2.676	2.365	5.108	5.419
8	9.627	7.702	2.594	2.181	5.108	5.521
15	9.803	7.842	2.470	2.222	5.372	5.620
22	9.918	7.934	2.434	2.253	5.500	5.681
29	9.918	7.934	2.374	2.150	5.560	5.784
5 Nov	9.918	7.934	2.284	1.986	5.650	5.948
12	9.811	7.849	2.016	1.823	5.833	6.026
19	9.525	7.620	2.012	1.925	5.608	5.695
26	9.298	7.438	2.104	1.956	5.334	5.482
3 Dec	8.987	7.190	2.156	1.761	5.034	5.429
10 Dec	8.787	7.030	2.035	1.680	4.995	5.350

Table 5: DIFFERENTIAL BETWEEN THE BSP POLICY RATE AND THE US FEDERAL FUNDS RATE, 2001

2001	BSP Policy Rates 1/		US Federal Funds Rate		Differential
	Level	Increase / (Decrease)	Level	Increase / (Decrease)	
	(1)	(2)	(3)	(4)	(1)- (3)
3-Jan	13.50	...	6.00	(50 bps)	7.50
8-Jan	13.00	(50 bps)	6.00	...	7.00
15-Jan	12.50	(50 bps)	6.00	...	6.50
29-Jan	12.00	(50 bps)	6.00	...	6.00
31-Jan	12.00	...	5.50	(50 bps)	6.50
5-Feb	11.50	(50 bps)	5.50	...	6.00
12-Feb	11.00	(50 bps)	5.50	...	5.50
12-Mar	10.50	(50 bps)	5.50	...	5.00
20-Mar	10.50	...	5.00	(50 bps)	5.50
23-Mar	10.00	(50 bps)	5.00	...	5.00
18-Apr	10.00	...	4.50	(50 bps)	5.50
20-Apr	9.50	(50 bps)	4.50	...	5.00
15-May	9.50	...	4.00	(50 bps)	5.50
18-May	9.00	(50 bps)	4.00	...	5.00
27-Jun	9.00	...	3.75	(25 bps)	5.25
21-Aug	9.00	...	3.50	(25 bps)	5.50
17-Sep	9.00	...	3.00	(50 bps)	6.00
2-Oct	9.00	...	2.50	(50 bps)	6.50
5-Oct	8.75	(25 bps)	2.50	...	6.25
6-Nov	8.75	...	2.00	(50 bps)	6.75
9-Nov	8.25	(50 bps)	2.00	...	6.25
7-Dec	8.00	(25 bps)	2.00	...	6.00
14-Dec	7.75	(25 bps)	1.75	(25 bps)	6.00
TOTAL CUT		(575 bps)		(475 bps)	

1/ Overnight RRP Rate

At the same time, the Philippines' real lending rate remains high relative to those in other Asian countries. As of 12 December 2001, the country's real lending rate—measured by the difference between the prime lending rate (in this case the lower end of the range of banks' lending rates as compiled by the BSP) and the current inflation rate—was the second highest among a sampling of Asian countries at 8.29 percent. Among other things, this suggests that further interest rate reductions could be beneficial in terms of enhancing the competitiveness of local firms relative to their regional counterparts.

Table 6: AVERAGE PRIME RATES (Nominal and Real)
In Percent

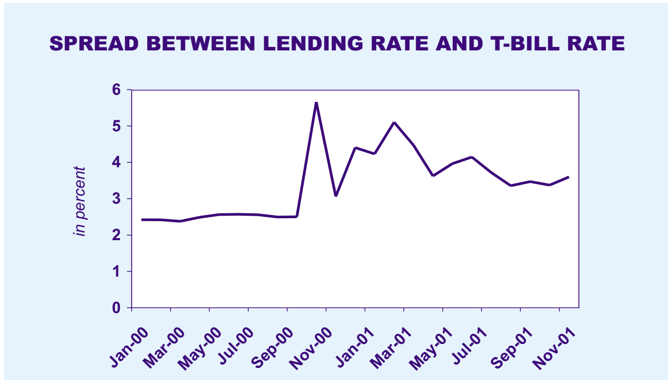
Country	Ave Prime Rates (Nominal) 1/	Inflation		Ave Prime Rates (Real)	Differential Nominal	Differential Real
Hong Kong	5.31	-1.2	Oct	6.51	7.39	1.79
India	11.50	4.2	Oct	7.30	1.19	0.99
Indonesia	17.22	12.9	Nov	4.32	-4.53	3.97
Japan	1.65	-0.8	Sep	2.45	11.04	5.84
Malaysia	6.96	0.9	Oct	6.06	5.73	2.23
Singapore	5.35	0.2	Oct	5.15	7.34	3.14
South Korea	7.16	3.4	Nov	3.76	5.53	4.53
Taiwan	7.60	-1.1	Nov	8.70	5.09	-0.41
Thailand	7.25	1.0	Nov	6.25	5.44	2.04
Philippines *	12.69	4.4	Nov	8.29	n.a.	n.a.

* *Lending rates reported by banks. The prime lending rate is the rate at the low end of the range for 6-12 December 2001*

1/ Hong Kong: HSBC's best lending rate (period average)
Indonesia: Average lending rate on investment (comm'l banks)
India: Prime lending rate
Japan: Long-term prime lending rate
Malaysia: Lending rate of commercial banks (weighted average)
Singapore: Prime lending rate of 10 leading banks (average)
South Korea: Lending rate of National Commercial Banks for general loans (average)
Taiwan: Prime lending rate of First Commercial Bank
Thailand: Prime rate-minimum loan rate (minimum)

Sources: Prime rates - Data provided by CEIC (14 December 2001 release)
Inflation rates - The Economist (14 December 2001)

Data also show that despite the substantial reduction in policy rates and, consequently, the benchmark T-bill rate over the past several months, the spread of lending rates over the benchmark T-bill rate has remained relatively high. This indicates that local banks are unable and/or unwilling to reduce their lending rates by as much as the decline in the benchmark rate. The relatively higher spread suggests that there is strong justification



for the monetary authorities' exercise of moral suasion on domestic banks to encourage them to reduce their lending rates in line with the easing of monetary policy. However, a casual comparison of the spread between the Philippines' lending rate and the benchmark T-bill rate with those of other Asian countries indicates that the Philippine spread is similar to that of other countries.

Table 6a. LENDING AND 3-MO. GOV'T SECURITIES RATE SPREAD: SELECTED ASIAN COUNTRIES

As of September 2001

Hong Kong	4.10
India	4.50
Singapore	3.93
Korea	2.99
Thailand	4.47
RP	3.47

EXCHANGE RATE

The pressure on the peso which began in 2000 as a result of both regional and domestic concerns continued until the middle of January 2001, with the peso-dollar exchange rate reaching an average of P55.013/US$1 on 18 January 2001 at the height of the political crisis. Following the peaceful resolution of the political crisis on 20 January 2001, the peso recovered and gained some stability. However, starting mid-March until the first week of August, the peso was again under pressure due to bearish market sentiment brought about by domestic and external factors. Renewed pressures brought about by the steady weakening of regional currencies (particularly the Japanese yen, the Thai baht, and the Indonesian rupiah), concerns over the economic slowdown in the US and in Japan, and rising political tensions exerted a drag on the peso again between June and August. In particular, the weakness of the peso was attributed to: (1) the continued tension resulting from the Abu Sayyaf hostage crisis and the spate of kidnappings in Metro Manila; (2) the downgrading of growth projections by the government due to the contraction in exports and the slowdown in industrial output; (3) worries over the budget deficit; (4) rising corporate dollar demand for mid-year import requirements and dividend repatriation; and (5) renewed weakening of investor sentiment on emerging market currencies due to the debt crisis in Argentina.

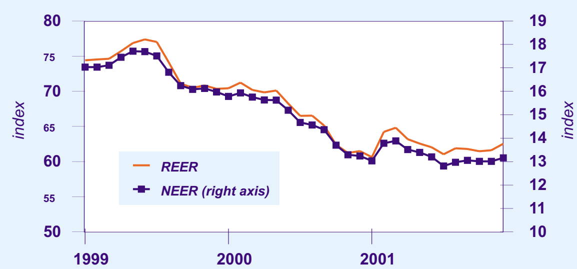
The BSP implemented a number of measures to address potential inflationary pressures and minimize speculation in the foreign exchange market. Among other things, these included raising the liquidity reserve requirement for banks to reduce excess liquidity in the system which could otherwise be used for speculative activity (July and August 2001), expanding the Currency Risk Protection Program (CRPP) to provide a hedging mechanism to a greater number of users (August and September 2001), tighter monitoring of foreign exchange transactions of banks (July 2001), and reducing the ceilings on undocumented over-the-counter foreign exchange sales from US$10,000 to US$5,000 (July 2001).

As a result of these measures, the peso has been broadly stable in recent months even as the increase in corporate demand and market uncertainty over the duration of US military action against the terrorists contributed to some volatility in the market. The standard deviation of the daily peso-US dollar rate has declined from about ₱1.80 in January 2001 to a low of about 9 centavos in November.

Likewise, the real effective exchange rate (REER) was broadly stable for most of 2001. The average REER index for the country's major industrial-country trading partners in 2001 declined by 6.9 percent from the previous year earlier, suggesting an improvement in the country's external competitiveness.

NOMINAL AND REAL EFFECTIVE EXCHANGE RATES

Major Industrial Countries



REER estimates for two sets of the Philippines' competitor countries (broad and narrow) meanwhile show marginal changes during the same period.[3] The REER for the broad list of competing countries declined by 0.3 percent during the period, while the REER for the narrow list of competitor countries rose by 0.1 percent.

MONETARY AGGREGATES

From January to May 2001, the demand for money accelerated steadily. From 12.2 percent in January, the annual growth in domestic liquidity (M3) expanded to 14.7 percent in May due to increased credits to the public sector. The BSP's monetary easing stance during the period, which resulted in the sustained rise in reserve money, contributed to the expansion in domestic liquidity. Reserve money—a narrower definition of money supply consisting of currency issue and banks' reserve balances with the BSP (net of cash in the vaults of the Bureau of Treasury)—grew by 7.8 percent year-on-year in January to 12.3 percent in May. In June 2001, M3 rose by 13.0 percent year-on-year, indicating a moderation from the previous months' level. The annual growth in M3 in the following months slowed down further as it reached 9.4 percent in October 2001. The slowdown in M3 growth can be attributed, in part, to the combined impact of the slowdown in bank lending and the increase in the liquidity reserve requirement in July and August which compelled banks to allocate their excess funds to comply with such regulatory adjustment.

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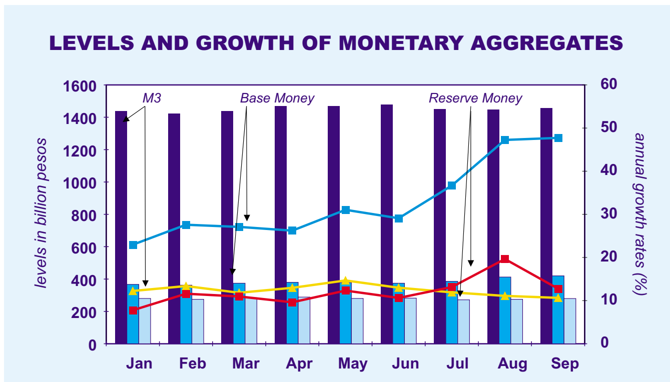
[3] *The broad list of competing countries is composed of Singapore, South Korea, Taiwan, Malaysia, Thailand, Indonesia, and Hongkong. The narrow list consists of Indonesia, Malaysia, and Thailand.*

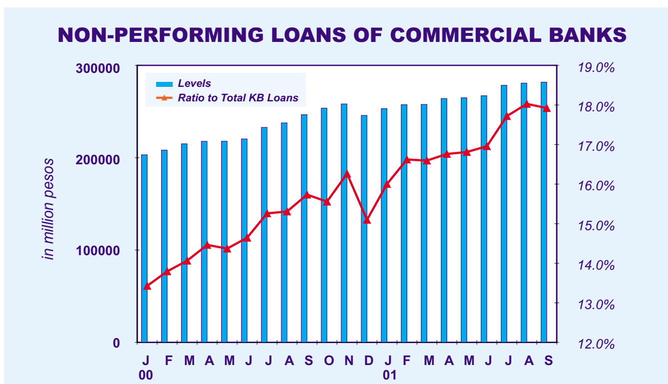
Domestic credits of the monetary system continued to grow, though at a decelerating pace, to 2.2 percent in September 2001 from 10.7 percent in January 2001. The pace of growth in domestic credits was driven mainly by the sustained increase—albeit at a slower pace—in credit activities in the public sector consisting of loans and holdings of securities, which registered an 11.3 percent growth in September 2001 from the 19.5 percent year-on-year rise in January 2001.



Meanwhile, the growth in private sector credits—which consisted mainly of loans and holdings of securities—decelerated from 7.6 percent in January to 0.23 percent in August. In September 2001, private sector credits declined by an annual rate of 1.4 percent as weak domestic demand combined with the presence of spare capacity in the manufacturing sector limited firms' need for bank credits. The observed increase in leverage ratios of manufacturing firms could have also tempered firms' need for credit. Based on a sample of manufacturing firms listed with the Philippine Stock Exchange, the majority reported an increase in their debt-to-equity ratios in October 2001 compared to the end-2000 level.

BANKING SYSTEM

The banking system has remained generally sound and stable amid the challenges faced during the past year. This was reflected in the 7.3 percent year-on-year growth in its total resources to ₱3.1 billion as of September 2001. This expansion was largely due to the increase in banks' deposit base and capitalization levels, the latter in accordance with the hike in minimum capital as prescribed by the BSP. Banks have also managed to remain profitable, although profitability remains considerably lower compared to pre-crisis levels.



Asset quality continues to be manageable. Non-performing loans (NPLs) have remained moderate despite a recent uptrend due to the lagged effects of the weaker peso and the high interest rates for the most part of 2000. As of October 2001, the ratio of non-performing loans (NPLs) to the total loan portfolio of commercial banks reached 18.8 percent compared to 15.6 percent a year earlier. Despite the uptrend in NPLs, loan-loss provisioning for commercial banks remained high at 42.2 percent of total NPLs as of October. This has provided a substantial buffer against expected loan losses. Meanwhile, the the NPL ratio of the entire banking system reached 17.5 percent as of September 2001.

The capital buffer of the banking system likewise remained comfortable as the capital adequacy ratio reached 16.7 percent as of end-June 2001. The ratio was well above the 10 percent minimum required by the Bangko Sentral and the 8 percent minimum required by the Bank for International Settlements (BIS). As of July 2001, the capital adequacy ratio of commercial banks was recorded at 16.1 percent.

Meanwhile, the ratio of real estate loans to total loans (inclusive of interbank loans) of commercial banks dropped to 11.7 percent as of June 2001, from the 12.3 percent recorded in June 2000. The latest ratio was considerably lower than the BSP's 20 percent ceiling on bank lending to the real estate sector.

Bank Lending

Outstanding loans of commercial banks as of end-September 2001 fell slightly by 0.6 percent to ₱1.4 trillion from the level a year ago. The slight decrease in bank lending during the period was attributed to reduced loans to the following sectors: manufacturing; financial institutions, real estate and business services (FIREBS); and transportation, storage and communication sectors. These sectors together accounted for about 60 percent of total loans outstanding. The sluggishness in bank lending could be attributed to the slowdown in business activities, particularly in the manufacturing sector as continued weakness in the global economy dampened external demand for locally-made goods. Moreover, as indicated earlier, the observed increase in the leverage ratios of manufacturing firms could have also prompted these firms to temper their borrowing activities. The presence of spare capacity in the manufacturing sector likewise limited firms' need for additional credit.

V. Inflation Outlook

Benign outlook for prices

Our assessment supports a generally benign outlook for inflation over the next 12 months. We expect inflation to remain subdued well into the first four months of 2002, with a slightly increasing trend toward the end of the year due in part to the base effect and an expected round of wage adjustments in late 2002. However, the full-year average is expected to decelerate from an estimated 6 percent in 2001 to the lower end of the 5-6 percent inflation target for 2002.

The benign inflation outlook is based on several factors. First, supply-side influences on prices are expected to be generally favorable, given reasonable expectations of decelerating oil prices, a broadly stable exchange rate, and stable food prices owing to good agricultural performance in the previous year.

The relative absence of significant supply-side cost pressures, along with the generally soft labor market, also limits the scope for sizable nominal wage adjustments. Demand-pull inflationary pressures will likewise be restrained, given the presence of weak external demand, spare manufacturing capacity and moderating liquidity growth.

Aggregate demand to improve

Aggregate demand is expected to improve on the strength of consumption spending and investments. Recent indicators suggest some lingering weakness in domestic demand, but this may improve as the series of policy rate reductions in 2001 work their way through the system. In addition, good agricultural crop production this year will help raise rural incomes and thereby underpin overall consumption levels. Moreover, the credibility of the government's commitment to the reform agenda will be a further boost to business and consumer confidence.

International oil prices likely to be lower

Weak global conditions also indicate continued low oil prices over the months ahead. The outlook for oil prices depends on global economic growth, especially in the major industrialized countries, on prospects of continued cohesion within OPEC, and on continued vulnerability of oil markets to disruptions in production. However, futures market data indicate that world oil prices remain relatively stable at an average of about US$19.14 per barrel (for the period January 2001-March 2002). The continued softening oil prices indicate a benign inflationary environment going forward.

Risks to the inflation outlook

In setting the appropriate stance of monetary policy, the prospect of a benign inflation environment will have to be weighed against the potential risks to price stability, particularly those coming from the external sector. The observed sluggishness in external demand is likely to continue in the next six months or so, given continued weakness in the world's major economies, particularly the US. While market watchers are of the view that the US economy will turn around by the second half of 2002, the impact of this development on the emerging economies including the Philippines could be realized with some lags. At the same time, confirmed evidence of a US recession could encourage the US Federal Reserve to make further interest rate reductions. However, the US Federal Funds rate level is already at a low level of 1.75 percent, thus limiting the scope for further aggressive monetary easing by the US Fed. This implies that significant interest rate easing in the Philippines runs the risk of excessively paring down interest rate differentials and triggering an abrupt shift to foreign currency-denominated assets that could lead to sharp volatility in the exchange rate and ultimately raise inflationary expectations.

The weak global environment also raises the probability of weaker foreign exchange earnings from exports and tourism, compounded by reduced access of corporates to the international capital markets. These risks may likewise lead to pressures on the peso, and these may, in turn, impact on inflation and inflationary expectations. Increased global risk aversion and continuing market concerns about the sustainability of the Government's fiscal targets may push up the interest spread, which may, in turn, further impact on the cost of financing the Government's budget deficit. However, of late, emerging market risk spreads have declined considerably, in part because of increased market confidence that the Arroyo administration will be able to meet its fiscal targets for the year.

In addition, the continued softening of oil prices remains far from assured. Significant declines in international oil prices could conceivably, at some point, induce OPEC to consolidate and intensify its plans to restrict supply, thereby reversing the current downtrend in oil prices. Although petroleum products account for only 5 percent of the CPI basket, past experience suggests that oil prices have important pass-through effects on consumer prices.

BSP inflation forecasts

The BSP forecasts inflation to remain low well into the first half of 2002, with a slightly increasing trend towards the end of the year. The inflation rate is expected to average between 5.0-6.0 percent in 2002, based on results from the BSP's single-equation and multiple-equation models used for forecasting inflation. The forecasts are based on the following main assumptions:

- Real GDP growth rate consistent with the National Government's revised target of 4.0-4.5 percent for 2002

- National Government deficit consistent with the whole year target of ₱130 billion

- Continued stability in the peso-dollar exchange rate
- Petroleum product prices maintained at the levels as of December 2001
- Increase in the minimum daily wage rate of ₱15.00 starting November 2001, with a second tranche of the increase at ₱15.00 starting February 2002. (Our analysis suggests that the phased implementation of the ₱30 wage increase for Metro Manila will result in only a marginal increase in average inflation for 2002).

The BSP's forecasts are also broadly in line with forecasts generated by a number of major multilateral institutions and foreign fund managers and credit rating institutions.

Table 6: INFLATION FORECASTS FOR 2002 *(in percent)*

BSP (as of 21 Dec. 2001)	5.0 - 6.0
IMF WEO (interim assessment, 4 Dec. 2001)	5.5
ADB Asian Development Outlook 2001 update	5.5
Nomura Research Institute Asian Economic Outlook (4th quarter 2001)	4.6
HSBC The View: Asia's Bond Markets (Sept. 2001)	5.0
UBS Warburg Asian Economic & Strategy Perspectives (Sept. 2001)	4.5
Lehman Brothers Global Weekly Economic Monitor (Sept. 2001)	4.5
AVERAGE	**4.9**

The inflation forecasts generated by the BSP's econometric models constitute a major basis for the BSP's assessment of the inflation outlook. This is, however, supplemented by other economic and financial indicators such as monetary aggregates, indicators of demand and production and measures of the public's inflationary expectations, including consensus inflation forecasts. With the shift by the BSP to an inflation targeting framework starting January 2002, the inflation forecast takes on heightened operational significance since the stance of monetary policy would be determined in large part by how the forecasted inflation rate compares to the targeted inflation rate.

It should be noted, however, that because of the considerable lag before monetary policy actions affect inflation (the BSP estimates that it takes about 15-21 months before changes in BSP policy rates reach their peak impact on the inflation rate), then the appropriate comparison would be between the inflation forecast and the target at the suitable time horizon, which is about two years. Given the monetary policy response lag, therefore, and the schedule of the introduction of inflation targeting, the policy horizon extends well into 2003 (i.e., policy decisions taken at the start of 2002 will impact largely on the inflation rate in 2003). For 2003, the government's inflation target is 4.5-5.5 percent, which represents a gradual deceleration of inflation from the forecast range for 2002. This gradual deceleration is meant to anchor inflationary expectations, while at the same time providing sufficient flexibility to monetary policy to respond to unforeseen shocks over the target horizon.

VI. Implications for the Monetary Policy Stance

The prospect of a generally benign inflation environment amid the risks of the present global downturn provides some scope for a growth-supportive monetary policy stance. The BSP believes that, going forward, an accommodative monetary policy stance would help the Philippine economy build upon the performance in the first three quarters of 2001 without any undue risk of causing an uptrend in prices. A growth-supportive monetary stance would also cushion domestic economic activity against the effect of the still weak global economic environment.

At the same time, potential policy rate adjustments will need to be carefully timed, calibrated and balanced against the associated risks. One concern is the possibility of a potential disorderly adjustment in the foreign exchange market as a result of narrowing interest differentials. Authorities will need to make sure that narrowing differentials due to lower interest rates do not encourage investors to shift away from peso-denominated financial assets in favor of foreign-currency denominated assets, thereby triggering a sharp peso depreciation and endangering the inflation outlook. The scope for accommodative monetary policy is also complicated by the fact that foreign interest rates are already at low levels at present, posing the risk that continued easing will excessively trim down interest differentials. The US federal funds rate, for example, is currently at 1.75 percent.

Monetary authorities are also always mindful of the possibility that countries pursuing an accommodative monetary policy in an environment of weak economic activity face the risk that, going forward, further monetary easing could have the effect of raising investment activity beyond the economy's long-run ability to generate savings. The potential mismatch between supply and demand for savings may lead to excessive leverage or debt build-up. In this regard, the BSP is closely monitoring various indicators of leverage in the corporate sector, such as the debt-to-equity ratios of major Philippine companies.

There are also certain risks to inflation outlook that the BSP is closely monitoring:

- The weak global economy could continue to weigh down on the country's external sector. The resulting volatility in the peso could lead to a pass-through effect on prices and inflationary expectations.

- Oil prices could trend upward depending on the responses that OPEC and other major oil producing countries would take. While petroleum products account for only about 5 percent of the CPI basket, it is important to note that its pass-through effects could move domestic prices across all commodity groups as well as services.

Given the above considerations, monetary policy over the next several quarters will remain on a cautious footing, with a slight easing bias given the following factors:

- Expectations of tame inflationary pressures for 2002;

- Presence of spare capacity in the manufacturing sector;

- Significant differentials between the BSP's policy rate (overnight borrowing or RRP rate) and the US target federal funds rate; and

- Prospects of further easing of interest rates in the U.S. and in other major economies.

VII. Conclusion

The year 2001 was marked by subdued price pressures, as indicated by decelerating headline and core inflation, due to favorable supply-side trends and moderate growth in both domestic liquidity and overall demand. External demand weakened due to the ongoing global slowdown, but domestic demand took up the slack, driven by consumption and investments. At the same time, output growth was driven largely by the agriculture and services sectors. Industry growth slowed as manufacturing activity was dampened by reduced demand for major export products.

Monetary conditions indicated a significant easing of the monetary stance in 2001 as shown by the series of policy interest rate reductions. As a result, market interest rates were on a generally declining trend. However, lending by banks continued to be quite restrained as banks adopted a cautious lending stance in order to preserve asset quality. Financial market conditions indicated a shift in investor preference from equities to government securities, suggesting an overall cautious mood and a desire for low-risk investments.

Our assessment of various indicators supports a generally benign outlook for inflation in 2002. This is based on expectations of favorable supply-side influences on prices, notably decelerating oil prices, a broadly stable exchange rate, and stable food prices. The relative absence of significant supply-side cost pressures, along with the generally soft labor market, also limits the scope for sizable nominal wage adjustments. Demand-pull inflationary pressures will likewise be restrained, given the presence of weak external demand, spare manufacturing capacity and moderating liquidity growth. We therefore expect inflation to remain subdued well into the first four months of 2002, with a slightly increasing trend toward the end of the year. The full-year average is expected to decelerate slightly from an estimated whole year average of close to 6 percent in 2001 to the lower end of the 5-6 percent inflation target for 2002.

The prospect of tame inflationary pressures going forward suggests some room for a continued growth-supportive monetary stance, but certain risks remain, particularly from the external sector. These external risks relate to movements in the exchange rate and the overall outlook for international oil prices. For this reason, monetary policy will continue to be on a cautious footing, with a slight easing bias without jeopardizing the attainment of the BSP's primary mandate of price stability. This policy stance should help cushion the adverse effects of a global slowdown on the domestic economy.