

0.63	159.4	4.1
0.63		
0.62	159.7	
0.62	160.1	3.8
0.62		
0.61	161.5	
0.61		
0.61	162.5	3.5
0.61	162.8	
0.61		
0.61	163.2	3.6
0.61		
0.61	163.4	3.6
0.60	163.8	3.6
0.60		
0.60	164.3	3.6
0.60		
0.60	165.1	3.0
0.60	164.8	3.0
0.60	165.2	
0.61		
0.61	165.5	2.6
0.61		
0.61	165.9	2.9
0.61		
0.61	166.7	2.6
0.61		
0.61	167.6	
0.60		
0.60	167.9	2.7
0.60	167.8	
0.60		
0.60	167.9	2.5

INFLATION REPORT



Fourth Quarter 2002



Bangko Sentral ng Pilipinas

INFLATION REPORT
Fourth Quarter 2002



Bangko Sentral ng Pilipinas



FOREWORD

The primary objective of monetary policy is to promote a low and stable rate of inflation conducive to balanced and sustainable economic growth. The adoption in January 2002 of the inflation targeting framework for monetary policy was aimed at helping fulfill this objective.

One of the key features of inflation targeting is greater transparency, which implies greater disclosure and communication by the BSP of its policy actions and decisions. This Inflation Report is published by the BSP as part of its transparency mechanisms under inflation targeting. The objectives of this Inflation Report are: (i) to convey to the public the overall thinking and analysis behind the BSP's decisions on monetary policy, so that monetary policy is easier to follow and understand, and (ii) to enable the public to better monitor the BSP's commitment to the inflation target, thus helping anchor inflation expectations. For 2003, the government's target for annual headline inflation under the inflation targeting framework has been set at 4.5-5.5 percent.

The report is published on a quarterly basis, presenting a survey of the various factors affecting inflation. These include recent price and cost developments, prospects for aggregate demand and output, monetary and financial market conditions, labor market conditions, fiscal developments, and the international environment. A section is devoted to the BSP's view of the inflation outlook during the policy horizon. This is followed by a discussion of the implications of the assessment of inflation and economic conditions on the monetary policy settings of the BSP. The report also contains box articles that offer more detailed information on issues relevant to monetary policy.

The Monetary Board approved this Inflation Report at its meeting on 3 January 2003.

A handwritten signature in black ink, appearing to read 'Rafael B. Buenaventura', written over a vertical line.

RAFAEL B. BUENAVENTURA
Governor, Bangko Sentral ng Pilipinas
January 2003

THE MONETARY POLICY OF THE BANGKO SENTRAL NG PILIPINAS

The BSP Mandate

The BSP's main responsibility is to formulate and implement policy in the areas of money, banking and credit, with the primary objective of maintaining stable prices conducive to balanced and sustainable economic growth in the Philippines. The BSP also aims to promote and preserve monetary stability and the convertibility of the national currency.

Monetary Policy Instrument

The BSP uses the overnight repurchase rate (RP) and reverse repurchase rate (RRP) as the key policy rates to set the monetary policy stance.

Policy Targets

The BSP uses CPI or headline inflation (published by the National Statistics Office) as its target for monetary policy. The policy target is expressed in the form of a range for a given year and is set by the National Government in coordination with the BSP. For 2003, the government's target for annual headline inflation has been set at 4.5-5.5 percent.

The Monetary Board

The powers and functions of Bangko Sentral, such as the conduct of monetary policy and the supervision over the banking system, are exercised by its Monetary Board, which has seven members appointed by the President of the Philippines. The Monetary Board meets at least once a week.

Chairman Rafael B. Buenaventura

Members Manuel A. Roxas II
Antonino L. Alindogan, Jr.
Fe B. Barin
Juan Quintos, Jr.
Melito S. Salazar, Jr.
Vicente B. Valdepeñas, Jr.

The Advisory Committee

The Advisory Committee was established as part of the institutional setting for inflation targeting. Its task is to deliberate, discuss and make recommendations on monetary policy to the Monetary Board. The Committee meets regularly every four weeks but may also meet in between the regular meetings, whenever it is deemed necessary.

Chairman Rafael B. Buenaventura
Governor

Members Amando M. Tetangco, Jr.
Deputy Governor, Banking Services
Sector, Research and Treasury

Alberto V. Reyes
Deputy Governor, Supervision and
Examination Sector

Ma. Cyd N. Tuaño-Amador
Director, Department of Economic
Research

Ma. Ramona GDT Santiago
Director, Treasury Department

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I. OVERVIEW

The inflation environment remained benign in the fourth quarter of 2002. Headline inflation continued to decelerate, largely on account of subdued demand-pull inflationary pressures as well as lower food prices. Core inflation likewise declined during the quarter, confirming the absence of generalized price pressures.

The low inflation environment provided the backdrop for the continued expansion in the economy, fueled by the sustained growth in private consumption as well as a modest rebound in fixed capital spending. Nevertheless, other demand indicators suggest areas of weakness in overall demand conditions. Meanwhile, output growth was driven by the modest rebound of the industry sector and the sustained growth of the services sector. Agricultural output was dampened by unfavorable planting conditions due to the El Niño weather phenomenon. Prevailing labor market conditions remained generally soft as employment generation continued to be generally sluggish and unemployment relatively high. The softness in job market conditions precluded forceful calls from labor groups for wage adjustments.

The fiscal sector remained a focal concern for the economy, as revenue shortfalls raised the likelihood of a considerable overshoot of the earlier announced 2002 target deficit of ₱130 billion. Financial market activity nevertheless tended to favor government securities over equities as stock market sentiment remained cautious. Growth in the money stock thus continued to be propelled mostly by credits to the public sector, along with inflows from exports and overseas workers' income. Nevertheless, bank lending posted a modest recovery in September and October, reversing several months of year-on-year declines. This coincided with a decline in the non-performing loan ratio of commercial banks. Fiscal concerns partly contributed to an uptrend in domestic interest rates as well as a weakening of the peso, although ample liquidity and increased overseas remittances in December provided a countervailing influence on interest rates and the exchange rate.

Monetary authorities continue to expect generally manageable price conditions over the policy horizon, given muted demand-side pressures and transient and short-lived cost-side risks to future inflation. Average annual inflation is expected to move broadly in line with the government's targets for 2003-2004. However, the inflationary risks from the impact of a possible war in the Middle East on oil prices and the uncertainty over the fiscal performance have a considerable bearing on the inflation outlook and could, therefore, affect prospective monetary decisions.

At the same time, the greater risk of weaker global economic activity and the mixed signals regarding the strength of the domestic economic recovery suggest that ensuring appropriate liquidity conditions remains central to sustained economic recovery in the near term. However, it appears that past monetary stimulus is showing signs of exerting its impact on the real or productive sector of the economy. Although overall loan activity growth remains modest, the available evidence suggests a possible sustained rise in credit demand, which should lead to more vigorous consumption and investment activities.

With inflation contained and given the prevailing risks to global economic activity, monetary authorities believe that the present policy settings are compatible with the liquidity requirements of the economy, and that due recognition of the long lags in monetary policy will provide firmer indication of the extent to which the stimulatory impact of past monetary easing has worked its way through the system.

II. RECENT DEVELOPMENTS IN INFLATION AND ECONOMIC CONDITIONS

Price and Cost Developments

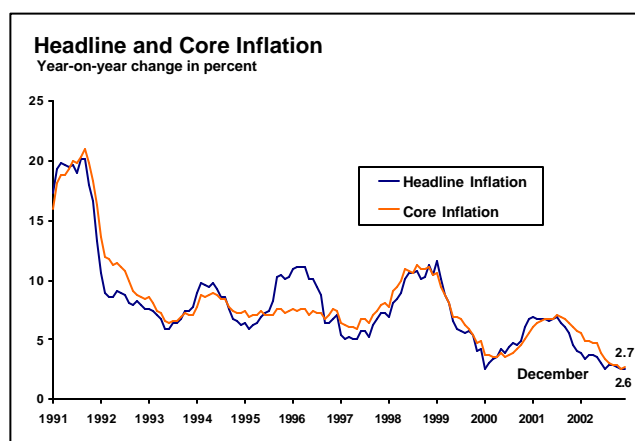
The inflation environment remained benign in the fourth quarter of 2002, largely on account of subdued demand-pull inflationary pressures as well as lower food prices. Headline inflation continued to decelerate in the fourth quarter to an average of 2.6 percent from 2.8 percent in the third quarter. Average headline inflation for 2002 was 3.1 percent, more than a full percentage point below the 2002 target and lower than the average of 6.1 percent in 2001. Similarly, BSP estimates of core inflation, which take out the effects of temporary disturbances on headline CPI by excluding food and fuel components, showed a decline during the fourth quarter, confirming the absence of generalized price pressures at present.

Headline and Core Inflation

Headline inflation fell to an average of 2.6 percent year-on-year in the fourth quarter from 2.9 percent in the third quarter, driven mostly by lower food inflation as well as fairly stable non-food prices. December inflation remained subdued at 2.6 percent, slightly higher than the 2.5 percent inflation rate in November. Inflation rates for food, beverages and tobacco (FBT), fuel, light and water (FLW) and services rose during the month. Month-on-month headline inflation in December was also higher at 0.4 percent compared to 0.1 percent in November and 0.3 percent in the third quarter.

The full-year average inflation of 3.1 percent was more than a full percentage point below the 2002 target and was also lower than the average of 6.1 percent in 2001.

Similarly, BSP estimates of core inflation, which strip out the effects of temporary disturbances on headline CPI by excluding food and fuel components, showed a decline in the fourth quarter.¹ The BSP's main definition of core inflation (CPI less unprocessed food and energy) averaged at 2.7 percent during the quarter, lower than the 3.1 percent average in the third quarter and 6.1 percent for the same period in 2001. For 2002, average core inflation (BSP main definition) was 3.8 percent. Meanwhile, the trimmed mean, weighted median, and net of volatile items measures averaged at 2.8 percent, 2.7 percent, and 1.9 percent, respectively, during the year.



The benign trend in core inflation suggests muted demand-side influences on future inflation. This may be attributed to limited pricing power on the part of producers in the light of the continued mixed outturn in domestic demand to date in 2002. These developments are discussed in greater detail below.

¹ A description of the BSP methodology for measuring core inflation can be found in the box article entitled "Estimating Core Inflation," which appeared in the Fourth Quarter 2001 issue of the BSP Inflation Report.

BSP ESTIMATES OF CORE INFLATION					
<small>1994=100: percent changes year-on-year</small>					
Year/Month	<u>BSP DEFINITION 1/</u>		<u>ALTERNATIVE MEASURES</u>		
	Core Inflation	Non-Core Inflation	Trimmed Mean 2/	Weighted Median 3/	Net of Volatile Items 4/
2001	6.5	5.2	5.3	5.5	4.9
January	6.1	9.5	5.6	5.4	5.0
February	6.3	8.1	5.3	5.5	5.0
March	6.5	7.2	5.4	5.8	5.1
April	6.8	6.6	5.4	5.7	5.3
May	6.7	6.0	5.3	5.6	5.3
June	6.7	6.9	5.9	6.0	5.5
July	7.1	6.1	6.2	6.2	5.6
August	7.0	4.5	5.8	6.4	5.3
September	6.8	4.6	5.7	5.5	5.1
October	6.4	2.9	5.2	5.1	4.4
November	6.1	0.2	4.5	4.2	3.9
December	5.8	-0.7	3.9	3.9	3.4
2002	3.8	1.0	2.8	2.7	1.9
January	5.5	-1.2	3.4	3.5	3.1
February	4.9	-1.1	3.1	3.2	2.7
March	4.9	0.2	3.1	3.2	2.7
April	4.7	0.6	3.0	3.0	2.6
May	4.7	0.6	2.9	3.2	2.7
June	3.8	0.2	2.4	3.0	1.9
July	3.3	0.5	2.0	2.2	1.4
August	3.1	2.5	2.7	2.4	1.3
September	2.8	3.1	2.8	1.9	1.1
October	2.8	2.6	2.7	1.9	1.2
November	2.6	2.0	2.6	2.3	1.2
December	2.7	2.6	2.8	2.5	1.5

Notes:
1/ The main definition excludes the following CPI items: rice, corn, fruits & vegetables, fuel, transport & communication. Excluded items account for 25.5 percent of the CPI index.
2/ The trimmed mean represents the average inflation rate of the (weighted) middle 70 percent in a lowest-to-highest ranking of year-on-year inflation rates for all CPI components.
3/ The weighted median represents the middle inflation rate (corresponding to a cumulative CPI weight of 50 percent) in a lowest-to-highest ranking of year-on-year inflation rates.
4/ The net of volatile items method excludes the following items: educational services, fruits and vegetables, personal services, rentals, recreational services, rice, and corn.
Source of Basic Data: National Statistics Office

Food Prices and Weather Conditions

Food inflation in the fourth quarter of 2002 was slightly lower relative to the level in the previous quarter. CPI data from the National Statistics Office (NSO) show that the inflation rate for food alone in the quarter fell slightly to 1.5 percent from the third-quarter average of 1.9 percent. Higher inflation rates for rice and corn during the period were offset by lower rates for fish and dairy products as well as negative rates for fruits and vegetables and meat.

Food prices are expected to remain in check over the near term given the prospect of a good agricultural harvest in the fourth quarter of 2002, helped, in part, by timely government intervention through imports. In addition, the sustained

uptrend in livestock, poultry, and fishery production is expected to cushion the impact on food prices of the contraction in crop production, particularly in the third quarter of 2002.

Government weather forecasters expect near-normal to above-normal harvest conditions during the fourth quarter of 2002 in many parts of the country, particularly for rice crops.² With the favorable rainfall brought about by the southwest monsoons and the Department of Agriculture's (DA) quick turnaround planting scheme, the production of *palay* (unmilled rice) is expected to grow by 8.9 percent year-on-year to 5.4 million metric tons (MT) in the fourth quarter.³ 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. However, corn production could contract by as much as 4.9 percent year-on-year in the fourth quarter of 2002 to 4.3 million MT, as earlier floods affected the standing crops and delayed the planting especially in the corn-growing areas in the south.

The government's importation program has also helped mitigate the upward price pressures 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 January to 4 December 2002.⁴ Moreover, as of 30 November 2002, the national rice inventory of 2.7 million MT is sufficient to last for 104 days, based on an estimated daily consumption of 25.7 thousand MT.⁵ Of this stock, the share of the NFA amounting to 859.1 thousand MT (or about 32 percent) is sufficient to last for 33 days. Meanwhile, the stock of corn at 200.3 thousand MT is estimated to last for 14 days.⁶

For 2003, agricultural output performance will continue to depend on the extent of warm climate conditions. Forecasts by the Climatology and

² PAGASA Climatology and Agrometeorology Branch (CAB), "Agroclimatic/Crop Condition Assessment for October 2002," No. 10, Volume 18, October 2002; downloaded from <http://www.philonline.com.ph/~cab/impact.htm>

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 weather disturbances due to the El Niño weather phenomenon. Under the scheme, irrigated rice areas that 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 is expected to produce an additional 339,598 metric tons of rice for 2002. (Source: Department of Agriculture).

⁴ NFA, Grains Situation Report as of the First Week of December 2002, 5 December 2002

⁵ The national inventory is composed of NFA palay and rice stocks, and commercial and household inventories. Commercial and household stocks are as of 1 November 2002 (Source: NFA, Grains Situation Report as of the First Week of December 2002, 5 December 2002)

⁶ This is based the NFA's estimate of a 14.6 thousand MT daily requirement of the corn industry but excludes those held by commercial livestock and poultry producers, corn processors, and corn mixed feeds.

Agrometeorology Branch (CAB) of the Philippine Atmospheric, Geophysical and Astronomical Services Administration (PAGASA) continue to suggest a generally moderate impact on crop production in the coming months of the present El Niño episode as compared with the 1997-98 El Niño episode.⁷ Nevertheless, in the first quarter of 2003, palay production could decline by 1.9 percent year-on-year to 3.0 million MT in the first quarter of 2003 as irrigated rice farmers have tempered their planting activities due to apprehensions over the effect of the El Niño phenomenon. However, corn production for the first quarter of 2003 is expected to grow by 6 percent year-on-year to 1.2 million MT. Similarly, livestock and other crops subsectors are likely to record good production figures.⁸ Sugar production is projected to rise by 2.5 percent to 1.95 million MT in 2003 from 1.89 million MT in 2002 from the use of higher yielding varieties.⁹

Moreover, the agricultural sector is expected to gain from other government programs aimed at boosting agricultural production and mitigating the impact of the El Niño phenomenon. For the first 11 months of 2002, the Quedan and Rural Credit Guarantee Corporation (Quedancor) extended a total of ₱1.2 billion worth of loans to the grains sector, livestock and poultry, fisheries and various agribusiness projects.¹⁰ In addition, the Department of Budget and Management released for the period January- October 2002 a total of ₱1.3 billion for irrigation projects and other El Niño mitigating projects of the DA.¹¹

Energy and Utilities Prices

International oil prices were generally lower in the fourth quarter compared to the levels in the previous quarter. The price of Dubai crude oil in the international market settled at an average of US\$25.02 per barrel for the period October-26 December 2002, falling by 2.2 percent from the level in the third quarter. World oil prices declined in November following the granting of permission by the Iraqi government for the United Nations (UN) arms inspection team to enter Iraq in compliance with the UN resolution. However, world oil prices subsequently trended upward in December following the decision of the Organization of Petroleum Exporting Countries (OPEC) to cut production quotas of members by 1 January 2003

⁷ PAGASA Climatology and Agrometeorology Branch (CAB), "El Niño Advisory," 2 December 2002. Downloaded from <http://www.phionline.com.ph/~cab/ensopage.htm>.

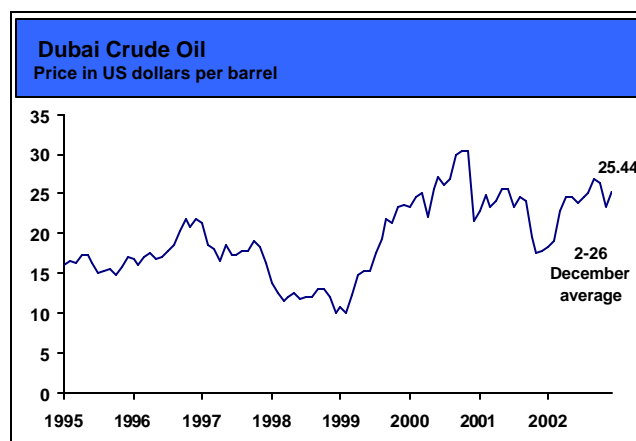
⁸ Bureau of Agricultural Statistics, Selected Tables on Crop Forecasts, 6 November 2002

⁹ Source: Department of Agriculture

¹⁰ "DA credit firm loan releases to hit ₱2 billion this year," Department of Agriculture press release dated 24 November 2002, downloaded from <http://www.da.gov.ph>

¹¹ "Montemayor lauds DBM's release of ₱1.25 billion for El Niño preparation," Department of Agriculture press release dated 16 October 2002, downloaded from <http://www.da.gov.ph>

in a move to maintain the US\$22-28 per barrel price band mechanism.¹² In addition, the renewed threat of a US-led assault on Iraq, the general strike in Venezuela that stalled oil exports and the seasonal increase in demand for heating oil during the winter season in the Northern hemisphere have combined to push up oil prices in the world market.

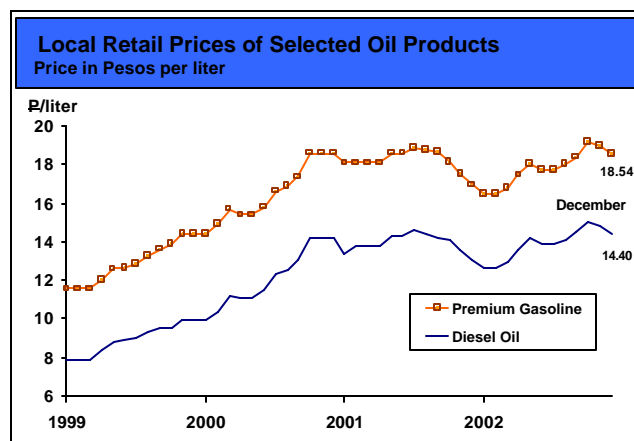


Domestic oil prices generally mirrored the movements in world oil prices, albeit with a lag of about one month. Local petroleum prices were on an uptrend in October largely in response to the September increase in international prices. Oil prices were subsequently rolled back by local oil companies as world prices began to soften in October and November. Local oil firms reduced their prices for premium and regular gasoline by ₱0.25 per liter each on 19 November 2002, while those for diesel and kerosene were cut by ₱0.20 per liter each.¹³ Pump prices for gasoline, kerosene, diesel oil, and other oil products were further reduced by an average of 40 centavos on 9 December 2002. By contrast, the price of liquefied petroleum gas (LPG), which is commonly used for household cooking, increased in October-November, ending with a cumulative rise of ₱1.36 per liter during the period end-September-9 December 2002. Despite the recent cuts in most domestic oil prices, the price per liter of gasoline and other petroleum products as of 9 December 2002 remained higher by an average of 36 centavos compared to their end-September levels. The year-to-date net increase in domestic oil prices as of 9 December 2002 stood at ₱1.48, ₱1.75 and ₱1.84 per liter for diesel, gasoline, and kerosene.¹⁴

¹² Organization of Petroleum Exporting Countries (OPEC) press release dated 12 December 2002, available at <http://www.opec.org>

¹³ Source: Department of Energy (DOE)

¹⁴ In 2001, pump prices of petroleum products declined by ₱1.32 per liter for diesel, ₱1.85 per liter for gasoline and ₱1.29 per liter for kerosene. (Source: Department of Energy)



Meanwhile, utilities charges were generally stable during the fourth quarter, but these are expected to rise beginning next year. Charges for water services, for example, are expected to increase in early 2003. The Metropolitan Waterworks and Sewerage System (MWSS), which regulates the pricing of water services in Metro Manila, has approved an initial ₱4.25 per cubic meter increase in the water tariff of Manila Water Co. (MWC) beginning in January 2003.¹⁵ Initial estimates by the MWSS indicate that the MWC's rate adjustment will be about ₱7.03 per cubic meter. To soften the impact of the rate increase on consumers, the MWSS and MWC have agreed to implement the tariff adjustment in stages. An initial increase of ₱4.25 per cubic meter will take effect in January 2003 while the remaining ₱2.78 per cubic meter increase will be spread out during the period 2004-2005. Meanwhile, the other water concessionaire in Metro Manila, Maynilad Water Services Inc. (MWSI), also has a pending tariff adjustment petition with the MWSS. Initial estimates by the MWSS showed that the average weighted all-in water tariff of MWSI could increase by ₱6.84 from its current level of ₱19.92.¹⁶ MWSI was earlier reported to have expressed its interest in terminating its concession agreement with the government. The process of arbitration between the MWSS and MWSI has yet to be initiated. Given the relatively small share of water to the CPI basket of 0.7 percent, the 38.5 percent average increase in water rates is estimated to result in a 0.14 percentage point rise in the average annual inflation in 2003.¹⁷

¹⁵ This will 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.

¹⁶ Source: MWSS Regulatory Office

¹⁷ The approved rate hike for MWC represents a 42.6 percent increase from its current rate while initial estimates for Maynilad showed that its current rates could rise by 34.3 percent for an average tariff increase of 38.5 percent. The estimated impact on average annual inflation is based on an analysis using the 1994 input-output (I-O) tables published by the National Statistical Coordination Board (NSCB).

Meanwhile, the outlook for power rates remains uncertain. In its decision issued on 15 November 2002, the Supreme Court affirmed the findings of what was then known as the Energy Regulatory Board (ERB, later renamed the Energy Regulatory Commission or ERC) findings on the unwarranted power rate increases by the Manila Electric Company (Meralco) and urged the company to not only reduce its rates but also to reimburse its customers for excess charges during the period February 1994-February 1998. The Supreme Court decision stems from a January 1994 ERB order granting Meralco the provisional authority to raise its rates by ₱0.184 per kwh. After further study, however, the ERB ruled in 1998 that Meralco should have raised its rates by only ₱0.017 per kwh and ordered Meralco to refund the excess ₱0.167 per kwh it had collected since February 1994. The case was brought before the Court of Appeals, which set aside the ERB ruling. The impact of the Supreme Court decision on Meralco's electricity charges remains uncertain at the moment as Meralco has filed a motion for reconsideration of the said case.¹⁸

On the other hand, the ERC has yet to reach a decision on Meralco's proposed power rate unbundling. 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.¹⁹ This represents an average increase of 19.6 percent from the November 2001 average tariff of ₱5.73/kwh.²⁰ 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).²¹

¹⁸ "SC affirms ERB findings, orders Meralco to refund its customers", press release dated 15 November 2002 downloaded from <http://www.supremecourt.gov.ph>; "Meralco customers billed at rates approved by law", undated press release downloaded from <http://www.meralco.com.ph>

¹⁹ Source: Copy obtained by the BSP from Meralco (via facsimile transmission) of its application filed with ERC for the unbundling of rates, dated 26 December 2001

²⁰ Ibid.

²¹ The WESM is a spot market for the trading of electricity in which power generation companies (gencos) submit their offers to sell electricity to distribution utilities at their desired price. Distribution utilities, in turn, submit their demand requirements to a market operator who is assigned to match the supply and demand for power. The Electric Power Industry Reform Act of 2001 (R.A. 9136) requires the Department of Energy (DOE) to establish the WESM in coordination with electric power industry participants to ensure greater supply and rational pricing of electricity. Meanwhile, 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.

Box 1. Tracing the Impact of World Oil Prices on Domestic Inflation²²

Oil is an important commodity affecting every economy in the world. As a valuable input of production, changes in oil prices affect the prices of other commodities and services, both directly and indirectly. Such impact, however, depends on the economy's reliance on oil as a source of energy and on the share of oil imports to total oil consumption. In the Philippines, where oil contributes 45.6 percent to total energy consumption and crude oil imports account for 99.7 percent of the country's domestic oil requirements, oil price pressures are reflected in the movements of the general price level. This article describes the impact of movements in world oil prices on local consumer price inflation.

Some Basic Facts

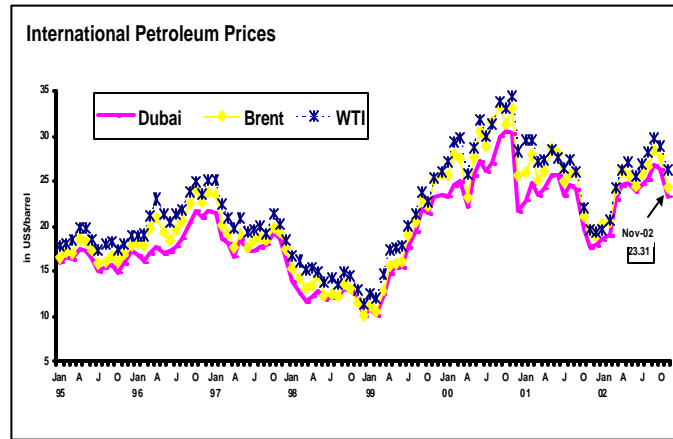
Crude oil, also known as petroleum, is the world's most actively traded commodity. Given the many different varieties and grades of crude oil in the world market, buyers and sellers have, over time, developed references or benchmarks for the pricing of crude oil. Benchmark prices are commonly named after the places where they are posted. The prices of Brent, Dubai and the West Texas Intermediate (WTI) oil refer to prices used as benchmark for the crude oil in the spot and futures markets in Europe, Asia, and North America, respectively. Brent oil is generally accepted to be the world benchmark, although sales of Brent oil itself are lower than those of Saudi Arabian oils. According to the International Petroleum Exchange (IPE), Brent oil is used to price two-thirds of the world's internationally traded crude oil supplies. In the Gulf, Dubai crude is used as a benchmark to price the sales of other regional crude oil in Asia mainly because it is one of the few Gulf crudes available on spot sale as opposed to long-term supply contracts. In the United States, crude oil sales are usually priced in relation to the WTI.²³

²² This box article was prepared by Mr. Joselito R. Basilio, Senior Research Specialist, Monetary Policy Research Group, Department of Economic Research (DER), BSP, in coordination with Ms. Eden B. Tengco, Bank Officer II, Balance of Payments and International Research Group of the DER, BSP.

²³ The Organization of Petroleum Exporting Countries (OPEC)—a cartel of some of the world's leading producers—has its own reference price known as the OPEC basket price which include the following crudes: Saudi Arabia's Arab Light, the United Arab Emirates' Dubai, Nigeria's Bonny Light, Algeria's Saharan Blend, Indonesia's Minas, Venezuela's Tia Jana Light, and Mexico's Isthmus. Six of these crudes are produced by OPEC members while the seventh is from a non-OPEC member, Mexico.

Trends in Crude Oil Posted Prices

In practice, the price differences between the Dubai, Brent, and WTI crudes tend to be relatively small, often—but not always—averaging about US\$1-2 per barrel between the Dubai and Brent crudes and about US\$2-3 per barrel between the Dubai and WTI crudes. Since 1995, prices of Dubai crude oil have been the lowest compared to those of Brent crude and WTI crude. Brent crude and WTI oil prices have generally moved in the same direction as those of Dubai posted prices. However, the posted price of WTI crude oil has generally been higher compared to those of Dubai and Brent crude oil. The price differential can be attributed mainly to the weight or gravity and higher quality (degree of refinement in terms of sulfur content) as well as the relatively lower level of production of WTI crude compared to those of Brent and Dubai crudes.²⁴ Because the WTI is a very light and sweet (low sulfur content) crude, it is generally more expensive than the other types of crude. Brent is also lighter and sweeter than the Dubai crude oil.²⁵



²⁴ In particular, the higher quality of WTI crude is determined by higher API gravity of 38-40 degrees and lesser sulfur content of approximately 0.3 percent compared with Brent crude's API gravity of 38.5 degrees and 0.36 percent sulfur content as well as with the Dubai crude's 31.2 degrees of API gravity and 2.01 percent sulfur content (Platts 2001).

²⁵ Energy Information Administration (EIA), US Department of Energy, 2002a

For the period 1995-2002, world oil prices reached their lowest level of US\$10.14 per barrel (for the Dubai crude oil) in February 1999. The general downtrend in crude oil prices from 1998 to 1999 was driven mainly by the large build-up of oil inventories combined with lower oil consumption due to the relatively low economic activity in many countries following the Asian financial crisis. After bottoming out in early 1999, oil prices subsequently trended upward, fueled by the strong world economic growth, which resulted in higher consumption of and demand for oil. This was followed by coordinated cuts in oil production by the OPEC which raised further crude oil prices to a peak of US\$30.52 per barrel for Dubai crude in October 2000. During the period April-September 2001, Dubai crude oil prices exhibited a downtrend to a range of US\$24-US\$25 per barrel. Subsequently, crude oil prices dropped rapidly to less than US\$20 per barrel from October 2001 to February 2002 due to the sharp contraction in demand following the 11 September 2001 events and given the warmer-than-expected winter season in the Northern Hemisphere.

After hitting its lowest monthly average in more than two years at US\$17.67 per barrel in November 2001, the prices of Dubai crude oil registered an uptrend from January to September 2002. This was due mainly to the sustained cuts in the oil production quota agreed upon by OPEC member countries and the escalation of the tensions in the Middle East. Starting in October 2002, however, world crude oil prices started to decline as tensions in the Middle East calmed down. However, world oil prices again showed an uptrend in December due to the seasonal increase in demand for heating oil during the winter season, the renewed threat of a US-led military assault on Iraq in early 2003 and the general strike of labor groups in Venezuela—the third largest producer of crude oil among OPEC-member countries.²⁶

Factors Affecting World Oil Prices

Like any traded commodity in the market, the movements of crude oil prices have been brought about by a combination of demand and supply factors. On the demand side, the economic activities (both residential and industrial) of a country determine largely the amount of oil

²⁶ Venezuela accounted for 10.1 percent of OPEC crude oil production as of second quarter 2002 (EIA, 2002b).

consumption. Rising income levels are expected to lead to increased demand for and consumption of oil. Crude oil prices are also influenced by the energy policies of exporting and importing countries, especially those relating to tax and tariff policies. On the supply side, the coordination of oil producers, particularly through the Organization of Petroleum Exporting Countries (OPEC)—which accounts for 41.0 percent of total crude oil production—also influences the trends in world oil prices.²⁷ In particular, net exporters of crude oil coordinate the size of stocks that they would supply in the international market.

In addition, the world political environment is a crucial factor affecting oil price trends. For instance, conflicts in the Middle East (which account for 31.7 percent of total world oil production) could sway output and reservoir levels significantly, and thereby, affect oil prices.²⁸ A familiar example was the Middle East conflict in the early 1990s due to the Iraqi invasion of Kuwait. World oil prices then rose to peak levels from those experienced during the previous decade, as the spot price of Dubai crude oil reached a high of US\$37.75 per barrel on 28 September 1990.²⁹

Seasonal patterns also influence the movements of production, consumption and hence oil prices.³⁰ In general, oil prices tend to peak during the onset of the winter season as inventories of crude oil and products are run down during this time, as the demand for heating oil and petroleum products rise in the Northern Hemisphere. At the middle of each year, stocks are rebuilt, leading to some stability in oil prices during the period. However, sudden variations in seasonal patterns could affect the trends in oil prices. For example, the warmer-than-expected winter season in the Northern Hemisphere in 2001 translated into lower demand for heating oil, resulting in lower oil prices compared to those in the previous winter seasons.

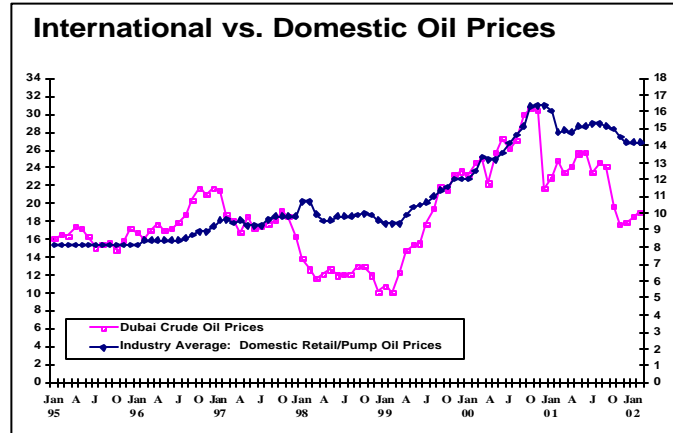
²⁷ Oil production for the year 2001 (OPEC 2001)

²⁸ Oil production for the year 2001 (OPEC 2001)

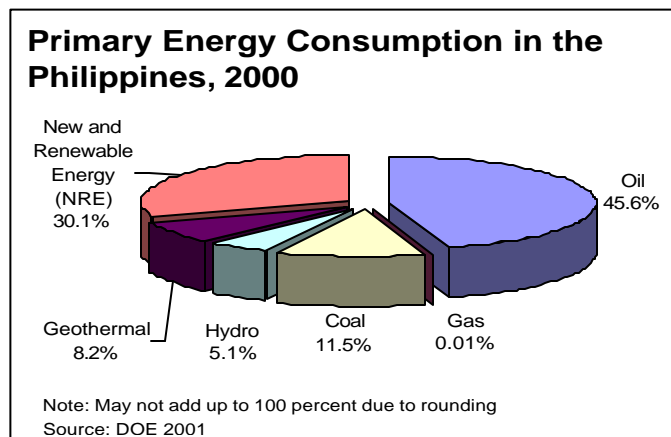
²⁹ Source: Bloomberg

³⁰ Seasonality is apparent in the higher-than-usual consumption of oil during the summer and winter seasons.

Oil Consumption in the Philippines

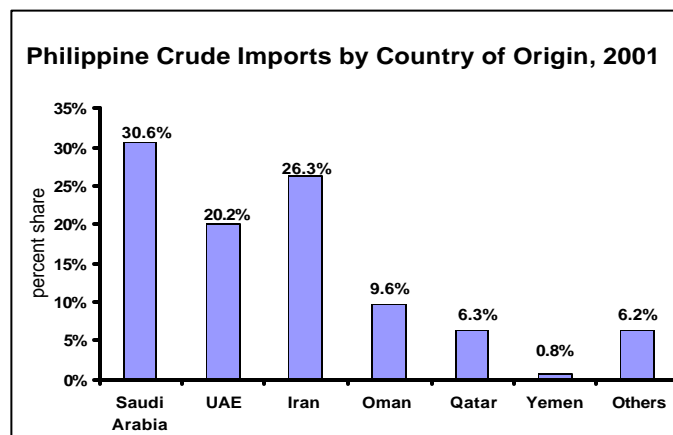


In the Philippines, movements in domestic oil prices tracked closely the movements of world oil prices. This can be attributed to the relatively dominant share of crude oil to total energy consumption in the Philippines and the large share of imported crude oil to the country's total oil consumption. The country's dependence on crude oil as a primary source of energy, however, has declined significantly from its 64.5 percent



share to total energy consumption in 1990 to 45.6 percent in 2000. While its share was expected to decline further to 41.8 percent in 2002 with the increased utilization of domestically sourced energy, the country's reliance on crude oil is still relatively high, with the other sources of

energy contributing the following shares to total energy consumption during the year 2000: coal (11.5 percent), geothermal (8.2 percent) and hydro energy (5.1 percent), among others.³¹



The Philippines is a net importer of crude oil, with about 99.7 percent of its total oil consumption being imported. In 2001, about 93.8 percent of the country's total oil imports were imported from the Middle East. Oil imports from Saudi Arabia accounted for 30.6 percent of the country's total oil imports while those from United Arab Emirates (UAE) and Iran constituted 26.6 percent and 20.2 percent, respectively. The relatively large share of oil imports from the Middle East also explains why the posted price of Dubai crude is used as the benchmark for oil prices in the Philippines.

Impact of Oil Prices on the Consumer Price Index (CPI)

The movements in world oil prices affect the general price level, either directly or indirectly through their impact on domestic oil prices. In the Philippines, oil price movements feed into the Consumer Price Index (CPI)-based inflation through: (1) the first round or direct effects on specific items in the CPI basket which include oil/petroleum products, particularly, household fuel (LPG, gas and kerosene) and oil, gasoline, diesel and other lubricants (classified as services allied to transport in the CPI basket); and (2) the second round or indirect effects on other CPI

³¹ Source of basic data: Department of Energy, 2001

components which use oil as an input in production such as food, beverages and tobacco and utility services such as electricity and transportation charges.

1994 CPI WEIGHTS FOR ALL INCOME HOUSEHOLDS			
Description	Philippines	NCR	AOMM
All Items	100.0	28.0	72.0
I. Food, Beverages and Tobacco	55.1	12.7	42.4
II. Non-Food	44.9	15.2	29.6
A. Clothing	3.7	0.9	2.8
B. Housing and Repairs	14.7	6.3	8.4
C. Fuel, Light and Water	5.7	1.8	3.9
1. Fuel	2.3	0.3	2.0
of which:			
Gas, LPG	0.7	0.2	0.5
Kerosene	0.4	0.1	0.3
2. Light	2.7	1.2	1.6
3. Water	0.7	0.4	0.3
D. Services	12.3	4.2	8.1
of which:			
Transportation and Communication	4.8	1.7	3.1
1. Transportation	3.2	1.0	2.2
· Air	0.2	0.1	0.1
· Land	2.8	0.8	2.0
· Water	0.1	0.0	0.1
2. Services Allied to Transport	1.1	0.6	0.6
of which:			
· Oil, Gasoline, Diesel	0.7	0.4	0.3
· Other Lubricants	0.1	0.0	0.1
3. Communications	0.5	0.2	0.2
E. Miscellaneous	8.5	2.1	6.4

Fuel and services allied to transport account for a combined weight of 3.4 percent in the total CPI basket. In particular, fuel accounts for 2.3 percent share in the total CPI basket, of which gas, LPG and kerosene constitute 1.1 percent. Meanwhile, within the services allied to the transport subcomponent in the CPI basket, oil, gasoline, diesel and other lubricants make up 0.8 percent of the CPI basket. In practice, local oil companies apply the price adjustments only to those produced from the imported crude oil inventory affected by international price changes.

However, the indirect effect of world oil price movements on the CPI covers a relatively wide range of other commodities and services in the CPI basket including food, which accounts for 55.1 percent of the CPI basket; transportation and communication services, 4.8 percent; light, 2.7 percent; and other miscellaneous items, 8.5 percent.

The various producers of goods and providers of services considered in the CPI take into account the volatility of world oil prices and the eventual changes in local petroleum and fuel products. For instance, farmers factor in the additional costs of higher fuel prices (including higher expenses for the fuel used in their farm equipment and machineries as well as for the transportation of their agricultural produce) in costing their activities. This compels them to demand for higher returns or prices for their products. Moreover, commercial and industrial firms—which account for about 63.5 share in total energy consumption³²—are generally expected to pass on the cost of higher fuel to the final consumers in terms of higher prices of goods and services.³³

Similarly, adjustments in oil prices—which feed into changes in transport costs and other freight charges—affect the costs of trading and distribution of various agricultural products and manufactured goods from farmers/manufacturers to traders/retailers, and finally to end-consumers. Fare adjustments in air, land and water transport services are also done, upon approval by the regulating agencies such as the Land Transportation and Franchising Regulatory Board (LTFRB) for land transport services. Thus, world oil prices—through their direct impact on domestic petroleum and energy-related products and services—also affect indirectly other components of the CPI basket, since oil is an important input in the production and in the distribution of a wide variety of goods and services.

After falling together with world oil prices starting in February 1995 when there was relative stability in demand and supply conditions, the prices of fuel as well as the transport and communication components of the CPI remained steady until the middle of 1996. The inflation rate of

³² Based on the energy sales profile of Meralco for the year 2001

³³ Some firms could, however, absorb the higher oil costs through reduced profit margins in order to maintain their market share amidst weakness in domestic demand and stiff market competition.

these two commodity groups rose in 1997 due mainly to the adjustments in transport fares. In the first half of 1998, the drop in world oil prices led to downtrends in domestic fuel prices while adjustments in transport and communication costs were observed with a lag, with decreases experienced only at the beginning of 1999.³⁴ Specifically, inflation for transportation and communication dropped to 2.5 percent in March 1999 from 15.3 percent in March of 1998. The uptrend in crude oil prices in 1999 to 2000 subsequently raised the inflation rate of fuel and transport prices to their highest levels since 1995 at 18.8 percent and 20.6 percent, respectively, in January 2001. Subsequently, the inflation rate of fuel and transport costs from January 2001 until February 2002 declined as world oil prices trended downward.

Based on the BSP's single-equation inflation forecasting model, a one percent increase in Dubai crude oil price would lead to a 0.02 percentage point increase in the direct impact on the average annual inflation. Meanwhile, the indirect effect is estimated to be about 0.04 percentage point or twice the amount of the direct impact, leading to a total impact of about 0.06 percentage points to the inflation. For example, an increase in the price of Dubai crude oil from an average of US\$22.81 per barrel in 2001 to US\$23.80 per barrel in 2002 or about 4.3 percent would translate to a total increase in the average annual inflation rate of 0.3 percentage point—other factors being constant—broken down as follows: direct impact of 0.1 percentage point and indirect effect of 0.2 percentage point.

ESTIMATED IMPACT OF INCREASES IN WORLD OIL PRICES ON AVERAGE ANNUAL INFLATION		
Impact on Inflation	One-percentage point increase	4.3-percentage point increase 1/
Direct Impact	0.02	0.09
Indirect Impact	0.04	0.17
Total Impact	0.06	0.26
1/ Based on the assumption that the price of Dubai crude would trend up to average US\$23.80 per barrel in 2002 from US\$22.81 per barrel in 2001.		

³⁴ The lag could be explained by the time needed to petition for adjustments in fares and the time for the regulatory agencies to make and implement their decisions.

The relationship between world oil prices and the inflation was evident especially in 2001 as inflation trended downward following the softening of the prices of Dubai crude oil in the world market. Meanwhile, the uptick in world oil prices from mid-February to May 2002—arising from the coordinated cuts in oil production by the OPEC and non-OPEC countries as well as the hostilities in the Middle East—raised domestic oil prices during the period.³⁵

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³⁵ After the price of Dubai crude oil bottomed out at a monthly average of US\$17.86 per barrel in December 2001, it reached US\$24.51 per barrel in April 2002. Meanwhile, domestic pump prices of petroleum products increased by an average of about ₱1.61 per liter for all gasoline products and ₱1.56 per liter for diesel and kerosene from 7 January 2002 to end-May 2002.

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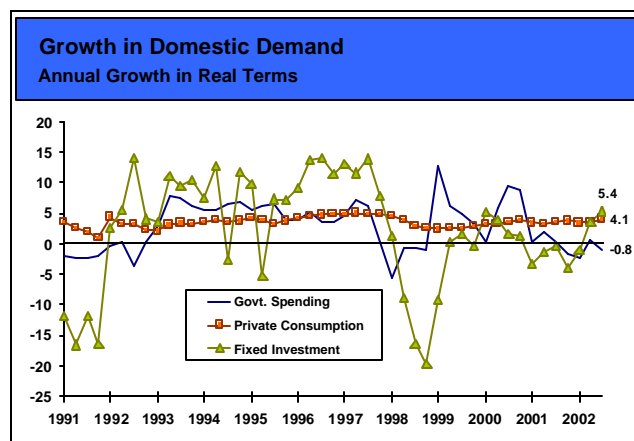
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Aggregate Demand and Output

The economy continued to gather momentum in the third quarter of 2002 amid uncertainty on the domestic and external fronts. The economy's growth momentum was fueled by the sustained growth in private consumption as well as the modest rebound in fixed capital spending due to construction activity. Real GDP grew by 3.8 percent year-on-year in the third quarter of 2002, higher than the 3.0 percent growth posted a year earlier. This brought the first three-quarters GDP growth to 4.1 percent, which was broadly in line with the government's full-year GDP growth target of 4.0-4.5 percent. Nevertheless, other demand indicators suggested areas of weakness in overall demand conditions. Meanwhile, output growth was driven by the modest rebound of the industry sector and the sustained growth of the services sector. Agricultural output was dampened by reduced rice and corn production on account of unfavorable planting conditions due to the El Niño phenomenon, although the output of livestock, poultry, fishery and other crops grew moderately during the third quarter.

Domestic Demand

Robust household spending and investments in fixed capital were the main drivers of domestic demand in the third quarter. By contrast, government consumption fell due to the government's efforts to curb expenses such as operating and maintenance costs. Private consumption grew at its fastest rate of 4.1 percent in four and a half years. Spending on transportation, food, and miscellaneous items accounted for the increase in private consumption. Food spending, which accounted for 52.4 percent of consumer spending, grew by 3.5 percent during the third quarter in 2002 compared to 3.0 percent a year ago. Transportation spending also went up due to the higher volume of elevated train ridership and the increase in the number of registered private motor vehicles. Likewise, the surge in the total volume of domestic and international calls, the sustained increase in the number of mobile phone subscribers that led to the substantial flows of short messages, and the widened use of the Internet boosted the spending in communication.



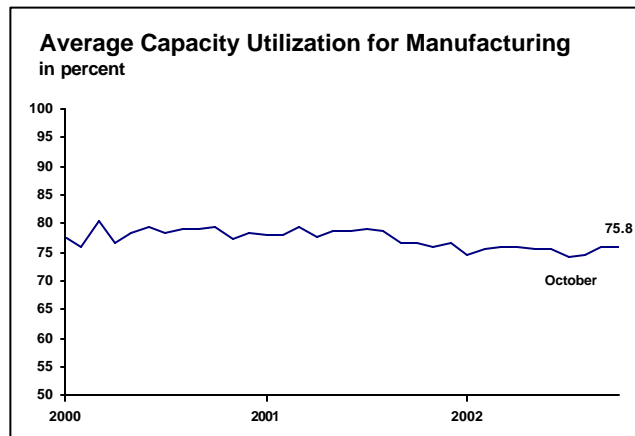
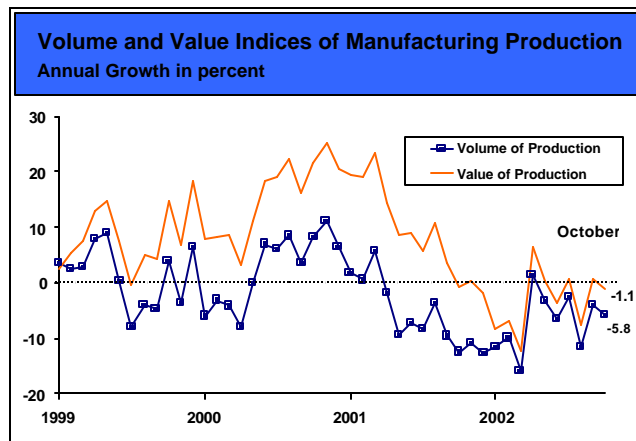
Real total investments declined by 3.8 percent year-on-year in the third quarter of 2002, pulled down by the withdrawals in the stocks of petroleum, sugar and government inventory. However, real spending on fixed capital rose by a healthy 5.4 percent, owing to a rebound in construction spending.

Other Demand Indicators

Other demand indicators pointed to continuing mixed signals of the strength of domestic demand to date in 2002. On the one hand, consumer demand continued to be buoyant. Results of the Business Expectations Survey (BES) conducted by the BSP in October 2002 showed that the majority of the respondent firms continued to expect positive prospects for business in the fourth quarter, as the Business Outlook Index settled at 16.2 percent.³⁶ Demand for cars showed strong double-digit year-on-year growth rates from September to November 2002. The growth of total commercial vehicles, including those sold by the Chamber of Automotive Manufacturers of the Philippines, Inc. (CAMPI), doubled to 41.1 percent in November 2002 from 22.2 percent a year ago. Electricity consumption continued to be lower on an annual basis, but the decline has eased in recent months. The cumulative year-on-year decline in Meralco electricity sales has eased steadily from 6.3 percent in March to 1.9 percent in June and 0.6 percent in September.

³⁶ The Business Outlook Index is computed as the percentage share of firms that have an “improving” outlook less the percentage share of firms that have a “deteriorating” outlook. A positive index indicates a favorable view by respondents.

On the other hand, other indicators pointed to areas of weakness in domestic demand. Manufacturing activity, for example, remains sluggish. Data from the Monthly Integrated Survey of Selected Industries (MISSI) published by the National Statistics Office (NSO) show that the Value of Production Index (VAPI) of the manufacturing industry fell by 1.1 percent in October 2002 compared with the year-ago figure. Likewise, the Volume of Production Index (VOPI) fell by 5.8 percent on an annual basis during the same month. Capacity utilization in manufacturing also remains fairly low at 75.8 percent for October 2002.



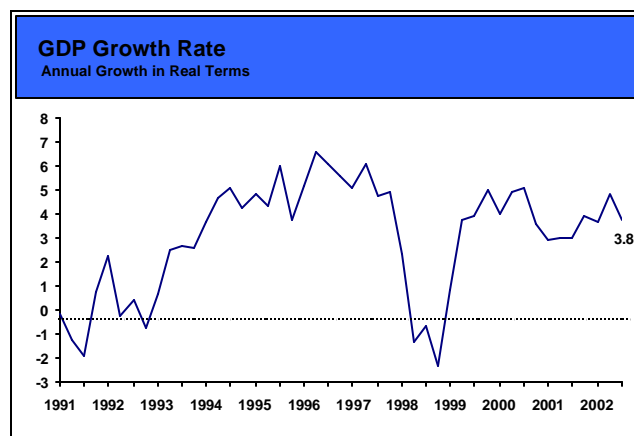
External Demand

Demand for Philippine goods overseas continued to be buoyant despite signs of a weaker-than-expected recovery in the major economies. Cumulative year-on-year growth of total merchandise exports continued to improve in recent months, registering a turnaround from a 5.3 percent decline as of March 2002 to a 4.3 percent increase in June which strengthened further to 8.1 percent by October. The strengthening of exports reflected largely the recovery in electronics shipments, which grew by 10.1 percent in the first ten months of 2002 as well as the sustained expansion in exports of machinery and transport equipment. The recovery in garments exports also contributed to the favorable export performance. Garments exports appeared to have recovered partly as a result of the government's strategy to tap high-end markets and veer away from traditional quota-driven markets such as the US as well as increase penetration of non-quota markets such as Japan, United Arab Emirates, Hong Kong, and Mexico with the impending quota phase-out in 2004.

Aggregate Output

The economy continued its growth momentum during the third quarter, led by the services and industry sectors. On an annual basis, growth in real Gross Domestic Product (GDP) strengthened to 3.8 percent during the quarter following a 3.0 percent rise in the same period in 2001, while real Gross National Product (GNP) maintained the 3.4 percent expansion observed during the same period last year. For the first nine months of 2002, real GDP and GNP grew by 4.1 percent and 4.2 percent, respectively, which are broadly in line with the government's 2002 growth targets of 4.0-4.5 percent for real GDP and 4.5-5.5 percent for real GNP.

The recovery in mining and quarrying and the construction sectors contributed to the 4.4 percent year-on year growth in the industry sector in the third quarter. Mining and quarrying output registered a turnaround with an increase of 58.7 percent in the third quarter following a decline of 8.3 percent a year ago, driven by contributions from the Malampaya project, the increase in copper output and the rebound in production of Semirara coal. Likewise, construction increased by 8.6 percent, reversing the 1.1 percent decline last year. Meanwhile, the manufacturing sector managed to grow by 1.3 percent while the utilities sector recorded a stronger growth of 6.1 percent from 4.3 percent a year ago.



The services sector also turned in a favorable performance during the quarter, with all subsectors registering positive growth. The transportation, communication and storage subsector sustained a high growth of 7.4 percent followed by private services at 5.3 percent and government services at 5.0 percent. The finance subsector registered a notable improvement, posting a 3.9 percent increase vis-à-vis the minimal growth of 0.4 percent during the same period last year. This was largely attributed to the improved performance of banks, non-banks and insurance companies. Growth in banking was driven mainly by trading gains in government securities, increased fee-based activities and aggressive promotion of credit cards. Meanwhile, increased availment of loans from non-bank financial intermediaries propelled the growth of non-bank institutions. The output of insurance companies grew on the strength of increased demand for pension plans.

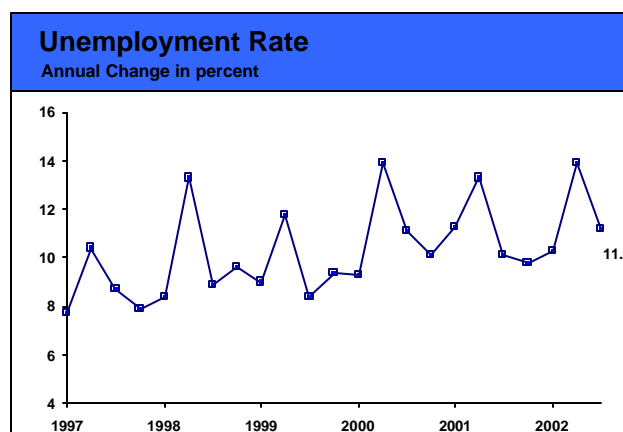
Output in the agriculture, fishery and forestry (AFF) sector fell by 0.4 percent after expanding by 1.7 percent a year earlier. Unfavorable weather conditions and lower production plans in anticipation of the El Niño weather disturbance reduced the production of major crops such as rice and corn. However, output of livestock, poultry, and fishery as well as other crops grew favorably.

For the first nine months of 2002, the industry and services sectors registered growth rates at 3.8 percent and 5.1 percent compared to 1.5 percent and 4.2 percent, respectively, during the same period in 2001. Meanwhile, the agriculture, fishery and forestry sector grew slightly slower at 2.3 percent during the first three quarters compared to the 2.8 percent growth in the previous year.

Labor Market Conditions

Latest available data continued to suggest soft labor market conditions, with relatively high unemployment accompanied by generally stable wage rates. Results from the October 2002 Labor Force Survey published by the NSO showed a slight decrease in unemployment to 10.2 percent from 11.2 percent in July. This was, however, higher than the 9.8 percent unemployment rate in October 2001.

Employment generation continued to be generally sluggish, with growth in total employment slowing to 0.6 percent year-on-year in October following a 2.8 percent increase in July and an 8.3 percent rise in October 2001. The increase in total employment was due largely to higher employment in the services and agriculture sectors, which offset the decline in jobs in the industry sector. Employment in the services sector was recorded at 14.3 million in October 2002, posting an increase of 0.8 percent from last year's level of 14.2 million. Higher employment in services was attributed to own-account workers in the wholesale and retail trade, repair of motor vehicles, motorcycles and personal and household goods sub-sectors. Meanwhile, employment in the industry sector declined due, in part, to reduced employment in the manufacturing and mining-quarrying subsectors, despite increased jobs in the construction and electricity, gas and water subsectors.



The softness in job market conditions has generally precluded labor groups from making forceful calls for nominal wage adjustments in 2002. In the National Capital Region (NCR, i.e. Metro Manila), for example, the most recent wage increase of ₱15 in February 2002 for non-agricultural workers was still part of the ₱30 adjustment granted in November 2001, which was implemented in two

stages.³⁷ Since then, the NCR Regional Tripartite Wage and Productivity Board (RTWPB-NCR) has not received demands for wage increases despite cost-side consumer price pressures in recent months. As of 2 December 2002, there were no pending minimum wage adjustment petitions filed with the RTWPB-NCR. This suggests limited prospects for nominal minimum wage increases over the near term for most of the country, since other regions often tend to take their cue from wage movements in NCR. Nevertheless, cumulative cost-side price pressures in recent months could still prompt calls for moderate cost-of-living adjustments in 2003. Based on the previously implemented wage adjustments in the different regions, the earliest possible wage adjustments may take place in February 2003.

Fiscal Developments

The deficit of the National Government (NG) for the first eleven months of 2002 was recorded at ₱200.6 billion, considerably higher than the full-year target deficit of ₱130.0 billion (3.3% of GDP). This was the result of the shortfall in revenue collections and higher-than-programmed expenditures. Revenue collections of ₱506.6 billion for the first eleven months of the year were also 0.4 percent lower compared to the level recorded a year earlier. Collections by the Bureau of Internal Revenue (BIR) fell during the period on account of the general slowdown in economic activity, particularly in the manufacturing sector, as well as the downtrend in interest rates, which reduced collections from interest-related taxes. Meanwhile, revenues from the Bureau of Customs (BOC) declined due to the increased amount of non-dutiable imports and deferred duty payments.

At the same time, government spending increased during the first eleven months due to higher current operating expenses and capital expenditures. Increased current expenditures were due largely to the increase in the revenue allotment to local government units (LGUs) in support of poverty alleviation as well as peace and order programs and the increase in interest payments resulting

³⁷ Minimum wages are adjusted once a year. Wage petitions are filed at the Secretariat of the RTWPB. The Department of Labor and Employment (DOLE) chairs the RTWPB. The National Economic and Development Authority (NEDA) and the Department of Trade and Industry (DTI) are also RTWPB members representing the government, although the DTI has no voting power. Other members of the RTWPB include the representatives of the labor groups and business groups. Public hearings or consultations are held in the regions to discuss the petitions of labor groups. Petitions usually come from the *Kilusang Mayo Uno* (KMU), the Trade Union Congress of the Philippines (TUCP), the Labor Advisory Consultative Council (LACC) and other labor federations/organizations.

from the ₱63 billion Retail Treasury Bonds issued by the government in June 2002 and the US\$1 billion RP global bonds issued in March 2002. The increase in capital spending was primarily attributed to the rise in infrastructure expenses and in capital transfers to LGUs.

The NG has announced that the indicative budget deficit for 2002 has been raised to 5.6 percent of GDP (₱223 billion) from the original 3.3 percent of GDP (₱130 billion).³⁸ For 2003, the NG expects the fiscal deficit to be around 4.7 percent of GDP (approximately ₱202 billion). The financing mix is expected to consist of about 48 percent foreign borrowing and 52 percent domestic borrowing.³⁹

Financial Market Conditions

Activity in Philippine equities markets remained tepid in the fourth quarter, with trading marked largely by caution as investor sentiment remained weak due to domestic and external concerns, along with the absence of positive market news. Meanwhile, ample liquidity in the financial system continued to drive banks' appetite for government securities, as shown in the oversubscriptions of primary auctions for Treasury bills.

Stock Market

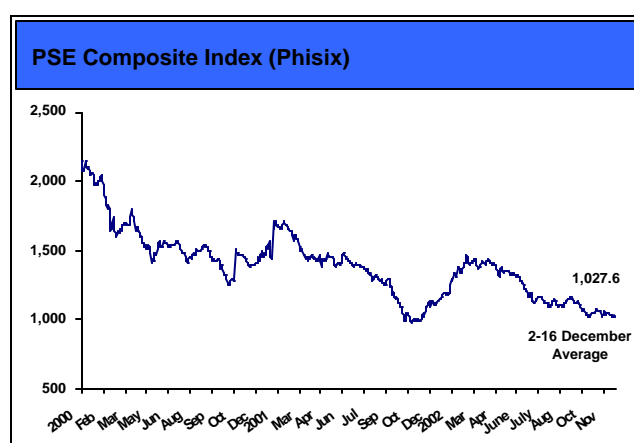
The sluggish tone displayed by the local equities market since the second quarter of 2002 persisted up to the fourth quarter of the year. This was evident in the continued downtrend in the Philippine Stock Index (PHISIX). From an average of 1,118.6 index points in the third quarter of 2002, the PHISIX fell to an average of 1,027.6 index points for the period 2-16 December 2002. This represented an 8.1 percent decline during the period and a 17.4 percent decline relative to the average level in January 2002.

Both domestic and external concerns weighed down on investor sentiment. Concerns over the fiscal performance, domestic security problems and the lack of

³⁸ The ₱223 billion indicative budget deficit target was estimated using the low-end of the nominal GDP consistent with the real GDP growth of 4-4.5 percent for 2002.

³⁹ Source: Press Statement by Department of Budget and Management Secretary Emilia T. Boncodin on 21 November 2002 at the Department of Finance

positive corporate developments along with the weakness in the peso kept investors on the sidelines. The local stock market was also negatively affected by uncertainties in the pace of global economic activity as well as the threat of war in the Middle East. Market analysts expect trading to remain generally cautious in the near term, with the possibility of modest seasonal gains towards year-end as institutional investors attempt to boost their end-year returns for reporting purposes. The market is expected to continue to take its lead from external developments, particularly the pace of growth of the US economy and peace and order conditions in the Middle East. In addition, domestic corporate developments would also be a key factor in setting the direction of the equities market.



Foreign participation in the local equities market remained sizable as total foreign transactions accounted for 49 percent of total value turnover in October-November 2002. However, foreign investors maintained their net selling position in October-November 2002 with foreign selling exceeding foreign buying by ₱1.5 billion.⁴⁰

Government Securities

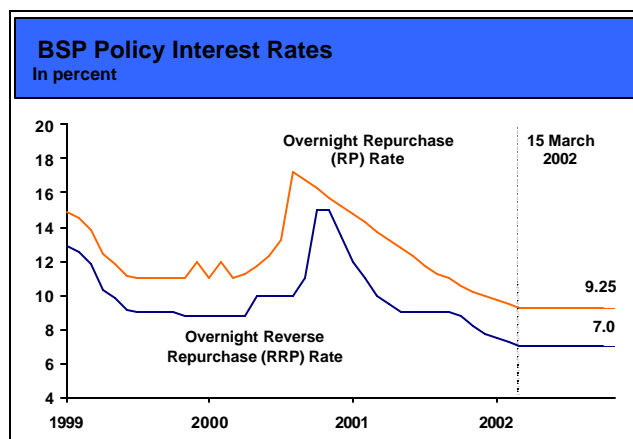
Regular Treasury bill auctions conducted by the Bureau of Treasury (BTr) continued to be oversubscribed in the fourth quarter of 2002 as moderate loan activity and ample liquidity in the financial system continued to fuel banks' appetite for government securities. Oversubscriptions during the quarter reached

⁴⁰ Source: Philippine Stock Exchange

₱40 billion. This was significantly larger than the ₱9.9-billion oversubscription posted in the previous quarter. Banks generally submitted higher bid yields at the primary auctions, as the news of fiscal slippages fueled expectations of higher interest rates. The BTr sought to limit the increases in T-bill rates by rejecting excessively high bid yields. Total rejections for the period amounted to ₱43.5 billion. This was ₱4.6 billion higher than the ₱38.8 billion total rejection in the third quarter.⁴¹

III. MONETARY POLICY DEVELOPMENTS

The monetary policy stance of the BSP in the fourth quarter of 2002 reflected the view that, given a weaker external environment and with inflation largely contained, monetary policy should be supportive of domestic demand. It also reflected the view that present policy settings are adequately expansive for the needs of the growing economy. Thus, the Monetary Board voted to keep the BSP's policy interest rates unchanged during the period at 7.0 percent for the overnight reverse repurchase (RRP) rate and 9.25 percent for the overnight repurchase (RP) rate. The last recorded change in BSP policy interest rates was on 15 March 2002 when the MB reduced rates by 25 basis points (a quarter of a percentage point).



⁴¹ Figures as of 9 December 2002 auction

In deciding to leave the BSP's policy rates unchanged, the Monetary Board expressed the view that price conditions will remain manageable over the policy horizon (estimated at approximately two years) despite cost-side pressures, with average inflation staying broadly in line with the government's targets. In addition, although upside pressures accompany the inflation outlook—notably supply-side factors such as the El Niño weather disturbance, the increase in oil prices and possible increases in power rates and water charges—generalized demand-side pressures on consumer prices are expected to remain quiescent given soft labor market conditions and spare capacity in manufacturing as well as weak credit conditions. Moreover, the largely supply-side and transient nature of foreseeable price pressures over the policy horizon, the risks to sustained economic activity posed by uneven and tentative growth in domestic demand, and the uncertainties in global economic conditions argue for continued caution in the monetary policy stance and maintaining the present interest rate environment to help support non-inflationary economic growth while guarding firmly against price pressures. Against a backdrop of low inflation, the present low-interest rate environment will help ensure that liquidity is appropriate for the continued strengthening of activity in the real sector.

Members of the Monetary Board also noted indications of a turnaround in credit demand, which suggested that previous reductions in the BSP's policy interest rates could be already having their intended effect. Given the recognized long lags in monetary policy, the stimulatory impact of past monetary easing may have yet to work itself fully through the system, and maintaining policy rates at present levels would provide monetary authorities with sufficient time to gain a firmer indication of how previous policy moves all play out.

The Monetary Board decision to stay its hand was also informed in part by its view on government debt dynamics. Given the fiscal outlook for the whole of 2002 and 2003, the Monetary Board noted that forecasts for next year's inflation show that it is likely to settle within the 4.5-5.5 percent target range. Thus, the expected budget deficits do not warrant a monetary response in the form of higher policy rates.

IV. RECENT MONETARY CONDITIONS

Bank lending posted a modest recovery in September and October, reversing several months of year-on-year declines. This coincided with a decline in the non-performing loan ratio of commercial banks, which was attributed to increased foreclosures and collections as well as the redefinition of banks' NPLs. At the same time, liquidity in the financial system continued to find its way mainly to the government securities market, while banks' placements with the BSP under the reverse repurchase (RRP) and special deposit account (SDA) facilities declined in the fourth quarter. The decline was partly seasonally related, as banks' demand for liquidity tends to increase towards December in anticipation of holiday-related cash withdrawals by banks' depositors. The RRP and SDA placements in December 2002 were, however, higher compared to their year-ago levels. Growth in the money stock or M3 continued to be driven mainly by credits to the public sector rather than the private sector, along with increases in net foreign assets due to inflows from overseas workers' remittances and exports.⁴² Meanwhile, domestic interest rates increased slightly early in the fourth quarter but began to trend downward in November-December as ample liquidity continued to prevail in the financial system. In addition, the peso continued to weaken steadily during the fourth quarter, weighed down by market concerns over domestic security as well as the burgeoning fiscal deficit. The peso was also affected by the general depreciation in regional currencies, notably the Japanese yen. However, the peso began appreciating in the second week of December on the strength of increased remittances from Filipinos working overseas.

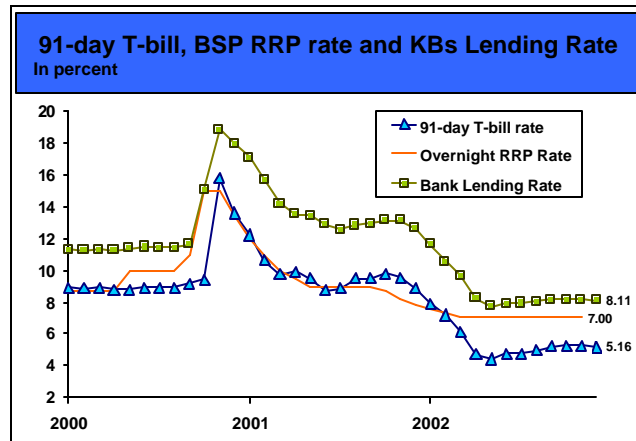
Interest Rates

Trends in domestic interest rates were mixed during the fourth quarter. Market interest rates continued to move upward in October—extending the uptrend observed in the second quarter—but started to go down in November until the first two weeks of December. The recent trend decline in RP market interest rates reflected in part the strong demand for short-term government securities resulting from ample liquidity in the system. In particular, the average

⁴² Domestic liquidity or M3 is a broad measure of the money supply consisting of currency in circulation, peso demand deposits, quasi-money (peso savings and time deposits), and deposit substitutes of deposit money banks (DMBs) held by the general public.

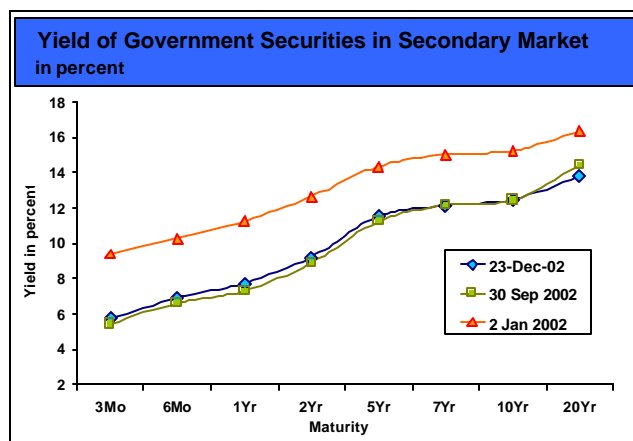
benchmark 91-day Treasury bill rate fell from 5.282 percent in October to 5.257 percent and 5.164 percent in November and December, respectively.

Rates charged on bank loans were generally steady during the quarter. Average bank lending rates from October to December moved at a steady range of 8.1-10.1 percent. This range was about 11-23 basis points higher compared to that for the previous quarter. However, relative to the 18.9-20.8 percent range in November 2000, when the BSP began pursuing an accommodative monetary stance, bank lending rates were considerably lower, by about 1,075 basis points.

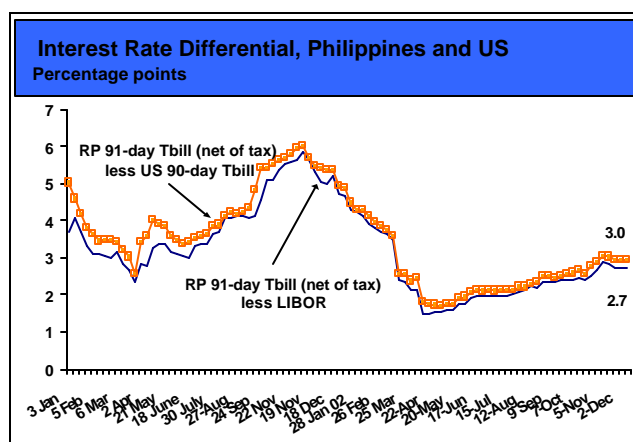


Yield Curve

The yield curve for government securities in the secondary market as of 23 December 2002 was generally flatter compared to that which prevailed as of end-September 2002 as a result of the slightly higher rates for the shorter tenors. Compared to the 4 January 2002 yield curve, however, the 23 December 2002 yield curve continued to show a downward shift.

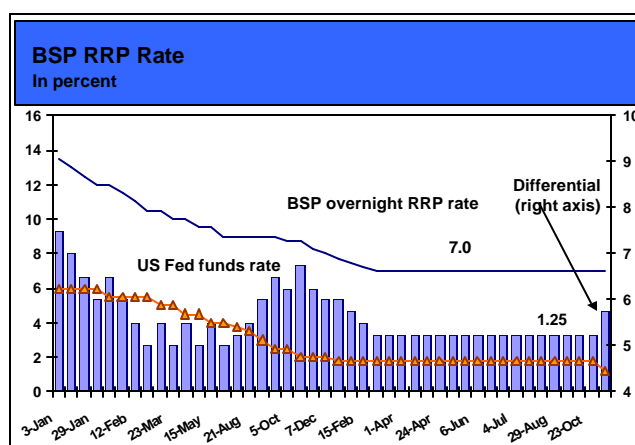


Current interest rate differentials with the US have continued to widen in the fourth quarter, as foreign interest rates declined by a larger amount (following the 50 basis-point cut in the US federal funds target rate in November) compared to the decline in RP market interest rates. Average monthly differentials between the RP 91-day T-bill rate (net of RP withholding tax) and the 90-day LIBOR and 90-day US T-bill increased from 2.4 percent and 2.7 percent in October, respectively, to 2.7 percent and 3.0 percent as of the third week of December 2002.



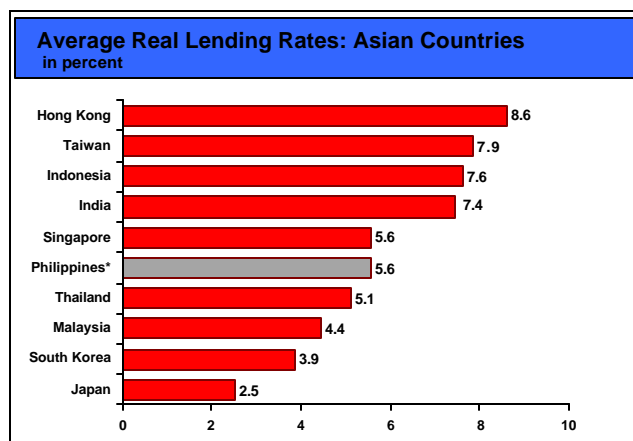
Meanwhile, the differential between the BSP's policy interest rate (overnight borrowing or RRP rate) and the US federal funds target rate widened to 575 basis points from 525 basis points following the reduction in the US federal funds target rate by 50 basis points—which brought the US policy rate to

its lowest level since July 1961—while the BSP policy rates remained steady at their 15 March 2002 levels (the lowest in more than a decade). 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’s RRP rate and the US federal funds target rate generally widened in the fourth quarter, with the end-November risk-adjusted differential at an average of 89.5 basis points from the end-October differential of 59 basis points, again a result mainly of the 50-basis point cut in the US federal funds target rate in November. However, the risk-adjusted differential narrowed significantly starting December, as the risk premium jumped to 510 basis points in 9 December from 474 basis points as of end-November. The sharp rise in the premium was due largely to fiscal deficit concerns, which prompted a downgrade in the country’s debt-rating outlook by international rating agencies Standard & Poor’s (S&P) and Fitch Ratings.

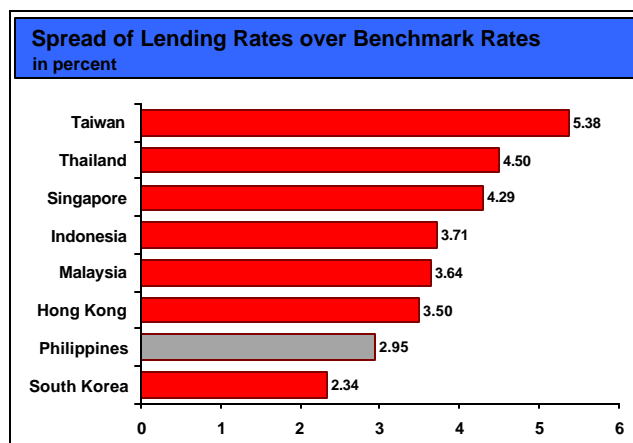


Real Lending Rate

Meanwhile, the real lending rate in the Philippines increased relative to the level in the previous quarter but continued to be one of the lowest real lending rates in the Asian region. The real lending rate rose from 5.5 percent in October to 5.6 percent for the period 18-23 December 2002, making the Philippines the country with the fifth lowest real lending rate in a sample of Asian countries which had a range of 2.5-8.6 percent during the same period.



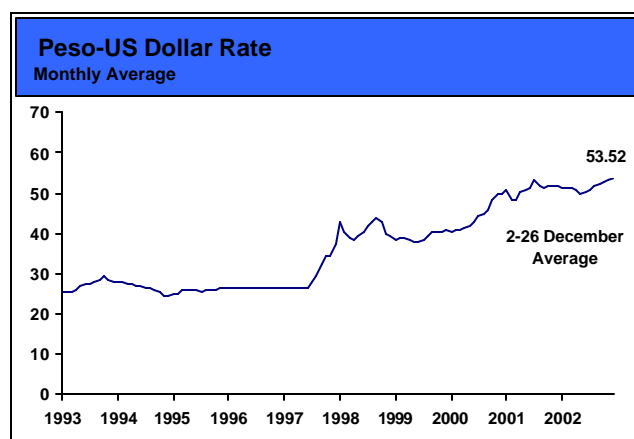
The margin between the Philippine lending rate and the benchmark 91-day T-bill rate increased marginally to 297 basis points as of 18-23 December 2002, compared to 294 basis points in September 2002, reflecting the almost steady trend in both RP market interest rates and lending rates during the quarter. However, this differential makes the Philippines the country with the second lowest spread among those surveyed after South Korea.



Exchange Rate

The peso generally weakened during the last quarter of 2002. The peso-dollar rate averaged ₱53.33/US\$1 in November 2002 and ₱53.52/US\$1 during the period 2-26 December 2002 compared to an average of ₱51.54/US\$1 in the third quarter. The domestic currency was weighed down by market concerns over security as well as the burgeoning fiscal deficit. The peso was also affected by the

general depreciation in regional currencies, notably the Japanese yen. Nonetheless, the peso began appreciating starting the second week of December on the strength of increased remittances from Filipinos working overseas. Moreover, there are signs of increasing stability in the market as the volatility of the peso, measured by the daily standard deviation, declined to 18 centavos during the period 2-26 December 2002 from the year highs of 32 centavos in May and 32 centavos in November.

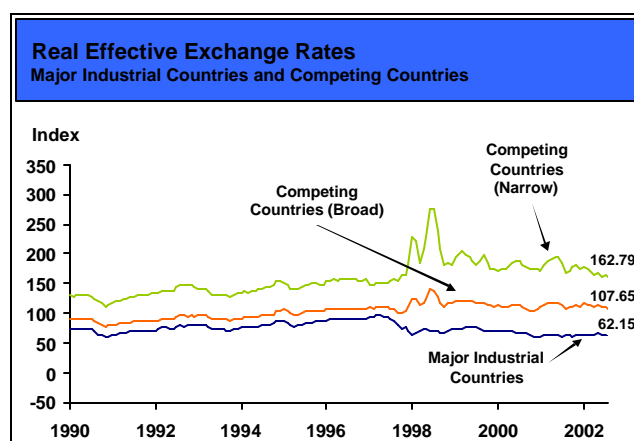


On a trade-weighted basis, the peso depreciated relative to the currencies of the major trading partners by about 7.6 percent in November 2002 from its level in January 2002, as shown in the nominal effective exchange rate (NEER).⁴³ The peso similarly exhibited a depreciation trend over the same period vis-à-vis the two sets of currencies of the Philippines’ competitor countries. The NEER for the broad and narrow baskets of competitor currencies fell by about 10.0 percent and 12.3 percent, respectively.

On a trade-weighted inflation-adjusted basis, the peso likewise depreciated against the currencies of the major trading partners. The real effective exchange rate index (REER) of the peso depreciated by 7.2 percent from January 2002 to November 2002. The real depreciation of the peso was more pronounced relative to the broad and narrow baskets of currencies of competitor countries. The REER

⁴³ The basket of the major trading partners is composed of the currencies of the US, Japan, Germany 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.

for the two baskets showed that the peso depreciated in real terms by 10.3 percent and 13.4 percent respectively, suggesting an improvement in the country's external price competitiveness. The decline in the REER was brought about by both the nominal depreciation of the peso and the tightening of the inflation gap between the Philippines and its major trading partners and competitor countries.



For 2003, the movement of the peso is expected to be influenced by, among other things, developments in the fiscal sector as well as by concerns over geopolitical risks arising from the possible escalation of conflict in the Middle East.

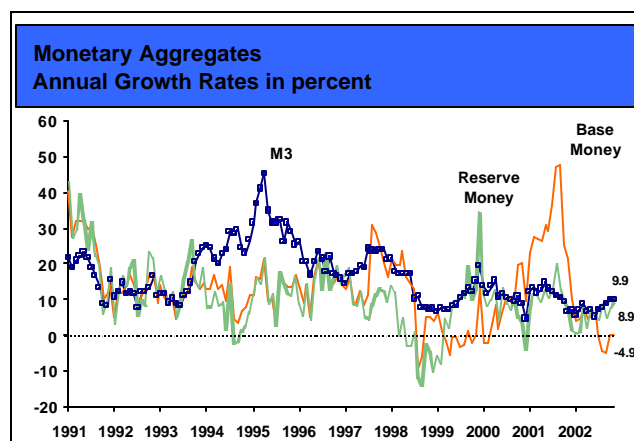
Monetary Aggregates

Demand for money continued to improve in the latter half of 2002. Year-on-year growth in domestic liquidity or M3 accelerated steadily from an average of 6.2 percent in the second quarter to 7.9 percent for the third quarter. M3 growth improved further to 9.7 percent in October and 9.9 percent in November, reflecting mainly the increases in the net foreign assets (NFA) of the monetary system and the continued growth in credits to the public sector.

The rise in the money stock over the last few months continued to be driven by two main factors: (1) increases in the net foreign assets (NFA) of the monetary system (i.e., the BSP and the commercial banks); and (2) increases in credits to the public sector through banks' holdings of government securities. Increases in NFA were partly a result of continued strong dollar remittances by overseas Filipino workers (OFWs) together with increased foreign exchange

receipts from exports. Meanwhile, the increase in credits to the public sector was fueled by the steady investor demand for government securities.

Narrower monetary aggregates exhibited a similar trend. For example, the year-on-year growth in reserve money (a narrower definition of money supply consisting of currency issue net of cash in the vaults of the Bureau of Treasury and banks' reserve balances with the BSP) rose to an average of 8.3 percent in October-November from 5.9 percent in the third quarter and 5.2 percent in the second quarter.



Banking System

Asset quality in the banking system improved in the third quarter as the level of non-performing loans of commercial banks declined relative to the level in the previous quarter. The reduction in the NPL level was a result of foreclosures and collections as well as the change in the definition of NPLs. At the same time, bank lending activity strengthened as total outstanding commercial bank loans grew by 1.2 percent and 1.1 percent, respectively, from the year-ago levels in September and October 2002. This was a reversal of the year-on-year declines observed in previous months. Banks' placements with the BSP also declined relative to the previous quarter, although the reduction may have been partly seasonally related. Nevertheless, the ample cash positions of banks enabled them to increase their portfolio of fixed-income government securities.

Capital Adequacy

Capital adequacy remained one of the strong points of the Philippine commercial banking system as its aggregate capital base continued to be well above both domestic and internationally prescribed capital standards. The capital adequacy ratio (CAR), or the ratio of net worth to risk assets for commercial banks, rose to 17.5 percent in August 2002 from 16.0 percent in December 2001. This was more than the Philippine statutory requirement of 10 percent and the Basle standard of 8 percent. Relative to other Asian countries, the Philippine banking system's CAR was higher than those for Indonesia (6.2 percent), Korea (10.8 percent), Malaysia (13.2 percent), and Thailand (14.3 percent).⁴⁴

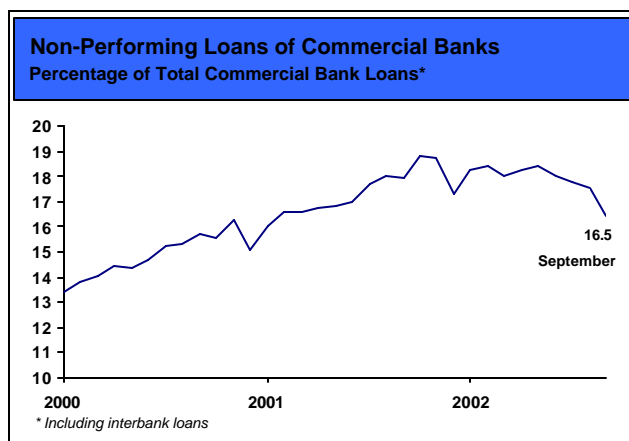
Asset Quality

Latest data on the non-performing loans (NPL) of the Philippines' 44 commercial banks (KBs) point to an improvement in asset quality. As of end-September 2002, KBs reduced their NPL levels to ₱267.4 billion from ₱285.8 billion in July 2002. This brought down the ratio of KB's NPLs to total loans to 16.5 percent of total loans as of end-September compared to 17.8 percent as of end-July 2002. The reduction in the NPL level was a result of foreclosures and collections as well as the redefinition of NPLs under BSP Circular No. 351 to exclude loans that are fully covered by allowances for probable losses.⁴⁵ BSP data indicate that without the re-definition, the NPL ratio for September would be 17.02 percent, still an improvement from the previous quarter.⁴⁶

⁴⁴ CAR as of June 2002 for Malaysia; March 2002 for Thailand; December 2001 for Indonesia and Korea; and January 1999 for Singapore

⁴⁵ BSP Circular No. 351, which took effect on 19 September 2002, allowed banks to exclude from their non-performing loans those that are fully covered by allowance for probable losses, provided that such loans are also deducted from total loan portfolio and interests thereon are not accrued. NPL data as of end-September was based on the revised computation of banks' NPLs under BSP Circular No. 351.

⁴⁶ "KB NPLs as of September 2002 Fall Anew," BSP press release dated 25 November 2002, available on the BSP website at <http://www.bsp.gov.ph/news/2002-11/news-11252002a.htm>

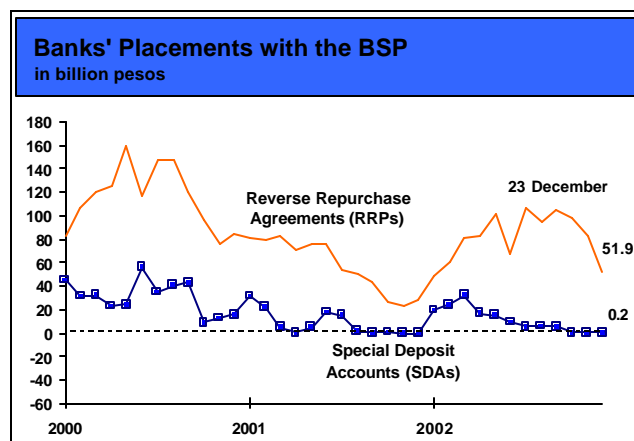


Compared with other Asian countries, Philippine banks' NPL ratio was higher than those of Indonesia (10.8 percent), Thailand (10.2 percent), Malaysia (9.8 percent), and South Korea (1.9 percent).⁴⁷ However, the lower NPL ratios of other Asian countries could be attributed partly to the transfer of their NPLs to publicly managed asset management companies (AMCs).⁴⁸ By contrast, the approach to the disposition of banks' non-performing assets in the Philippines continued to emphasize the creation of privately owned AMCs. Activity in AMCs has not yet proceeded in earnest, although this may change with the expected passage into law of the Special Asset Management Company (SAMC) bill. The SAMC bill had already been approved by the Bicameral Conference Committee of Congress and is expected to be ratified soon.

At the same time, KBs' loan loss provisioning declined slightly to ₱128.9 billion as of end-September from ₱137.7 billion as of end-July 2002. This current level of loan loss provisions, however, represented 48.2 percent of KBs' NPLs, the same as the ratio as of end-July. Potential losses from loan defaults are thus well covered.

⁴⁷ NPLs of commercial banks (KBs) as of August 2002 for Malaysia and Thailand; September 2002 for Indonesia; and June 2001 for South Korea

⁴⁸ Source: Asian Development Bank Asia Recovery Information Center (ARIC) Database; available at <http://aric.adb.org>



External Developments

Recent data on the major economies (US, Japan and the euro area) suggest heightened risks of a downturn in output growth amid evidence of a weaker than earlier expected recovery, particularly in the US. Signs of weakness and uncertainty in the pace of global recovery imply that foreign interest rates are likely to remain low in order to provide support to the economic recovery.

Despite stronger real GDP growth of 4.0 percent in the third quarter from 1.3 percent in the previous quarter, the US economy continued to show signs of weakness. The unemployment rate, for example, rose to 6.0 percent in November from 5.7 percent in the previous month, underlining further the downside risks to the outlook for US consumer spending going forward. Manufacturing and business investment have also shown little indication of a sustained recovery. The Institute of Supply Management (ISM) index of manufacturing conditions edged up only marginally in November to 49.2 from 48.5 in the previous month, but continues to be under the 50 threshold that separates expansion from contraction. Capacity utilization also declined by 0.6 percent from the previous month to 75.2 percent in October, its lowest level since February. This highlights the weaker state of manufacturing in recent months. Consumption of durables—particularly cars—has held up well but has been spurred in part by zero financing schemes from car dealers, and thus may not be sustainable. On the other hand, consumer confidence remained buoyant, partly due to the improved tone in the equities market. The University of Michigan’s consumer sentiment index rose to 84.2 in November from 80.6 in the previous month, but remains at a level below the September index of 86.1. The prevailing signs of weakness in the US

economy combined with the lack of price pressures were the major factors behind the Fed's decision to maintain its neutral monetary policy stance, keeping the federal funds target rate at a 41-year low of 1.25 percent on 10 December 2002. Some analysts even contend that the Fed could reconsider a shift to an easing bias from the current neutral stance if weak economic conditions persists.⁴⁹

In the euro area, economic weakness in the 12 EU member-countries (particularly Germany) persisted while inflation remained above the European Central Bank's (ECB) 2-percent target despite indications that price pressures have begun to dissipate. Uncertainty arising from geopolitical tensions and their impact on oil prices, developments in financial markets, the tepid growth of the world economy and the persistence of global imbalances weighed heavily on confidence in the eurozone economies, thereby exerting pressure on consumption, investment and the labour markets.⁵⁰ Such developments prompted the ECB to reduce its policy rates by 50 basis points on 5 December 2002.⁵¹

Meanwhile, the Japanese economy has stabilized as a whole, but recovery prospects have become more uncertain, according to the latest assessment by the Bank of Japan (BOJ). The growth in real GDP slowed down to 0.7 percent in the third quarter from 1.0 percent in the previous quarter. The BOJ noted that the decline in business fixed investment appeared to have eased but private consumption remained weak, while housing spending remained sluggish and public investment has been declining. In addition, the growth of Japanese exports also appeared to be losing its momentum. Japanese firms are also maintaining their stance to reduce personnel expenses, and household income continued to decrease noticeably due to, among other factors, the decline in wages. Thus, the employment and the overall income situation of households remain difficult.⁵²

The Bank of Japan (BOJ) also noted that a significant recovery of the Japanese economy is unlikely in the near term due to the greater uncertainty regarding economic conditions overseas. For this reason, Japanese monetary

⁴⁹ Employment Situation, November 2002, US Economic Data at http://www.bocm.com/bocmrs/Research_Fixed/usdata/employment/employment.htm

⁵⁰ Introductory statement by ECB President Wim Duisenberg to the Press Conference on 5 December 2002, Frankfurt, Germany, downloaded from the ECB website at <http://www.ecb.int/key/02/sp021205.htm>

⁵¹ The ECB also reduced the interest rate on the marginal lending facility by 50 basis points to 3.75 percent and that on the deposit facility by 50 basis points to 1.75 percent effective 6 December 2002 in ECB Press Releases at <http://www.ecb.int/press/02/pr021205en.htm>

⁵² Bank of Japan, *Monthly Report of Recent Economic and Financial Developments*, November 2002 (The Bank's View) at <http://www.boj.or.jp/en/down/siryō/data/gp0211.pdf>

authorities have opted to maintain an accommodative policy stance. In its Monetary Policy Meeting held on 18-19 November 2002, the Bank of Japan decided to keep its policy stance aimed at maintaining the outstanding balance of current accounts⁵³ at around ¥15-20 trillion.⁵⁴

V. INFLATION OUTLOOK

Outlook for Prices

Available data suggest generally manageable price conditions over the policy horizon. In particular, the benign trend in core inflation suggests muted demand-side influences on future inflation. This may be attributed to limited pricing power on the part of producers amid continuing mixed indications regarding the strength of domestic demand. Inflation remained subdued in December 2002, leading to an annual average of 3.1 percent, which was substantially below the inflation target of 4.5-5.5 percent. Meanwhile, average inflation in 2003 is likely to track broadly the government's full-year target of 4.5-5.5 percent. The possible risks to the inflation outlook over the policy horizon arising from supply-side or cost-push factors—such as movements in world oil prices due to geopolitical factors, the impact of the El Niño weather phenomenon on food prices, possible one-off increases in utility charges, and the cost-side implications of the fiscal performance—are expected to be mitigated by weak demand-pull pressures owing to the continued presence of spare capacity in manufacturing, still-weak demand for credit and generally soft labor market conditions.

Given these factors, the BSP expects the average inflation rate in 2003 to lie within the government's target range of 4.5-5.5 percent. This is also broadly in line with expectations of private sector analysts, which are discussed below.

⁵³ Current accounts are reserves set aside by private financial institutions to meet withdrawals from customer deposits, among others. The BOJ's current accounts serve as an indicator of the amount of funds circulating in the financial markets.

⁵⁴ Bank of Japan, Monetary Policy Meetings, 19 November 2002 at http://www.boj.or.jp/en/seisaku/02/seisak_f.htm

The baseline inflation forecast is based on the following major assumptions:

- a. Real GDP growth was assumed consistent with the National Government's (NG) targets of 4.0-4.5 percent for 2002, 4.2-5.2 percent for 2003 and 4.9-5.8 percent for 2004;
- b. Growth of monetary aggregates was assumed consistent with the revised monetary program set internally as of June 2002;
- c. The NG deficit was assumed to be equivalent to 5.6 percent, 4.7 percent, and 4.2 percent of 2002, 2003, and 2004 GDP, respectively;
- d. The overnight RRP rate was assumed constant at 7.0 percent from November 2002 to December 2004;
- e. The 91-day Treasury bill rate was assumed at 8.5 percent for 2003 and 8 percent for 2004;
- f. Oil prices were assumed consistent with the DBCC's assumption of US\$26.50/bbl for 2003 and US\$22.65/bbl for 2004;
- g. Increase in the daily minimum wage rate (measured by the non-agricultural wage rate for NCR) of ₱30.00 was assumed in February 2003 and 2004, since the previous nominal adjustment was in February 2002 and the National Wage Productivity Council (NWPC) guidelines specify that minimum wage adjustments may only be done at least once every 12 months; and
- h. Mild El Niño phenomenon was assumed in 2003.

Risks to the Inflation Outlook

The baseline scenario exhibits a generally rising trend for inflation in 2003, while remaining consistent with the 4.5-5.5 percent target for the year. The upward trend reflects the BSP's judgment of possible upside risks to the inflation outlook arising from several factors. These risks include the potential inflationary impact of any underperformance in the fiscal sector, the expected impact on food prices of the El Niño weather phenomenon, the uptrend in world oil prices, as well as the anticipated hikes in the costs of water and electricity.

Possible Inflationary Impact of Financing the Budget Deficit

The overshooting of the 2002 target deficit is not expected to pose immediate problems for government finances since, as fiscal authorities have maintained, the NG had earlier prefunded its financing requirements for 2002. However, a large overshoot for 2002 also means that the NG will enter 2003 with less funds to deal with its financing requirements. The resulting tightness in government finances could force fiscal authorities to withdraw from the NG's deposits with the BSP and/or increase their borrowing next year. The withdrawal of NG deposits with the BSP implies an infusion of additional liquidity into an already-liquid financial system, which in principle could lead to demand-related inflationary pressures.

In most countries, a large public sector deficit typically creates pressure on monetary authorities to accommodate the fiscal imbalance through monetization. Such a situation leads to excessive money growth, which adversely affects the central bank's price stability objective. In the Philippines, however, the New Central Bank Act (Republic Act No. 7653) sets out very clearly the limits on the amount of assistance that may be extended by the BSP to the National Government (NG). In particular, Section 89 of RA No. 7653 states that the BSP "may make direct provisional advances with or without interest to the National Government to finance expenditures authorized in its annual appropriation: Provided, That said advances shall be repaid before the end of three (3) months extendible by another three (3) months as the Monetary Board may allow following the date the National Government received such provisional advances and shall not, in their aggregate, exceed twenty percent (20%) of the average annual income of the borrower for the last three (3) preceding fiscal years." These limits thus set a cap on the extent and duration of provisional advances to the NG by the BSP, thereby preventing fiscal underperformance from compromising the inflation target.

Nevertheless, a growing budget deficit may have cost-side implications for consumer prices. A higher fiscal deficit tends to put pressure on market interest rates through increased government domestic borrowing, which would, in turn, raise the cost of capital. The higher cost of capital then becomes a potential source of cost-push inflationary pressures, which will have an impact on current inflation as well as on the inflation outlook.

In addition, a weaker fiscal position could also increase the risk premium on the country's sovereign borrowings. This, in turn, could reduce the inflow of

foreign funds into the country. A sharp reversal in foreign fund inflows could lead to pressure in the foreign exchange market, thereby raising inflation expectations. For these reasons, the fiscal outlook poses upward risks to inflation and inflation expectations over the policy horizon. However, the BSP's baseline inflation scenario for 2003 indicates that the 4.5-5.5 percent inflation target for 2003 remains achievable given an NG deficit level of ₱223 billion for 2002 and ₱202 billion for 2003.

Possible Impact of the El Niño Weather Phenomenon

The El Niño weather phenomenon has already affected rice and corn production in 2002, particularly in the third quarter, through reductions in the area planted and from a delay in the planting season. Most forecasters suggest that the rainfall deficiency will continue to prevail over the next two to three months, but they also think that the El Niño disturbance this year will be substantially weaker than the 1997-1998 episode. A slight decline in output is thus anticipated in the first quarter of 2003. However, pre-emptive measures are being implemented by the government in order to assure adequate supply and stable food prices in 2003. These include the QTA planting scheme and timely rice importation program by the National Food Authority. These efforts are likely to mitigate any upward pressure on prices for the coming year.

Uncertainty in the Stability of World Oil Prices

The prospect of war in the Middle East has fueled upward pressures on international oil prices in December following a downtrend in the previous month. For example, the price of Dubai crude in the international market rose by 9.1 percent to average US\$25.44 per barrel for the period 2-26 December 2002 from US\$23.31 per barrel in November. The uptick in December was also attributed to a seasonal increase in demand for heating oil during the winter season in the Northern hemisphere along with the nationwide strike in Venezuela which stalled its oil exports.

Data from the futures market indicate higher expected prices in early 2003. For example, the price of January 2003 deliveries for benchmark Brent crude oil settled at US\$28.63 per barrel as of 16 December from US\$23.37 per

barrel quoted a month earlier.⁵⁵ The direction of oil prices in the near term would be dictated by the risk premium associated with the stability of world oil supply in the face of a likely US-led military campaign against Iraq, interacting with moderate demand due to the expected sluggish activity of the US economy and other major economies as well as the possibility of increased non-OPEC oil production as OPEC competitors respond to rising market prices.⁵⁶

Anticipated Hikes in Water and Electricity Rates

Higher utility costs in the near term in the light of planned and proposed rate adjustments by utility companies. Water rates in Metro Manila, for example, are scheduled to rise in early 2003 with the MWSS' approval of an initial ₱4.25 per cubic meter increase in the water tariff of Manila Water Co. (MWC) beginning January 2003. A further increase of ₱2.78 per cubic meter will be spread out during the period 2004-2005. Meanwhile, MWSI is also applying with the MWSS for an adjustment of its own water rates. MWSI was earlier reported to have expressed its interest to terminate its concession agreement with the government. The process of arbitration between the MWSS and MWSI has yet to be initiated. Given the relatively small share of water to the CPI basket of 0.7 percent, the 38.5 percent average increase in water rates is estimated to result in a 0.14 percentage point rise in inflation in 2003.⁵⁷

Similar proposals for increases in power rates are already under review, although the outcome remains uncertain in light of unresolved regulatory and legal issues. The Energy Regulatory Commission (ERC) is currently studying a petition from the Manila Electric Co. (Meralco) for the unbundling of Meralco power rates, which will entail raising the cost of electric power consumption by an average of ₱1.12 per kwh.⁵⁸ The proposed new rates represent an average increase of 19.6 percent from the November 2001 average tariff of ₱5.73/kwh.⁵⁹ However, the impact of the unbundling of Meralco power rates would also need

⁵⁵ Source: Bloomberg. 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.

⁵⁶ SG *Global Economic Outlook*, First Quarter 2003, 9 December 2002

⁵⁷ The approved rate hike for MWC represents a 42.6 percent increase from its current rate while initial estimates for Maynilad showed that its current rates could rise by 34.3 percent for an average tariff increase of 38.5 percent. The estimated impact on average annual inflation is based on an analysis using the 1994 input-output (I-O) tables published by the National Statistical Coordination Board (NSCB).

⁵⁸ Source: Copy obtained by the BSP from Meralco (via facsimile transmission) of its application filed with ERC for the unbundling of rates, dated 26 December 2001

⁵⁹ Ibid.

to be weighed against those of planned power sector reforms aimed at lowering the final cost of electric power consumption, such as the SPEED and WESM.

At the same time, Meralco faces the prospect of having to reduce its rates. On 15 November 2002, the Philippine Supreme Court released a decision affirming a 1998 ruling by the Energy Regulatory Board (ERB) that Meralco was overcharging its customers and ordering it to not only reduce its power rates but also to reimburse its customers for excess charges for the period February 1994-February 1998.⁶⁰ The final impact of the Supreme Court's decision on Meralco's electricity charges remains uncertain since Meralco has filed a motion for reconsideration of the said case.⁶¹

Private Sector Analysts' Inflation Forecasts

Forecasts by analysts from various private financial and research institutions indicate that expected inflation will be generally higher in 2003 and 2004 but broadly in line with the government's targets. A poll of twelve analysts yielded an average inflation forecast for 2003 of 4.8 percent. Forecasts of higher inflation in 2003 relative to 2002 could be traced mainly to expected cost-side pressures arising from the impact of a potential increase in world oil prices as well as increases in domestic utility charges, particularly water rates. Analysts also cited election spending—which many expect to begin as early as the first quarter of 2003—as being a factor in movements of consumer prices next year. At the same time, analysts also noted certain downside influences on inflation in 2003. For example, the still relatively weak domestic demand conditions are seen to offset the effects of cost-side price pressures in 2003 on the external front. In addition, China's accession to the World Trade Organization (WTO) could have a dampening effect on imported inflation in the Philippines by providing a source of relatively cheaper imported goods into the country.

⁶⁰ The ERB originally gave Meralco the provisional authority to raise its rates by ₱0.184 per kwh in January 1994. However, after further review, the ERB ruled in 1998 that Meralco should have raised its rates by only ₱0.017 per kwh and ordered Meralco to refund the excess ₱0.167 per kwh it had collected since February 1994. The case was brought before the Court of Appeals, which set aside the ERB ruling.

⁶¹ "SC affirms ERB findings, orders Meralco to refund its customers", 15 November 2002 at <http://www.supremecourt.gov.ph> and "Meralco customers billed at rates approved by law", undated at <http://www.meralco.com.ph>.

A sample of six analysts also provided forecasts for 2004, which averaged 5.2 percent, with a range of 4.5-6.0 percent. The forecasters are of the view that the rise in election spending would have a contributory impact on inflation for 2004.

Private Analysts' Inflation Forecasts for 2003 and 2004		
Institution	2003	2004
AB Capital Securities	4.4	5.9
ABN AMRO Asia Securities *	5.8	
Cemex Corporation	5.4	6.0
Multinational Investment Bancorporation*	5.0	5.0
Nomura Research Institute	3.9	
ATR Kim Eng Securities *	4.3	
Bank of the Philippine Islands	5.5 ^{1/}	4.5
BNP Paribas	4.7	
Santander Investments	4.5	4.5
ING Securities *	4.2	
UBS Warburg Securities	5.0	5.5
United Coconut Planters' Bank	5.0	
Median Forecast	4.9	5.3
Average Forecast	4.8	5.2
High	5.8	6.0
Low	3.9	4.5
No. of observations	11	6
<i>Sources: www.PhilippineBusiness.com.ph (*) ; BSP poll</i>		
<i>1/ Midpoint of best and worst case scenarios</i>		

VI. IMPLICATIONS FOR THE MONETARY POLICY STANCE

Despite foreseeable cost-side risks, the outlook for inflation suggests generally manageable price conditions over the BSP's policy horizon, with average annual inflation moving broadly in line with the government's targets for 2003-2004. The lingering areas of weakness in overall demand conditions imply that demand-side factors are likely to continue to be a muted influence on consumer prices. At the same time, the potential upside pressures implied by supply-side or cost-push factors—notably the impact of El Niño weather on food prices in 2003 and the expected increases in power and water charges—are by their nature likely to be transient and short-lived. However, the 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 will, therefore, continue to inform prospective monetary decisions.

At the same time, the continued mixed outturn for domestic demand is accompanied by a greater risk of tepid global economic activity, which is likely to translate into muted export demand, thereby adding to existing real sector weakness, particularly in manufacturing activity. Ensuring appropriate liquidity conditions in the economy, therefore, remain central to sustained economic recovery in the near term, and prudence would suggest monetary settings that are supportive of domestic demand.

There are, in fact, indications that the monetary stimulus undertaken in previous months could already have started to have an impact on economic activity. In particular, the low-interest rate environment of the past few months has coincided with a modest decline in the NPL ratio of commercial banks along with an improvement in fixed capital spending by firms in the third quarter. This was also accompanied by the turnaround in commercial bank lending in September-October. These factors suggest a possible easing of the financial burden on the corporate sector that could translate into an improvement in credit demand. To be sure, overall loan activity remains moderate, as banks continue to derive income largely from non-lending activities, and liquidity continues to find its way mostly into government securities. Nevertheless, the improvement in bank lending could be taken as evidence that previous monetary easing actions are now beginning to filter through to the real economy, thus signaling the start of a sustained rise in credit demand.

Given the above considerations, monetary authorities believe that, with inflation contained and given the prevailing risks to global economic activity, the present policy settings are compatible with the liquidity requirements of the economy, and that due recognition of the long lags in monetary policy will provide firmer indication of the extent to which the stimulatory impact of past monetary easing has worked its way through the system.

VII. CONCLUSION

The combination of a manageable inflation outlook, uneven domestic demand conditions, and the prospect of weaker economic activity overseas highlight the need for policymakers to ensure that monetary policy settings are supportive of the liquidity requirements of a growing economy. This argument is strengthened further by evidence of the impact of previous monetary easing on private sector credit demand and capital spending, which could signal a sustained rise in bank lending and economic activity. Nevertheless, 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.

The overall assessment for future inflation and output, therefore, supports 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.