INFLATION REPORT

First Quarter 2003

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 14 April 2003.

RAFAEL B. BUENAVENTURA
Governor, Bangko Sentral ng Pilipinas

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. It is tasked 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
	Diwa C. Guinigundo Managing Director, In-Charge of Research
	Ma. Cyd N. Tuaño-Amador* Director, Department of Economic Research
	Ma. Ramona GDT Santiago Director, Treasury Department

* On two-year secondment to the International Monetary Fund (IMF) beginning on 3 March 2003.

SCHEDULE OF MEETINGS OF THE ADVISORY COMMITTEE AND THE MONETARY BOARD ON MONETARY POLICY FOR 2003			
Meeting No.	**Advisory Committee [1/]**	**Monetary Board [2/]**	**Publication of Highlights of Monetary Board Discussions [3/]**
1	14 January, Tuesday	16 January, Thursday	27 February, Thursday
2	11 February, Tuesday	13 February, Thursday	27 March, Thursday
3	11 March, Tuesday	13 March, Thursday	24 April, Thursday
4	8 April, Tuesday [a/]	10 April, Thursday	22 May, Thursday
5	6 May, Tuesday	8 May, Thursday	19 June, Thursday
6	3 June, Tuesday	5 June, Thursday	17 July, Thursday
7	1 July, Tuesday	3 July, Thursday	14 August, Thursday
8	29 July, Tuesday	31 July, Thursday	11 September, Thursday
9	26 August, Tuesday	28 August, Thursday	9 October, Thursday
10	23 September, Tuesday	25 September, Thursday	6 November, Thursday
11	21 October, Tuesday	23 October, Thursday	4 December, Thursday
12	18 November, Tuesday	20 November, Thursday	8 January 2004, Thursday [b/]
13	16 December, Tuesday	18 December, Thursday	29 January 2004, Thursday

Notes:

[1/] Held every four weeks

[2/] MB meetings are held on the Thursday after the latest Advisory Committee meeting

[3/] Six weeks after the Monetary Board meeting on the Review of the Monetary Policy Stance

[a/] 9 April 2003 is a holiday

[b/] The MB Highlights will be published on the seventh week after the 20 November 2003 MB meeting since 1 January 2004-the sixth week following the MB meeting-is a holiday.

CONTENTS

OVERVIEW

- ***Inflation remains low on subdued demand and stable food prices.*** *Headline inflation remained low in the first quarter of 2003, mainly on account of continued subdued demand conditions and stable food prices. These factors provided a counterbalance to price pressures caused by movements in oil prices and utility charges. Core inflation was also lower relative to the fourth quarter and a year earlier, suggesting that current demand conditions continue to support benign inflation.*

- ***Economic activity remains buoyant, but has room to expand.*** *Economic activity continued to be buoyant, with demand fueled by consumer spending. Nevertheless, there appears to be enough room for expansion in demand without the buildup of inflationary pressures. Labor market conditions remain soft, and manufacturing capacity utilization continues to be below normal levels.*

- ***Interest rates trended up, but liquidity remains ample.*** *Market interest rates were slightly higher during the quarter. The benchmark 91-day Treasury bill rate rose from 5.2 percent in January to 6.4 percent in March due to market concerns over the economic impact of the US-led war against Iraq, the slowdown in global demand, and rising international oil prices. Nevertheless, liquidity in the financial system remained more than ample, with most of the funds finding their way into government securities.*

- ***Bank lending continues to improve.*** *Commercial bank lending continued to strengthen in the first two months of 2003, posting a 4.4 percent rise compared to 1.6 percent in the fourth quarter. The improvement was accompanied by increased loans to the manufacturing sector.*

- ***Peso weakens against US dollar in January, but recovers in March.*** *The peso weakened in nominal terms against the US dollar in the first two months of 2003 due to external and domestic factors but recovered in the last two weeks of March immediately following the outbreak of US-Iraq hostilities. The peso's recovery was also helped by BSP measures to address market volatility and curb speculative demand for dollars.*

- ***Monetary policy remains cautious.*** *The stance of monetary policy remained cautious in the first quarter, with BSP policy interest rates left unchanged. However, the BSP took some steps to reduce the amount of excess liquidity in the financial system that may be finding its way into speculative activity against the peso.*

- ***Outlook for inflation remains benign.*** *Future inflation is expected to remain benign, given the absence of demand-side risks to prices and the short-lived nature of potential supply-side pressures. Average headline inflation in 2003-2004 is expected to broadly track the government's targets.*

- ***Monetary policy will continue to support growth but guard against any inflationary buildup.*** *The BSP believes that the principal risk to the domestic macroeconomic environment at present relates not to rising consumer prices but to the moderate (although improving) pace of domestic activity. The stance of monetary policy will continue to focus on providing a supportive environment that ensures sufficient liquidity to fuel the economy's growth requirements. At the same time, monetary policy will remain cautious to guard against any potential build-up of price pressures that could dampen the growth momentum.*

I. RECENT DEVELOPMENTS IN INFLATION AND ECONOMIC CONDITIONS

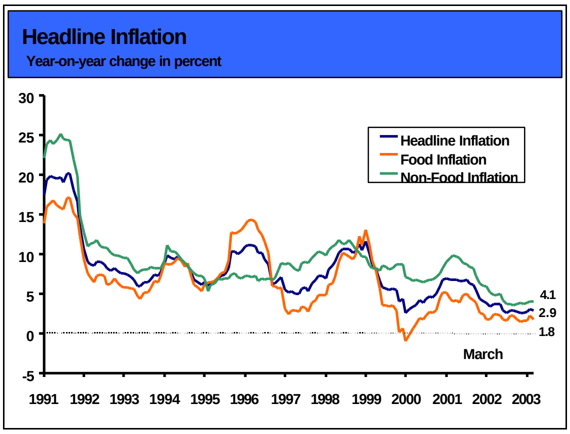
Price and Cost Developments

The inflation environment remained generally benign in the first quarter of 2003, mainly on account of continued subdued demand conditions. Current movements in consumer prices appear to be still driven primarily by supply- or cost-side factors. Headline inflation rose slightly from an average of 2.6 percent in the fourth quarter to 2.9 percent in the first quarter of 2003 due to short-term movements in food and gas prices as well as cost-related increases in government-regulated utility charges. Nevertheless, prices for major food items, notably rice, corn and meat products, have remained generally stable on account of the favorable performance of livestock and agricultural crop production in 2002. Meanwhile, BSP estimates of core inflation, which take out the effects of temporary disturbances on headline CPI by excluding food and fuel components, continued to show a benign trend, posting a decline relative to levels recorded during the fourth quarter and a year ago. This suggests that present aggregate demand conditions remain consistent with a benign inflation setting, and current price trends continue to support the BSP's expectations of a generally subdued inflation environment going forward.

Headline and Core Inflation

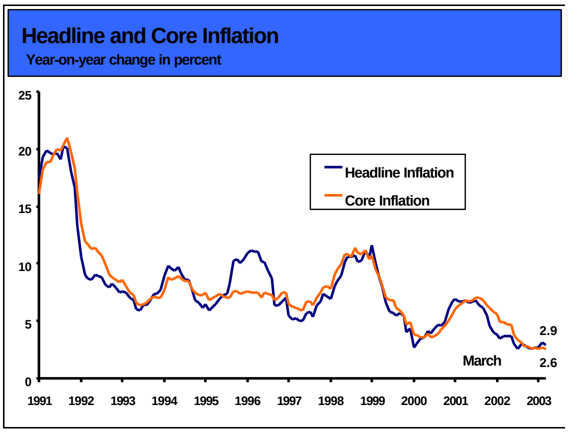
Headline inflation rose slightly to an average of 2.9 percent year-on-year in the first quarter of 2003 from 2.6 percent in the fourth quarter, mainly on account of price movements in selected food and energy-related items. Higher inflation rates were recorded during the period for food items such as fruits and vegetables, dairy products, and fish. Meanwhile, increases in petroleum prices fed directly into inflation rates for energy-related items such as fuel (for household cooking) and light as well as transportation services (which include gas and diesel).

Nevertheless, lower inflation rates were observed for major food items such as rice and other commodity groups such as clothing, housing and repairs, and miscellaneous items. Month-on-month inflation also registered a slowdown throughout the quarter, from 0.5 percent in January to 0.1 percent in March. This was due primarily to a decline in the prices of major food items such as rice, fish, fruits and vegetables, and chicken, which cushioned the impact on the CPI of the upward adjustments in electricity rates and prices for household cooking fuels such as liquefied petroleum gas (LPG) and kerosene.



Meanwhile, BSP estimates of core inflation, which strip out the effects of temporary disturbances on headline CPI by excluding food and fuel components, continued to show a benign trend, posting a decline relative to the fourth quarter and a year earlier.[1] The BSP's main definition of core inflation (CPI less unprocessed food and energy items) averaged at 2.6 percent in the first quarter, lower than the 2.7 percent average in the previous quarter and 5.1 percent for the same period a year earlier. Meanwhile, the trimmed mean, weighted median, and net of volatile items measures averaged at 3.2 percent, 2.5 percent, and 1.8 percent, respectively, during the period.

[1] A description of the BSP's 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.



On the whole, movements in overall inflation remain linked to specific CPI components such as food and fuel rather than to broad price changes across commodity groups. Current price pressures remain comparatively mild and are driven mainly by supply-side factors that are not expected to be persistent. Moreover, present aggregate demand conditions, which are discussed below, remain consistent with a benign inflation setting, and current price trends continue to support the BSP's expectations of a generally subdued inflation environment going forward. At the same time, the BSP recognizes that there are potential risks to inflation in the months ahead, primarily in the form of cost-push pressures from factors such as higher farm prices due to the El Niño weather phenomenon and further oil prices increases due to the war in the Middle East. These risks are discussed below in the section on the inflation outlook (see page 43).

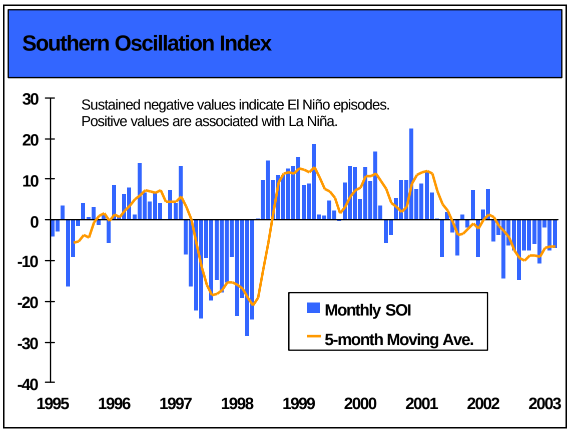
Food Prices and Weather Conditions

Food inflation was slightly higher in the first two months of 2003 compared to the fourth quarter of 2002 but remained relatively subdued at around 2 percent. The slight increase during the period was attributed to movements in prices for fruits, vegetables, dairy products, and fish. These movements are likely to be of relatively short duration, since overall food supply conditions are expected to remain normal as a result of the favorable performance of the livestock and crop production sectors in 2002. Indeed, agricultural crop prices appear to remain generally stable. The inflation rate for rice, for example, fell from 3.6 percent in the fourth quarter to 3.1 percent in January-February, while that for corn remained steady at 3.6 percent. Both items together account for about 13 percent of the entire CPI basket.

The subdued price trends for major crops such as rice and corn suggest positive food supply conditions despite the dry weather from the El Niño phenomenon. In particular, the recovery of *palay* (rice) production in the fourth quarter of 2002 should help temper any tightness in supply in the coming months of warm weather and thereby help keep stable rice prices during the year.

In addition, the observed weakening El Niño weather phenomenon and the measures of the government to avert possible supply problems of basic commodities in response to the ongoing war in Iraq are expected to keep a lid on prices of agricultural products while the production outlook remains positive.

The dry weather conditions associated with the El Niño phenomenon have shown signs of abating as temperatures over the tropical Pacific registered a sharp decline and trade winds were generally near-average in January 2003. The Australian Bureau of Meteorology notes that the present El Niño episode is "very close to being over", and observes that most computer predictions continue to indicate neutral or normal temperature conditions in the Pacific by the middle of the year.[2] Recorded values in recent months of the Southern Oscillation Index (SOI), a measure commonly used by meteorologists as an indicator of El Niño activity in the Pacific, suggest a gradual reversion to zero, which is associated with normal ocean temperatures.[3]



[2] Australian Bureau of Meteorology, *El Niño Wrap-Up*, Current Status as of 8th April 2003, available online at http://www.bom.gov.au/climate/enso/.

[3] The SOI is an indicator of monthly fluctuations in the air pressure difference between the Central Pacific and Indian oceans. Sustained negative values of the SOI often indicate episodes of the El Niño weather phenomenon in the tropical Pacific region.

Nevertheless, the analysis of seasonal rainfall between October 2002 and February 2003 revealed that around two-thirds of the country received below-normal rainfall, and this may have some impact on farm output.

However, despite an anticipated drop in rice production in the second semester due to farmers' expectations of the lingering effect of the El Niño, agricultural production is expected to grow by 3.0-4.0 percent in 2003. The warm episode from the El Niño phenomenon is expected to last until the early part of the second quarter of 2003 leaning towards a neutral condition.[4] As such, standing *palay* crops are expected to yield 3.2 million metric tons (MT) of rice for January to March 2003—about 4.9 percent higher than a year ago—due to the favorable weather in the last quarter of 2002 and measures implemented by the government, including cloud seeding, the provision of irrigation facilities, and the planting of early-maturing crops that require less water and are more resistant to drought. A positive first-quarter growth of 21.4 percent for corn production (2.1 million MT) is likewise expected due to the expansion in area planted and increase in yield with the use of higher-yielding varieties. For the second quarter of 2003, the expected harvests based on farmers' planting intentions may decline by 8.6 percent for *palay* (2.4 million MT) and 9.3 percent for corn (749,000 MT).

On the other hand, the livestock sector and the other agricultural crop subsectors are expected to sustain the favorable production figures recorded in 2002.[5] Sugarcane production, for example, is projected to rise by 2.5 percent to 1.95 million MT in 2003 from 1.89 million MT in 2002 through the use of higher-yielding varieties.[6]

Authorities also continue to work to mitigate the potential impact of El Niño on agricultural production. The Department of Agriculture (DA), for example, has allocated some ₱700 million for the following activities: (1) providing irrigation facilities and cloud seeding; (2) shifting of planting calendars or early planting; (3) planting of early maturing crops requiring less water and/or more tolerant to drought; (4) providing livelihood assistance to compensate for loss of income from farm and fishery; and (5) emergency food assistance. Moreover, 27 irrigation projects amounting to ₱7.01 billion are expected to be funded in 2003. Quedan and Rural Credit Guarantee Corporation (Quedancor) is

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[4] Source: PAGASA El Nino Advisory No. 05, 28 February 2003
[5] Source: Bureau of Agricultural Statistics, Selected Tables on Crop Forecasts, 6 November 2002
[6] Source: Department of Agriculture

also expecting a ₱1.0 billion lending capital from the Agricultural Competitiveness Enhancement Fund (ACEF) to fund production loans of farmers and fisher folks.

The government's rice importation program can also help cushion the adverse impact of the El Niño phenomenon on domestic supply. Total rice import requirement under the new system of importation for 2003 is estimated at 800 thousand MT, half of which was bid out last 12 March 2003.[7] The remaining 400 thousand MT will be imported by local farmers under the Farmers as Importers Program of the National Food Authority (NFA). As of 27 March 2003, the total rice imports reached 59,122 MT. Meanwhile, the national rice inventory of 2.03 million MT as of 26 March 2003 is sufficient to last for 77 days.[8] Of this stock, the share of the NFA amounting to 704.7 thousand MT (about 35 percent) is sufficient to last for 27 days. Meanwhile, the stock of corn at 222.7 thousand MT is estimated to last for 15 days as of 26 March 2003.[9]

To address food security issues related to the ongoing war in Iraq, the NFA intensified its procurement and milling of *palay* to ensure the availability of high quality rice for emergency and stabilization purposes and to augment the rice stocks in high consumption areas such as Manila, Cebu and Davao. Some ₱2.6 billion has been released for rice procurement as of 14 March 2003 from a total of ₱7.0 billion earmarked this year. Other contingency measures of the NFA include the following: activate a 24-hour operation and complaints centers, authorize its regional directors to react quickly to the changing situation, take security measures to ensure the safety of rice stocks, and regularly submit demand and supply conditions for rice to the President.

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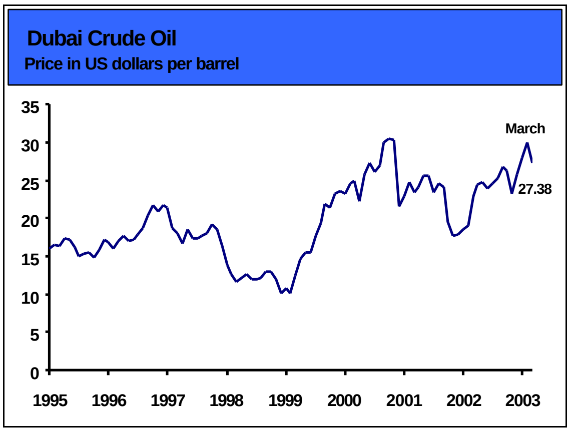
[7] This is being implemented by the NFA under the letter circular dated December 10, 2002, which amended the NFA Council Resolution No. 14-2K2 dated October 2002. Under the new circular, all rice importations other than NFA's shall be covered by letters of credit (LCs) to be opened initially only with the Land Bank of the Philippines (LBP).

[8] The national rice inventory consists of NFA palay and rice stocks as well as commercial and household inventories. Rice self sufficiency is estimated based on the daily consumption of 26.4 thousand MT of rice. (Source: NFA)

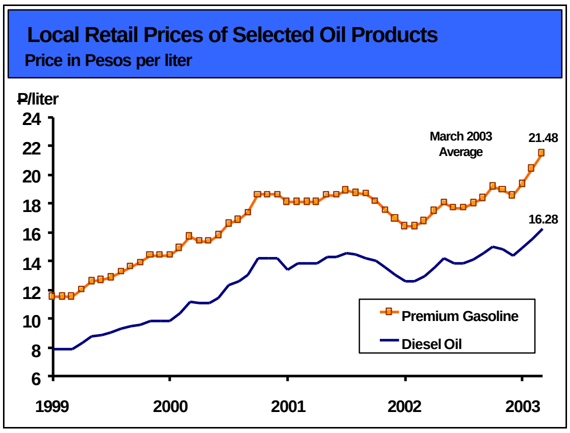
[9] The stock of corn is estimated based on the 14.6 thousand MT daily requirement of the corn industry but excludes those held by commercial livestock and poultry producers, corn processors, and corn mixed feeds. (Source: NFA)

Energy Prices and Utility Charges

After slowing down in the fourth quarter, international oil prices trended upward during the first quarter of 2003 in the runup to the US-led attack on Iraq. However, prices quickly began to soften in March shortly after the fighting commenced in the Middle East. The uncertainty surrounding the prospect of a US-led military offensive in Iraq drove up the average price of Dubai crude oil in the international market from US$25.73 per barrel in December 2002 to around $30 per barrel in February. Prices were also partly pushed up by worries over the political crisis in Venezuela, the fifth largest oil exporting country in the world. In March, however, Dubai crude oil prices began to soften as tension and uncertainty were eliminated by the start of the US-led coalition attack on Iraq. The international crude oil market responded positively to the coalition attack, with the expectation that the fighting will be short-lived. This response is largely similar to the experience during the Gulf conflict in 1991 when crude oil prices fell from their peak shortly after the US launched its attack on Iraq and liberated Kuwait in a span of less than three months. The price of Dubai crude settled back down to US$24.77 per barrel by end-March 2003, with an average of US$27.38 per barrel for the month.



The resulting rise in the cost of crude oil imports prompted local oil companies and dealers to raise their own pump prices for petroleum products a number of times during the quarter. Between January and the first week of March, the prices of gasoline products rose by a cumulative ₱2.23 per liter, while those of other fuel products rose by ₱1.34-₱1.51 per liter and that for liquefied petroleum gas (LPG) by ₱1.51 per liter. Nevertheless, the subsequent softening of international prices has enabled local companies to begin reducing their retail prices, beginning with diesel oil which had a 40-centavo per liter price reduction in late March. However, prices for other gasoline products have remained unchanged as local oil companies continued to build up their inventories in compliance with the government's directive to ensure adequate stocks during the US war against Iraq. Sizeable present inventories of crude oil bought at higher prices have also thus far prevented the recent decline in international prices from feeding through to domestic pump prices.



Meanwhile, government regulatory agencies approved increases in charges for both power and water services during the first quarter. The adjustments were partly in response to the higher costs faced by utility companies. In January, the Department of Energy (DOE) approved a ₱0.13 per kilowatt hour (kwh) increase in the purchased power adjustment (PPA) component of the monthly electricity charges for customers of the Manila Electric Co. (Meralco) to ₱2.74 per kwh. The increase in Meralco's PPA charges was due to the higher selling rates of power producers and the reduced consumption of electricity during the colder month of December.[10] The PPA had been on an uptrend during the period October 2002-January 2003. In March, the Energy Regulatory Commission (ERC) also approved Meralco's petition to unbundle its power rates, resulting in an overall average tariff increase of ₱0.054 per kwh from the utility firm's February 2003 effective selling rate of ₱5.404 per kwh. In its rate unbundling application, Meralco originally sought a ₱1.12 per kwh increase over

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

the November 2001 average tariff of ₱5.7345 per kwh.[11] With the unbundling of its rates, Meralco was also allowed to adopt the new cost-recovery mechanisms approved by the ERC in February to replace the purchased power adjustment (PPA) and currency exchange rate adjustment (CERA) schemes currently in place. The generation rate adjustment mechanism (GRAM) and the incremental currency exchange adjustment (ICERA) prevent automatic rate adjustments by distribution utilities and requires them instead to seek ERC approval before introducing rate adjustments to recover costs. The new cost-recovery mechanisms also allow power companies to adjust rates on a quarterly rather than on a monthly basis.

Meanwhile, the Manila Water Company (MWC) raised its tariff rate by ₱4.25 per cubic meter for Manila's east zone in January 2003 upon the approval of the regulatory agency Manila Waterworks and Sewerage System (MWSS).[12] This brought the average weighted all-in water tariff of MWC to ₱14.22 per cubic meter of water from its current rate of ₱9.97 per cubic meter. Further rate adjustments may be implemented in 2004-2005 since MWSS' initial estimates for MWC's rate adjustment showed that the rates could be raised by as much as ₱7.03 per cubic meter.[13] The MWSS likewise approved a ₱5.35 per cubic meter increase in the weighted average all-in water tariff of Maynilad Water Services, Inc. (MWSI), which services the rest of Metro Manila.[14] This should bring the weighted average all-in water tariff of MWSI to ₱29.79 per cubic meter of water from the current rate of ₱24.44 per cubic meter. However, MWSI has not yet implemented the MWSS-approved rates as it is experiencing financial problems and has tendered a notice of early termination of its concession agreement with the government. The matter remains under review.

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[11] "Decision on Application for approval of revision of rates schedules and appraisal of properties with provisional authority", ERC Case No. 2001-646 and ERC Case No. 2001-900, 20 March 2003, available online at http://www.erc.gov.ph

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

[13] Source: Manila Water Company

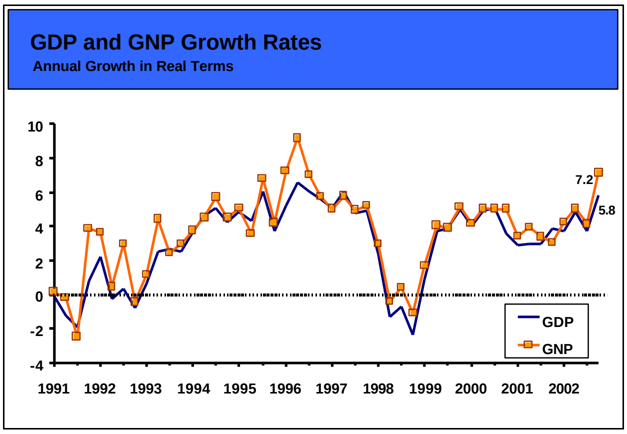
[14] MWSI services Metro Manila's west zone which covers Valenzuela, Bulacan, Malabon, Navotas, parts of Quezon City and Makati City, Manila City, Pasay City, Las Piñas, Parañaque City, Muntinlupa City and areas in Cavite.

Aggregate Demand and Supply

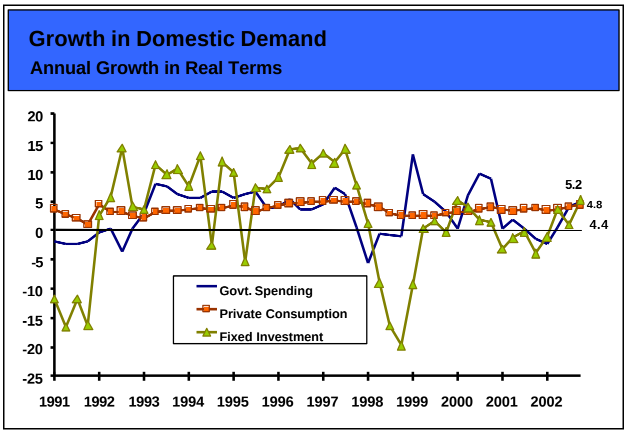
Economic activity continued to be buoyant, as evidenced by latest available data for the fourth quarter of 2002. Real Gross Domestic Product (GDP) rose by 5.8 percent year-on-year in the fourth quarter of 2002, an acceleration from the 3.9 percent growth registered in the same period a year earlier. This brought the full-year GDP growth to 4.6 percent in 2002, exceeding 4.0–4.5 percent growth target for the period. Aggregate demand continued to be fueled largely by private consumption spending, which benefited in part from the strong rise in earnings sent home by overseas Filipino workers (OFWs). Net factor inflows from abroad rose significantly by 31.3 percent year-on-year in the fourth quarter of 2002, a turnaround from the 9.5 percent decline in the same period in the previous year. This helped propel growth in real Gross National Product (GNP) to a record high of 7.2 percent year-on-year during the quarter, bringing full-year growth to 5.2 percent.

Aggregate Demand

GDP growth in the fourth quarter was driven largely by consumer spending. Personal consumption expenditures (PCE) rose by 4.4 percent during the period from 3.8 percent in the same quarter in 2001. This marked the first time since the second quarter of 1998 that PCE growth exceeded 4 percent. Supported by the low inflation and interest rate environment, expenditures on food, transportation and communication, and miscellaneous services underpinned the surge in PCE growth. Government consumption rose by 4.8 percent in the fourth quarter of 2002, a reversal from the 1.5 percent decline posted during the same period a year ago due to increased spending on personnel services following the lifting of Administrative Order No. 5 which provided for the freeze-hiring of government personnel and the grant of additional Christmas bonus to government employees.



The low-interest rate environment has also helped boost construction spending. Private construction for housing and business establishments surged by 11.8 percent during the fourth quarter. This in turn helped fuel the recovery in overall investment spending, which registered an 11.3 percent year-on-year rise in the fourth quarter, a reversal of the 1.5 percent contraction posted a year ago.



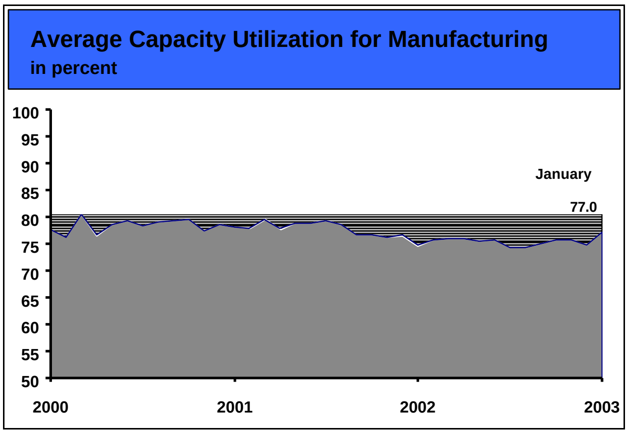
Domestic Demand Indicators

Indicators of economic activity continue to show encouraging signs of a pickup in demand, but the overall trend remains mixed, and the general strength of aggregate demand remains for the most part moderate.

- The volume of passenger car sales surged by 14.6 percent month-on-month in January 2003. However, this was partly due to car buyers' desire to avoid the anticipated increase excise tax on Asian Utility Vehicle (AUV)-type of passenger vehicles.

- At the same time, capacity utilization in the manufacturing sector remains below normal levels at 77 percent in January 2003.

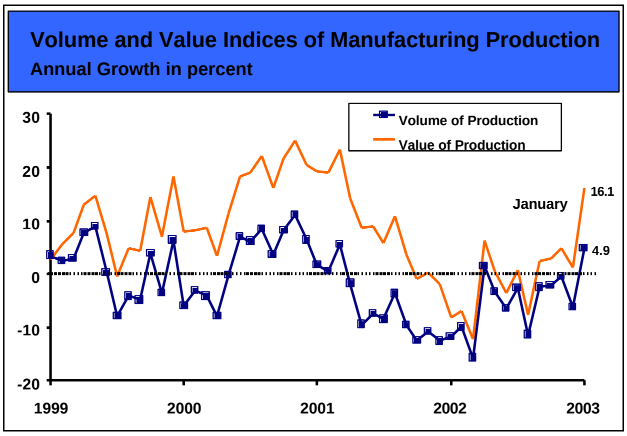
- This coincides with the cautious business sentiment indicated by the results of the Business Expectations Survey (BES) conducted by the BSP for the first quarter of 2003, which showed that overall business outlook diffusion index fell to -3.0 percent during the quarter compared to 16.2 percent for the fourth quarter of 2002. However, business prospects for the second quarter of 2003 may yet improve as the overall business outlook index increased to 17.5 percent from 6.3 percent in the first quarter of 2003.

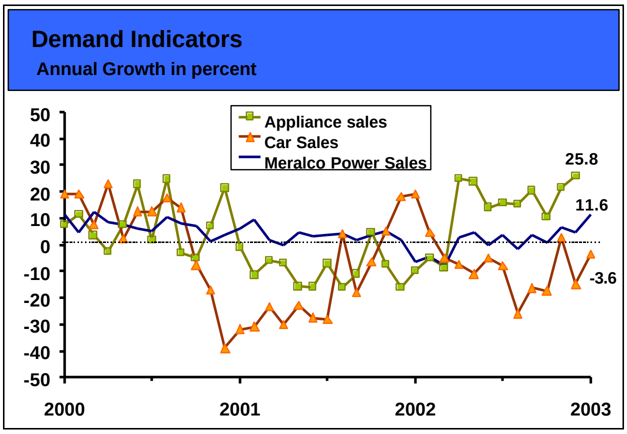


On the other hand, signs of improvement in demand continue to be observed:

- Manufacturing output recorded a strong upsurge in January after a sluggish performance for most of 2002. The volume of production index (VOPI) for the manufacturing sector rose by 4.9 year-on-year in January 2003 following a 6.1 decline in the previous month. Similarly, the value of production index (VAPI) likewise expanded by 16.1 percent year-on-year in January, the highest recorded growth in almost two years since April 2001.

- Meanwhile, growth in power consumption rose by 16.3 percent year-on-year in January 2003 compared to 5.9 percent in December 2002.



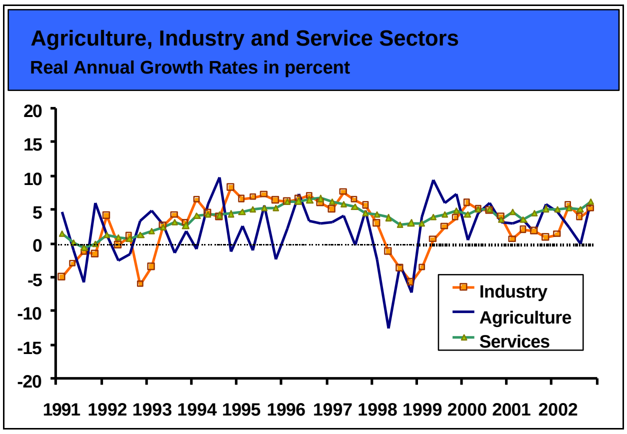


External Demand

Demand for Philippine goods overseas continued to show signs of improvement in recent months but remained moderate as a result of the overall economic weakness in the country's trading partners. Dollar earnings from exports of Philippine goods rose by about 10 percent in the fourth quarter of 2002, fueled by increased shipments of semiconductors and electronic microcircuits as a result of the rebound in the electronics sector along with the recovery in exports of garments, another major Philippine export. The improved performance of the garment export sector in recent months was a result of the Government's strategy to target high-end markets and to shift reliance from traditional quota-driven markets such as the US to non-quota markets such as Japan, United Arab Emirates, Hong Kong, and Mexico in preparation for the impending quota phase-out in 2004. Data for January 2003 showed a 2.3 percent rise in merchandise exports, with electronic components posting a growth of 4.7 percent and garments exports growing by 6.1 percent.

Aggregate Supply

On the production side, the continued strength of services and agriculture as well as the sustained recovery of industry fueled the growth of the Philippine economy during the last quarter of 2002. Services—which accounts for more than 40 percent of total GDP—continued to be the main driver of economic growth during the quarter. The services sector expanded by 6.1 percent—the highest growth rate of the sector since the first quarter of 1999—from 5.1 percent during the same period last year. Except for the transportation, communication and storage subsector, whose growth rate decelerated to 8.7 percent during the fourth quarter of 2002 from 10.3 percent during the same period in 2001, all subsectors exceeded their year-ago performance. In particular, the trade subsector rose by 6.2 percent during the fourth quarter of 2002 from 6.0 percent during the same period of the previous year amid increased retail outlets as giant local retailers opened new malls in regions outside Metro Manila, improved agricultural output and higher merchandise imports.

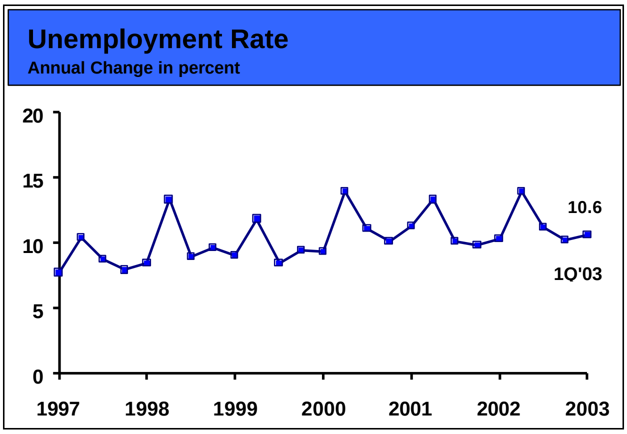


Next to the services sector, the industry sector contributed 1.7 percentage points to overall GDP growth during the fourth quarter as it increased by 5.1 percent from a marginal expansion of 0.9 percent a year ago. Industry sustained its recovery amid the substantial gains posted by mining and quarrying due to the ramped up production of Malampaya Gas and to the continued growth of the manufacturing sector due partly to tariff reduction on inputs in December, recovery of exports and the surge in imports on consignment. The construction subsector also exhibited a rebound from a 1.7 percent decline in the fourth quarter of 2001 to a 0.3 percent rise during the same period in 2002 as private construction for housing and trade establishments such as malls, rose significantly.

Meanwhile, agriculture, fishery and forestry (AFF) sector, which contributed 1.3 percentage points to GDP growth, grew by 6.1 percent in the fourth quarter of 2002 from 5.9 percent a year ago. With the recovery of palay, the agriculture and fishery subsector recovered from the 0.1 percent contraction in the third quarter of 2002. The timely implementation of the Quick Turnaround (QTA) planting scheme by the government coupled with favorable weather conditions and expansion in irrigated areas, provided the boost in palay production. Part of the *Ginintuang Masaganang Ani* (GMA) Rice Program of the Department of Agriculture (DA), the QTA aimed to compensate for the possible loss in rice output brought about by drought and flooding that accompany the El Niño phenomenon. Under the scheme, irrigated rice areas which had been harvested in August or early September 2002 were immediately replanted with early maturing rice varieties and certified seeds within two or three weeks to make up for the delays in planting during the second quarter. Farmer participants to the program could also avail of fertilizer on credit under the Quedan and Rural Credit Guarantee Corporation (Quedancor).

Labor Market Conditions

Labor market conditions remained soft in the first quarter as the overall jobless rate increased. Based on the results of the January 2003 Labor Force Survey of the National Statistics Office (NSO), unemployment rose slightly to 10.6 percent of the labor force in January 2003 to 3.6 million from 10.2 percent or 3.4 million in October 2002. The unemployment rate in the first quarter of 2003 is also slightly higher than the 10.3 percent recorded in the first quarter of last year.



As a ratio to the total labor force, the number of employed workers declined slightly by 0.3 percentage point to 89.4 percent in the first quarter of 2003 from 89.7 percent in the same period a year ago and 89.8 percent in the previous quarter. In terms of number , however, the number of employed workers rose by 1.4 percent to 30.1 million in the first quarter compared to the year-ago level. The increase in total employment was due largely to increased employment in the services and agriculture sectors, notably in the agriculture, hunting and forestry subsector and the trade and transport subsectors of the service sector. Increased employment in these sectors offset the decline in jobs in the industry sector, with the exception of its construction subsector. Employment in the services sector was recorded at 14.4 million in January 2003, up by 2.2 percent from the year-ago level and by 1.0 percent over the quarter ago level.

The increased employment in services can be attributed largely to the number of own-account workers. Meanwhile, employment in the industry sector declined by 1.0 percent, with the gains seen in construction partially compensating for declines in the other subsectors, particularly in manufacturing.

The softness in job market conditions has limited the actions of labor groups to make 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.[15] 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 25 March 2003, 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.

Fiscal Developments

The National Government's fiscal performance remained well on track as both the fiscal deficit for the period and the cumulative deficit in the first two months of 2003 were lower than the levels posted in the same period a year ago. This helped improve expectations of on-target fiscal performance for the entire year, a key influence on the expectation of low inflation and positive outlook for growth.

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[15] 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.

For the month of February 2003, the budget deficit of the National Government (NG) was well on track at ₽17.6 billion, lower by 16.1 percent than the ₽21.0 billion budget gap recorded in the same month a year ago. This brought the January-February 2003 cumulative deficit to ₽31.5 billion, lower than the P35.9 billion level posted last year. The enforcement of revenue reform measures and prudent expenditure management policies during the month continued to keep the fiscal deficit within target. The revenue enhancement measures in the BIR and the on-going reforms at the Bureau of Customs continued to keep revenues on track while a tight reign on budgetary allotments is being implemented as the government operates on the basis of the re-enacted 2002 budget.

National Government Fiscal Position (In Billion Pesos)			
	January-February		
	2002	**2003**	**% Chg**
Surplus/(Deficit)	-35.9	-31.5	-12.3
Revenues	85.2	91.5	7.4
Expenditures	121.1	123.0	1.6
Borrowings	51.6	30.7	-40.5
Source : Bureau of Treasury (BTr)			

Total revenue collections in February reached ₽40.6 billion, 7.1 percent higher compared to the ₽37.9 billion collections registered in the same period in 2002. The revenue collections of the Bureau of Internal Revenue (BIR) increased by 9.0 percent to ₽27.1 billion from ₽24.9 billion a year ago reflecting the notable growth of collections from taxes on income and profits, value-added tax, other percentage taxes and other taxes. Similarly, the Bureau of Customs (BOC) collected ₽8.1 billion in February, exceeding by 18.6 percent the collections recorded in the same period last year. The Bureau of Treasury collected ₽2.6 billion, 46.1 percent higher than receipts in the same month a year ago, while revenues from other offices declined to ₽2.8 billion when compared with the previous year.

Government expenditures during the month amounted to ₽58.2 billion, 1.2 percent lower than the ₽58.9 billion level of expenditures recorded a year earlier, despite a noted expansion in interest payments (27.1 percent) and maintenance expenditures (38.2 percent). The NG contained the growth of disbursements through the strict monitoring of spending levels to avoid overruns seen early last year on account of frontloading of activities.

Net borrowings for the month increased by 66.5 percent as the NG decided to front load its external commercial borrowings ahead of the increased risk aversion in the financial markets on account of the US-Iraq war jitters. However, net borrowings of the NG for the first two months continue to be lower by 41.1 percent compared to the same period last year providing the elbow room needed to contain the upward movement in domestic interest rates given the prevailing low inflation environment.

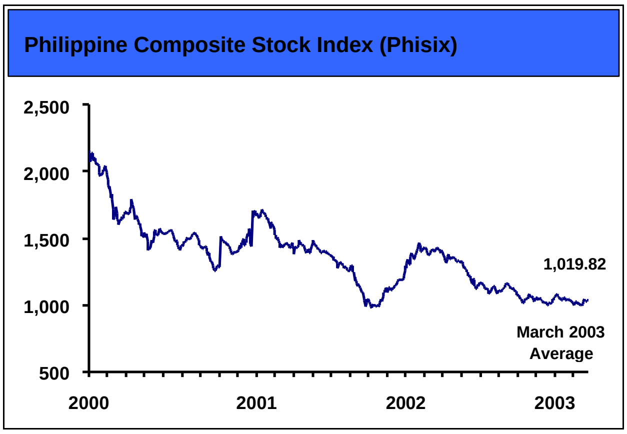
The favorable fiscal position in January-February period could support expectations of on-target fiscal performance in 2003. If sustained, this will provide a positive influence on expectations of future inflation as well as on the outlook for output growth.

Financial Market Conditions

Trading in the first quarter of 2003 was generally laced with caution as the local bourse was hounded by a string of negative developments. The domestic stock market was greeted by some early gains in January 2003 but the market was unable to consolidate these gains in February and March. Meanwhile, regular T-bill auctions by the Bureau of Treasury (BTr) were characterized with oversubcriptions. The BTr, however, rejected overly high bids.

Stock Market

The local bourse posted some modest gains in January 2003. The average PHISIX advanced by 8.7 index points to 1,046.7 in January 2003 from the 1,038 average PHISIX posted in the fourth quarter of 2002. The market's ascent in the first month of the year can be attributed to encouraging news such as the signing into law of the Special Purpose Asset Vehicle Act (SPV) as well as the better-than-expected GDP growth.

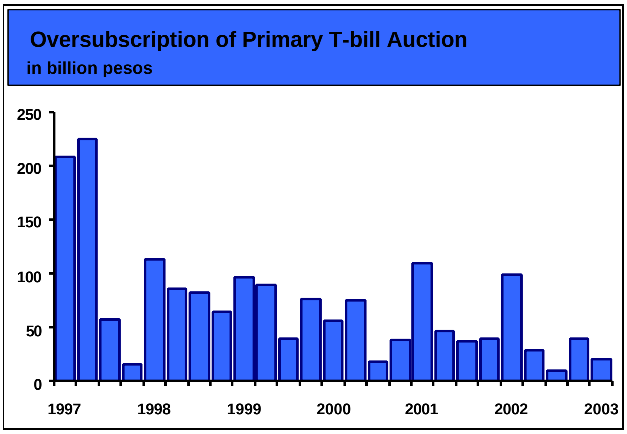


However, bearish sentiment resurfaced in February and March. The average PHISIX slipped to 1,031 in February 2003. It dropped further to 1,014 as of 21 March 2003, Investors were sidelined and opted to stay liquid as the domestic stock market faced a string of negative news. In particular, the uncertainties surrounding the war between the US-led coalition forces and Iraq, the weakness of the peso and for some time, the threat that the Paris-based Financial Action Task Force would impose sanctions against the country over the unsatisfactory Anti-Money Laundering Act dampened investors' enthusiasm. In addition, heightened concerns over domestic security also weighed down on the market.

Foreign participation in the local equities market remained significant as total foreign transactions accounted for 43 percent of total value turnover in January-February 2003. Foreign investors were also net buyers in January 2003 after being net sellers for nine consecutive months. Foreign buying in January 2003 outpaced foreign selling by ₱171.9 million. However, foreign investors revert to their net selling stance in February 2003 with foreign selling exceeding foreign buying by ₱183.5 million.

Government Securities

Banks' appetite for government securities remained healthy in the first quarter of 2003 as evident in the oversubscriptions in the auctions (except for the 17 March 2003 auction) conducted by the BTr for the said period. Total oversubscriptions for the quarter amounted to ₱20.6 billion, lower by ₱19.4 billion compared to the ₱40.0 billion oversubscription posted in the previous quarter. Banks were reported to have demanded higher yields due to continuing concerns over the country's fiscal position. Meanwhile, the Auction committee continued to moderate increases in T-bill rates by exercising its option to reject excessively high bids. Total rejections for the period reached ₱38.5 billion. This was ₱5 billion lower than the ₱43.5 billion rejection in the fourth quarter of 2002.



II. MONETARY POLICY DEVELOPMENTS

The monetary policy stance of the BSP was generally cautious in the first quarter of 2003 but remained supportive of the economy's growth. During its regular discussions on the BSP's monetary policy stance, the Monetary Board voted to maintain the overnight reverse repurchase (RRP) rate at 7.0 percent and the overnight repurchase (RP) rate at 9.25 percent. BSP policy interest rates were last changed on 15 March 2002 when the Board reduced rates by 25 basis points (i.e., a quarter of a percentage point).

Continuing evidence of subdued future inflation underlies the Monetary Board's expectations that average inflation in 2003 will be broadly in line with the government's full-year target of 4.5–5.5 percent. Recent movements in headline inflation have been traced mainly to food and fuel-related products and services, suggesting that it is supply-side factors that are mostly behind current consumer price changes. Present demand conditions also remain consistent with benign inflation due to the relative absence of broad-based price changes across commodity groups. Prospective risks to inflation likewise relate mainly to temporary cost-push influences, notably that of higher farm prices due to the El

Niño phenomenon and the increased world oil prices due to geopolitical developments.

At the same time, the Monetary Board believes that the overall strength of aggregate demand, while improving, remains tentative. Labor market conditions remain soft and capacity utilization in the manufacturing sector is still below normal levels. These indicators suggest that previous monetary easing can still be allowed to work its way through the real sector. The lack of clear-cut signs of a sustained upturn in domestic demand is complicated by indications of weaker economic activity overseas, implying continued sluggishness in external demand.

Recent movements in the foreign exchange rate briefly caused some concern among policymakers owing to the risks of a possible sustained depreciation to the inflation outlook. As discussed above, the peso was relatively stable against the US dollar in December 2002 until early 2003 on the strength of inflows from OFW remittances. In January 2003, however, the currency began to weaken due to various external and domestic worries of currency market participants. The Monetary Board publicly expressed its concern over the volatility in the peso and took steps to prevent the depreciation of the peso from endangering the inflation target. In a special meeting on March 19, the Board voted to remove the three-tiered system for banks' placements with the BSP and to increase the liquidity reserve requirement for universal banks and commercial banks by one percentage point. The removal of the tiering system took effect on 20 March. Overnight reverse repurchase (RRP) transactions with the BSP were accepted at a uniform rate of 7 percent, while term RRPs and special deposit accounts (SDAs) with the BSP were paid the published rates for corresponding tenors, i.e., at a certain spread over the overnight RRP rate. Meanwhile, the liquidity reserve requirement against peso demand, savings, time deposit and deposit substitute liabilities of universal banks (UBs) and commercial banks (KBs) was raised to 8.0 percent effective 21 March 2003.

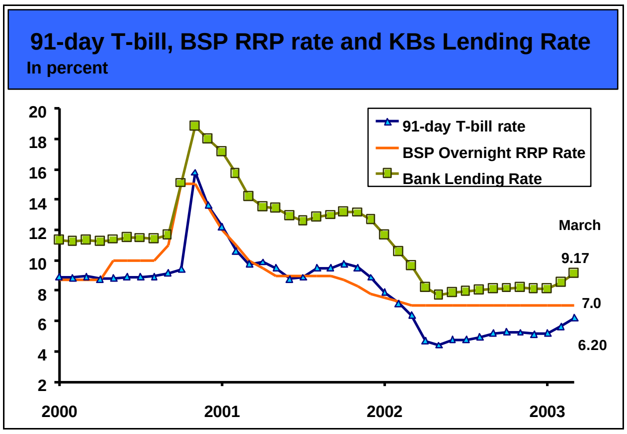
The decision to remove the tiering scheme and raise the liquidity reserve requirement was intended as a preemptive response to inflationary risks. In assessing the prospective inflation environment and overall macroeconomic conditions, the Monetary Board expressed the view that a sustained weakening of the peso poses risks to the inflation outlook, and that the risk of higher future inflation arising from exchange rate movements required a policy response in order to limit the potential impact on consumer prices.

The preemptive action appeared to have sent a strong signal to market participants and helped reduce the volatility in the exchange rate. The peso recovered against the US dollar in the last two weeks of March, climbing back to ₱53.60/US$ by the end of the month. The currency was also helped by the removal of the uncertainty surrounding the prospect of war in the Middle East, allowing financial markets to price in a quick resolution to the US-Iraq conflict.

III. RECENT MONETARY CONDITIONS

Interest Rates

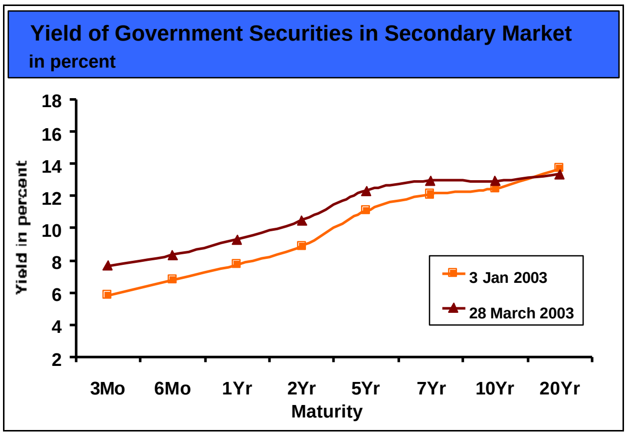
Domestic interest rates were generally higher during the first quarter. The benchmark 91-day Treasury bill rate rose from 5.181 percent in January to 5.672 percent in February and edging up sharply to 6.356 percent as of the latest 17 March 2003 auction. The uptrend in T-bill rates reflected market concerns over the Middle East conflict, the repercussions on the domestic economy of a likely slowdown in global demand, and the expected higher inflation rate due to the rising price of oil in the world market. Nevertheless, the auction for T-bills during the first quarter was generally oversubscribed, indicating ample liquidity in the financial system.



Similarly, rates charged on bank loans rose during the quarter. Average bank lending rates increased from a range of 8.1-10.0 percent in January to a range of 8.5-10.4 percent and 8.9-10.8 percent in February and March, respectively.[16] The 8.1-10.8 percent range from January to February was higher compared to the relatively steady range of 8.1-10.1 percent from October to December 2002. However, compared 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 1,000-1,080 basis points.

Yield Curve

The yield curve for government securities in the secondary market as of 28 March 2003 shifted upward and was generally steeper compared to that which prevailed as of 3 January 2002. The secondary market yields reflected mainly the increases in primary market rates during the quarter.



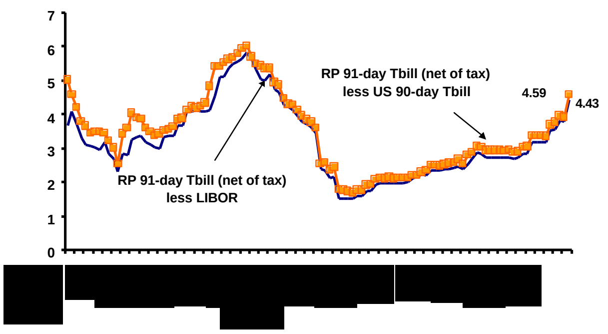
Interest Rate Differentials

Current interest rate differentials with the US continued to widen in the fourth quarter, as foreign interest rates declined while RP market interest rates moved upward. Average monthly differentials between the RP 91-day T-bill rate

[16] For the review period 13-19 March 2003

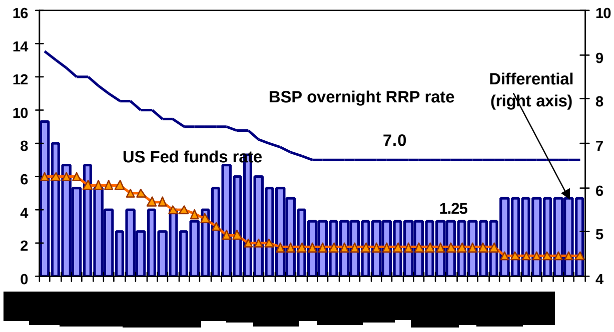
(net of RP withholding tax) and the 90-day LIBOR and 90-day US T-bill increased significantly from 2.8 percent and 3.0 percent in January, respectively, to 3.8 percent and 4.0 percent as of the third week of March 2003.

Interest Rate Differential, Philippines and US
Percentage points



The differential between the BSP's policy interest rate (overnight borrowing or RRP rate) and the US federal funds target rate was unchanged at 575 basis points as the BSP policy rates and the US federal funds rate remained steady at their 15 March 2002 and 6 November 2002 levels, respectively. However, the Monetary Board during its special meeting held on 20 March 2003, decided to remove the three-tiered system for banks' placements with the BSP effective 20 March 2003 and increased the liquidity reserve requirement for universal banks (UBs) and commercial banks (KBs) by one percentage point to 8.0 percent effective 21 March 2003. 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 narrowed anew in the first quarter of 2003, with the end-March risk-adjusted differential at an average of 34 basis points from the end-January differential of 57 basis points, a result mainly of declining yields in the US 10yr. Treasury notes, which were contrasted by increasing yields in the 10-yr ROP notes, thereby causing the risk premium to rise sharply. The rise in the premium can be traced to higher risk aversion on less-than-investment grade papers amidst concerns over the US-led war against Iraq, which caused demand for the relative safety of fixed-income assets to increase.

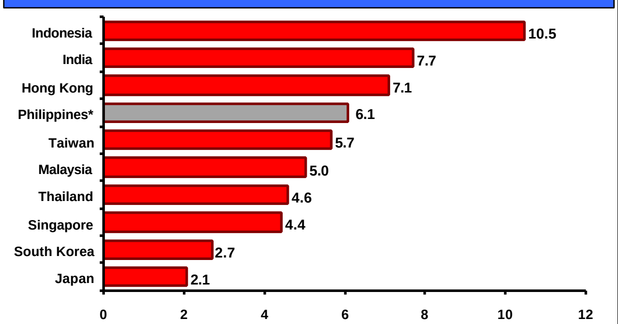
BSP RRP Rate and US Fed Funds Rate
In percent



Real Lending Rate

Meanwhile, the real lending rate in the Philippines declined relative to the level in the previous quarter due mainly to the uptick in the inflation rate in January and February. Hence, the Philippines continues to have one of the lowest real lending rates in the Asian region. The real lending rate rose from 5.4 percent in January to 5.8 percent for the period 13-19 March 2003, making the Philippines the country with the fifth lowest real lending rate in a sample of Asian countries which had a range of 2.8-10.5 percent during the same period.

Average Real Lending Rates: Asian Countries
In percent



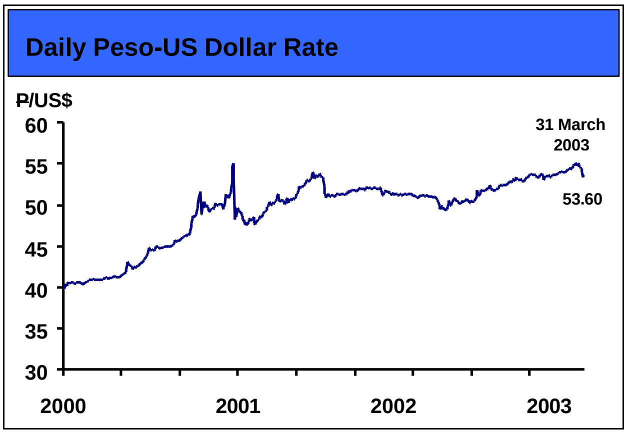
** Data as of 20-26 March 2003*

The margin between the Philippine lending rate and the benchmark 91-day T-bill rate declined anew to 257 basis points as of 13-19 March 2003, compared to 296 basis points in December 2002, reflecting the steady uptrend in both RP market interest rates and lending rates during the quarter, with the RP 91-day T-bill rate increasing by a larger magnitude. This differential makes the Philippines the country with the second lowest spread among those surveyed after South Korea.

Exchange Rate

The peso-dollar rate was relatively stable in December 2002 until early 2003 on the strength of OFW remittances and the favorable macroeconomic environment. However, during the first quarter of 2003, the peso generally depreciated against the US dollar. From an average of ₱53.50/US$ in December 2002, the peso weakened to an average of ₱54.55/US$ in March 2003. The peso started the year at the ₱53.41/US$ level and reached a low average of ₱55.08/US$ on 12 March 2003. A wide array of factors combined to put downward pressure on the peso during this period. Externally, war jitters in the Middle East, regional tensions involving North Korea and the weakened global economic outlook conspired to heighten investor risk aversion and exert pressure on the peso. Domestically, the increase in the demand for US dollars by oil companies to fund their inventory build-up contributed to the depreciation of the peso.[17] Other factors which adversely affected the peso include: security concerns in Mindanao; the possible imposition of sanctions by the FATF (before the passage of the amendments); lingering concerns over the budget deficit; and the relatively low domestic interest rates.

[17] According to the Department of Energy's Circular No. DC 2003-01-001 (issued 20 January 2003), refiners are required to maintain an inventory of petroleum crude oil and refined petroleum products equivalent to 30 days of consumption while other oil companies are required to maintain a 15-day supply of petroleum products excluding liquefied petroleum gas (LPG), which shall be maintained at 7 days supply. This is part of the country's oil contingency plan.



The peso began to recover in the last two weeks of March as it reached an average of ₱53.60/US$ in end-March. The market priced in a quick resolution to the conflict in the Middle East which positively affected the peso. The recovery was also due in part to a number of measures implemented by the BSP to curb speculative demand for dollars and moderate market volatility. These measures included the following:

1. Reduction in the tenor of forward contracts to a maximum of 6 months;

2. Reduction in the allowable overbought position of banks to 2.5 percent of unimpaired capital or US$5 million, whichever is lower;

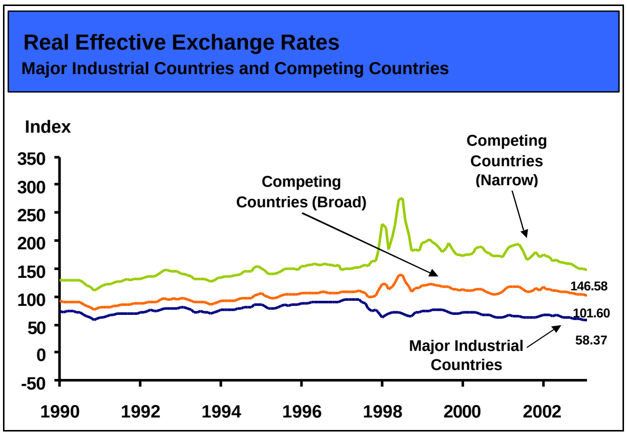
3. Imposition of appropriate sanctions against banks violating BSP foreign exchange regulations;

4. Increase in the liquidity reserve requirement by one percentage point, from 7 percent to eight percent; and

5. Removal of the tiering scheme for banks' short-term deposits under BSP's Reverse Repurchase Facility and Special Deposit Accounts.

While the peso experienced increased depreciation pressure for most of the first quarter of 2003, the peso was relatively stable. Volatility, as measured by the standard deviation of daily exchange rates, was at ₱0.13 in January and ₱0.19 in February compared to ₱0.18 in December 2002. However, market volatility increased in March to ₱0.50 due to the large gains of the peso against the US dollar during the last two weeks of that month.

On a real, trade-weighted basis, available data suggest that the peso depreciated relative to the currencies of the major trading partners (MTP) by about 2.7 percent in February 2003 from its level in December 2002, as shown in the real effective exchange rate (REER) index.[18] This is a result mainly of the nominal depreciation of the peso against the MTP basket of currencies. The peso showed a similar depreciation trend over the same period vis-à-vis two sets of currencies of the Philippines' competitor countries. The REER for the broad and narrow baskets of competitor currencies fell by about 3.0 percent and 2.9 percent, respectively. This was brought about by the combined nominal depreciation of the peso and the narrowing of inflation differentials relative to competitor countries. Overall, these developments indicated the continued improvement in the country's external price competitiveness.



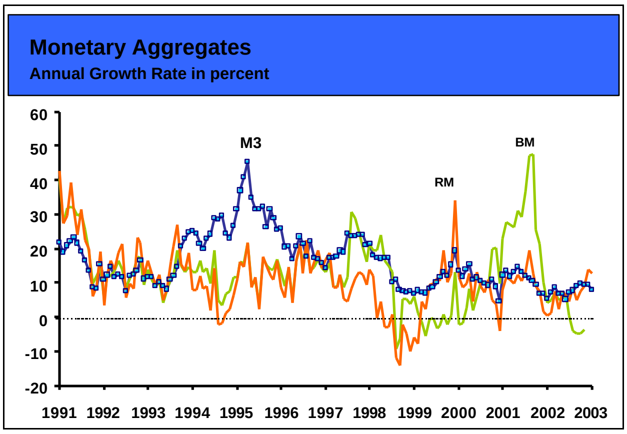
For the remainder of 2003, the near-term movement of the peso is expected to be partly influenced by developments in the Middle East conflict and regional tensions concerning the Korean peninsula. However, such exaggerated downward pressures may be viewed as temporary as demonstrated by the strong recovery of the peso in late March. A moderation of the depreciation pressure of the peso is expected on the back of the continued growth of exports in 2003, which is forecasted at 5 percent. Moreover, structural reforms pursued in the past by the government and its firm commitment to further reform measures is

[18] 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.

expected to increase the growth potential of the economy and have a positive effect on the peso.

Monetary Aggregates

The demand for money moderated slightly in the first quarter of 2003, with the year-on-year growth in domestic liquidity (M3) slowing from 9.5 percent in December 2002 to 8.0 percent in January and 6.7 percent in February. The slowdown in M3 growth in February 2003 can be traced in part to the base effect of the reduction in liquidity reserve requirement by 2 percentage points in January 2002, which raised the M3 level in the following month and, in turn, tempered the year-on-year liquidity growth in February 2003. The relative deceleration also appears to be seasonally related, since December has traditionally been a month of increased consumption spending.



The growth in M3 was driven mainly by the increased net foreign assets (NFA) of the monetary system (i.e., the BSP and the banking system) due to the net build-up of international reserves by the BSP and increased US dollar purchases by banks. M3 growth was also supported by the expansion in domestic credits of both the public and private sectors. Credits to the public sector continued to be boosted by strong investor appetite for risk-free assets (such as government securities) combined with ample liquidity in the financial system. Credits to the private sector meanwhile have turned around after 15 months of contractions, rising for a third consecutive month by 4 percent year-on-year in February 2003, as bank lending activity continued to recover.

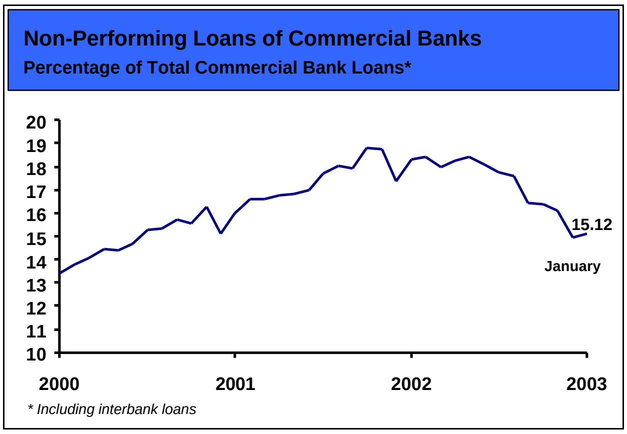
Narrower monetary aggregates exhibited a similar trend. For example, the growth in reserve money (a narrower definition of money supply consisting of currency issue net of cash in the vaults of the Bureau of the Treasury and banks' reserve balances with the BSP) slowed down to 12.7 percent year-on-year in January 2003 from 13.8 percent in December 2002.

Banking System

The banking system remained resilient in the first quarter. The total resources of the banking system continued to grow, rising by 5.3 percent year-on-year to reach ₱4.3 trillion as of end-January 2003. Banks' asset quality likewise improved as the non-performing loan (NPL) ratio improved steadily, due partly to increased foreclosure and restructuring efforts as well as actual collections. Meanwhile, the banking system's capital adequacy ratio (CAR), based on the old framework, rose to 17.3 percent as of end-September 2002 from 16.5 percent in the end of the second quarter. Available data based on the new risk-based capital adequacy framework, show a ratio of 16.8 percent in June 2002 for commercial banks (KBs), almost the same level recorded during the previous quarter. These CARs far exceeded the BSP's statutory norm of 10.0 percent and the Bank for International Settlements (BIS) standard of 8.0 percent.

Asset Quality

The banking system's asset quality sustained its improvement in the fourth quarter to reach 14.9 percent at end-December 2002. Despite the slight increase to 15.12 percent in January 2003, the NPL ratio has declined significantly from peak of 18.81 percent registered in October 2001. The NPL ratio started its steady decline as early as May but a more significant reduction was observed beginning September 2002 due to the impact of BSP Circular No. 351 dated 19 September 2002. The Circular allowed banks to exclude from the computation of NPLs those classified as "Loss" which are fully covered by allowance for probable losses, provided that such loans are also deducted from total loan portfolio and interests on these loans shall not be accrued. For commercial banks, the NPL ratio would still be lower than the September level at 15.8 percent, even without the redefinition. Banks' increased foreclosure and restructuring efforts as well as actual collections also contributed to the decrease in the banking system's NPL ratio.



The banking system's NPL ratio at the end of the fourth quarter of 2002 remained above that of its regional counterparts. In particular, Malaysia, Thailand, Korea and Indonesia posted NPL ratios of 9.3 percent, 10.09 percent, 1.9 percent and 8.1 percent, respectively,[19] as most of these countries' NPLs were purchased by asset management companies (AMCs) established in 1997 and 1998 for this purpose.[20] In the case of the Philippines, the disposition of at least half of the non-performing assets (NPAs) of financial institutions is expected to be facilitated by the passage of Republic Act No. 9182 or the Special Purpose Vehicle Act (SPVA) on 10 January 2003.[21] Unlike the AMCs of other Asian countries, which are state-owned, the SPVs will be put up by private investors. Under the law, the role of the government will be limited to granting tax and other incentives that would reduce transaction costs attendant to asset transfers. It has been estimated that the SPVA should cut costs related to selling NPAs by 15-20 percent.[22]

[19] Source: ARIC Financial Indicators, ADB website. Malaysia (December 2002, commercial banks); Thailand (November 2002, commercial banks); Korea (September 2002, commercial banks); and Indonesia (September 2002, financial system).

[20] NPL purchases by AMCs were 39.3 percent for Malaysia (November 2001); 60.1 percent for Thailand (January 2002); 77.1 percent for Korea (September 2002); and 91.7 percent for Indonesia (December 2002).

[21] Source: Supervisory Reports and Studies Office (SRSO), Bangko Sentral ng Pilipinas

[22] UBS Warburg, Philippine Banks, 16 January 2003

Capital Adequacy

Based on the old capital adequacy framework, the banking system's capital adequacy ratio (CAR) as of September 2002 (as measured by net worth-to-risk assets) was higher at 17.3 percent compared to the 16.5 percent posted as of end-June 2002. Meanwhile, the CAR of KBs also increased to 17.3 percent from 16.5 percent during the same period. The improvement in the CAR was traced to both the increase in capital reserves of banks and the reduction in risk assets. Using the risk-based framework,[23] the CAR of KBs stood at 16.8 percent in June 2002, almost the same level recorded at end-March 2002. The CAR —using both the old and new frameworks—exceeded the statutory level set by the BSP at 10.0 percent and the Bank for International Settlements (BIS) standard of 8.0 percent. To date, the Philippines' CAR is the highest in the region compared to those of Malaysia (12.8 percent), Thailand (14.1 percent) and Korea (10.8 percent).[24]

Notwithstanding the decline in banks' NPL ratio, loan–loss provision as a percent of total NPLs further improved to 50.2 percent as of the fourth quarter compared to the 47.6 percent recorded during the previous quarter, reflecting banks' prudent stance in providing adequate cover for their distressed loans.

Bank Lending

The outstanding loans of commercial banks rose by an average of 4.4 percent year-on-year in the first two months of 2003, an acceleration from the 1.6 percent average growth registered in the previous quarter. Commercial bank lending has been growing steadily for the fifth straight month since September 2002. The continued improvement in commercial bank lending during the first two months was driven by increased loans to the following sectors: agriculture, fisheries and forestry (26.9 percent); community, social and personal services (16.4 percent); and manufacturing (8.9 percent) which altogether comprise about 45 percent of total outstanding loans of commercial banks. The upturn in bank lending to the manufacturing sector during the period also marked a turnaround from 17 months of year-on-year declines.

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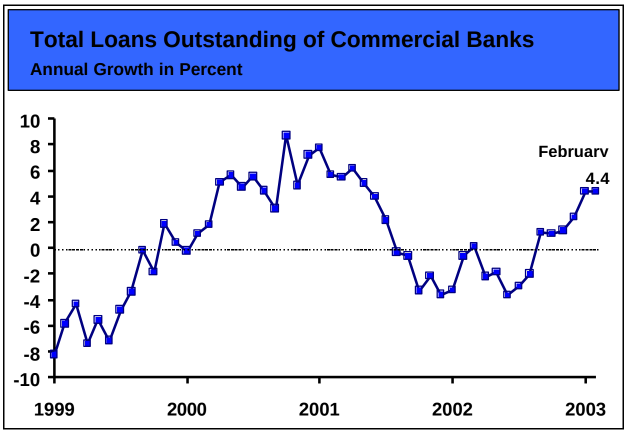
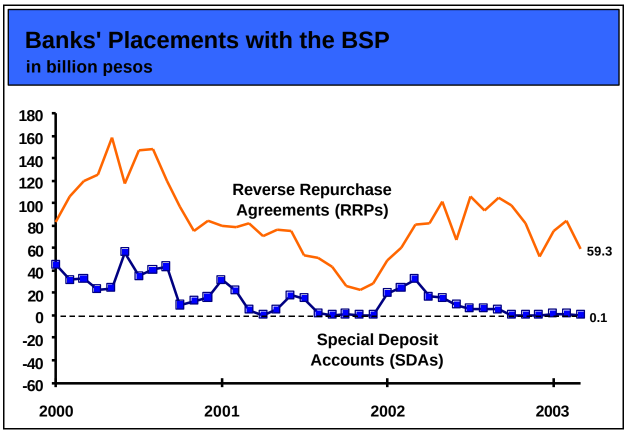
[23] BSP Circular No. 280, dated 29 March 2001, approved the guidelines for the adoption of the risk-based capital adequacy ratio along the criteria prescribed by the Bank for International Settlements (BIS).

[24] Source: ARIC Financial Indicators, ADB website. Malaysia (December 2002); Thailand (November 2002); and Korea (March 2002).



Banks' Placements with the BSP

The volume of banks' placements with the BSP under the RRP and SDA facilities stood at ₱59.3 billion and ₱74 million, respectively, as of end-March 2003. Compared to the levels as of end-December 2002, the outstanding levels of RRPs and SDA placements of banks with the BSP rose by ₱7.0 billion and ₱378 million, respectively. The increase in the volume of banks placements with the BSP under these windows may be attributed in part to the recent lifting of the tiering scheme on banks' placements under these facilities, which was aimed at absorbing excess liquidity in the system that may find its way into speculative activity in the foreign exchange market.



External Developments

Latest indicators in the world's major economies continue to point to a hesitant and uneven global economic recovery. Although the outbreak of US-Iraq hostilities has dispelled the initial economic uncertainty generated by the conflict, consumer and business confidence have been weighed down of late by fears of a long drawn-out war. As a result, the growth of industrial production in the major economies has been sluggish, labor markets have remained soft and the main leading economic indicators continue to show signs of weakness.

In the US, for example, real GDP rose by an annual rate of 1.4 percent in the fourth quarter of 2002, a deceleration from the 2.7-percent growth in the same period a year ago and the 4.0-percent growth recorded in the third quarter of 2002. The slower growth in real GDP growth reflected primarily slower consumer spending, a downturn in exports, and a slowdown in private inventory investment, all of which were only partly offset by higher federal government spending.[25] Other data continue to point to a slackening in US demand. The University of Michigan's consumer confidence index fell sharply to 77.6 in March 2003 from 79.9 in the previous month, while retail sales in February fell by 1.6 percent after a mild 0.3 percent rise in the previous month from auto sales.

The outlook for job creation also remains uncertain. The unemployment rate remains relatively high at 5.8 percent as of February and businesses trimmed their workforce and deferred hiring new workers.[26] Industrial production registered a minimal increase of 0.1 percent in February, slightly lower than the 0.8 percent growth seen in the previous month. Likewise, new orders for manufactured durable goods decreased in February by 1.2 percent. Meanwhile, the Institute for Supply Management (ISM) reported that growth in the manufacturing sector slowed down in February compared to the previous month.[27]

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[25] US Department of Commerce News, "Gross Domestic Product: Fourth Quarter 2002 (Final), Corporate Profits: Fourth Quarter 2002," available at http://www.bea.gov/bea /rels.htm

[26] "Jobs plunge 308,000 amid war worries," Reuters, 7 March 2003, available online at http://www.reuters.com

[27] "Unemployment seen rising," Bloomberg, available online at http://www.bloomberg.com

Amid weak consumption and business sentiment and a general climate of uncertainty due to geopolitical events, the US Federal Reserve has opted to stay its hand on key interest rates during the US Federal Open Market Committee (FOMC) meeting on 18 March 2003. The benchmark overnight bank lending rate thus remains unchanged at 1.25 percent, the lowest level recorded since 1961. In its press statement, the US Fed provided no outlook on the economy due to unusually large uncertainties over geopolitical events, but most analysts believe that US monetary authorities are likely to keep policy rates steady in the near term or even turn more accommodative.

Recent economic data in the euro area also paint a bleak outlook. Geopolitical tensions and rising oil prices continue to dampen consumer and business confidence and undermine growth prospects in the euro area. Manufacturing activity in the euro zone contracted in March while unemployment rate rose further to 8.7 percent in February from 8.6 percent a month earlier on account of the large number of jobless workers in Germany exceeding 10 percent.[28] Meanwhile, the annual Harmonized Index of Consumer Prices (HIPC) inflation rate in the euro area edged up to 2.3 percent in February from 2.2 percent in the previous month. Temporary upward pressures from the uptrend in oil prices and various increases in indirect taxes and administered prices pushed consumer inflation above the European Central Bank's (ECB) 2.0 percent target.[29]

Nevertheless, the strengthening of the euro is expected to dampen inflation expectations going forward. In view of the need to provide stimulus for growth without jeopardizing the medium-term prospects for growth and inflation, the Governing Council of the ECB voted to cut the ECB's benchmark interest rate by 25 basis points to 2.5 percent in its last meeting on 6 March 2003. The ECB Governing Council also indicated that it stands ready to cut interest rates again should economic prospects worsen.[30] In a statement following the start of military action by the US-led coalition against Iraq, the ECB's Governing Council maintained that monetary policy will continue to provide sufficient liquidity even under exceptional circumstances. The ECB also emphasized that "in times of

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[28] EU Business, "Euro zone unemployment rate rises to 8.7 percent." available online at http://www.Eubusiness.com

[29] European Central Bank, ECB Press Conference, "Introductory Statement of President Willem F. Duisenberg", 17 February 2003 available at http://www.ecb.int

[30] "Update 6-ECB cuts rates modest quarter point, ready for more," Reuters, 6 March 2003, available online at http://www.reuters.com

severe tension the primary responsibility of policy makers is to reduce uncertainty and strengthen confidence."[31]

In the United Kingdom, the Monetary Policy Committee (MPC) of the Bank of England (BOE) voted for a 25-basis point cut in the benchmark repo rate amid growing evidence of a slowing economy. Inflation in the UK rose to its highest level in five years at 3 percent in February, but this was driven mainly by short-term cost-side factors such as movements in oil prices. Meanwhile, the MPC has revised downwards its outlook for growth in the UK economy over the next two years due mainly to weaker prospects on the world economy, further falls in equity prices as well as sluggish business investment.[32]

Economic activity in Japan remains stagnant without any clear sign of recovery in domestic demand. Although real GDP was relatively stronger at 2.4 percent year-on-year in the fourth quarter, other indicators suggest continuing sluggishness in the economy. Weak consumer spending and persistent deflationary pressures have more than offset the improvements seen in employment. Japan's jobless rate fell unexpectedly in February to 5.2 percent from 5.5 percent in the previous month.[33] Prices declined anew by 0.2 percent in February from 0.4 percent, year-on-year drop in the previous month. Spending by Japanese wage earners fell by 1.6 percent in real terms in February from a year-ago level.[34] In addition, industrial production fell by 1.7 percent in February as companies such as Honda Motor Co. cut manufacturing and transportation costs by shifting operations overseas.[35]

On price developments, Japanese inflation stood at -0.4 percent year-on-year in January 2003. Consumer and corporate services prices have continued to decline despite the rise in import prices brought about by the higher crude oil prices overseas.[36] In its latest assessment, the Bank of Japan (BOJ) believes that the economy is unlikely to show clear signs of recovery for some time as business

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[31] European Central Bank, "Statement of the Governing Council following the start of military action in Iraq." available online at http://www.ecb.int
[32] Bank of England, "Press Conference for *Inflation Report*," 12 February 2003, available online at http://www.bankofengland.co.uk
[33] Bank of Japan, *Bank of Japan Statistics and Other Key Statistics*, available online at http://www.boj.or.jp/en/siryo/sk/ske.htm
[34] "Jobless rate declines in Japan," Dow Jones Newswire, 31 March 2003
[35] "Japan's February industrial production falls 1.7%," Bloomberg News, 31 March 2003
[36] Ibid.

investment remains weak as high levels of unemployment and debt persist.[37] During its last monetary policy meeting, the Policy Board of the BOJ voted unanimously to increase its current account balance target[38] to a range of 17-22 trillion yen beginning April 2003 from 15-20 trillion yen.[39]

In general, the major economies have pursued an accommodative monetary policy stance to support domestic economic activity as the balanced of risks weighed heavily on the weakness in their respective domestic economies combined with heightened geopolitical uncertainties. Despite some price pressures, the BOE and the ECB have eased monetary policy, recognizing that such pressures are only temporary due to the recent upturn in oil prices. Both central banks noted that the current easing are consistent with the medium-term objectives for growth and inflation.

In the other Asian economies, the Monetary Policy Committees of the Bank of Thailand (BOT) and the Bank of Korea (BOK) decided to maintain their policy rates during their respective meetings on 3 and 6 March 2003.[40] Despite higher crude oil prices which are exerting some pressures on consumer prices, the BOK decided to keep its benchmark overnight call rate at 4.25 percent to support economic activity as investors' sentiment have weakened and geopolitical developments have reduced the prospects of early recovery in the global economy. Similarly, the BOT maintained the 14-day repurchase rate at 1.75 percent to keep the momentum for economic growth in Thailand given the external uncertainties with respect to the recovery of in industrial economies, higher oil prices and increased volatility in the financial markets.[41]

[37] Ibid.

[38] 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.

[39] Bank of Japan, *Monetary Policy, Monetary Policy Meetings,* 5 March 2003, available online at http://www.boj.jp/en

[40] Bank of Korea, *Monetary Policy Decision*, 6 March 2003, available online at www.bok.or.kr

[41] Bank of Thailand, Press Release on the Current Monetary Policy (3 March 2003), available online at http://www.bot.or.th

IV. INFLATION OUTLOOK

Outlook for Prices

Inflation is expected to track broadly the target for the year.

Based on the latest inflation readings of the BSP, the overall outlook for inflation has not drifted away from the full-year target average inflation of 4.5-5.5 percent in 2003. Recent movements in headline inflation have remained largely limited to specific components of the CPI basket, notably food and fuel. The relative absence of broad price changes across commodity groups suggests that demand pressures are largely muted. Equally important, the dominant influence of food and fuel prices on current inflation implies that supply-side factors are driving the inflationary process.

After taking into account the prevailing conditions for prices, output and other relevant economic variables, we maintain our assessment that the present state of domestic demand continues to point to a benign inflation setting for the future, that supply-related factors such as food and fuel prices continue to drive the recent movements in inflation, and that the pressures from such factors are not likely to be persistent. All of this suggests that there are no broad-based pressures on consumer prices in the offing. We therefore continue to expect average inflation to broadly track the Government's target of 4.5-5.5 percent for 2003.

This assessment is in line with the BSP's forecasts for inflation. Estimations by the BSP staff show a forecasted average inflation rate of 3.9 percent for 2003 from both the single equation model and the multiple-equation model, while results from a working version of the BSP's Long-Term Macroeconomic Model (LTMM) show a 5.5 percent average inflation rate for the year. Meanwhile, average inflation in 2004 is expected to be broadly in line with the government's 4-5 percent target.

The following major assumptions underlie the BSP's forecasts:[42]

a. Real GDP growth is consistent with the National Government's (NG) targets of 4.2-5.2 percent for 2003 and 4.9-5.8 percent for 2004;

b. Growth of monetary aggregates is consistent with the revised monetary program set internally by the BSP as of December 2002;

c. NG deficits for 2003 and 2004 equivalent to 4.7 percent and 4.2 percent of GDP, respectively;

d. The overnight RRP rate was assumed constant at 7.0 percent from February 2003 to December 2004;

e. The 91-day Treasury bill rate was assumed at an average of 8.5 percent for 2003 and for 2004, the midpoints of the range of interest rate assumptions for both years;

f. Oil price projection consistent with the assumption of the Development Budget Coordinating Council (DBCC) of US$31.26/bbl for 2003 and US$27.64 for 2004 (as of 11 March 2003);

g. Increase in the daily minimum wage rate (measured by the non-agricultural wage rate for NCR) of ₱30.00 each for 2003 and 2004, to be given on a staggered basis as follows: ₱15.00 each for May 2003, August 2003, May 2004, and August 2004. This pattern of wage adjustment follows the last wage increase approved in October 2001 where the ₱30.00 wage increase was given in two tranches: November 2001 and February 2002. It may be noted, however, that to date, no petition for a wage hike has yet been filed at the NCR-Regional Tripartite Wage and Productivity Board; and

h. Mild El Niño phenomenon was assumed in 2003.

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[42] For the multiple equation model, the forecasts for real GDP growth, monetary aggregates and the 91-day T-bill rate were determined exogenously.

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 uptrend reflects our judgment of possible upside risks to the inflation outlook arising from several factors. These upside risks to the outlook for inflation relate mainly to cost-push influences, i.e., factors that affect producers' cost of doing business which are largely outside the direct influence of monetary policy. Such factors include the following:

- The impact on farm prices of the El Niño phenomenon, which could translate into higher prices for major agricultural crops such as rice and corn, both of which account for about 13 percent of the CPI basket;

- Adverse movements in international and domestic oil prices, which in the past have prompted increases in basic commodity prices as well as calls for transport fare and wage adjustments; and

- One-time increases in prices associated with adjustments in regulated utility charges, particularly for power.

The potential pressures from the above set of risks are generally expected to be transitory and should not require a policy response from monetary authorities. One specific risk that deserves attention, however, is the recurrence of exchange market pressure, as was briefly the case at the beginning of 2003. Although the foreign exchange market has already regained stability as of end-March, the possibility of a sustained exchange rate depreciation presents a risk to inflation expectations and therefore to future inflation. Movements in the foreign exchange market thus bear continued monitoring.

Private Sector Analysts Inflation Forecasts

The BSP's expectations of subdued inflation going forward are echoed by the independent forecasts of private sector analysts. On the average, private sector forecasts of headline inflation for 2003-2004 are generally in line with the government's targets. The lower-than-expected outturn for headline inflation in the first three months of 2003 has already prompted downward revisions in private sector forecasts of inflation. Results from an informal BSP poll of analysts from various private financial institutions indicated a slightly lower whole-year average inflation forecast for 2003 compared to the previous forecasts in the fourth quarter of 2002, as the level of inflation for the first two months of the year (2.7 percent in January and 3.1 percent in February) remains consistent with the outlook of a generally subdued inflation environment in the near term.

Forecasts from eight institutions indicate that inflation will average at 4.4 percent for 2003, slightly below the quarter-ago average forecast of 4.7 percent. Analysts attribute price pressures to be coming from cost-push factors, particularly increases in fuel prices and the depreciation of the peso in recent months, which could have a spillover effect in the second quarter of the year. However, they expect these price movements to be transitory and will be countered by the still-weak domestic as well as external demand. The forecasters also noted that the impact of the El Niño phenomenon on agricultural crop production will be less severe than was previously expected, as the government has already started taking measures to mitigate the harmful effects of this weather disturbance. Meanwhile, election-related spending is not expected to put significant pressure on prices this year but may begin to be felt in the first quarter of 2004.

Private Analysts' Inflation Forecasts for 2003		
Institution	**As of 1st Qtr 2003**	**As of 4th Qtr 2002**
AB Capital Securities	3.9	4.4
Cemex Corporation	4.4	5.4
Bank of the Philippine Islands	4.3*	5.5**
BNP Paribas	3.8	4.7
Metropolitan Bank and Trust Co.	4.3	...
Santander Investments	4.5	4.5
UBS Warburg Securities	4.5	5.0
United Coconut Planters' Bank	5.5	5.0
Median Forecast	5.0	5.0
Average Forecast	4.4	4.9
High	5.5	5.4
Low	3.8	4.4
No. of observations	8	6

** Average of 4.0-4.5 percent range*

*** Average of 5.0-6.0 percent range*

Sources: BSP poll

V. IMPLICATIONS FOR MONETARY POLICY STANCE

Careful consideration of the outlook for inflation and the prevailing state of economic activity suggests that the main risk to the domestic macroeconomic environment at present relates not to rising consumer prices but to the continuing unevenness of trends in domestic demand. On the whole, the near-term risks to the inflation outlook appear to be largely contained. Meanwhile, the overall strength of aggregate demand remains tentative, and there are as yet no clear-cut signs of a sustained improvement in domestic economic activity. Labor market conditions remain soft, with sizeable unemployment preventing strong calls from labor groups for wage adjustments. In addition, there is still some spare capacity in manufacturing despite the slight improvement. These factors suggest that there is still adequate room for the impact of monetary policy feed-through the real sector without endangering the government's inflation objective.

Thus, the lack of foreseeable major demand-side risks to inflation argues against the need for significant monetary tightening measures and supports the case for ensuring that liquidity conditions remain appropriate for the domestic economy's requirements. The mixed evidence on domestic demand is compounded further by more pronounced indications of weaker global economic activity and greater uncertainty due to the possibility of protracted conflict in the Middle East, which suggests continued sluggishness in external demand. In the present environment, therefore, the main policy concern would be to preserve the ongoing stimulus to the real sector and ensure that the observed improvements in bank lending activity and overall demand are sustained.

This does not mean, however, that monetary authorities should set aside its concerns about the outlook for prices. In fact, the BSP remains continuously alert to changes in prevailing economic conditions and various influences that can undermine the inflation target. For example, depreciation pressures on the currency, if left unchecked, can fan inflationary expectations and generate pressures on the overall price level. The possibility of a significant and sustained nominal exchange rate shock thus presents a case for a pre-emptive monetary policy response in order to head off inflationary risks. This was the reason behind the Monetary Board's decision in March to raise the liquidity reserve requirement of banks and lift the tiering scheme on the interest rates applied by the BSP on banks' placements under the RRP and SDA facilities. The intention was to reduce the amount of excess liquidity in the financial system that could find its way into speculative activity against the peso.

At the same time, monetary authorities recognize that monetary tightening, particularly increases in policy interest rates, should be done with some caution, since this could introduce greater uncertainty in an environment already marked by geopolitical tensions and generalized weakness in global economic activity. Moreover, given the need to assure the sustainability of domestic economic growth, an increase in policy rates—which would lead to higher market interest rates—could dampen incentives for increased consumption and investments. A high interest rate environment could worsen the downturn in domestic stock market, increase the debt service burden of both the corporate sector and the NG and stall the recovery in bank lending. Thus, an increase in the BSP's policy rates could dampen stimulus for a sustained economic recovery.

Against this backdrop, the stance of monetary policy will continue to focus on providing a supportive environment that ensures sufficient liquidity to fuel the economy's growth requirements. At the same time, monetary policy will remain cautious to guard against any potential build-up of price pressures that could dampen the growth momentum.

VI. CONCLUDING REMARKS

Amid present geopolitical uncertainties, low inflation continues to be one of the brightest spots in the current macroeconomic environment. This has been primarily because the continued strengthening of aggregate demand has still left ample room for expansion without triggering generalized pressures on consumer prices. In addition, the continued favorable performance of agricultural production has ensured stable food prices for the foreseeable future, thus providing a counterbalance to potential supply-side pressures from factors such as movements in oil prices.

The prospect of continued benign inflation preserves the latitude of monetary policy in providing a supportive environment for economic activity aimed at allowing an appropriate level of liquidity that is consistent with the economy's growth requirements. This is borne of the belief that the predominant risk to the current economic environment at present relates not to rising inflation but to the lack of unambiguous signs of strength in domestic demand. The significant monetary easing conducted by the BSP in 2001-2002 has already begun to bear fruit in terms of improved bank lending activity, and the priority now is to preserve the ongoing monetary stimulus so that the recovery strengthens further toward sustainability. Moreover, as the ECB has remarked recently, in these times of economic and political tension, the main task of economic policy is to reduce uncertainty and bolster confidence. This is what the BSP has tried to do over the past year or so with its accommodative monetary policy stance.

It goes without saying, however, that the BSP will continue to keep a sharp eye on emerging inflation pressures. The practical experience of central bankers around the world and the evidence gathered by economists engaged in the science of monetary policy have shown that a central bank's singular lasting contribution to long-term sustainable growth is a low and stable inflation rate. This is the basis for the BSP's enduring commitment to price stability.