INFLATION REPORT

Third 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. The government's targets for annual headline inflation under the inflation targeting framework have been set at 4.5-5.5 percent for 2003 and 4-5 percent for 2004.

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. In certain cases, 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 9 October 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. Ramona GDT Santiago Director, Treasury Department

SCHEDULE OF THE MEETINGS OF THE ADVISORY COMMITTEE AND THE MONETARY BOARD ON MONETARY POLICY FOR 2003

Mtg No.	Advisory Committee [1/]	Monetary Board [2/]	Publication of MB Highlights [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	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	2 July, Thursday	14 August, Thursday
8	28 July, Monday	31 July, Thursday	11 September, Thursday
9	25 August, Monday	28 August, Thursday	9 October, Thursday
10	22 September, Monday	25 September, Thursday	6 November, Thursday
11	20 October, Monday	23 October, Thursday	4 December, Thursday
12	17 November, Monday	19 November, Thursday	8 January, Thursday [*/]
13	15 December, Monday	18 December, Thursday	29 January, Thursday

Notes:

[1/] Held every four weeks

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

[3/] Six weeks after the Monetary Board meeting on the BSP's Monetary Policy Stance

[*/] 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 meeting-is a holiday.

CONTENTS

OVERVIEW

- ***Inflation remains benign amid subdued demand and cost-side pressures.*** The inflation environment continued to be generally benign in the third quarter of 2003, with upticks driven mainly by changes in relative prices rather than generalized pressures on consumer prices. These developments reflect the continuing absence of significant demand-side pressures, and is supported by the benign trend for core or underlying inflation.

- ***The strength of aggregate demand remains generally moderate.*** The Philippine economy continued to grow amid the risks posed by the El Niño phenomenon, the US-Iraq conflict, and the SARS outbreak, driven by robust consumption spending. Nevertheless, the overall strength of aggregate demand remains generally moderate, with sluggishness observed in key areas such as manufacturing activity, employment, and exports.

- ***Money and credit demand are slowing down.*** Demand for money appears to have slowed down in the third quarter. M3 grew at a slower pace of 3.6 percent and 3.8 percent, respectively, in July and August, compared to 5.9 percent in June. Commercial bank lending has consistently risen in the eleven months to July 2003 but has recently been at a slowing pace. Consumer loan activity appeared to be generally sluggish as well, based on data on credit card receivables and auto loans by banks.

- ***Fiscal performance within target in the first eight months.*** The fiscal position of the National Government (NG) remained on track in the first eight months of the year vis-à-vis the country's fiscal program. The improved fiscal condition allowed a little flexibility for increased public spending in August to stimulate economic activity.

- ***Growth in the major economies picks up but risks to sustainability remain present.*** Economic growth in the world's major economies is showing signs of picking up after months of slow and uneven recovery. Evidence of an economic upturn appears to be strongest in the United States, with milder improvements seen in the euro area and Japan. However, risks to sustainability remain present, given the possibility of further fallout in the equities market, still-weak corporate investment, continuing adjustments in global current account imbalances, and security concerns. In response, the major central banks have been cautiously optimistic and kept their policy interest rates on hold.

- ***Outlook for inflation remains tame over the policy horizon.*** Amid moderate improvements in aggregate domestic demand conditions, manageable pressures from the supply side and downside risks to global recovery, the BSP is maintaining its assessment of a tame inflation outlook over the policy horizon. Current BSP forecasts indicate that inflation will likely fall below the 4.5–5.5 percent inflation target for 2003, and settle broadly within the 4–5 percent target in 2004.

- ***However, some risks to the inflation outlook remain.*** Several factors are thought to exert some upward pressure on the price level. The first is the volatility of the exchange rate which, if left unchecked, could have a bearing on the public's expectation of future prices. Meanwhile, attempts by the Organization of Petroleum Exporting Countries (OPEC) to control production to counter the rise in oil output from Iraq and other petroleum-producing countries could exert upward pressure on international oil prices, which could have pass-through effects on basic commodity prices as well as transport fares and wage rates.

- ***Assessment of conditions for future inflation and output suggests need for a more accommodative monetary policy stance.*** A combination of benign future inflation and moderate economic activity would argue for an accommodative policy stance to ensure a steady pace of economic expansion. Indeed, additional evidence of slowing money and credit demand would also tend to bolster arguments for increasing the ongoing stimulus to economic activity. Current domestic monetary conditions, other economic developments and the likelihood of low and stable interest rates in the major economies provide flexibility for monetary authorities to assume a more supportive policy stance while remaining cautious of possible resurgence of inflationary threats.

- ***Nevertheless, such considerations must be weighed against the remaining risks to the inflation outlook***. Specific risks include the possibility of renewed exchange market pressure in the face of concerns about political uncertainty and fiscal performance. Proper consideration of such risks requires authorities to exercise continued caution in formulating the monetary policy stance. Prospective assessments of monetary settings will therefore continue to emphasize prudence in responding to the evolving outlook for inflation and output growth in the economy.

I. Recent Developments in Inflation and Economic Conditions

Price and Cost Developments

Inflation environment remains benign

The inflation environment continued to be generally benign in the third quarter of 2003, with upticks driven mainly by changes in relative prices rather than generalized pressures on consumer prices. Headline inflation rose slightly in July-September compared to both the preceding quarter and the average recorded in the period a year earlier, but remained relatively low at 3.1 percent. Current price pressures appear to remain confined to specific goods markets, implying that such pressures are not broad-based. These developments reflect the continuing absence of significant demand-side pressures in the current inflation environment. This absence is evidenced by the benign trend for core or underlying inflation.

Therefore, the current situation for consumer prices remains quite benign. Such trends continue to support the BSP's outlook of a subdued inflation environment over the near term, the details of which are discussed in a later section.

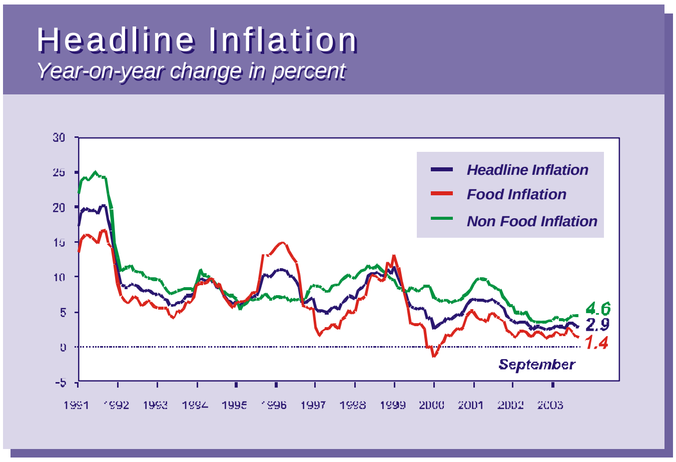
Headline and Core Inflation

Headline inflation slightly higher in third quarter

Year-on-year CPI or headline inflation was slightly higher in the third quarter of 2003, averaging at 3.1 percent for the July-September period compared to 3.0 percent average for the second quarter and 2.8 percent in the same period a year ago. The slight increase from the second quarter was due mainly to movements in energy prices, reflecting the uptrend in international crude oil prices observed during the quarter. Higher inflation rates relative to the second quarter were recorded for fuel, light and water as well as transport services, which includes gasoline and diesel.

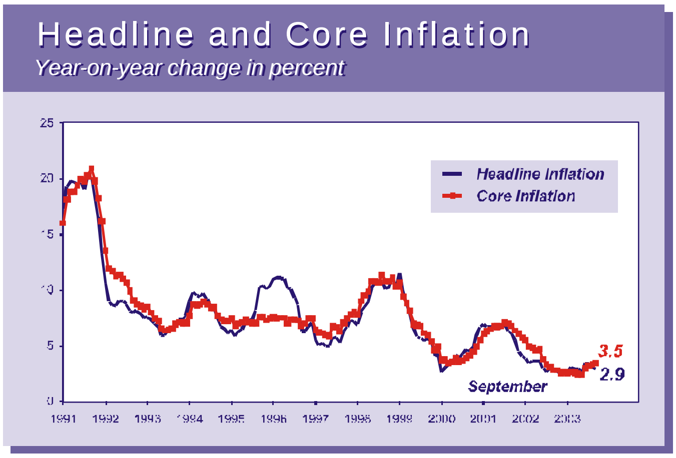
Movements in prices for these commodity groups pushed up non-food inflation to 4.5 percent for July-September from 3.9 percent in the second quarter. However, the remaining items generally showed either stable or lower inflation rates during the same period. Food items, for example, were eased to 1.7 percent for July-September, as lower inflation rates for corn, fish, fruits and vegetables, beverages and tobacco offset higher inflation rates for rice, dairy, and meat products. Average headline inflation for the first nine months of 2003 was 3.0 percent, lower than the 3.3 percent average inflation for the same period in 2002 and the 4.5-5.5 percent target for 2003.

The above trends suggest that current price pressures remain confined to specific goods markets and are therefore not broad-based. These developments reflect the continuing absence of significant demand-side pressures in the current inflation environment.



Core inflation estimates show mixed trends in third quarter but remain relatively low

The absence of demand-related pressures on consumer prices is reflected in the benign trend for core or underlying inflation. BSP estimates of core inflation, which strip out the effects of temporary disturbances on headline CPI by excluding items such as food and energy, showed mixed trends during the quarter but remained relatively low.[1] The BSP's main definition of core inflation (CPI less unprocessed food and energy items) averaged at 3.4 percent in July-September, slightly higher than the recorded averages of 3.1 percent for the same period a year earlier and 2.6 percent in the previous quarter. The average for the first nine months of 2003 was 2.9 percent, lower than the observed average of 4.2 percent for the same period in 2002. Meanwhile, alternative measures of core inflation calculated by the BSP also remained low in July-September. The trimmed mean, weighted median, and net of volatile items measures averaged at 3.4 percent, 2.5 percent, and 2.4 percent, respectively, during the period.



---

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

Food Prices

Food inflation edges down due to lower rice prices

Based on CPI data, the third quarter saw generally lower inflation rates for major food items such as rice, fish, and fruits and vegetables. The decline helped offset the higher inflation rates observed for corn, dairy, and meat products. Food inflation for July-September thus fell slightly to 1.7 percent compared to 2.1 percent the second quarter. On the other hand, beverage and tobacco products showed slightly higher inflation rates relative to the second quarter.

The higher inflation rates for corn may be traced to lower production due to the damage from strong typhoons in May and June. Growth in corn output decreased to 16.0 percent in the second quarter of 2003, its lowest recorded growth since Q1 1999. Unfavorable weather also affected rice production. Output of *palay* (unmilled rice) fell by 10.3 percent in the second quarter due to the impact of the El Niño weather phenomenon on planting conditions.[2] However, high levels of inventories of rice, which makes up about 13 percent of the CPI basket, have helped temper the impact of lower crop production on prices. The national rice inventory remained substantial during the quarter, averaging at around 1.8 million metric tons (MT), which is equivalent to about 69 days' worth of consumption. Much of the inventory has been built up through imports by the National Food Authority (NFA) and by farmers under the government's Farmers as Importers (FAI) Program. As of 12 September 2003, the country's total rice imports have reached 764.1 thousand MT, more than twice the level recorded as of 20 June 2003 of 364.3 thousand MT.

---

[2] NSCB Press Release dated 28 August 2003, "Second Quarter 2003 GDP Grew by 3.2 percent," available online at http://www.nscb.gov.ph/sna/2003/2qtr-2003/20031sempr.asp

Not all agricultural crops were affected by the inclement weather, however. Sugarcane production, for example, posted a 22.1 percent growth following a 0.7 percent decline a year earlier. Moreover, overall agricultural output continues to be supported by improved livestock and fish production.

Neutral weather conditions are expected to continue for the rest of the year

With normalizing weather conditions in the second semester, the outlook for food supply and prices in the remainder of 2003 continues to be positive. The most recent weather outlook issued by the Climate Information, Monitoring and Prediction Service (CLIMPS) indicates that near neutral weather conditions are likely to prevail in the tropical Pacific region for the period October to December 2003. This implies near-normal levels of rainfall in most parts of the Philippines, which will help support planting activity and overall agricultural crop production.

Improved weather, programs to support output will help ensure ample food supply and stable prices

The combination of improving weather, government programs to support crop production and quick turnaround, and the sustained favorable performance of the livestock and fishery industries, is expected to help agricultural output grow by 4.0 percent in 2003.[3] This, in turn, should help ensure ample food supply and stable prices over the near term.

---

[3] Programs such as the Ginintuang Masaganang Ani (GMA) Rice Program and the GMA Corn Production Program are intended to offset the crop production losses caused by the dry weather brought on by El Niño and the damage wrought by strong typhoons during the rainy season. The GMA Rice Program employed a two-pronged strategy of early planting and quick turnaround to help the agricultural sector generate 300,000 metric tons of rice, which would be sufficient to compensate for the first semester shortfall in production. The GMA Corn Production Program sought to offset the loss of crops amounting to ₱1.0 billion caused by two successive typhoons through input subsidies to farmers in the form of seeds and credit for early replanting.

Non-Food Prices

Non-food prices generally higher

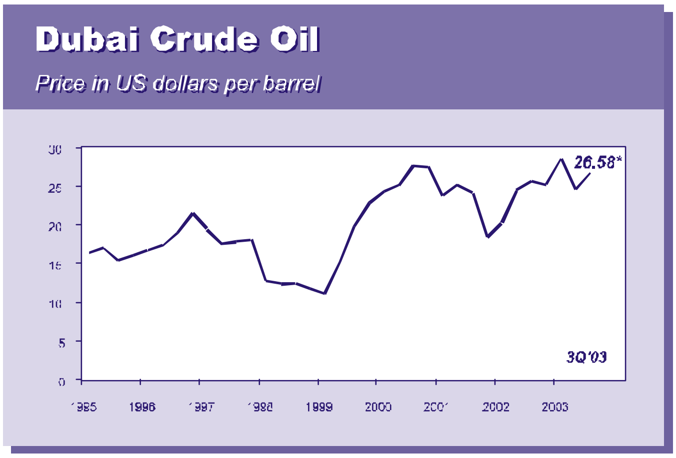
Non-food inflation was generally higher in the third quarter, driven mainly by higher inflation rates for energy-related items, which appear in the CPI basket under Fuel (for household cooking), Light and Water (FLW). FLW inflation rose from 5.2 percent in the second quarter to 9.7 percent in July-September, owing mainly to increased charges for electric utilities. Other non-food CPI items, notably clothing, housing (which includes rentals), and miscellaneous items also recorded higher inflation rates during the same period.

Energy Prices

International oil prices pick up in third quarter but should hold steady over the winter season

International crude oil prices again saw an uptick in the third quarter as record-high temperature levels in the Northern Hemisphere induced higher demand for transport fuel for travel activity during the summer season. The average price of Asian Dubai crude oil rose from US$24.44 per barrel in the second quarter to US$26.57 per barrel in the third quarter. World supply also tightened early in the quarter due to the reduced output of Organization of Petroleum Exporting Countries (OPEC) and delays in the resumption of Iraqi oil exports owing to general security problems in the country. However, stable OPEC production and easing seasonal demand subsequently allowed Dubai crude prices to soften in early September. The international spot price of Dubai crude oil fell to an average of US$25.37 per barrel for September 2003 from the US$27.66 per barrel in August 2003. Recent reports of an OPEC production cut to 24.5 million barrels per day effective 1 November 2003 are not expected to lead to tighter supply given the continued rise in non-OPEC supplies and the recovery in Iraqi production. World oil stocks are thus expected to remain ample during the winter season. OPEC itself has noted that the oil market is stable and well-supplied, and that the price of Dubai crude remained within its target band of US$22-28 per barrel.[4]

Local oil prices briefly rise during the quarter

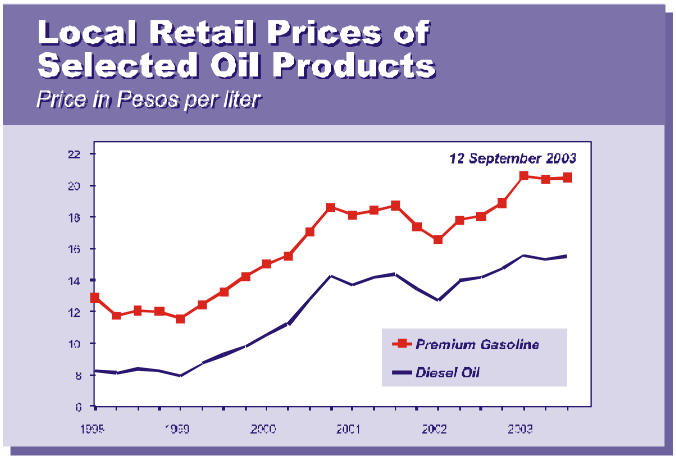


The uptick in world crude oil prices in August and the depreciation of the Philippine peso prompted a corresponding increase in local petroleum prices during the quarter. On 11 August 2003, oil companies raised their retail prices of gasoline by 60 centavos and those of kerosene and diesel by 40 centavos. These would be later rolled back when world prices eased in September. Gasoline prices were reduced by 10 centavos on 12 September 2003, and by another 10 centavos on 27 September 2003, while that of kerosene was reduced by 10 centavos on the latter date. The oil companies also began providing discounts of around 20-40 centavos per liter on diesel oil to drivers of public utility vehicles (PUV) in more than 62 gasoline stations in Metro Manila and nearby provinces. The move was intended to ease the

---

[4] OPEC Press Release No.11/2003 during its 126th (Extraordinary) Meeting, available online at http://www.opec.org.

burden of recent increases in fuel costs and dissuade the drivers' associations from petitioning the government for transport fare increases. Going forward, the ample local oil inventory is expected to help maintain stability in domestic retail prices. As of 29 September 2003, the industry inventory was estimated at 65 days of supply, significantly above the required minimum inventory level of 7 to 15 days.[5]



Utility Charges

Generation charges reduced

Changes in utility charges during the third quarter mainly involved reductions in generation charges. However, this was not accompanied by an adjustment in electric power rates.

The National Power Corporation (NPC) adjusted its generation charges pursuant with the ERC's Order issued on 15 May 2003. The rates were adjusted in accordance with generation rate adjustment mechanism (GRAM) as

---

5 The present inventory consists of crude in stock (equivalent to 45 days) and crude in transit (20 days).

prescribed by the ERC. The NPC's generation charge for Luzon was reduced to ₱2.1258 per kwh from ₱2.1913 per kwh previously. For the Visayas region, NPC's generation charge was raised to ₱2.2412 per kwh from ₱2.0837 per kwh. Meanwhile, the generation charge for Mindanao was almost unchanged at ₱1.0262 per kwh from ₱1.0217 per kwh. The new NPC generation charges were implemented in the July billing cycle and were retroactive to cover the May and June billing cycles.

Generation Rate Schedule of the National Power Corporation
in peso per kwh

	New Rates	***Old Rates***	***NPC Proposed Rates***
Luzon	2.1258	2.1913	2.9334
Visayas	2.4212	2.0837	2.9256
Mindanao	1.0262	1.0217	1.4223

Source: ERC (ERC Case No. 2003-44)

The reduced NPC generation charges are likely to contribute to lower power rates in the future. For the moment, however, the Manila Electric Company (Meralco) is engaged in the implementation of its refund scheme for customers. The ERC has reported that Meralco is still in the process of complying with deadline set by the regulatory agency to complete Phase I of its refund scheme by end-August 2003. Phase I of the scheme covers around 2 million residential and general services customers with monthly consumption level of 100 kwh and below as of April 2003. As of 25 August 2003, Meralco has refunded about ₱1.7 billion for some 1.5 million eligible customers under this phase. The total refund amount under Phase I is estimated to reach ₱2.1 billion.

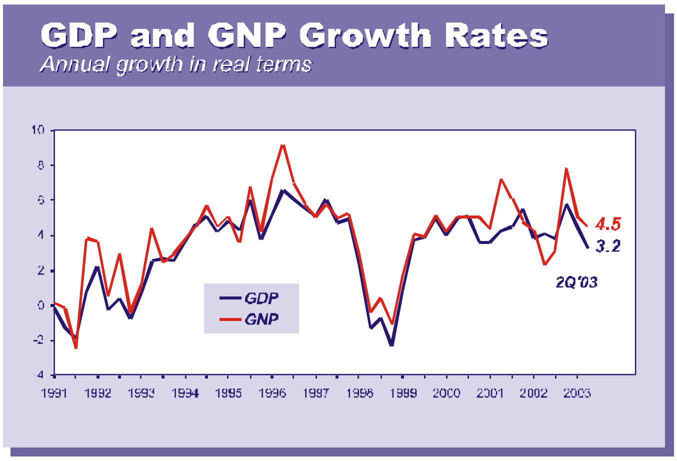
Meralco has also begun implementing Phase II of its refund scheme on 1 September 2003. This phase covers some 2.3 million residential and general service customers with monthly electricity consumption level of 101 to 300 kwh as of April 2003. Based on computations of total kwh consumption for the period February 1994-May 2003, the amount of refund due under Phase II is estimated to reach around P4.6 billion. Phase II is expected to be completed by end-2003.

At the same time, Meralco has asked the Energy Regulatory Commission (ERC) for more time to submit the proposed guidelines and procedures for the implementation of Phases III and IV. Phase III of the refund scheme shall cover residential and general service customers with monthly consumption level of 301 kwh and up while Phase IV shall cover commercial, industrial, government hospitals and streetlights customers not covered by Phases I-III.

Aggregate Demand and Supply

Overall economic activity continues to show improvement

The economy continued to grow amid the risks posed by the drought due to the El Niño phenomenon, the US-Iraq conflict, and the outbreak of SARS, and the compounding effect of the government's policy decision to keep fiscal spending under control. The country's gross domestic product (GDP) increased by 3.2 percent in the second quarter of 2003, while the gross national product (GNP) expanded at a much stronger pace of 4.5 percent on account of large net factor income from abroad which rose by 22.6 percent. However, the GDP growth in the second quarter was slower than the 4.1 percent growth recorded a year ago. For the first semester, GDP grew by 3.9 percent and GNP rose by 4.8 percent. On a seasonally adjusted basis, GDP rose 0.1 percent in the second quarter after a 0.5 percent quarter-on-quarter decline in the first quarter.

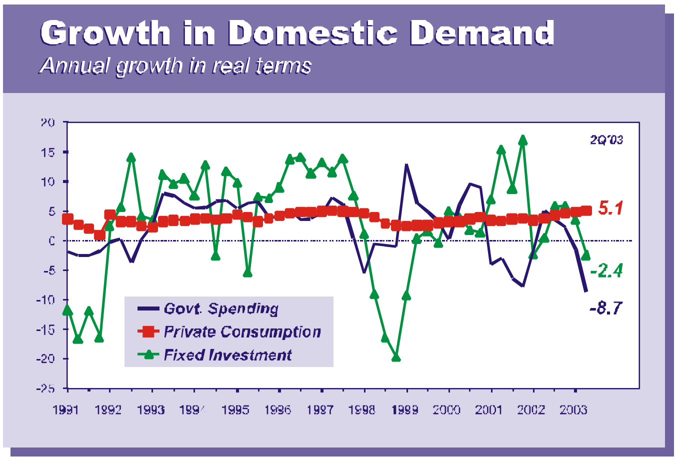


Aggregate Demand

Robust consumption spending and increased investments fuel domestic demand

Strong private consumption growth continued to drive the economy on the demand side as government consumption and public construction took a backseat to private investments in the form of spending on durable equipment and private construction. Meanwhile, the trade sector was weaker as both exports and imports grew at much slower pace.

Personal consumption expenditure rose by 5.1 percent in the second quarter, stronger than both the 3.8 percent growth recorded in the same period last year as well as the first quarter growth of 4.9 percent. The combination of low and stable inflation and a low-interest rate environment appeared to benefit overall consumption demand.



Meanwhile, the government's efforts to keep its fiscal program firmly on target caused government consumption to decline by 8.7 percent in the second quarter and public construction to shrink by 22.3 percent. Nevertheless, such efforts helped to improve investor confidence and allowed private construction activity to take the lead. The emphasis on fiscal discipline also induced increased investment in durable equipment. Investments in durable equipment expanded by 6.5 percent in the second quarter, higher than the 5.7 percent rise in second quarter of 2002.

Domestic Demand Indicators

Other areas of domestic demand show indications of sluggishness, with slower growth in manufacturing activity, imports and credit demand

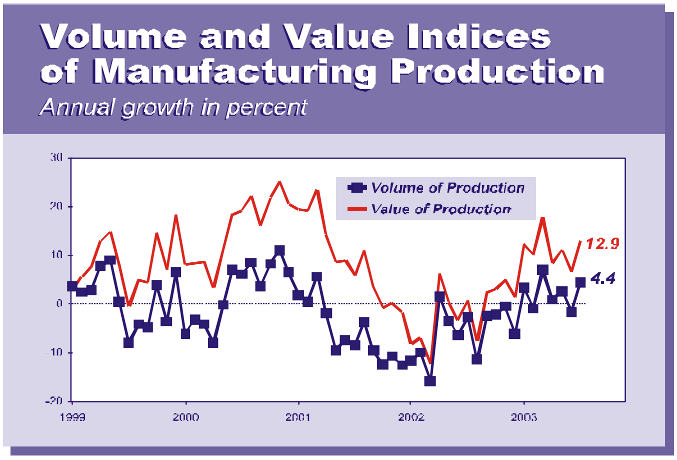
The pace and strength of domestic economic activity remains uneven and tentative. Economic indicators continued to point generally to subdued aggregate demand conditions. Manufacturing activity, for example, has slowed down while unemployment has risen and demand for exports continued to be weak.

- Commercial bank lending has consistently risen in the eleven months to July 2003 but at a moderate and, more recently, slowing pace. Total outstanding loans of commercial banks rose by 3.7 percent year-on-year in July after a 5.1 percent increase in the previous month.

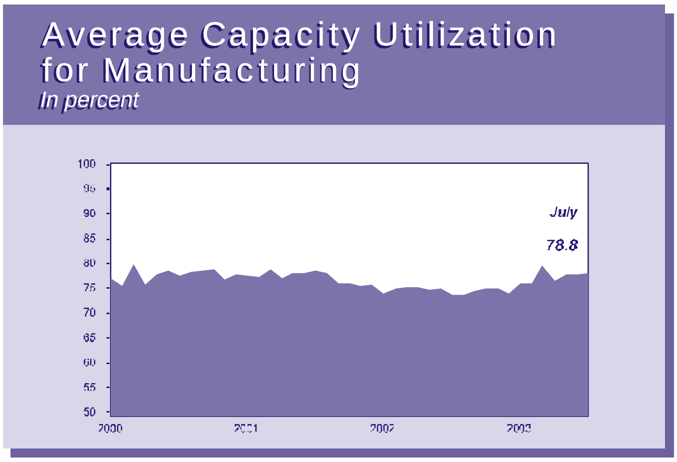
- Consumer loan activity appeared to be generally sluggish as well, according to latest data. Available data as of end-June 2003 show that the year-on-year growth in the credit card receivables (CCRs) and auto loans of commercial banks and thrift banks decelerated compared to end-March (see page 43).

- Based on the survey conducted by the BSP in July-August 2003, overall business confidence continued to be optimistic in the third quarter of 2003 as the overall business outlook diffusion index increased to 17.2 percent from 4.0 percent during the second quarter of the year. The quick resolution of the US-led Iraq war and the immediate control of the SARS were cited as the main reasons for the positive outlook. Indicators of fourth quarter sentiment showed greater optimism with the overall business outlook index of 44.5 percent from 27.6 percent in the third quarter. Businesses are expecting higher exports and increased consumer demand in anticipation of the Christmas holidays.

- Production in the manufacturing sector improved in July 2003 as the volume of production index (VOPI) rose by 4.4 percent year-on-year in June after falling by a revised 1.5 percent in the previous month. Meanwhile, the increase in the value of production index (VAPI) accelerated to 12.9 percent year-on-year in June from 6.6 percent in June.

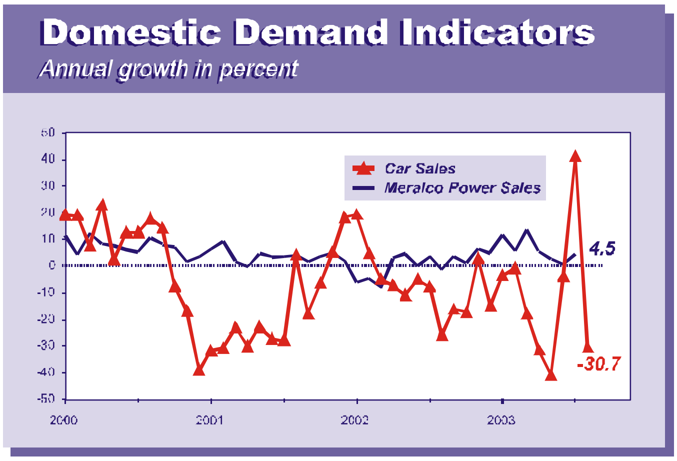


- Average capacity utilization of the manufacturing sector was almost unchanged at 78.8 percent in July from its month-ago level of 78.5 percent.



- Total automotive vehicle sales increased by an average of 13.4 percent year-on-year for the period July-August 2003, higher than the 0.8 percent rise in the second quarter. The stronger sales in 2003 was traced to the 16.0-percent increase in commercial vehicle sales and the 5.3 percent increase in passenger car sales, the latter a turnaround from the 25.5-percent decline during the second quarter. For the period January-August 2003, total vehicle sales rose by 16.5 percent year-on-year, higher than the 8.0 percent growth recorded in the same period in 2002.

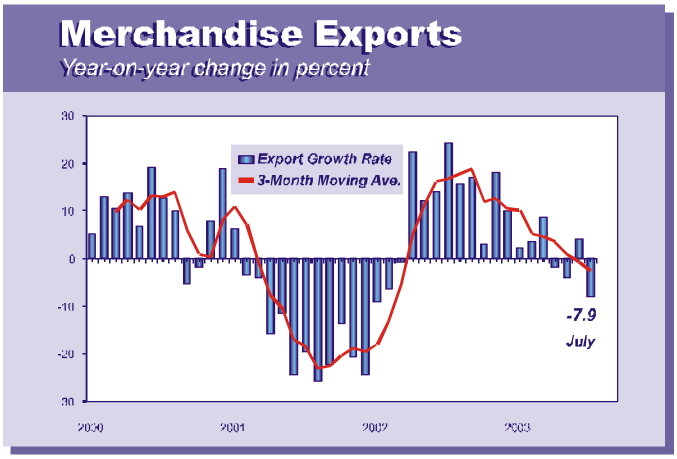
- Meanwhile, registered energy sales by the Manila Electric Company increased by 4.5 percent on annual basis in July 2003 following a 2.9-percent average increase in the second quarter. Total energy sales in the first eight months rose by 5.6 percent, a turnaround from the 1.0-percent decline in the same period in 2002.



External Demand

Export demand remains moderate due to continued economic weakness overseas

The country's exports continued to post a positive growth with decelerating trend on a cumulative basis. The deceleration was caused mainly by the limiting demand for Philippine products particularly for electronics items as global output and prospects remained uncertain. Electronics exports accounted for about 65.6 percent of the aggregate exports. Total merchandise exports reported by the National Statistics Office (NSO) showed a 0.5 percent decline in the second quarter, a reversal of the 4.9 percent increase recorded in the first quarter. Exports further declined by 7.9 percent in July 2003 due mainly to the 11.1 percent drop in electronics exports.

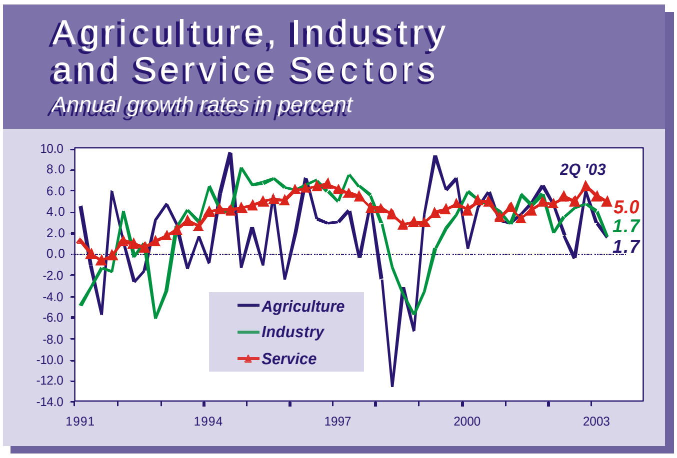


Meanwhile, total imports leveled off in the second quarter to record a flat growth from the import level a year ago, and after generating a robust 22.4 percent growth in the first quarter. The huge growth in the first quarter was due mainly to the front-loading of raw materials and crude oil imports in response to concerns over the outcome of the US-led war in Iraq. In July 2003, imports showed a slight pick up albeit at a modest pace of 1.3 percent compared to 11.0 percent in July last year. However, capital and consumer goods imports continued to show encouraging growths of 12.0 percent and 14.3 percent, respectively in July 2003.

Aggregate Supply

Output growth remains broad-based, led by services sector

The major production sectors continued to expand, based on latest available national accounts data for the second quarter. The services sector continued to lead all the sectors as it expanded strongly by 5.0 percent during the quarter. Transportation, communication and storage, and trade sectors slowed down from their performances a year ago but remained upbeat as they grew by 8.2 percent and 5.3 percent, respectively in the second quarter. Further expansion in wireless communication services and the entry of new player in the telecommunication market drove the sector. The finance sector, led by the banking industry, improved by 6.0 percent in the second quarter, sustaining the 4.9 percent growth a year ago while the real estate rebounded to 3.8 percent from a contraction of 0.2 percent in 2002.



Industry suffered a sluggish growth of 1.7 percent in the second quarter from 4.0 percent a year ago. Manufacturing held up unexpectedly well to grow by 4.1 percent, despite contraction in export-oriented sectors—notably electrical machinery (by 15.1 percent) along with electronics, transport equipment, and beverages. A positive development is that the chemical sector, which has been experiencing negative growths for several quarters, posted a positive growth of 5.1 percent in the second quarter.

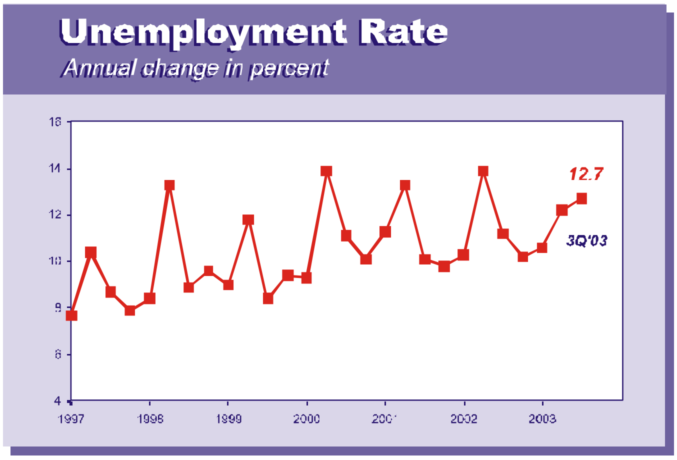
In agriculture, all sectors continued to post positive growth despite the drought caused by the El Niño phenomenon as the decline in the production of the major crops were offset by the production of other crops. The growth of agriculture, fishery and forestry registered a 1.6 percent increase in the second quarter, lower than the 1.9 percent growth a year ago. Palay and corn production contracted by 10.3 percent and 16.0 percent, respectively. However, farmers showed resilience from drought due to support measures that enabled them to shift the production of other crops (i.e. non-rice crops). The growth of other crops rose by 5.7 percent from the first quarter contraction of 1.1 percent and the 2002 first quarter growth of 5.1 percent growth. Fishery production, which was affected by El Niño in the first quarter also rebounded to grow by 5.5 percent in the second quarter. Meanwhile, the growths of livestock (3.0%) and poultry (4.5%) continued to indicate strong demands.

Moving forward to the second semester, GDP is expected to average 4.5 percent to result in a full year growth of 4.2-5.2 percent. The Bureau of Agricultural Statistics (BAS) is expected increased production of cereals in the second half, with *palay* and corn production expected to expand by 2.5 percent and 2.0 percent, respectively. Other positive developments that are expected to spur consumption and investments in the second semester include the expected opening of several new malls in the countryside. Pre-election-related spending and strong inflows of overseas remittances are also seen to contribute to consumer spending. Although deployment of OFWs has been minimal of late, remittances have increased as the deployment of workers shifts toward higher-paying jobs such as nursing, caregiving, and information technology. The risks to growth could, however, tilt to the negative with significant deterioration in confidence that may undermine the ongoing recovery in private construction, financial sector, utilities, and import-dependent manufacturing sectors.

Employment Conditions and Wages

Labor market conditions improve but remain soft

Employment conditions appeared to show a slight improvement in the manufacturing sector but on the whole remained soft, due mainly to the slowdown in agricultural employment as a result of the drought caused by the El Niño phenomenon. According to the Labor Force Survey published by the National Statistics Office (NSO), the unemployment rate increased to 12.7 percent in July 2003 compared to 11.2 percent in July 2002, mainly on account of the 760,000 jobs lost in agriculture. The survey conducted by the NSO covering the second to fourth week of July coincided with the drought, during which agriculture activities were also on hold. Agriculture production was also seasonally low in the third quarter. Meanwhile, underemployment rate rose to 20.8 percent in July 2003 from 17.1 percent a year ago.



Industry generated 259,000 jobs in July 2003, representing a 5.5 percent increase over a year ago. The sector constituted about 16.6 percent of the country's total employment. The increase in jobs in the industrial sector was a reversal form year-ago of about 7,000 jobs lost. The major sources of jobs in the industry were manufacturing

(138,000), which showed an improvement of 4.8 percent over a year ago, construction (119,000), and mining (7,000).

The services sector, which comprised close to half (48.6 percent) of total employment, generated 254,000 jobs in July 2003. The 1.8 percent growth of the sector came from hotel and restaurants (69,000), real estate, renting and business activities (188,000), transport, storage and communication (141,000), and health and social work (15,000). However, jobs were lost in public administration (84,000) and financial intermediation (17,000).

Meanwhile, the labor demand for overseas Filipino workers (OFWs) appeared to weaken as total deployment of OFWs for the period January to July 2003 fell by 5.3 percent, a reversal of the 4.5 percent growth for the same period a year earlier. The SARS epidemic and the uneven global performance contributed to the reduced deployment of workers.

For the remaining quarter of the year, prospects for wage adjustments in response to higher domestic oil prices are likely to be weak given the continued absence of wage petitions in regional wage boards. Excess labor supply and the subdued environment for consumer prices have continued to deter labor groups from filing petitions minimum wage adjustments. This is particularly true in Metro Manila, where the last minimum wage adjustment took effect in November 2001. Since then, the Regional Tripartite Wage and Productivity Board of the National Capital Region (RTWPB-NCR) has not received any demands for wage increase. At the same time, new notices of strikes and lockouts filed with the DOLE as of 30 August 2003 reached 424, a 21.6 percent decline from the recorded 541 cases filed for the same period a year ago. However, actual number of strikes increased to 34 as of August 2003 from last year’s 25.

Employment generation will take its cue from the pace of activity in areas such as the retail trade sector through the building of new shopping complexes outside the NCR and work opportunities from housing-related activities. For the agricultural sector, the return to normal weather conditions should allow normal farming activity to resume. The risks related to SARS appear to have faded—at least for the time being—and economic activity in SARS-affected countries where the Philippines has large numbers of overseas workers, has normalized.

Fiscal Developments

Fiscal performance remains on track

The fiscal position of the National Government (NG) remained on track in the first eight months of the year vis-à-vis the country's fiscal program. The improved fiscal condition allowed a little flexibility for increased public spending in August to stimulate economic activity. The NG remains committed to achieving its 2003 target deficit of 4.7 percent of GDP or roughly ₱202 billion. Improve prospects for fiscal performance should generate positive sentiment in financial markets and provide positive influence on inflation expectations.

The fiscal deficit for the month of August reached ₱18.2 billion, higher than the ₱8 billion target deficit for August and the ₱12.2 billon fiscal gap registered for the same month a year ago. The higher-than-target fiscal deficit in August resulted from the NG's efforts to increase its spending in order to counteract the observed slower economic activity for the month. Nevertheless, the fiscal gap for the first eight months of the year of ₱114.5 billion was below the ₱144 billion deficit posted for the same period in 2002.[6]

National Government Fiscal Position
in billion pesos

	August		Annual Growth (%)	January-August		Annual Growth (%)
	2002	2003		2002	2003	
Surplus/Deficit	-12.2	18.2	49.1	-144.0	-114.5	-20.5
Revenues	50.3	51.1	1.7	363.4	408.4	12.4
Expenditures	62.5	69.3	10.9	507.4	522.9	3.1
Borrowings	14.3	-4.7	-133.2	200.5	183.2	-8.6

Source: Bureau of Treasury

Total revenue collections in August missed the program level of ₱51 billion by 0.6 percent. The collections by the Bureau of Customs (BOC) fell short for the first time this year by around ₱863 million due to weaker trade inflows. This was compensated for by the improved collections of the Bureau of Internal Revenue (BIR), which exceeded its monthly target by ₱460 million as a result of ongoing reforms to help expand the tax base and increase tax collection efficiency. In particular, the growth in revenue collections came mainly from higher value-added taxes, corporate income of the manufacturing sector, and taxable income from the services sector particularly, finance and information and communications technology. Over the period January-August 2003, total revenue collection was well above the target by 6.5 percent to settle at ₱408.4 billion.

[6] Department of Finance press release entitled, "Pump priming in August raises fiscal deficit to ₱18.2 billon," dated 18 September 2003

Meanwhile, total expenditures for August amounted to ₱69.3 billion, about 16 percent higher than the target for the month. During the month, the NG settled ₱4.7 billion worth of accounts payable and paid for the ₱1.5 billion tax liability of the Department of Transportation and Communication (DOTC). For the first eight months of the year, total expenditures reached ₱522.9 billion, ₱12 billion higher than the program. The increase in total disbursements was traced to the rise in interest payments, additional spending for the Comprehensive Agrarian Reform Program (CARP), increased spending on personal services following the release of pension and salary adjustments for police and military personnel, and the hiring of new employees by the Department of Education and by the Philippine National Police.

Financial Market Conditions

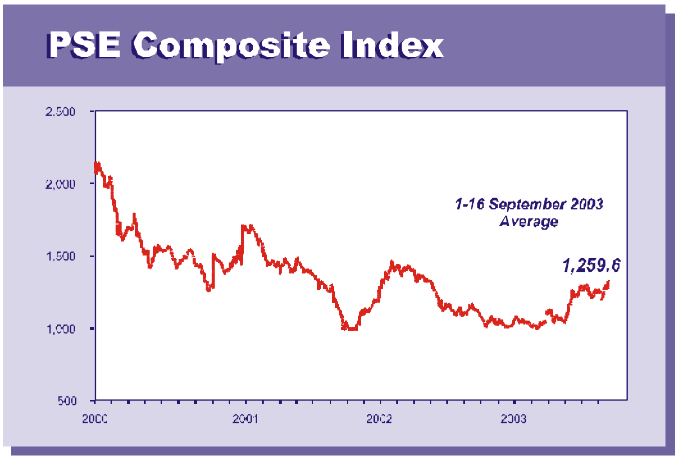
Domestic markets remain liquid and show improvement

Philippine financial markets performed better in the third quarter of 2003. The equities market, for example, displayed a general uptrend relative to the second quarter of 2003 despite the market's lingering concerns over political developments. Equity trading was also propped up by favorable news from stock markets overseas coupled with the positive developments in the fiscal and monetary sectors. Meanwhile, the government securities market continues to attract strong demand from banks, a result in part of moderate loan activity. At the same time, the financial system continued to show indications of ample liquidity, as Treasury bill (T-bill) auctions by the Bureau of the Treasury (BTr) continued to be oversubscribed. However, the amount of oversubscription in the third quarter declined significantly relative to the previous quarter.

Stock Market

Stock market picks up on improved investor confidence and positive news

Despite the presence of political and security concerns, the Philippine Stock Composite Index (PHISIX) managed to register gains in the third quarter of the year. From an average of 1,121.5 in the second quarter, the PHISIX edged higher to close at 1,240 index points in July 2003 before falling to 1,192.8 index points in end-August. However, the PHISIX strengthened again in September to close at 1,314 index points on 21 September 2003.



The relatively bullish market sentiment in July 2003 was largely a result of favorable developments in the both the monetary and fiscal sectors. Market analysts attributed the uptrend in the PHISIX in July compared to the previous quarter's level to the optimism generated by the decision of the BSP to lower its key policy rates during its monetary policy meeting on 2 July 2003 as well as to reports of favorable fiscal performance. The market's momentum, however, was not carried into August as security jitters arising from persistent coup rumors along with the depreciation of the local currency dampened market sentiment. In September, investors brushed aside these domestic concerns as the local bourse took its lead from rallies in equity markets abroad. Indications of a recovery in the US and Japan buoyed the local equity market as stronger economic activity overseas could exert a positive influence on the domestic economy.

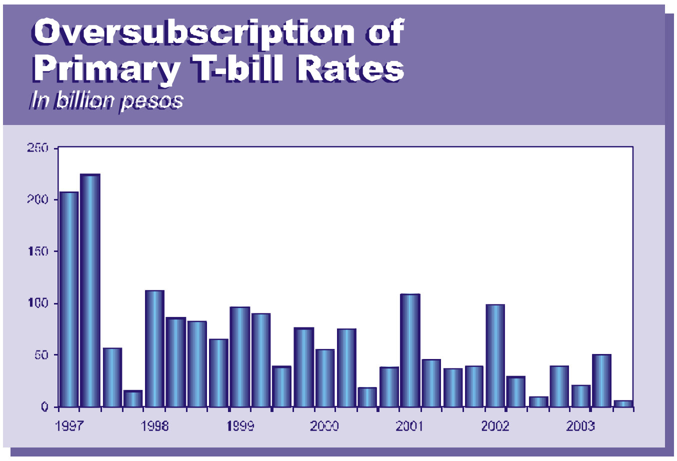
Government Securities

Market demand for government securities remains strong

T-bill auctions conducted by the Bureau of the Treasury (BTr) were generally oversubscribed in the third quarter with the exception of the auctions held on 1 and 29 September 2003. Relative to the second quarter, however, the volume of excess bids fell considerably from ₱50.7 billion to ₱6.1 billion in the third quarter. This was a result mainly of the demand for the newly issued Retail Treasury Bonds, which drew away funds from short-term government debt papers.[7] Meanwhile, the BTr continued to reject bids as the BTr sought to cap further increases in yields. Total rejections for the period reached ₱34.7 billion with all tenders fully rejected during the 4 August and 1 September auctions. The volume of rejections in the third quarter also reflected a decline compared to the ₱60 billion worth of rejections posted in the second quarter.

---

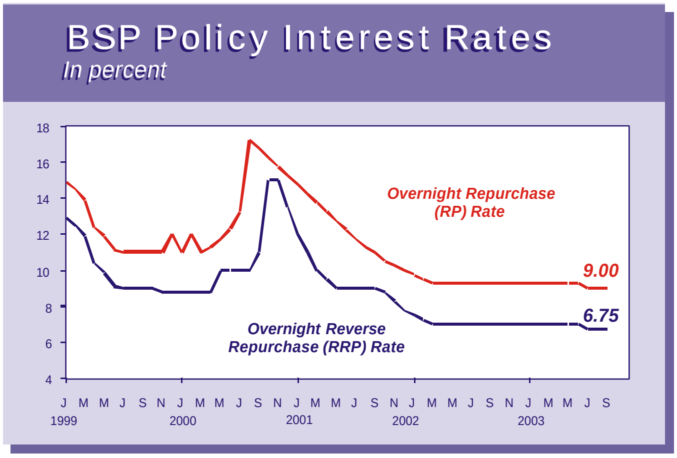
[7] In connection with the issuance of the Retail Treasury Bonds, the BTr decided to reduce the total volume of T-bill offered to ₱6.5 billion for the month of July.



II. Monetary Policy Developments

Monetary policy stance in third quarter generally cautious but growth-supportive

The monetary policy stance of the BSP in the third quarter of 2003 may be generally described as cautious but supportive of the economy's growth objectives. During its regular monetary policy meeting on 2 July 2003, the Monetary Board, the BSP's policymaking body, voted unanimously to reduce the overnight reverse repurchase rate (RRP) and the overnight repurchase rate (RP) by 25 basis points (a quarter of a percentage point) each to 6.75 percent and 9.0 percent, respectively, representing the lowest levels recorded for policy interest rates since May 1992. The previous action on policy interest rates took place on 15 March 2002, when rates were also lowered by 25 basis points. For the period December 2000-July 2003, the BSP's key policy rates have been reduced by a cumulative 825 basis points.



In its assessment of the inflation environment and overall macroeconomic conditions, the members of the Monetary Board maintained the view that future inflation was likely to continue to follow a benign inflation path over the policy horizon. Both demand and supply factors pointed to subdued price conditions going forward as the main inflationary risks considered in setting the targets for 2003 and 2004 have diminished significantly.

The current state of activity in the economy was also still marked by moderate strength in aggregate demand conditions as key areas of demand continued to register signs of sluggishness. For instance, growth in leading indicators of production in the manufacturing sector remained tentative while the labor market conditions remained soft and demand for exports continued to be relatively weak. This supported the Monetary Board's view of limited demand-side pressures on prices. At the same time, the Monetary Board noted that the main supply-side risks to future inflation have started to taper off with normalizing weather conditions and the relative stability in the international market for crude oil. Meanwhile, there are recent indications of an improvement in global economic conditions led primarily by favorable outturns in economic indicators in the US and Japan. However, the global economic recovery process was expected to be gradual given the presence of imbalances in major economies such as the still-weak corporate investment, continuing adjustments in global current account imbalances, and security concerns. The prospect for a benign inflation, moderate growth in domestic demand, receding cost-side risks to prices, and downside risks to external demand together provided the Monetary Board the room to further ease the monetary policy settings to help sustain the ongoing impetus for growth.

The outlook for inflation still contained an undercurrent of risk in the form of adverse cost-side developments and adjustments in the foreign exchange market

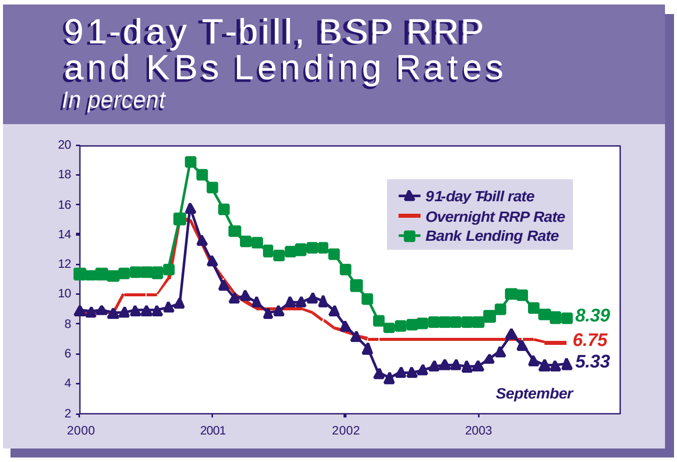
Nevertheless, the outlook for inflation still contained an undercurrent of risk in the form of adverse cost-side developments and adjustments in the foreign exchange market, which have a bearing on public expectations about future prices. Following the observed volatility in the foreign exchange market in late July to August, the Monetary Board decided to remove the tiering scheme on bank placements under the overnight RRP and SDA window during its monetary policy meeting held on 28 August 2003. Although the Monetary Board believed that the nominal depreciation of the peso was largely a result of temporary, non-economic and seasonal factors, the Monetary Board was also of the view that persistent large daily movements in the exchange rate could raise the public's expectations on inflation. Thus, as a preemptive measure against adverse changes in inflation expectations due to volatilities in the foreign exchange market, the Monetary Board lifted the three-tiered system on bank placements with the BSP. Effective 28 August 2003, bank placements with the BSP were accepted at a flat rate of 6.75 percent. This was the second time for this year that the BSP suspended the tiering scheme on bank placements. It could be recalled that the Monetary Board lifted the tiering scheme on 20 March 2003 but restored it on 5 June 2003.

III. Recent Monetary Conditions

Interest Rates

Interest rates trend down in third quarter

Domestic interest rates were relatively lower in the third quarter. Market interest rates continued to generally move downward in July—extending the overall downtrend observed in June 2003—but had a slight uptick beginning mid-August. The general downtrend in domestic interest rates can be traced to the BSP's policy rate reduction in July, amidst the political tension and security concerns that arose during the month, as well as continued presence of ample liquidity in the system. In particular, the weighted average benchmark 91-day Treasury bill rate fell from 5.24 percent in July to 5.23 percent in August, after finally reaching 5.33 percent in September.[8]



Rates charged on bank loans followed a declining trend during the quarter. After registering a range of 8.6-10.2 percent in July, bank lending rates both averaged at a

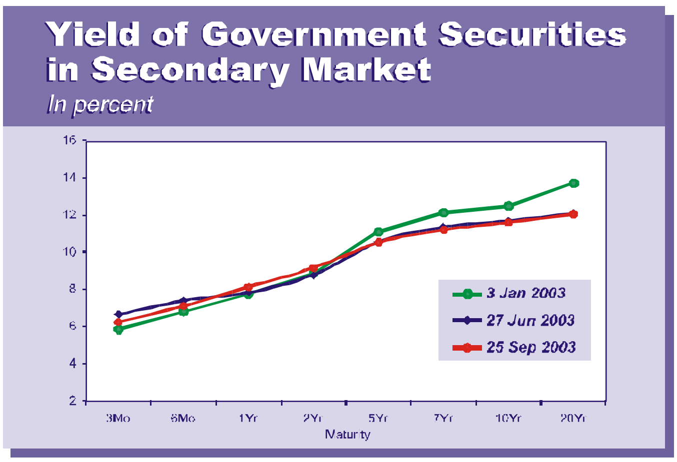
[8] Rate as of the latest 91-day Treasury bill auction on 15 September 2003

range of 8.4-10.1 percent in August and September, respectively. The range of bank lending rates in July to August at 8.4-10.2 percent was lower compared to the 9.0-12.0 percent range from January to March. However, compared to the 18.9-20.8 percent range reached in November 2000, when the BSP began pursuing an accommodative monetary stance, bank lending rates during the quarter have declined by about 1,051-1,067 basis points.

Yield Curve

Yield curve flattens and shifts downward from previous quarter

The yield curve for government securities in the secondary market as of 25 September 2003 was generally flatter and exhibited a slight downward shift compared to the yield curve as of 27 June 2003. Lower secondary market yields in September reflected mainly the downtrend in the primary market rates during the month.

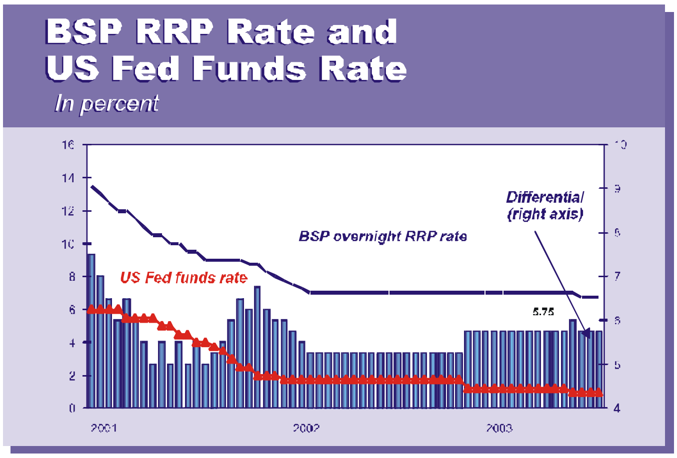


Interest Rate Differentials

Interest rate differentials narrow in May-June as RP interest rates fall

Philippine interest rate differentials with the US continued to narrow in the third quarter, on account of the larger decline of market interest rates in RP relative to the foreign interest rates. Average monthly differentials between the RP 91-day T-bill rate (net of RP withholding tax) and the 90-day LIBOR and 90-day US T-bill fell from 333.4 basis points and 354.0 basis points in June, respectively, to 311.9 basis points and 332.1 basis points in September 2003.

The differential between the BSP's policy interest rate (overnight borrowing or RRP rate) and the US federal funds target rate narrowed to 575 basis points following the 25 basis point-cut in the BSP's overnight RRP rate to 6.75 percent on 2 July 2003. Meanwhile, the US Fed's funds target rate remained steady at 1.0 percent, the level to which it was cut on 25 June 2003.



On 28 August 2003, the Monetary Board decided to remove the tiering scheme on banks' placements with the BSP which had the following rates under the RRP and special deposit accounts (SDA) windows: 6.75 percent for the first ₱5.0 billion; 3.75 percent for additional amounts in

excess of ₱5.0 billion up to ₱10 billion; and 0.75 percent in excess of ₱10 billion.

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 widened in the third quarter of 2003. The risk-adjusted differential widened to 186 basis points as of 15 September 2003 from the 157 basis points registered as of end-June, a result mainly of the 2 July 2003 policy rate cut by the BSP. Meanwhile, The lower yield on the 10-year ROP note since the last week of August was attributed to global investors' increased appetite for emerging market bonds on expectations that the US Federal Reserve may keep its federal funds target rate unchanged at its meeting on 16 September 2003.[9]

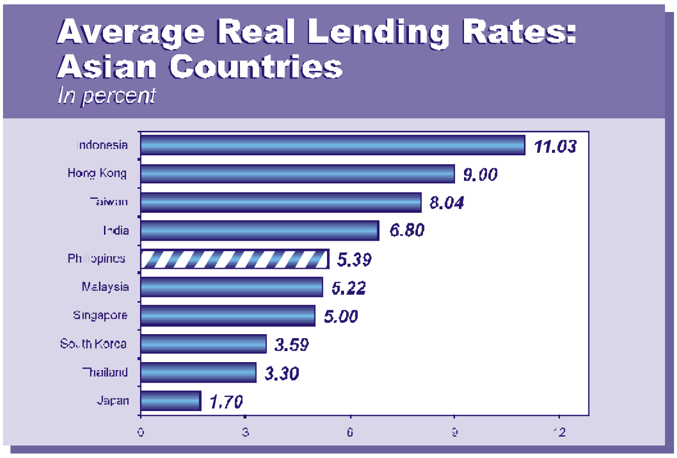
Real Lending Rate

Real lending rate heads down but remains generally higher than first quarter

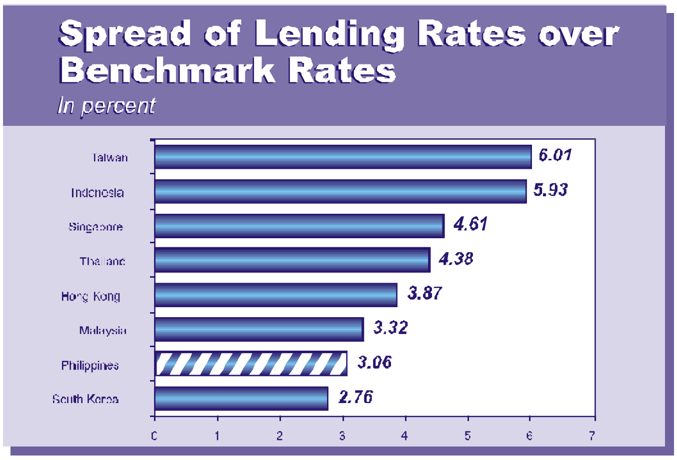
Meanwhile, the real lending rate in the Philippines followed a mixed trend during the third quarter but remained generally lower compared to that of the previous quarter. The real lending rate declined from 5.6 percent in June 2003 to 5.4 percent in September. The average real lending rate for the third quarter of 5.4 percent was lower than the 6.7 percent average recorded in the second quarter. The Philippines' real lending rate for September ranked the fifth highest in a sample of 10 Asian countries with real lending rates ranging from 1.7-11.3 percent during the same period.

---

[9] "Philippine Dollar Bond Rises; Fed May Keep rates on Hold", Bloomberg News, 16 September 2003



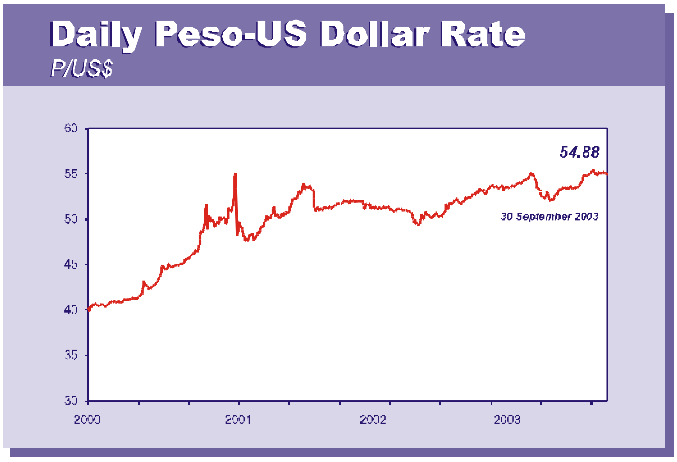
The differential between the Philippine lending rate and the benchmark 91-day T-bill rate narrowed to 306 basis points in September , compared to 346 basis points in June 2003, due to the decline in the low-end of the range of Philippine lending rates. Among the 10 Asian countries surveyed, ranked the second lowest in terms of spread, next to South Korea.



Exchange Rate

Exchange rate stable on the back of overseas remittances and inflows prompted by good fiscal performance

During the third quarter of 2003, the peso experienced episodes of heightened pressure. From an average of ₱53.41/US$1 in June 2003, the peso depreciated to an average of ₱55.02/US$1 in September, reaching its lowest since the beginning of the year at ₱55.53/US$1 on 26 August 2003. The weakening trend of the peso was traceable to seasonal factors, including the slowdown in dollar remittances from overseas Filipino workers (OFWs) coupled with higher dollar demand to cover import requirements and end-of-quarter debt servicing by corporates. The movement of the peso during the quarter was also partly sentiment-driven and reflected overreaction by the market to non-economic factors particularly, security concerns and political issues in the run up to the election next year.



Volatility, as measured by the standard deviation of the daily exchange rates was ₱0.44 in July, ₱0.22 in August and ₱0.12 in September. The marked fluctuations of the peso against the US dollar as a result of heightened pressure explain the magnitude of the volatility during the three months in review.

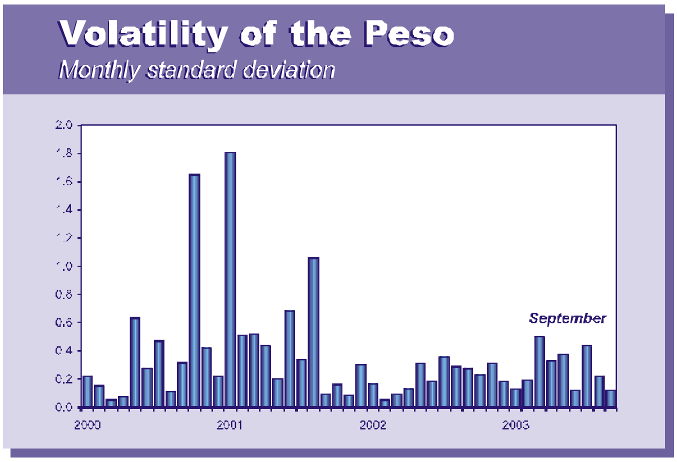
Compared to its level as of 2 January 2003, the peso-dollar rate as of end-September 2003 depreciated by 3.1 percent, while other Asian currencies appreciated against the US dollar over the same period.

CHANGES IN SELECTED DOLLAR RATES	
Currencies	**Appr/Depr (-) from 2 January 2003**
Thailand baht	7.60
Japanese yen	7.17
Indonesian rupiah	6.25
South Korean won	3.08
New Taiwan dollar	2.70
Hong Kong dollar	0.60
Singapore dollar	0.21
Malaysian ringgit	0.00
Philippines Peso	(3.07)

On a real, trade-weighted basis, the peso maintained its competitiveness relative to the currencies of the major trading partners (MTP) as shown by the depreciation in the real effective exchange rate (REER) index in August 2003 from the level in June 2003.[10] This resulted mainly from the nominal depreciation of the peso against the MTP basket of currencies. The peso also posted real depreciations over the same period vis-à-vis the currencies of the Philippines' competitor countries. The REER for the

[10] The basket of the major trading partners is composed of the currencies of the US, Japan, Euro 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.

broad and narrow baskets of competitor currencies fell by 1.1 percent and 0.2 percent, respectively, due mainly to the nominal depreciation of the peso against the currencies in these baskets and the narrowing price differential between the Philippines and competitor countries. Overall, these developments indicated the continued improvement in the country's external price competitiveness.



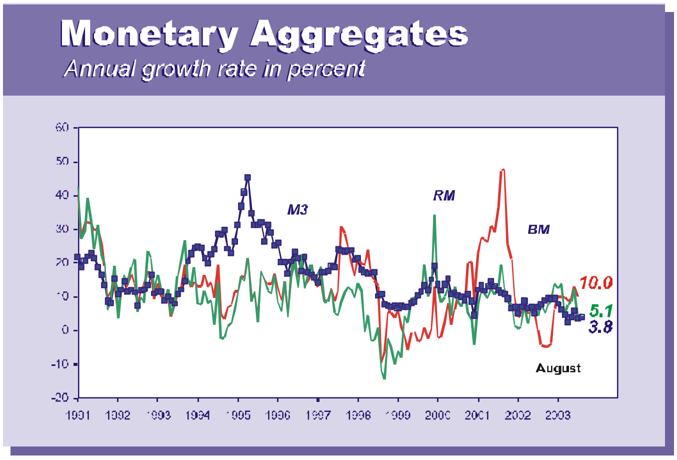
For the remainder of 2003, the continued growth of exports in 2003, which is forecasted at 5 percent and stronger inflows of OFW remittances are expected to have a positive impact on the peso. Based on BSP's projections, while the trade in goods balance is projected to revert to a deficit in 2003 from a modest surplus in 2002, the current account balance is still projected to record a surplus, though at a level lower than that posted in 2002. Moreover, the country's strong economic fundamentals and improving fiscal scenario suggest a generally positive outlook for the economy. Also, the continued commitment to structural reforms (such as the passage of the SPVA and the Procurement Act early this year) creates fresh incentives for foreign investments, thereby providing support for the peso. Thus, the peso is expected to remain generally stable for the remainder of the year.

Going forward, BSP will allow market forces to determine the exchange rate but stands ready to provide dollar liquidity if the situation warrants. BSP shall continue to monitor closely FX rate developments to assess their impact on the inflation outlook so that appropriate policy responses are implemented to ensure the attainment of the BSP's primary objective of price stability.

Monetary Aggregates

Demand for money slows down

Demand for money appears to have slowed down in the third quarter. In June, year-on-year growth in M3 accelerated to 5.9 percent year-on-year from 3.9 percent in May 2003. In July and August, however, M3 grew at a slower pace of 3.6 percent and 3.8 percent, respectively. The increase in money stock over the last three months was traced mainly to the improvements in the levels of domestic credits to both the public and private sectors and the expansion in the net foreign assets (NFA) of the monetary system. Strong demand for government securities against a backdrop of ample liquidity in the system contributed to the growth in lending to the public sector. Net purchases of foreign exchange by banks and other corporates, combined with the net repayments of their foreign-denominated obligations, also contributed to available liquidity in the system.



Growth in other money aggregates showed a similar slowdown during the period. Year-on-year growth in reserve money (a narrower definition of money supply defined as the sum of currency issue net of cash in the vaults of the Bureau of the Treasury and banks' reserve balances with the BSP) decelerated from an average of 10.5 percent in the second quarter to 4.3 percent for July-August.

Banking System

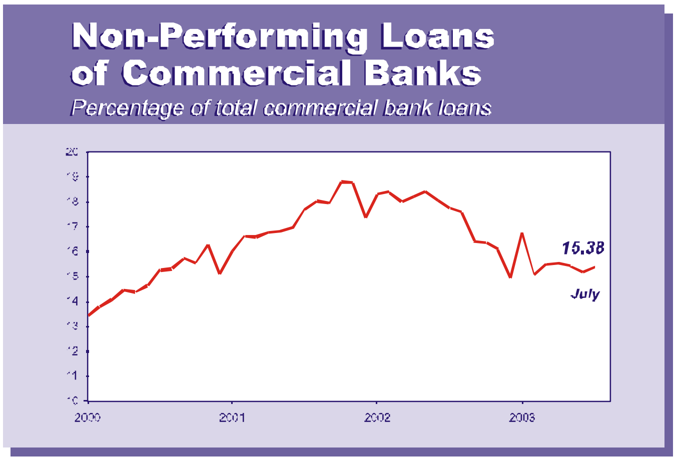
Banking system remains stable

The banking system remained sound and stable in the second quarter. The aggregate resources of the banking system increased by 4.4 percent year-on-year to ₱3613.8 billion as of end-July 2003. The year-on-year growth in total resources was largely due to increases in bank deposits (4.3 percent) and capitalization (5.4 percent). By type of bank, commercial banks accounted for the largest share in the banking system's total resources with 90.4 percent; followed by thrift banks, 7.2 percent; and rural banks, 2.4 percent. Asset quality slightly declined relative to the previous quarter but rallied compared to last year's non-performing loans (NPL) ratio to total loans, as the banking system's loan loss provision (LLP) ratio to NPL continued to improve.

Asset Quality

Asset quality improves compared to a year ago

As of end-July 2003, the commercial banks' NPL ratio to total loans rose to 15.4 percent compared to the end-June 2003 level of 15.2 percent but was lower than the 17.8 percent recorded in July 2002. The increase in commercial banks' NPL ratio was brought about by the 1.6 percent reduction in total loan portfolio.



The Philippines' NPL ratio remained one of the highest among the Asian countries surveyed. For the second quarter of 2003, the NPL ratio of Thailand's banking system at 15.7 percent was the highest among the sample Asian countries, followed by the Philippines (15.2 percent), Malaysia (9.5 percent), Indonesia (8.3 percent) and Korea (3.5 percent).[11]

[11] Source: ARIC Financial Sector Indicators, ADB Website. (April 2003 data for Thailand, June 2003 for Malaysia and Indonesia, and December 2003 data for Korea)

Capital Adequacy

Capital adequacy and provisioning against loan losses remain high

Based on the old capital adequacy framework, the capital adequacy ratio (CAR) of the banking system as of March 2003 was higher at 17.0 percent relative to the 16.7 percent recorded as of December 2002, due to the increase in banks' capital reserves and the decrease in risk assets, an indication of the banking system's improved resilience to financial shocks. Using the risk-based framework,[12] the CAR of commercial banks was slightly lower at 16.6 percent in December 2002 from 16.7 percent posted in September 2002. The CAR – using both the old and new frameworks - exceeded the statutory level set by the BSP at 10.0 percent and the BIS standard of 8.0 percent. The Philippines' commercial banking system's CAR (16.6 percent) remained the highest among Asian countries, followed by Thailand (13.2 percent), Malaysia (13.1 percent) and Korea (10.5 percent).[13]

The commercial banks' loan loss provision (LLP) ratio to NPL improved in July 2003 after a generally decreasing trend in the second quarter of 2003. The NPL coverage (LLP/NPL) rose to 51.3 percent in July 2003 from 50.6 percent in June 2003 and from 48.2 percent a year ago, due to increasing loan loss provisions in the first six months of 2003 reflecting banks' diligent compliance with the loan loss provisioning requirements of the BSP as a cushion against possible losses.

---

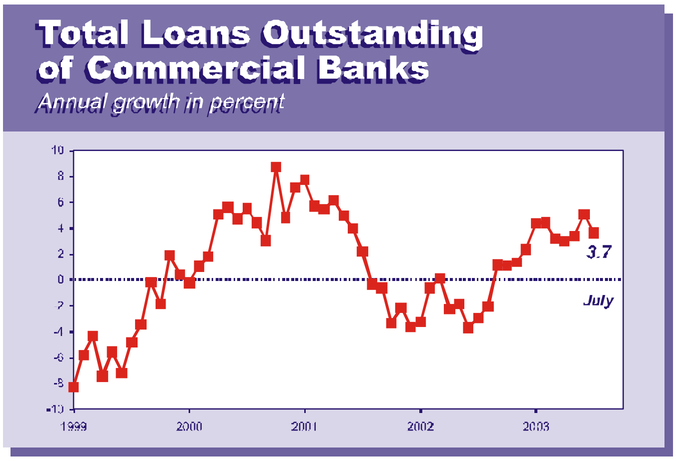
[12] BSP Circular No. 280, dated 29 March 2001, approved the guidelines for the adoption of the risk-based capital adequacy ratio along the criteria prescribed by the Bank for International Settlements (BIS).

[13] Source: ARIC Financial Sector Indicators, ADB Website

Bank Lending

Bank lending continues to rise but is slower in second quarter

Total volume of outstanding loans of commercial banks increased to ₱1.4 billion as of July 2003, 3.7 percent higher than the level recorded a year ago. Total loans outstanding of commercial banks rose by an average of 4.4 percent year-on-year in June and July 2003, higher than the 3.2 percent year-on-year growth in April and May 2003. The growth in commercial bank lending was led primarily by the increase in loans to the following sectors: agriculture, fisheries and forestry (69.5 percent); community, social and personal services (8.1 percent); electricity, gas and water (4.1 percent); wholesale and retail trade (2.5 percent); and manufacturing (1.7 percent). These sectors made up for 64.4 percent of the total outstanding loans of commercial banks.

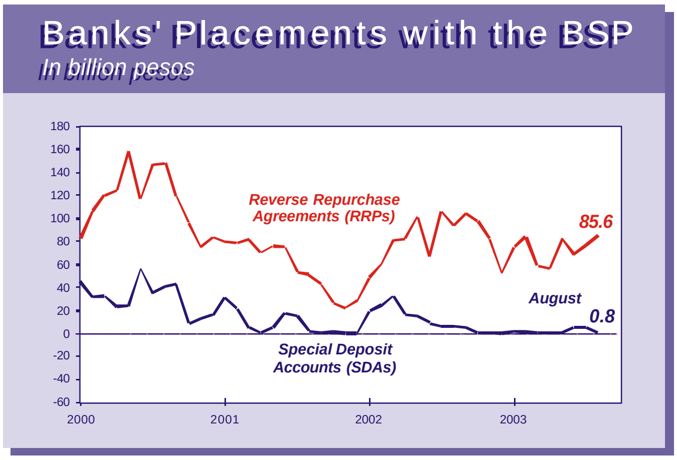


Consumer loan activity appeared to be generally sluggish as well, according to latest data. Available data as of end-June 2003 show that the combined credit card receivables (CCRs) of commercial banks and thrift banks, inclusive of credit card subsidiaries, fell by 2.4 percent year-on-year following a modest 2.1 percent increase in March. Data also indicate that auto loans of commercial banks and thrift banks as of end-June 2003 grew by 10.5 percent year-on-year following a 33.9 percent increase in end-March.

Banks' Placements with the BSP

Banks' placement of funds with the BSP rise under the RRP window but fall under the SDA facility

The total volume of banks' placements with the BSP under the reverse repurchase (RRP) window reached ₱85.6 billion as of end-August 2003, higher by ₱17.1 billion from the end-June level, due to the reduction in the BSP's policy interest rates by 25 basis points to 6.75 percent for the overnight borrowing or RRP and 9.0 percent for the overnight lending or repurchase (RP) rate effective 2 July 2003, and the lifting of the three-tiered system for banks' overnight RRP placements with the BSP effective 28 August 2003. The total volume of banks' placements with the BSP under the Special Deposit Account (SDA) window declined to ₱8 million as of end-August 2003, lower by ₱4.5 billion from the end-June level, due to banks' withdrawal of their funds to purchase government securities from the BSP in compliance with the increase in the liquidity reserve requirements.



IV. External Developments

Growth in the major economies picks up but risks to sustainability remain present

Economic growth in the world's major economies is showing signs of picking up after months of slow and uneven recovery. Evidence of an economic upturn appears to be strongest in the United States, with milder improvements seen in the euro area and Japan. However, risks to the sustainability of the recovery remain present, including the possibility of further fallout in the equities market, still-weak corporate investment, continuing adjustments in global current account imbalances, and security concerns. In response, the major central banks have been cautiously optimistic and kept their policy interest rates on hold. The prospect of stronger economic activity overseas should contribute to improved demand for Philippine exports going forward and could possibly add to the strength of the US dollar.

US recovery gathering steam

- Recovery in the US appears to be gathering steam, driven by robust consumer spending and a gradual rise in business investments as a result of supportive policy in the form of defense-related fiscal spending and monetary stimulus. Real GDP grew by an annualized 3.1 percent in the second quarter, higher than the earlier announced 2.4-percent growth estimate and the 1.4-percent year-on-year growth registered in the first quarter. Nevertheless, output remains below potential and capacity utilization continues to be below historical levels. Employment also remains sluggish as payroll employment continued to decline, which could dampen consumer sentiment. On the other hand, inflation remains low but positive, helping dispel deflation concerns without fueling inflation fears. Core inflation was 0.1 percent in August, while CPI or headline inflation was 0.2 percent in July, with an annual rate of increase of 2.1 percent.[14]

Euro area activity has stabilized but remains subdued

- In the euro area, the latest data pointed to still-subdued economic activity and lack of confidence. Economic conditions have but there are no clear signs as yet of underlying strength in production and market confidence. Economic activity has broadly stabilized but remained subdued in the first half of 2003, in line with expectations. However, the European Central Bank sees "increasing reason to expect that economic activity will recover gradually in the second half of 2003 and strengthen further in 2004. The observed increase in real disposable income owing to past improvements in the terms of trade of the euro area is expected to support consumption spending, while low interest rates and favorable financing conditions are expected to support investment. At the same time, moderate wage developments and price-setting behavior are expected to lead to subdued price conditions. The annual Harmonized Index of Consumer Prices (HICP) inflation rate is expected to hover at around 2 percent for the rest of 2003 and remain below 2 percent in 2004.

Japan GDP growth stronger but private consumption will likely remain lackluster

- Output growth strengthened in Japan, as quarter-on-quarter GDP growth exceeded forecasts in the second quarter and strengthened to 0.6 percent from a revised 0.3 percent growth for the first quarter. Economic activity was helped by a recovery in business fixed investment and domestic consumption, the latter helped in part by the Severe Acute Respiratory Syndrome (SARS) outbreak which forced Japanese

---

[14] US Bureau of Labor Statistics news release dated 15 August 2003, available online at http://www.bls.gov/news. release/cpi.

consumers to cancel their travel abroad and spend their money at home instead. However, the overall employment and income situation of households remains generally severe as unemployment remains high at 5.3 percent as of June. These conditions suggest that private consumption will likely remain lackluster for some time. Deflationary conditions also continue to persist as the rate of decline in consumer prices was recorded at 0.2 percent year-on-year in June as in the previous month. The declines in goods prices has been attributed to reduced import prices in both May and June on account of falling crude oil prices during the early spring.

UK GDP growth weaker than expected

- In the United Kingdom, real GDP growth in the second quarter has turned out to be weaker-than-expected at an estimated 0.3 percent. On a year-on-year basis, real GDP growth also slowed to 1.8 percent during the period from 2.1 percent in the first quarter. Consumption expenditures, however, have been stronger than expected, as seen in the steady rise in retail sales. Unemployment remained relatively steady at 5.0 percent in June as in the previous month. Recent surveys showed that labor market conditions could improve in the near-term, given greater flexibility and the relaxation of constraints on workers' choice of hours. Inflation as measured by the Retail Price Index excluding mortgage interest payments (RPIX) edged up slightly to 2.9 percent in July from 2.8 percent in the previous month, reflecting an uptrend in oil prices combined with the rise in energy demand during the summer months.

In response, the world's major central banks have maintained a generally accommodative monetary policy stance

In the presence of continued imbalances across major economies, which pose a risk to the sustainability of the economic recovery process, the major central banks have maintained a generally accommodative monetary policy stance to help ensure that the recent gains transcend into a sustainable recovery path.

- In its meetings on 12 August 2003 and 16 September 2003, the US Federal Open Market Committee (FOMC) voted to keep its target for the federal funds rate unchanged at 1.0 percent. In statements issued after the meetings, the Fed noted that an accommodative monetary policy stance, coupled with robust underlying growth in productivity, is providing important ongoing support to economic activity.[15]

- In its meetings on 31 July 2003 and 4 September 2003, the Governing Council of the ECB decided to maintain the minimum bid rate on the main refinancing operations and the interest rates on the marginal lending facility and the deposit facility at 2.0 percent, 3.0 percent and 1.0 percent, respectively. The ECB noted that that the current level of ECB interest rates remains appropriate, as the medium-term outlook for price stability continues to be favorable.[16]

- The Monetary Policy Committee of the Bank of England (BOE) voted on 10 July 2003 to reduce the Bank's repo rate by 25 basis points to 3.5 percent. The Committee believed that the reduction was necessary in order to keep inflation on track to meet the target in

---

[15] US Federal Reserve Press Releases dated 12 and 16 September 2003, available at http://www.federalreserve.gov/fomc/#calendars.

[16] European Central Bank, "Introductory statement by Lucas Papademos, Vice-President of the European Central Bank, 4 September 2003, available online at http://www.ecb.int

the medium term, given the possibility of subdued economic activity continuing in the near term. The key repo rate was left unchanged during the Committee's subsequent meetings on 7 August and 4 September 2003.

- The Bank of Japan's guideline for money market operations were left unchanged during the quarter, with the conduct of money market operations aimed at an outstanding balance of current accounts held at the Bank of around 27 to 30 trillion yen.[17] The previous change in the guidelines for money market operations was made on 20 May 2003, when the target balance of current accounts held at the Bank was raised from around 22 to 27 trillion yen to around 27 to 30 trillion yen.

V. Inflation Outlook

Inflation Forecasts

Outlook for inflation remains tame over the policy horizon

Amid moderate improvements in aggregate domestic demand conditions, manageable pressures from the supply side and downside risks to global recovery, the BSP maintains its assessment of a tame inflation outlook over the policy horizon. Results generated from the inflation-forecasting models of the BSP indicate that inflation will likely fall within the range of 2.9–3.2 percent in 2003, below the 4.5–5.5 percent inflation target for the year, and to settle within the range of 3.4–4.5 percent, which is broadly in line with the 4–5 percent target in 2004. The baseline inflation forecasts generated from the single

[17] Bank of Japan, Monetary Policy Meetings held on 15 July, 8 August, and 12 September 2003, available online at http://www.boj.or.jp/en/seisaku/03/seisak_f.htm.

equation model, multi-equation model and Long-Term Macroeconometric Model (LTMM) of the BSP are based on the following major assumptions:[18]

- 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;
- Growth of monetary aggregates is consistent with the revised monetary program set internally as of May 2003;
- NG deficits of ₱202.0 billion and ₱197.8 billion for 2003 and 2004, respectively (equivalent to 4.7 percent and 4.2 percent of GDP, respectively);
- The 2003 and 2004 impact of the NG deficit on reserve money is assumed to be nil. This is based on the programmed change in cash in the NG medium-term financing program, which registered ₱165.0 million and ₱477.0 million in 2003 and 2004, respectively. For conservatism in our inflation forecasts, we took the assumed impact of NG deposits with the BSP on RM to be zero;
- The overnight RRP rate was assumed constant at 6.75 percent from July 2003 to December 2004;
- The 91-day Treasury bill rate was assumed at 8.5 percent for the period July 2003–December 2004, the midpoints of the range of the DBCC interest rate assumptions for both years;

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

- International crude oil prices consistent with the latest DER projections (as of 17 September 2003, based on futures prices) of US$25.66/bbl for 2003 and US$22.99/bbl for 2004;[19]

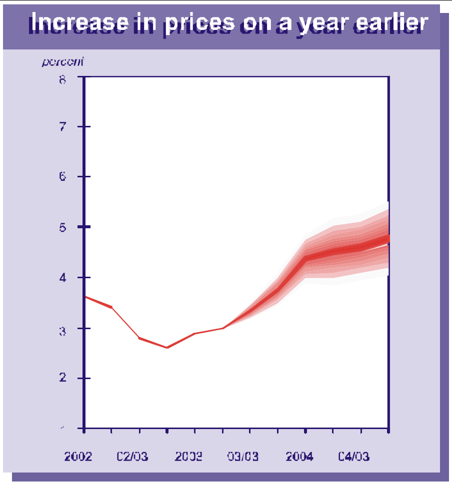
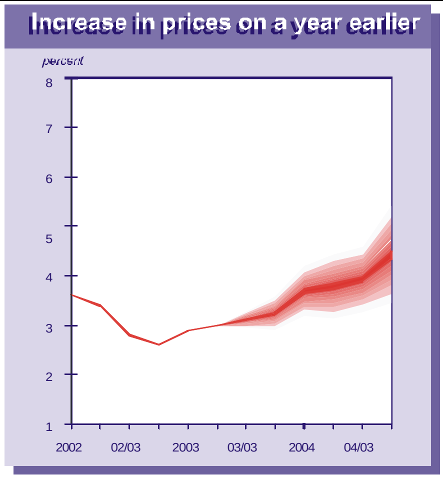
- Increase in the daily minimum wage rate (measured by the non-agricultural wage rate for NCR) by 4 percent in November 2003 and November 2004. It may be noted that as of this writing, no petition for a wage hike has been filed at the NCR-Regional Tripartite Wage and Productivity Board. However, the present forecasts incorporate a modest wage adjustment equivalent to the lower end of the inflation target for 2003. The last approved minimum wage increase was in October 2001 at ₱30.00.

The fan chart on the right panel depicts the BSP's current assessment of the direction of inflation until 2004. It is worthy to note that the current inflation profile is lower than that presented during the Second Quarter Inflation report. This is on account of several factors. Firstly, emergent risks to the inflation outlook have receded. Supply-side price pressures have tapered off following the end of the El Niño phenomenon. Food prices are expected to remain stable given improving weather conditions and importation. Moreover, inflationary expectations stemming from the National Government's fiscal position are expected to dissipate as the actual deficit for the first eight months of 2003 was better than expected amid above-target revenue collections. Secondly, demand prospects from both domestic and external sources appear to be modest. The pace and strength of domestic economic

---

[19] These projections correspond to an average WTI crude price of US$30.00/bbl for 2003 and US$26.55/bbl for 2004.

activity in the near term appears tentative in view of the mixed trends of economic indicators including slower growth in manufacturing, bank lending and passenger car sales. Meanwhile, the prospects for global economic recovery remain uncertain amid such risks as the persistence of global current account imbalances, threats of terrorism and the possibility of a continued rise in bond yields.

Inflation Profile as of Previous Quarter	Latest Inflation Profile
	

The fan chart shows the probability of various outcomes for inflation over the forecast horizon. The darkest band depicts the central projection which corresponds to the BSP's inflation baseline forecast. It covers 20% of the probability. Each successive pair of bands is drawn to cover a further 20% of probability, until 80% of the probability distribution is covered. The bands widen (i.e. "fan out") as the time frame is extended indicating increasing uncertainty about outcomes.

Risks to the Inflation Outlook

Risks to future inflation include volatile movements of the exchange rate and possible rise international oil prices

However, several risks to the inflation outlook remain. While the current assessment of the inflation outlook yielded a lower profile, the fan chart shows a moderately upward skew. This is due to the presence of several factors that can exert some upward pressure on the price level. Foremost of these is the movement of the exchange rate which, if not stabilized, could have a bearing on the public's expectation of future prices. Such volatility may be exacerbated by political uncertainties that underlie the recent weakening of the peso. However, the stronger inflows of OFW remittances, improving fiscal scenario and continued commitment to structural reforms (such as the passage of the SPVA and the Procurement Act early this year) which help create fresh incentives for foreign investments, can help provide additional support for the peso. In addition, the forthcoming Political Summit in October can reduce the risk factor on the political front. The BSP is closely monitoring foreign exchange rate developments to assess their impact on the inflation outlook so that appropriate policy responses, if any, are implemented to ensure the attainment of the BSP's primary objective of price stability.

Meanwhile, the decision of the Organization of Petroleum Exporting Countries' (OPEC) to cut its production ceiling in the face of a possible rise in oil output from Iraq and other petroleum-producing countries such as Russia, could exert upward pressure on international and domestic oil prices. In the past, oil price hikes have prompted increases in basic commodity prices as well as calls for transport fare and wage adjustments. However, the Government ensures that local oil supply remains ample. As noted previously, current industry inventories are significantly above the required minimum inventory of 7-15 days. The sizeable volume of oil inventories has helped maintain the relative stability in domestic retail pump prices of gasoline and other oil products.

Private Sector Analysts' Inflation Forecasts

Private forecasts continue to indicate subdued inflation expectations

Data on analysts' forecasts continue to indicate subdued public expectations about future inflation. An informal BSP survey of inflation forecasts from various private financial and research institutions indicated a slightly higher average inflation rate for 2003 relative to the second quarter and an unchanged average forecast for 2004.

Forecasts from nine private institutions polled by the BSP indicate that inflation is expected to average at 3.2 percent for 2003, slightly above the quarter-ago average forecast of 3.0 percent. Analysts attribute the higher inflation average to negative cost-side developments and the weakening of the peso in August 2003, which implied higher import costs over the near term. However, analysts also emphasized that the adverse developments in the foreign exchange market may be offset by the perceived absence of a pick-up in domestic demand.

The average inflation forecast for 2004 remained at the previous quarter's forecast of 3.9 percent.

Private Analysts' Inflation Forecasts for 2003 and 2004

Institution	2003	2004
Cemex Corporation	3.0	4.0
Banco de Oro	3-3.5	...
CLSA Philippines	3.0	3.5
Equitable PCI Bank	3.0-3.2	3.5-4.5
Metropolitan Bank and Trust Co.	3.03-3.06	…
Multinational Investments Bancorporation	3.2-3.5	4.5-5.0
Wallace Business Forum (as of June 2003)	3.0	3.3
Nomura Securities	3.0	4.1
UBS Warburg Securities	3.2	4.0
Median Forecast	3.1	4.0
Average Forecast	3.2	3.9
High	3.5	5.0
Low	3.0	3.3
No. of observations	9	7

Source: BSP poll

VI. Implications for the Monetary Policy Stance

Outlook for inflation and output suggests need for a more accommodative monetary policy stance

The economic data that have accumulated over the past quarter continue to indicate a benign inflation environment going forward amidst a backdrop of moderately improving economic activity. Evidence of moderate improvements in aggregate demand and downside risks to economic activity in the rest of the world point to subdued demand-side pressures on domestic prices, which are reinforced by expectations of manageable risks from the supply side.

Meanwhile, the current state of activity in the economy continues to be marked by indications of sluggishness. Despite robust consumption spending and other signs of improvement, key areas of domestic demand such as bank lending, passenger car sales, and exports have continued to register signs of slower growth.

Such a combination of benign future inflation and moderate economic activity would argue for an accommodative policy stance to ensure a steady pace of economic expansion. Indeed, additional evidence of slowing money and credit demand would also tend to bolster arguments for increasing the ongoing stimulus to economic activity. Current domestic monetary conditions, other economic developments and the likelihood of low and stable interest rates in the major economies provide flexibility for monetary authorities to assume a more supportive policy stance while remaining cautious of possible resurgence of inflationary threats.

Nevertheless, such considerations must be weighed against the remaining risks to the inflation outlook, particularly the possibility of renewed exchange market pressure in the face of concerns about political uncertainty and fiscal performance. The impact of political factors on investor confidence and financial market stability is perhaps best illustrated by the 27 July Oakwood mutiny episode, which triggered volatility in domestic financial markets. Although the continued evidence of below-capacity output in the economy suggests a low potential pass-through impact of exchange rate movements on inflation, sharp movements in the exchange rate still have a bearing on the public's expectation of future prices. Authorities are closely monitoring foreign exchange rate developments, along with movements in international oil prices, to ensure appropriate and timely policy responses to adverse occurrences.

All of these considerations require authorities to exercise continued caution in formulating the monetary policy stance. Prospective assessments of monetary settings will therefore continue to emphasize prudence in responding to the evolving outlook for inflation and output growth in the economy.

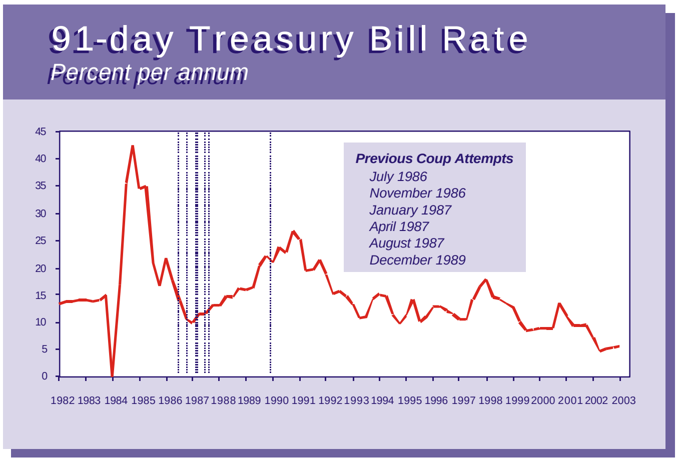
Box: Estimating the Economic Impact of the July 27 Coup Attempt

The Philippine economy has stood witness to a series of coup attempts, the latest being the 27 July 2003 mutiny in which a group of disgruntled young military officers seized a high-rise luxury apartment building in the Makati financial district and demanded the resignation of key Arroyo government officials. While there is general agreement that coup attempts or any other factor that could generate uncertainty could be detrimental to the domestic economy, it is a separate and more daunting task to ascertain the extent of its economic impact. This article attempts to gauge the possible impact of the 27 July 2003 failed mutiny on the domestic economy. In order to determine the possible channels through which a coup attempt can influence economic performance, inferences were drawn from the observed impact on key economic indicators during the past coup attempts, particularly the December 1989 coup attempt, which is considered to be one of the most serious attempts in the recent past.

Estimates using monthly data and the inflation equation of the BSP's multiple equation model indicate that the 1989 coup attempt did not have an independent impact on inflation when the presence of other factors affecting inflation is taken into account. This finding is supported by results from simulations with annual data and the core inflation equation from the BSP's long-term macroeconomic model (LTMM).

Based on the LTMM, however, the main channel of impact of the 1989 coup on the economy appeared to come from the risk premium. The T-bill equation of the LTMM indicates that, taking other factors into account, the 91-day Treasury bill (T-bill) rate was about 1.1 percentage point higher because of the coup attempt (Figure 1).

Figure 1

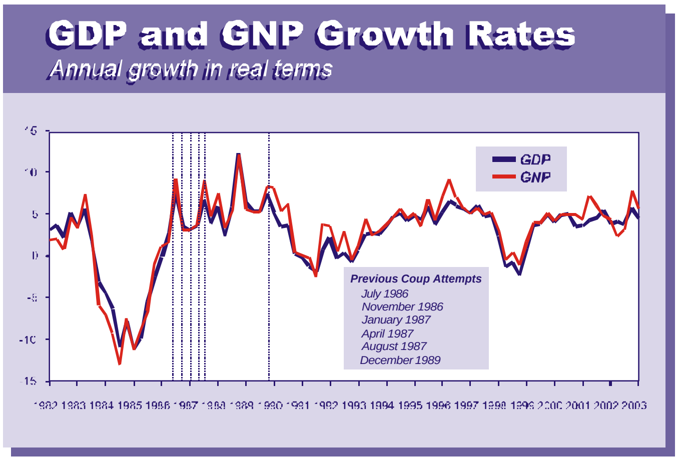


The LTMM equation for private investment estimates that each one percentage point increase in the real interest rate leads to a 1.3 percent decline in private investment. This implies a 1.4 percent decline in private investment because of the coup attempt.

Apart from the interest rate channel, however, there is some evidence of an additional channel of impact of the coup on investment, most probably accounting for the impact on expectations, amounting to about 7.3 percent reduction in private investment. Thus, the total reduction in private investment would be about 8.7 percent.

From simulations of the full LTMM, the investment reduction induced a 0.5 percentage point reduction in GDP growth (Figure II) and an initial 0.2 percentage point increase in inflation. However, the slower GDP growth led to higher unemployment, which reduced inflation by about 0.1-percentage point with a two-year lag.

Figure 2



The likely impact of the July 2003 mutiny may be gleaned from the results of the 1989 episode. The economic impact of the 2003 mutiny can be expected to be considerably less, since the recent mutiny was confined to a particular area, did not result in bloodshed and had a much smaller chance of success. Assuming an investment reduction equivalent to 25 percent of the estimated impact of the 1989 coup attempt, the simulations indicate a 0.13 percentage point reduction in GDP growth and 0.06 percentage point increase in inflation rate in 2004 arising from the coup attempt.

VII. Concluding Remarks

Outlook for inflation and output suggests need for a more accommodative monetary policy stance

Policymakers continue to derive considerable encouragement in the recent performance of the Philippine economy, particularly in the presence of adverse conditions on both the domestic and international front. The ability of the domestic economy to withstand the effects of bad weather, contagious outbreak, and military adventurism attests to its abiding resilience supports the argument that the general thrust of economic policy continues to be on the right track.

Nevertheless, the pace of the ongoing recovery remains far from hectic, and policymakers must take pains to ensure that the favorable environment remains in place to support the economic expansion. The BSP, thus, continues to face many challenges in its pursuit of price stability and the effective implementation of its inflation targeting framework for monetary policy. This requires not only continued vigilance against emerging risks to prices, but also the formulation measured responses to such risks in order to preserve the low-inflation environment without undermining the ongoing stimulus to economic activity.

Ensuring the success of inflation targeting in the Philippines also entails further strengthening and fine-tuning of the operational details and institutional arrangements relating to the conduct of monetary policy. Thus, monetary authorities will need to tailor their research agenda to reevaluate operational details pertaining to inflation targeting such as the length of the policy horizon, the treatment of asset prices in monetary policy decisions, the measurement of core inflation, as well as the need to identify measures necessary in strengthening the monetary policy transmission mechanism and enhancing the BSP's ability to achieve its inflation targets.

To the extent that successful inflation targeting also necessitates the maintenance of a sound fiscal position, the BSP must continue to encourage and support fiscal authorities in their efforts to achieve fiscal consolidation by strengthening the fiscal revenue base over the medium term and finding appropriate ways to manage the expansion in public sector debt.

These challenges underscore the fact that inflation targeting in the Philippines is still at an incipient stage and requires more work in the future. They also highlight the importance of the BSP's continued focus on strengthening the institutional framework and compliance with international best practices in the conduct of monetary policy as a means of creating a strong foundation for sustainable economic growth in the long-term.

Chronology of Monetary Policy Decisions

2000

24 January 2000

The Monetary Board–the policymaking body of the BSP–adopted in principle the shift to inflation targeting as the BSP's framework for conducting monetary policy.

2001

26 December 2001

The BSP announced formally the adoption of inflation targeting as framework for monetary policy beginning January 2002. The BSP also announced the Government’s annual average inflation targets of 5.0-6.0 percent for 2002 and 4.5-5.5 percent for 2003.

2002

17 January 2002

The Monetary Board decided to reduce the overnight reverse repurchase (RRP) and repurchase (RP) rates by 25 basis points each to 7.5 percent and 9.75 percent, respectively.

Consequently, the Monetary Board also adopted a change in the tiering structure for banks’ overnight RRP placements with the BSP as follows: 7.5 percent for the first ₱5 billion, 4.5 percent for the next ₱5 billion and 1.5 percent for placements in excess of ₱10 billion.

The Monetary Board also approved a two-percentage point reduction to 7.0 percent of the liquidity reserve requirements on deposits and deposit substitute liabilities, common trust funds and other trust and fiduciary liabilities of commercial banks and non-banks with quasi-banking functions.

These monetary policy measures took effect on 18 January 2003. Moreover, it could be noted that this decision marks the first action of the Monetary Board under the inflation-targeting framework.

14 February 2002

The Monetary Board opted to lower the BSP’s policy rates further by 25 basis points each, bringing the overnight RRP rate to 7.25 percent and the overnight RP rate to 9.5 percent effective 15 February 2002.

The Monetary Board also approved an adjustment in tiering scheme for banks’ overnight RRP placements with the BSP as follows: 7.25 percent for placements of up to ₱5 billion, 4.25 percent for the next ₱5 billion and 1.25 percent for placements in excess of ₱10 billion. The tiering scheme also covered special deposit accounts

(SDAs) and would be applied on a consolidated basis.

14 March 2002

The Monetary Board decided to reduce BSP's key policy rates by another 25 basis points. The overnight RRP rate was lowered to 7.0 percent while the overnight RP rate was reduced to 9.25 percent effective 15 March 2002.

Correspondingly, the interest rates on overnight RRP and SDA placements with the BSP under the tiering scheme were adjusted as follows: 7.0 percent for placements of up to ₱5 billion, 4.0 percent for the next ₱5 billion and 1.0 percent for placements in excess of ₱10 billion.

11 April, 8 May, 6 June, 4 July, 1 August, 29 August, 26 September, 23 October, 21 November, 19 December 2002

During the monetary policy meetings held for the period April-December 2002, the Monetary Board decided to keep the overnight RRP and RP rates steady at 7.0 percent and 9.25 percent, respectively.

<u>2003</u>

16 January 2003

The Monetary Board voted to keep the BSP's policy rates unchanged at 7.0 percent for the overnight RRP rate and 9.25 percent for the overnight RP rate.

7 February 2003

The BSP announced the Government's official target for the average annual inflation for 2004 at 4-5 percent.

12 February, 13 March 2003

The Monetary Board kept the BSP's policy rates unchanged at 7.0 percent for the overnight RRP rate and 9.25 percent for the overnight RP rate.

19 March 2003
(Special Monetary Board Meeting)

The Monetary Board decided to lift the three-tiered scheme on banks' placements with the BSP. Thus, overnight placements under the RRP window would be accepted at a flat rate of 7.0 percent effective 20 March 2003.

The Monetary Board also raised the liquidity reserve requirement against peso demand, savings, time deposit and deposit liabilities of universal banks and commercial banks by one-percentage point to 8.0 percent effective 21 March 2003.

10 April, 8 May 2003

The Monetary Board maintained the overnight RRP and RP rates steady at 7.0 percent and 9.25 percent, respectively.

5 June 2003

The Monetary Board decided to leave the overnight RRP and RP rates unchanged at 7.0 percent and 9.25 percent, respectively.

The Monetary Board also decided to restore the tiering scheme on banks' placements with the BSP under the RRP and SDA windows effective 5 June 2003. In particular, overnight RRP placements would be subject to the following interest rates: 7.0 percent for the first ₱5 billion, 4.0 percent for additional amounts in excess of ₱5 billion but below ₱10 billion and 1.0 percent for amounts in excess of ₱10 billion.

2 July 2003

The Monetary Board voted to reduce the BSP's key policy interest rates by 25 basis points each to 6.75 percent for the overnight RRP rate and 9.0 percent for the overnight RP rate effective 2 July 2003.

The interest rates on banks' placements under the tiered system were also adjusted as follows: 6.75 percent for the first ₱5 billion, 3.75 percent for amounts in excess of P5 billion up to ₱10 billion and 0.75 percent in excess of ₱10 billion.

31 July 2003

The Monetary Board left unchanged the overnight RRP and RP rates at 6.75 percent and 9.0 percent, respectively.

28 August 2003

The Monetary Board opted to keep the BSP's policy rates unchanged at 6.75 percent for the overnight RRP rate and 9.0 percent for the overnight RP rate.

The Monetary Board also decided to lift the tiering scheme for banks' placements with the BSP. Thus, effective 28 August 2003, overnight RRP transactions with the BSP were accepted at a flat rate of 6.75 percent.

2 October 2003

The Monetary Board voted unanimously to leave the BSP's policy rates unchanged at 6.75 percent for the overnight RRP rate and 9.0 percent for the overnight RP rate.

The *BSP Inflation Report* is published quarterly by the Bangko Sentral ng Pilipinas. The report is available as a complete document in pdf format, together with other general information about inflation targeting and the monetary policy of the BSP, on the BSP's website at: www.bsp.gov.ph/about_bsp/ inflation/default.htm.

If you wish to receive an electronic copy of the latest BSP Inflation Report, kindly send an e-mail to bspmail@bsp.gov.ph.

The BSP also welcomes feedback from readers on the contents of the Inflation Report as well as suggestions on how to provide comments or suggestions concerning the Inflation Report, kindly send them to these addresses:

By post:	BSP Inflation Report c/o Department of Economic Research Bangko Sentral ng Pilipinas A. Mabini Street, Malate, Manila Philippines 1004
By e-mail:	bspmail@bsp.gov.ph