BANGKO SENTRAL NG PILIPINAS

HIGHLIGHTS OF THE MEETING OF THE MONETARY BOARD ON THE MONETARY POLICY STANCE HELD ON 22 SEPTEMBER 2016[1]

I. Monetary Policy Decision

The Monetary Board (MB) decided to:

a) Maintain the overnight RRP (borrowing) rate at 3.0 percent;

b) Maintain the current overnight deposit and overnight lending rates; and

c) Maintain the current reserve requirement ratios.

II. Key Considerations in the Formulation of the Monetary Policy Stance

- The Monetary Board's (MB) decision to keep its monetary policy settings unchanged is based on its assessment that the inflation environment remains manageable.

  - Average inflation is likely to settle slightly below the 3.0 percent ± 1.0 percentage point target range in 2016 and rise toward the mid-point of the target range in 2017 and 2018. The MB observed that inflation is still being driven mainly by supply-side factors. Nevertheless, inflation expectations remain broadly in line with the inflation target over the policy horizon.

  - The overall balance of risks surrounding the inflation outlook is seen to be tilted to the upside, with pending petitions for adjustments in electricity rates along with the proposed adjustment in the excise tax rates of petroleum products and the potential second-round effect on transport fares. Slower global economic activity poses the main downside risk.

- The MB also recognized that while global economic conditions have remained subdued since the previous meeting, trends in domestic economic activity show sustained firmness, supported by solid private household consumption and investment, buoyant business and consumer sentiment, and adequate credit and domestic liquidity. With available fiscal space, higher public spending is also expected to further boost domestic demand.

[1] The discussions herein reflect the assessment made by the Monetary Board based on a comprehensive set of economic information available at the time of the policy meeting. The highlights of the discussions during the 22 September 2016 meeting were approved by the Monetary Board during its regular meeting held on 6 October 2016. The next meeting of the Monetary Board on the monetary policy stance is scheduled on 10 November 2016.

III. Recent Developments and Inflation Outlook

The MB considered the following developments in deciding on the monetary policy stance:

A. Domestic price conditions

- Headline inflation eased to 1.8 percent in August (year-on-year) from 1.9 percent in July due largely to moderate price increases of certain food items. By contrast, official core inflation increased to 2.0 percent from 1.9 percent in the previous month.

- The slowdown in August inflation rate was traced mainly to slower price increases of some food items particularly corn, meat, and vegetables. The continued decline in prices of condiments also contributed to lower food inflation. On the other hand, inflation rates of most non-food commodities rose in August including housing, water, electricity, gas, and other fuels which turned positive after declining for 20 consecutive months since December 2014. Higher prices of services relating to housing such as rent and repair of dwelling were enough to offset the continued decline in water and electricity rates, which declined during the month on lower generation charge from the Wholesale Electricity Spot Market (WESM).

- Two of the three alternative measures of core inflation advanced in August: the trimmed mean and net of volatile items measure rose to 1.8 percent (from 1.7 percent) and 1.7 percent (from 1.5 percent), respectively. In contrast, the weighted median eased to 2.0 percent from 2.1 percent in July. Meanwhile, the number of items within the 2.0-4.0 percent target was higher, although items below target still accounted for the bulk of the CPI weight.

B. Inflation expectations

- Results of the Q3 2016 Business Expectations Survey indicated that more respondents expected inflation to increase for the current and next quarters compared to those who said otherwise. Meanwhile, results of the August 2016 BSP's survey of private sector economists yielded a steady mean inflation forecast for 2016, a higher forecast for 2017, and a lower forecast for 2018. Results of the August 2016 Consensus Economics survey showed a steady mean inflation forecast for 2016 while the mean inflation forecast for 2017 was higher from the previous month's survey.

C. Inflation outlook

- The latest baseline forecasts show that average inflation will settle below the low end of the government's target range of 3.0 percent ± 1.0 percentage point for 2016 and rise to near the midpoint of the target range in 2017-2018. Inflation is projected to increase slightly towards the low end of the target range in the fourth quarter of the year, driven by higher oil prices, the above-trend growth in domestic economic activity, and the impact of positive base effects.

- The risks to future inflation appear to be on the upside. Slower global economic activity poses the main downside risk to the inflation outlook, while pending petitions for adjustments in electricity rates along with the proposed adjustment in the excise tax rates of petroleum products (and possible knock-on effects on transport fares) constitute the main upside risks to inflation. In addition, the proposed increase in taxes of sweetened beverages serves as a possible upside risk to inflation.

D. Demand conditions

- Domestic demand conditions remain firm, with sustained GDP growth momentum, supported by strong business and consumer confidence and other growth drivers, particularly capital formation. GDP expanded by 7 percent year-on-year (y-o-y) in Q2 2016, faster than the revised 6.8-percent growth in the previous quarter and the 5.9-percent growth in Q2 2015. Growth in the second quarter was driven by increased capital formation, particularly in durable equipment and construction, and higher growth in consumer spending. Growth was also supported by election-related spending and the government's accelerated expenditure. On the production side, the accelerated growth of the services sector mainly contributed to growth. Overall domestic demand contributed 12.1 ppts to total output growth. This was partly tempered by weak external demand, with net exports pulling down aggregate growth by 6.6 ppts in Q2 2016.

E. Supply-side indicators

Developments in Agriculture

- Agriculture, Hunting, Forestry and Fishing (AHFF) contracted by 2.1 percent in Q2 2016 from a deceleration of 0.1 percent in Q2 2015. In particular, the agriculture subsector declined by 1.0 percent in Q2 2016, following nearly flat growth of 0.4 percent in the same period last year. Declines in production were noted for *palay,* corn, coconut, banana, mango, coffee, cassava, rubber, and other crops while higher output was recorded for sugarcane and pineapple.

- International food prices increased in August. The FAO Food Price Index (FPI) averaged 165.6 points in August 2016, higher on a month-on-month and y-o-y basis. Except for cereals, prices of all commodities increased during the month led by dairy, oils, and sugar.

- According to PAGASA's latest climate advisory, ENSO-neutral conditions continue to prevail as of August 2016. Most climate prediction models suggest either a cool ENSO-neutral or a weak La Niña for the remainder of the year. Based on available data, PAGASA expects La Niña to occur during the September-October-November 2016 season and last until February 2017.

Oil Price Developments

- Dubai crude prices rose sharply in August amid speculations of a possible output freeze agreement among key oil-exporting countries. However, prices started to decline in early September on doubts over the agreement given Iran's rising production and pronouncements from Saudi Arabia and Russia that a production cap might not be necessary given the recent trends in oil prices.

- In its September 2016 report, the US Energy Information Administration (EIA) maintained its view that demand could still outstrip supply by the 2H 2017. Supply forecasts for both

2016 and 2017 were revised upward due largely to rising production from OPEC countries as they prioritize market share preservation over stabilizing prices. Meanwhile, demand forecasts for 2016 and 2017 were broadly steady compared to the previous month's assessment.

Developments in the Utilities Sector

- Electricity rates decreased in September 2016 due to lower transmission charges. According to Meralco, the decline in transmission charges was due mainly to the reduction in National Grid Corporation of the Philippines' (NGCP) ancillary charges. The reduction in the transmission charge more than offset the increase in generation charge, which in turn, was mainly driven by the higher cost of power from the Independent Power Producers (IPPs). Meanwhile, overall charges from the Wholesale Electricity Spot Market (WESM) posted a decrease.

F. Financial market developments

- Philippine financial markets were largely influenced by key macroeconomic developments overseas which outweighed the impact of economic developments on the domestic front.

    - Local equities lingered in bearish territory in early September as investor sentiment was dampened by uncertainties on US Fed's monetary policy direction as well as ECB's decision that it would no longer extend its bond-buying program. Partly tempering the decline is the lackluster payroll data and the weaker-than-expected non-manufacturing activity from the US, which diminished prospects for a September rate hike.

    - The peso traded firmer against the US dollar amid reduced expectations of a Fed rate hike in September following soft US data releases. Further, the sustained inflows of foreign exchange from overseas Filipino remittances, foreign direct and portfolio investments, BPO and tourism receipts, as well as the ample level of the country's gross international reserves provided support to the peso.

G. Domestic liquidity and credit conditions

- Liquidity and credit conditions indicate that overall monetary conditions remain sufficiently favorable to support domestic economic activity.

    - Domestic liquidity (M3) grew by 13.1 percent (y-o-y) to ₱8.8 trillion in July. This was faster than the 12.4-percent expansion recorded in June. On a month-on-month seasonally-adjusted basis, M3 increased by 1.0 percent.

    - Outstanding loans of commercial banks, net of reverse repurchase (RRP) placements with the BSP, continued to grow at 17.7 percent in July from 17.6 percent in June. On a month-on-month seasonally-adjusted basis, commercial bank lending for loans net of RRPs increased by 1.2 percent.

H. Fiscal developments

- The National Government (NG) recorded a fiscal deficit of ₱171.0 billion for the period January-July 2016, almost ten times higher compared to the ₱18.5-billion deficit incurred in the same period in 2015. Excluding interest payments in NG expenditures, the primary surplus amounted to ₱22.7 billion, which is only about 11 percent of the ₱190.7 billion primary surplus recorded in the same period a year ago.

I. External developments

- Global economic activity has remained subdued. Indicators of economic activity pointed to a firm pace of growth in the US, the euro area, and India, while production remained muted in Japan and China. Real GDP growth data for Q2 2016 showed faster US output growth of 1.1 percent (in seasonally-adjusted quarter-on-quarter (q-o-q) terms) reflecting an acceleration in personal consumption expenditures, a smaller decrease in non-residential fixed investment, an upturn in exports, and a smaller decrease in federal government spending. Meanwhile, economic activity in the euro area remains steady but sluggish with real GDP expanding by 0.3 percent (q-o-q) from 0.5 percent in the previous quarter. Meanwhile, the composite purchasing managers' index (PMI) for the euro area eased to 52.9 in August from 53.2 in July mainly as a result of a weaker rate of expansion in Germany.

  In Japan, real GDP increased by 0.2 percent (q-o-q) in Q2 2016 after increasing by 0.5 percent in the previous quarter. The seasonally-adjusted PMI for Japan rose slightly to 49.5 in August 2016 from 49.3 in the previous month, signaling a softer deterioration in manufacturing operating conditions. China's real GDP expanded by 6.7 percent y-o-y in Q2 2016, the same pace as in Q1 2016. Meanwhile, the seasonally-adjusted PMI for China slipped to 50.0 in July 2016 from 50.6 a month ago, indicating a slower expansion in manufacturing output and new domestic orders.

  Manufacturing conditions in the ASEAN improve slightly with the Nikkei ASEAN Manufacturing PMI inching up to 50.3 in August from 49.5 in July, indicating a fractional improvement in manufacturing operating conditions in the region.

- The recent volatility in global financial markets has been associated with renewed market speculation about a sooner-than-expected rate increase by the US Fed, coupled with the ECB holding off on stimulus measures in early September. Most central banks (CB) decided to maintain their policy settings in August, although some CBs like the Reserve Bank of New Zealand (RBNZ) and Reserve Bank of Australia (RBA) eased monetary policy settings in response to easing inflation.