BANGKO SENTRAL NG PILIPINAS

HIGHLIGHTS OF THE MEETING OF THE MONETARY BOARD ON THE MONETARY POLICY STANCE HELD ON 11 AUGUST 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 MB's decision to keep its monetary policy settings unchanged is based on its assessment that the inflation environment continues to be manageable.

  - Average inflation is projected 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. Meanwhile, inflation expectations continue to be broadly in line with the inflation target over the policy horizon.

  - The overall balance of risks surrounding the inflation outlook is perceived to be broadly balanced, with upside risks emanating from pending petitions for adjustments in electricity rates.[2] Meanwhile, slower global economic activity is still seen as the key downside risk to the inflation outlook.

- The MB also noted that prospects for global economic growth have remained subdued since the previous meeting. By contrast, domestic economic conditions continue to be firm, supported by solid private household consumption and investment, buoyant business and consumer sentiment, and ample credit and domestic liquidity. Higher fiscal spending is also expected to further boost domestic demand.

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[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 11 August 2016 meeting were approved by the Monetary Board during its regular meeting held on 25 August 2016. The next meeting of the Monetary Board on the monetary policy stance is scheduled on 22 September 2016.

[2] These include Meralco's petitions covering generation and transmission charges, system loss, lifeline subsidy, and the December 2013 rate adjustment—the subject of Supreme Court temporary restraining order. Meanwhile, PSALM's petitions cover adjustments for fuel and foreign exchange costs.

III. Recent Developments and Inflation Outlook

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

A. Domestic price conditions

- Year-on-year headline inflation remained steady at 1.9 percent in July as prices of both food and non-food commodities were broadly unchanged. Consistent with the pace of headline inflation, core inflation was also unchanged from the previous month at 1.9 percent.

- Two of the three alternative measures of core inflation were steady during the month: trimmed mean and weighted median remained at 1.7 percent and 2.1 percent, respectively. Meanwhile, the number of CPI items with inflation rates below the 2-percent threshold increased in July relative to the previous month but accounted for a smaller portion of the CPI basket.

- By geographical location, inflation in areas outside the National Capital Region (NCR) was steady at 2.1 percent while NCR inflation edged lower at 1.0 percent (from 1.1 percent). Likewise, the weighted average inflation rates by major island groupings were generally unchanged in July with inflation in Visayas and Luzon at 3.2 percent and 1.5 percent, respectively. Mindanao inflation decelerated to 2.6 percent in July 2016 from 2.7 percent in the previous month.

B. Inflation expectations

- Inflation expectations continue to be well-anchored to the inflation target. Results of the July 2016 BSP survey of private sector economists yielded higher mean inflation forecasts at 1.9 percent (from 1.8 percent) for 2016 and 2.8 percent (from 2.7 percent) for 2017 while mean inflation forecast for 2018 was steady at 2.9 percent. Similarly, results of the July 2016 Consensus Economics survey showed steady mean inflation forecast for 2016 at 1.9 percent while mean inflation forecast for 2017 was lower at 2.8 percent (from 2.9 percent) relative to the result of the previous month's survey.

C. Inflation outlook

- The latest baseline forecasts indicate that inflation could settle slightly below the low end of the government's announced target range of 3.0 percent ± 1.0 percentage point in 2016 but near the midpoint of the target range in 2017-2018. Inflation is projected to steadily rise towards the target range in the second half of 2016, driven by the continued strength in domestic economic activity, weaker domestic currency, and the impact of positive base effects. Thereafter, inflation is seen to approach the midpoint of the target range in the first half of 2017 and is expected to dwell within the target range for the rest of the forecast horizon.

- The risks to future inflation appear to be broadly balanced. Slower global economic activity constitutes the main downside risk, while upside risks are mainly associated with pending petitions for adjustments in electricity rates.

D. Demand conditions

- Domestic demand conditions remain firm. Information available to date suggested that the economy will continue to grow above its historical average rate in Q2 2016 as indicated by the BSP's business cycle analysis. Capacity utilization of the manufacturing sector has remained consistently above 80 percent while PMI readings have been steadily above the 50-percent expansion threshold. Strong consumer spending is also reflected in the continued increase in vehicle sales in the second quarter. The National Government's accelerated fiscal spending in Q2 2016 is likewise expected to boost activity and support the growth momentum.

E. Supply-side indicators

Developments in Agriculture

- Improved rainfall conditions associated with the La Niña phenomenon has historically improved domestic agricultural production, thus providing downward pressure on the prices of rice and other farm commodities. However, the risk of more frequent tropical cyclones and sustained flooding could also present some upside pressure on inflation.[3]

- According to the US-based Climate Prediction Center (CPC) and the International Research Institute (IRI) for Climate and Society, ENSO-neutral conditions have been prevailing since June and is expected to continue until September. Meanwhile, a La Niña episode is expected to develop by the August-September-October 2016 season. However, a weak La Niña episode is anticipated by the CPC-IRI to occur for the rest of the year due to lower La Niña forecast probabilities in the succeeding seasons.

Oil Price Developments

- Dubai crude oil prices decreased in July after rising in the first half of 2016 due mainly to global oversupply concerns largely as a result of increased US production. Active US oil rigs rose to a 12-week high in July, suggesting increased drilling activity in US onshore production of shale oil. At the same time, inventories remain elevated following lower-than-expected demand during the US summer driving season. Oil production from Iraq has also increased in July, adding up to existing inventory.

- Notwithstanding recent trends, latest estimates by the US Energy Information Administration (EIA) as of August 2016 continue to suggest that demand could outpace supply by 2H 2017 as a result of lower US shale production. The US EIA revised both supply forecasts for 2016 and 2017 downward due largely to lower US oil production, though this was tempered slightly by expectations of higher output from Iran and other major OPEC members. Meanwhile, demand forecast for 2016 and 2017 was broadly steady compared to the previous month's assessment.

[3] Given that the impact of La Niña is inherently unpredictable as it presents both downward and upward pressures on inflation, the effect of the La Niña to the agriculture sector is closely monitored pending official assessment by the Department of Agriculture.

Developments in the Utilities Sector

- Electricity rates inched up in July due to higher generation costs. According to Meralco, the increase in power generation charges from the Wholesale Electricity Spot Market (WESM) and Independent Power Producers (IPPs) was due to more frequent power plant outages and lower dispatch of power plants. Meanwhile, generation charges from the Power Supply Agreements (PSAs) posted a slight reduction due primarily to the higher dispatch of Ilijan power plant.

F. Financial market developments

- Trends in the Philippine financial markets largely reflected key macroeconomic developments overseas which outweighed economic developments in the domestic front.
    - In early August, the local stock market dipped below the 7,900 benchmark after recording a 15th month high of 8,102.3 index points in July. The hawkish tone of the US Fed at the close of their two-day policy meeting and the Bank of Japan's failure to meet expectations of stronger stimulus measures weighed on local stocks, offsetting the optimism brought by reports of ramped up government spending, which was expected to have spurred Q2 2016 GDP growth.
    - Nevertheless, the peso strengthened against the US dollar on improved investor sentiment on emerging market assets following the Bank of England's decision to cut its policy rates at the end of its policy meeting in 3 August. Furthermore, the sustained inflows of foreign exchange from overseas Filipino remittances, foreign direct and portfolio investments, business process outsourcing and tourism receipts, as well as the ample level of the country's gross international reserves provided stability 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 12.4 percent year-on-year to ₱8.7 trillion in June. This was a slight deceleration from the 13.5-percent expansion recorded in May. On a month-on-month seasonally-adjusted basis, M3 decreased by 0.3 percent. Money supply continued to expand due largely to sustained demand for credit.
    - Outstanding loans of commercial banks, net of reverse repurchase placements with the BSP, increased by 17.6 percent in June from 17.7 percent in May. On a month-on-month seasonally-adjusted basis, commercial bank lending increased by 1.2 percent for loans net of RRPs.

H. Fiscal developments

- Fiscal spending, net of interest payments, expanded during the first half of year albeit below program levels. The National Government (NG) recorded a fiscal deficit of ₽120.3 billion for the period January-June 2016, a turnaround from the ₽13.7 billion surplus incurred in January-June 2015. Excluding interest payments from NG expenditures, the primary surplus amounted to ₽33.4 billion, lower by 80.0 percent from the ₽169.9 billion primary surplus recorded in the same period a year ago.

I. External developments

- The global economy remains in a low growth year. Indicators of economic activity show a firm pace of growth in the US, euro area, and India, while production continues to decline in Japan and China. However, the outlook for global growth has tilted further to the downside following the results of the UK referendum on its membership in the European Union.

    - The IMF has downgraded its global GDP growth projections for 2016 and 2017. The downward revisions reflected the increase in uncertainty following the Brexit vote, which is projected to have an adverse impact on market sentiment and investment, including a potential tightening of global financial conditions.

- Key central banks continue to have divergent monetary policy stances to date. The US Federal Reserve maintained its policy rates in the Federal Open Market Committee (FOMC) meeting in July, but hinted that an interest rate increase was still possible in the months ahead. On the other hand, several major central banks – Bank Negara Malaysia, Bank of Japan, Reserve Bank of Australia and Bank of England – have eased their monetary policy settings largely to support domestic output growth.