HIGHLIGHTS OF THE MEETING OF THE MONETARY BOARD ON THE MONETARY POLICY STANCE HELD ON 22 JUNE 2017[1]

I. Monetary Policy Decision

The Monetary Board 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 continues to be manageable. Latest baseline forecasts indicated a lower path of future inflation, with average inflation remaining within the target range of 3.0 percent ± 1 percentage point for 2017-2019. Inflation expectations also continued to be firmly anchored to the target over the policy horizon.

- At the same time, the assessment of risks to the inflation outlook remained tilted toward the upside. While there may be potential transitory impacts of the proposed tax reform program, the social safety nets are expected to mitigate the resulting inflationary pressures. The long-run effects on productivity will improve overall supply and further dampen inflation. Meanwhile, prospects for the global economy have improved, but risks to external demand remain tilted to the downside. Nonetheless, the MB emphasized that while global economic conditions remain challenging, prospects for domestic economic activity continue to be firm owing to buoyant consumer and business sentiment, ample liquidity, and sustained credit growth.

- In addition, the MB considered the potential impact on global financial market conditions of the ongoing monetary policy adjustment in the US, noting that maintaining monetary policy settings at this time would allow the BSP to continue to assess evolving economic developments and calibrate its policy tools as appropriate.

[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 June 2017 meeting were approved by the Monetary Board during its regular meeting held on 13 July 2017. The next meeting of the Monetary Board on the monetary policy stance is scheduled on 10 August 2017.

III. Recent Developments and Inflation Outlook

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

A. Domestic price conditions

- Both headline inflation and official core inflation rates decelerated in May to 3.1 percent and 2.9 percent, respectively. Likewise, alternative measures of core inflation estimated by the BSP were generally lower during the month. The 3-month moving average annualized headline and core inflation rates likewise decreased further. Meanwhile, the number of CPI items below the lower threshold of 2-percent still accounted for bulk of the CPI weight at 53 percent.

- A 60-day price freeze on basic necessities was implemented upon the declaration of martial law in Mindanao. The regions included in the price freeze accounted for 15.8 percent of the total CPI basket. Price freeze will last for 60 days from 23 May 2017 *except* for kerosene and LPG which will only last for 15 days (up to 7 June). Based on DTI's monitoring reports, supply and prices of basic necessities including LPG and kerosene in Mindanao were generally adequate and stable. However, there were uncertainties in prices of selected commodities in Iligan City. DTI noted that agricultural products such as Bangus and Tilapia could be less-than-sufficient while kerosene prices were reportedly higher by ₱0.18-₱ 0.65. Iligan city is part of Region 10, which accounts for 3.5 percent of total CPI basket. Marawi City, which is part of ARMM accounts for 1.6 percent of total CPI basket.

B. Inflation expectations

- Inflation expectations—based on forecast surveys of private sector economists by the BSP and by Consensus Economics—continue to be in line with the within-target inflation outlook. Results of the Consensus Economics survey in May 2017 showed steady mean inflation forecasts for 2017 and 2018 at 3.3 percent. Results of the BSP's May 2017 survey of private sector economists likewise showed unchanged mean inflation forecasts for 2017 at 3.4 percent, for 2018 at 3.5 percent and for 2019 at 3.4 percent.

C. Inflation outlook

- The latest baseline forecasts show lower and within-target inflation path for 2017-2019. The decline in global crude oil prices, lower-than-projected May 2017 inflation outturn, slower domestic economic growth, the delay in the implementation of the assumed minimum wage increase, and slightly stronger peso, which were partially offset by the approved Philippine National Railways (PNR) fare hike, contributed to the downward adjustment in the inflation forecasts.

- The balance of risks to future inflation remains tilted to the upside. The first-round impact of the government's fiscal reform program on prices and the pending petitions for adjustments in electricity rates are the main upside risks to inflation. Meanwhile, the lingering uncertainty in global economic activity continues to be the main downside risk to inflation.

D. Demand conditions

- Philippine GDP grew at a moderate pace as consumer and government spending eased. GDP growth decelerated to 6.4 percent in Q1 2017 from 6.6 percent in Q4 2016 and 6.1 percent in Q1 2016. On the demand-side, the lower-than-expected GDP growth in the first quarter could be attributed to slower private and public consumption and fixed capital formation, which were partly offset by stronger trade. On the supply-side, the deceleration in public construction offset the recovery in agriculture.

- Nevertheless, domestic growth fundamentals are expected to remain intact. Growth momentum remain above the ten-year average of 5.6 percent. Prospects for the domestic economy also continue to remain favorable. GDP expansion could continue due to solid growth in services and industry as well as improved external trade conditions. Private demand is expected to remain firm, aided mainly by sustained remittance inflows and low inflation. Private capital formation should also contribute to economic growth, particularly as more infrastructure programs get underway.

- Latest indicators of domestic demand continue to broadly point to firm growth prospects. Using leading and forward-looking indicators, both composite leading index (CLI) and nowcast model suggest a steady GDP growth momentum in Q2 2017. Business and consumer optimism remained positive. Consumer confidence reached an all-time high for Q2 2017. Trends in other high-frequency demand indicators are also generally positive, with continued increases in sales volume of automobiles (20.0 percent year-on-year growth in Q1 2017) while more than half of the 20 major industries in the manufacturing sector continue to operate above the 80.0 percent capacity level.

  However, some indicators suggest potential downside risks to domestic demand with NG spending still relatively slower in April while the Philippine composite PMI posted the lowest reading since data was made available in October 2010. Meanwhile, based on the April 2017 Labor Force Survey, the country's unemployment rate went down to 5.7 percent (from 6.6 percent in January 2017 and 6.1 percent in April 2016) while underemployment reached its lowest level in ten years. However, the services sector—which accounts for more than half of the country's total employment—recorded a net employment loss of 557,000 workers.

E. Supply-side indicators

<u>Developments in Agriculture</u>

- On 22 May 2017, the Office of the President released Executive Order No. 23, extending the reduced rates of duty on agricultural products (including rice) in EO No. 190 for another three (3) years (i.e., until 30 June 2020), or until such time that a law amending certain provisions relating to rice tariffication in RA No. 8178 is enacted, whichever comes first. EO No. 23 specifies that the MAV commitment of 805.2 TMT, which was made in exchange for the waiver, shall likewise remain in force and in effect.

- As of 8 June 2017, most El Niño-Southern Oscillation (ENSO) prediction models now favor the continuation of ENSO-neutral weather conditions through Q1 2018.

Oil Price Developments

- Uncertainty in the oil market remains high as crude oil prices dropped anew in the first week of June due to higher US inventory, erasing the price gains from the OPEC-led agreement extension. This was further reflected in the uptrend in the different measures of volatility, similar to the uptick observed in early May. Likewise, tracking the movement of international oil prices, prices of most domestic petroleum products were adjusted downward thus far in June.

Developments in the Utilities Sector

- The overall electricity rate went down by ₱0.29 per kilowatt hour (kWh) to ₱9.60 per kWh in May 2017 due mainly to the decrease in generation charge. According to Meralco, the downward adjustment in the generation cost was primarily due to reduction of charges from the Independent Power Producers (IPPs) and Power Supply Agreements (PSAs), respectively. The lower charges from PSAs and IPPs were mainly driven by higher dispatch of plants and the appreciation of the Philippine peso against the US dollar. The reductions largely offset the higher cost of power from the Wholesale Electricity Spot Market (WESM).

F. Financial market developments

- As of 20 June 2017, the peso depreciated by 0.72 percent on year-to-date basis. The trend of the peso tracked the general depreciation of regional currencies, following the US Federal Reserve's decision to raise interest rates on the back of strong US economic data, and growing expectations of another US Fed rate increase before the end of 2017. Meanwhile, the Philippine Stock Exchange index reached the 8,000 mark in June 2017. Sentiments were boosted by Congress' approval of the government's first tax reform package, which raised expectation that this may lead to a credit rating upgrade in the future; the release of higher Philippines data for the month of May; and the rally in Wall Street that spilled over to the local bourse.

G. Domestic liquidity and credit conditions

- Prevailing credit and liquidity conditions continue to support the appropriateness of present policy settings**.** Domestic liquidity increased by 11.2 percent while bank lending grew by 19.2 percent in April 2017. Total bids and placements thru the BSP's open market operations (OMOs) and overnight deposit facility were higher in May relative to the previous month, indicating the continued excess reserve position of the banking system. Strong demand for shorter-dated term deposits also drove down the WAIR for the 7-day TDF, while the 28-day TDF remained undersubscribed.

H. Fiscal developments

- The National Government (NG) recorded a fiscal deficit of ₱30.2 billion for the period January-April 2017, lower by almost 50 percent compared to the ₱57.5 billion deficit posted in the previous year. Netting out the interest payments in NG expenditures, the primary surplus amounted to ₱81.2 billion, which is 35 percent higher than ₱59.9 billion primary surplus recorded in the previous year.

I. External developments

- The JP Morgan Global All-Industry Output Index rose slightly to 53.7 in May from 53.6 in April due largely to the increase in new orders. Stronger expansion was seen in the US, the euro area, China, Japan, India, and Russia, while growth slowed in the UK. Citing favorable developments in advanced economies, most central banks monitored by the BSP have each decided to keep policy rates unchanged in May. Meanwhile, the US Federal Reserve decided to raise the target range for the federal funds rate to 1.0–1.25 percent on 14 June following its assessment of continued strengthening in the domestic labor market and economic activity. The US Fed also expects that US economic conditions will evolve in a manner that will warrant gradual increases in the federal funds target rate.