HIGHLIGHTS OF THE MEETING OF THE MONETARY BOARD ON THE MONETARY POLICY STANCE HELD ON 17 DECEMBER 2015[1]

I. Monetary Policy Decision

The Monetary Board (MB) decided to:

a) Maintain the BSP's key policy interest rates at 4.00 percent for the overnight RRP (borrowing) facility and 6.00 percent for the overnight RP (lending) facility;

b) Maintain the current interest rates on term RRPs, RPs and SDAs; and

c) Maintain the current reserve requirement ratios.

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

- The Monetary Board's decision was based on its assessment of inflation dynamics and the risks to the inflation outlook over the policy horizon.
  - Latest baseline forecasts indicate that average inflation would likely settle below the target range of 3.0 percent ± 1 percentage point for 2015. However, inflation is seen to return gradually to a path consistent with the inflation target for 2016-2017, as the effects of recent weather disturbances continue to be felt. Meanwhile, inflation expectations remain firmly anchored within the inflation target band for 2016 and 2017.
  - Potential upside pressures could come from the impact of prolonged El Niño dry weather conditions on food prices and utility rates as well as pending petitions for power rate adjustments, while downside risks are associated mainly with slower-than-expected global economic activity.

- The Monetary Board also observed that domestic demand conditions are likely to stay firm, supported by solid private household and capital spending, buoyant market sentiment, and adequate domestic liquidity.

- In addition, the Monetary Board considered the potential impact of the recent monetary policy adjustment in the US on global financial conditions, noting that keeping monetary policy settings steady at this juncture would allow the BSP some room to continue to assess evolving global economic conditions 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 on the 17 December 2015 meeting were approved by the Monetary Board during its regular meeting held on 7 January 2016. The next meeting of the Monetary Board on monetary policy issues is scheduled on 11 February 2016.

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 rose to 1.1 percent in November 2015. Likewise, other inflation indicators showed an uptick such as the official core inflation, all three of the alternative measures of core inflation estimated by the BSP, and the seasonally-adjusted 3-month moving average annualized headline inflation. The number and weight of the above-threshold CPI items were also higher relative to the previous month.

- Food inflation increased due to temporary tightness in domestic supply conditions caused by weather-related supply disruptions, which in turn led to higher prices of key food items– particularly vegetables, fruits, meat, and fish.

- At the same time, non-food inflation went up as price increases for clothing and footwear as well as service-related CPI components such as health, restaurants and miscellaneous goods and services more than offset the continued decline in year-on-year inflation of housing, water, electricity, gas, and other fuels.

- By geographical location, inflation for both the National Capital Region (NCR) and areas outside NCR (AONCR) also advanced to 1.0 percent (from 0.2 percent) and 1.1 percent (from 0.5 percent), respectively.

B. Inflation expectations

- Results of the Consensus Economics inflation forecast survey and the BSP's survey of private sector economists both yielded lower mean inflation forecasts for 2015 and 2016. The November 2015 BSP's survey of private sector economists indicated that the mean inflation forecasts for 2015 and 2016 were lower at 1.4 percent (from 1.5 percent in October) and 2.5 percent (from 2.6 percent). By contrast, the mean inflation forecast for 2017 was higher at 2.9 percent (from 2.8 percent). Similarly, the December 2015 Consensus Economics inflation forecast survey for the country showed lower mean inflation forecasts for 2015 at 1.4 percent (from 1.6 percent in November) and at 2.5 percent for 2016 (from 2.6 percent).

- Meanwhile, results of the Business Expectations Survey (BES) for Q4 2015 indicated that more respondents expected inflation to increase for the current and next quarters compared to those who said otherwise. However, businesses expected that the rate of increase in commodity prices will remain low and settle within the 2 to 4 percent target range in 2015, at 2.1 percent for Q4 2015 and 2.3 percent for Q1 2016 compared to 2.7 percent and 2.9 percent in the previous quarter's survey results, respectively.

C. Inflation outlook

- The latest baseline inflation forecasts are higher for 2016-2017. The increase in the forecasted inflation path for 2016 – 2017 could be attributed mainly to the higher-than-expected inflation in November 2015 and the depreciation of the peso, which were partly offset by the decline in global crude oil prices.

- Risks to the inflation projections remain broadly balanced. The possible slower global economic activity continues to pose downside risks while potential adjustments in electricity rates given pending petitions and the impact of stronger-than-expected El Niño conditions are seen as the key upside risks to inflation.

D. Demand conditions

- Recent demand indicators affirm the earlier assessment that domestic demand conditions would remain relatively firm. Based on the latest national income accounts data, the economy grew by 6.0 percent in the third quarter, an improvement from the 5.8 percent growth in the previous quarter and from 5.5 percent in the third quarter in 2014. This brought year-to-date growth to 5.6 percent, albeit still below the government's growth target of 7-8 percent. Strong domestic demand fueled output growth, led by significant improvement in government spending, solid household consumption, and higher capital formation. On the supply side, growth was driven by the services sector while growth in the industry sector was supported by manufacturing activity.

- Consistent with these developments, other indicators continue to point to positive growth momentum. Business outlook on the economy turned more upbeat for Q4 2015, with the overall confidence index (CI) rising to 51.3 percent—the highest in two years. Business outlook also remain positive for Q1 2016 at 43.9 percent albeit lower due to the typical slowdown in demand after the holiday season, concerns over the adverse effects of El Niño, and uncertainties in the global economy. Meanwhile, consumers' outlook improved for Q4 2015 as the overall confidence index (CI) rose to -8.1 percent from -11.6 percent for Q3 2015. For the next quarter (Q1 2016), consumers' optimism was sustained as the CI was broadly steady at 5.7 percent while sentiment was more favorable for the next 12 months, with the CI increasing to 18 percent from 15.8 percent a quarter ago.

E. Supply-side indicators

<u>Developments in Agriculture</u>

- Agriculture, Hunting, Forestry and Fishing (AHFF) grew by 0.4 percent in Q3 2015, an improvement from a decline of 2.6 percent in Q3 2014. The growth of AHFF was supported by the lower rate of contraction of the agriculture subsector as well as the expansions in the livestock, poultry, and fisheries sub-sectors.

- The average retail price of rice declined in November and early December 2015 as a result of increased domestic production during the start of the harvest season and partly due to the arrival of the additional rice importations from the private sector.

- The Food and Agriculture Organization (FAO) food price index (FPI) averaged 156.7 points in November 2015, lower by 2.6 points (1.6 percent) from the month-ago level due to lower prices of cereal, vegetable oil, dairy, and meat. Meanwhile, the price of sugar rose.

Oil Price Developments

- Dubai crude prices dropped sharply in early December following the decision of the Organization of Petroleum Exporting Countries (OPEC) to retain its production quota at 30 million barrels per day (mmbd). Likewise, domestic petroleum prices were generally lower in November relative to end-October levels. According to the EIA, global oil production is expected to continue to outstrip consumption though the projected gap has narrowed for 2016 due in part to the lower expected production from non-OPEC countries and OPEC keeping its current production quotas. At the same time, global oil demand estimates for 2015 and 2016 are generally unchanged. Nonetheless, crude oil price volatility remains elevated.

Developments in the Utilities Sector

- Electricity rates increased in November due to higher generation costs. According to Meralco, the increase was mainly driven by the higher settlement prices at the Wholesale Electricity Spot Market (WESM), power plant outages during the supply month of October and lower dispatch of plants.

F. Financial market developments

- Changing expectations about the policy settings of the major central banks, outlook on the Chinese economy and more external headwinds continued to influence market sentiment over the past month. The PSEi closed at its lowest level in 17 months in mid-November on renewed expectations that the US Fed would finally increase policy rates in December. Disappointing Chinese data, contraction in Japan's GDP growth, and the terrorist attacks in Paris also dampened market sentiment. Through the end of November, the index recovered slightly on indications that rate hikes by the US Federal Reserve will likely be gradual and that government stimulus measures have started to stabilize the Chinese economy. Expectations of fresh stimulus from the Euro zone and higher Philippine GDP growth in the third quarter likewise supported the index. However, in early December, the PSEi lost some momentum following the release of strong US jobs data for November, which raised rate hike expectations ahead of the 15-16 December FOMC meeting.

- The peso depreciated in November and early December on safe-haven trade favoring the US dollar as data showing improvement in the US labor market supported the case for a US Federal funds rate increase by year-end. The weak data in China and lackluster exports data in the Philippines likewise boosted the demand for the US dollar.

- Debt spreads continued to ease in November as investors traded on a conservative stance awaiting the US Fed interest rate hike. In early December, the market reacted negatively despite the additional stimulus that the ECB provided by extending its monthly bond purchases and lowering its lending rate. Investors generally viewed the measures as limited relative to what was needed to boost the economy.

G. Domestic liquidity and credit conditions

- Domestic liquidity (M3) grew by 9.5 percent year-on-year in October 2015 to reach ₱7.9 trillion. This was faster than the 8.7-percent expansion recorded in September. On a month-on-month seasonally-adjusted basis, M3 increased by 1.1 percent. Money supply continued to expand due largely to sustained demand for credit.

- The outstanding loans of commercial banks, net of reverse repurchase (RRP) placements with the BSP, grew by 13.9 percent in October from 12.6 percent in September. On a month-on-month seasonally-adjusted basis, commercial bank lending increased by 2.2 percent for loans net of RRPs. The majority of banks' outstanding loans continued to be directed to key production sectors of the economy.

H. Fiscal developments

- The National Government (NG) recorded a fiscal deficit of ₱25.55 billion for the period January-September 2015, lower by 18 percent from the ₱31.07 billion incurred in the same period in 2014. Excluding interest payments from expenditures, the primary surplus amounted to ₱230.20 billion, ₱3.88 billion or 2.0 percent higher than the level recorded in the same period a year ago.

I. External developments

- Prospects across the globe continue to be uneven. Economic activity in the advanced economies has stayed firm, underscored by a solid recovery in the US and euro area. However, growth in emerging markets is still seen as likely to weaken further, given that indicators continue to point to subdued activity in the Chinese economy.

- On 16 December 2015, the US Federal Reserve raised] its federal funds rate by 25 bps. Meanwhile, the European Central Bank (ECB) cut its deposit facility rate by 10 bps but retained rates for both the main refinancing operations and marginal lending facility effective on 9 December 2015. The ECB also decided to extend its asset purchase program. The Reserve Bank of New Zealand likewise adjusted its monetary policy settings, reducing its official cash rate by 25 bps.