HIGHLIGHTS OF THE MEETING OF THE MONETARY BOARD ON THE MONETARY POLICY STANCE HELD ON 22 DECEMBER 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 inflation continues to be manageable, with a gradual return to the inflation target range expected over the policy horizon.

    - While latest forecasts indicate that average inflation would likely settle slightly below the target range of 3.0 percent ± 1.0 percentage point for 2016, it is projected to gradually return to a path consistent with the inflation target in 2017-2018 due to higher oil prices and stronger domestic economic activity.

    - The overall balance of risks surrounding the inflation outlook remains tilted to the upside, owing largely to the potential impact of the government's broad fiscal reform program as well as the pending petitions for adjustments in electricity rates. Increased uncertainty in global economic prospects continues to be a key downside risk. Meanwhile, inflation expectations remain broadly consistent with the inflation target over the policy horizon.

- The MB also observed that domestic demand conditions are likely to stay firm, supported by solid private household spending, higher government expenditure, and adequate domestic liquidity. In addition, the MB has considered the potential impact of the ongoing monetary policy adjustment in the US on global financial market conditions. The MB also noted that maintaining monetary policy settings at this juncture will give the BSP more time to assess evolving economic developments and calibrate its policy tools as appropriate.

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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 10 November 2016 meeting were approved by the Monetary Board during its regular meeting held on 24 November 2016. The next meeting of the Monetary Board on the monetary policy stance is scheduled on 9 February 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 accelerated in November, although measures of core inflation showed mixed trends.

- Inflation has gained traction with a higher headline inflation reading in November at 2.5 percent, the highest since February 2015. This brought the year-to-date average inflation to 1.7 percent, which is still below the Government's inflation target range of 3.0 percent ± 1.0 percentage point for the year. The uptick in November inflation can be attributed to higher prices of non-food items, namely higher electricity rates in a number of provinces, as well as price increases in domestic petroleum products and alcoholic beverages and tobacco. Meanwhile, food inflation held steady as increases in the prices of rice, fish, and fruits were offset by the lower inflation rates of items such as corn, meat, and vegetables.

- Core inflation meanwhile rose slightly to 2.4 percent year-on-year in November from 2.3 percent in October. However, alternative measures of core inflation showed mixed trends with both trimmed mean and weighted median decelerating to 1.8 percent (from 1.9 percent) and 1.9 percent (from 2.1 percent), respectively. The net of volatile items rose to 2.0 percent from 1.9 percent.

B. Inflation expectations

- Inflation expectations—measured using forecast surveys of private sector economists by the BSP and by Consensus Economics—continue to support the BSP's within-target inflation outlook. Results of the BSP's November 2016 survey of private sector economists showed a steady mean inflation forecast of 1.8 percent for 2016 but slightly higher mean inflation forecasts of 2.9 percent (from 2.8 percent) for 2017 and 3.0 percent (from 2.9 percent) for 2018. Meanwhile, results of the Consensus Economics survey for November 2016 showed steady mean inflation forecasts at 1.7 percent for 2016 and 2.9 percent for 2017.

C. Inflation outlook

- The latest baseline forecasts show that inflation will likely settle below the target range of 3.0 percent ± 1.0 percentage point for 2016 but return gradually to a path consistent with the inflation target in 2017-2018 due to higher oil prices and strong domestic economic activity.

- The risks to future inflation are seen to remain tilted to the upside, owing largely to the potential impact of the National Government's (NG) broad fiscal reform program as well as that of pending petitions for adjustments in electricity rates. Increased uncertainty in global economic prospects continues to be a key downside risk.

D. Demand conditions

- Latest demand indicators show that domestic demand conditions remain relatively firm. The economy grew by 7.1 percent in the third quarter, faster compared to the 7.0 percent growth in the previous quarter and from 6.2 percent in the third quarter in 2015. This brought year-to-date real GDP growth to 7.0 percent, which is at the high end of the government's growth target of 6-7 percent in 2016. Strong domestic demand continued to fuel output growth, led by 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.

  Consistent with these developments, other high-frequency indicators continue to point to sustained growth in the near to medium term. Prospects for aggregate demand are expected to remain solid on the basis of these indicators and on robust consumer confidence. Consumers' outlook improved significantly for Q4 2016 with the overall confidence index (CI) reaching an all-time high of 9.2 percent. The reasons cited by survey respondents' for the increased optimism were improvements in the peace and order situation, effective government policies on job contractualization, anticipated increase in salaries, and availability of more jobs.

  Meanwhile, business outlook on the economy turned less optimistic for Q4 2016 due mainly to perceived concerns over the direction of the country's foreign policy and economic reforms as well as weakening global demand. Nevertheless, the Philippine composite Purchasing Managers' Index remained above the 50-point expansion threshold, reaching 53.2 in October while manufacturing companies continue to operate above the long-term average capacity utilization of 80.0 percent.

E. Supply-side indicators

Developments in Agriculture

- The agriculture, hunting, forestry and fishing sector expanded by 2.9 percent in Q3 2016, reversing a 0.1-percent contraction in the same period in 2015. In particular, the agriculture subsector grew by 3.0 percent during the quarter with output increases in crop, livestock, and poultry subsectors. The increase in palay output in Q3 2016 was attributed to the expansion of harvested areas due to the rehabilitation of irrigation canals and early occurrence of rains and a shift in planting from Q1 to Q2 2016 in some regions, and the government's distribution of certified seeds in Central Luzon.

- International food commodity prices generally increased in October. The Food and Agriculture Organization (FAO) Food Price Index (FPI) rose by 1.2 points (0.7 percent) month-on-month and 14.4 points (9.1 percent) year-on-year. Rising sugar and dairy prices were the main drivers behind the October FPI increase. The FAO cereal price index also posted a modest increase due largely to hikes in wheat and maize prices. The FAO sugar price index also rose on reports of lower-than-expected production in the main production areas in Brazil. Meanwhile, sharp declines were noted in the FAO vegetable oil price index and meat price index on the back of an increase in palm oil stocks and lower pork and beef prices, respectively.

- As of 8 December 2016, most El Niño-Southern Oscillation (ENSO) prediction models indicate sea surface temperatures near the threshold of La Niña persisting through December 2016 - February 2017, then weakening to cool ENSO neutral by January-March 2017.

Oil Price Developments

- Dubai crude oil prices exceeded US$50 per barrel in the first week of December as members of the Organization of Petroleum Exporting Countries (OPEC) agreed to reduce production. Prices of domestic petroleum products followed suit.

- Nevertheless, in its December 2016 report, the US Energy Information Administration (EIA) showed an oversupplied oil market in 2017. Despite the OPEC's deal to cut production, the US EIA retained their oil supply forecasts for 2016 and 2017 due to expectations of higher oil production from producers outside the OPEC, particularly the US and Canada.

Developments in the Utilities Sector

- Electricity rates rose in December owing to higher generation cost. According to Meralco, the increase was largely driven by the depreciation of the Philippine peso against the US dollar in October and November. As a result, generation charges from the Independent Power Producers (IPPs) and Power Supply Agreements (PSAs) whose billings are around 96 percent and 75 percent dollar-denominated, respectively, posted increases. The increase was also due to lower dispatch and higher fuel cost. Meanwhile, generation charge from the Wholesale Electricity Market decreased due to lower demand and fewer power outages, which partly mitigated the higher charges from the IPPs and PSAs.

F. Financial market developments

- In the domestic financial markets, the peso breached the ₱49/US$1 level on sustained equity outflows. The Philippine Stock Exchange index was under pressure amid sustained net selling of foreign investors. Movements in financial market indicators reflected investors' risk-off attitude as a result of higher perceived probability of a US interest rate hike in December. More positive economic data in previous months have led to markets pricing in a higher likelihood of an increase in the US policy rate before the end of the year.

G. Domestic liquidity and credit conditions

- Liquidity and credit conditions indicate that overall monetary conditions remain supportive of domestic economic activity.

  - Domestic liquidity (M3) grew by 12.8 percent (y-o-y) to ₱8.9 trillion in October. This was slightly faster than the 12.7-percent (revised) expansion recorded in September. On a month-on-month seasonally-adjusted basis, M3 increased by 1.2 percent.

  - Outstanding loans of commercial banks, net of reverse repurchase (RRP) placements with the BSP, grew by 17.7 percent in October from 17.8 percent in September. On a month-on-month seasonally-adjusted basis, commercial bank lending for loans net of RRPs increased by 1.8 percent.

H. Fiscal developments

- The latest fiscal data reflected the efforts to step up government spending. The National Government (NG) recorded a fiscal deficit of ₱216.0 billion for the period January-October 2016, ₱163.5 billion higher than the ₱52.6 billion deficit incurred in the first ten months in 2015. Excluding interest payments from NG expenditures, the primary surplus amounted to ₱49.8 billion, which is lower by ₱169.5 billion than the ₱219.3-billion primary surplus recorded in the same period a year ago.

I. External developments

- Indicators of economic activity showed an improvement in demand across the globe, led mainly by advanced economies. However, growth in the emerging economies remained mixed. The JP Morgan Global All-Industry Output Index was unchanged at 53.3 in November from the same level in October, with solid growth seen in both the manufacturing and service sectors. Output expanded in the US, euro area, UK, and Japan. Among emerging economies, output growth was faster in Russia and steady in China. Meanwhile, the downturn in Brazil continued, while India slipped into contraction amid its demonetization process.

- Manufacturing conditions weakened in the ASEAN region with the Nikkei ASEAN Manufacturing PMI remaining in contraction territory at 49.4 in November from 49.2 in October, reflecting uneven performances across the region. Three out of the seven countries included in the index saw an improvement in growth—i.e., Philippines, Vietnam, and Myanmar. Meanwhile, contractions were observed in Thailand, Indonesia, Malaysia, and Singapore.

- Many central banks maintained their monetary policy settings in December. A notable exception was the US Federal Reserve, which decided on 15 December 2016 to raise the fed funds target rate by 25 bps to 0.50-0.75 percent. This action was largely anticipated by financial markets in view of rising CPI and PCE inflation in the US, which were recorded at 1.7 percent (for November) and 1.4 percent (for October), respectively. Furthermore, latest projections from the US Fed also showed a higher GDP growth path for 2017-2019.