HIGHLIGHTS OF THE MEETING OF THE MONETARY BOARD ON THE MONETARY POLICY STANCE HELD ON 9 FEBRUARY 2017[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 of inflation dynamics and the risks to the inflation outlook over the policy horizon.

  - While inflation has risen due to the recent increase in food and oil prices, latest baseline forecasts continue to indicate that the future inflation path will remain within the target range of 3.0 percent ± 1.0 percentage point for 2017-2018. Inflation expectations are also aligned with the inflation target over the policy horizon.

  - The balance of risks surrounding the inflation outlook continues to be weighted toward the upside, given possible adjustments in electricity rates as well as the initial impact of the government's broad fiscal reform program.

- The MB also stressed that while the global economic environment has become more challenging due to expected shifts in macroeconomic policies in advanced economies, including the ongoing normalization of monetary policy in the US, domestic economic activity is expected to stay firm, supported by buoyant household consumption and private investment, increased fiscal spending, and ample credit and liquidity.

[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 9 February 2017 meeting were approved by the Monetary Board during its regular meeting held on 23 February 2017. The next meeting of the Monetary Board on the monetary policy stance is scheduled on 23 March 2017.

III. Recent Developments and Inflation Outlook

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

A. Domestic price conditions

- Inflation in January 2017 accelerated to 2.7 percent from 2.6 percent in December 2016, which is the highest since January 2015. The uptick in inflation can be attributed mainly to higher price increases of selected non-food components such as electricity, gas, and other fuels, as higher prices of international crude oil were reflected in upward adjustments of domestic petroleum prices.

- Core inflation based on the official definition was unchanged at 2.5 percent while the three alternative measures of core inflation were also generally steady. Meanwhile, the 3-month moving average annualized headline and core inflation rates slowed down in January after gaining some momentum in Q4 2016.

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 January 2017 survey of private sector economists showed higher mean inflation forecasts for 2017 at 3.1 percent (from 3.0 percent) and for 2018 at 3.3 percent (from 3.1 percent). Mean inflation forecast for 2019 was at 3.3 percent. Meanwhile, results of the Consensus Economics survey for January 2017 showed higher mean inflation forecasts for 2017 at 3.1 percent from 2.9 percent while mean inflation forecast for 2018 is at 3.2 percent.

C. Inflation outlook

- The latest baseline forecasts show a higher but within-target inflation path for 2017-2018, due mainly to the increase in oil prices and approved hikes in jeepney and taxi fares.

- The balance of risks to future inflation remains tilted to the upside. The pending petitions for adjustments in electricity rates along with the short-term impact of the Malampaya maintenance shutdown and the impact of the government's fiscal reform program are the main upside risks to inflation. Meanwhile, the increased uncertainty in the global economic landscape poses the main downside risk to inflation.

D. Demand conditions

- Domestic economic activity continued to expand within expectations, supporting the maintenance of current present monetary policy settings. The economy grew by 6.6 percent in Q4 2016, bringing full year growth to 6.8 percent which is close to the high end of the government's growth target of 6-7 percent in 2016. Strong domestic demand fueled output growth, supported by household consumption and capital formation. On the supply side, growth was driven by the services sector while growth in the industry sector was supported by manufacturing.

- Prospects for the domestic economy remain favorable. Trends in high-frequency demand indicators are generally positive: volume sales of automobiles and electricity are still rising, the composite PMI has stayed above the 50-point threshold, and both business and consumer outlook continue to be favorable. The fiscal stimulus from higher infrastructure spending could also provide a boost to the economy. Sustained growth in capital formation and broad-based expansion in bank lending is expected to continue to underpin domestic economic activity.

E. Supply-side indicators

<u>Developments in Agriculture</u>

- The overall output of the agriculture, hunting, forestry and fishing sector declined by 1.1 percent in Q4 2016, from a 0.2-percent contraction in Q4 2015. In particular, the agriculture subsector slightly declined during the quarter with output reductions in *palay* and corn, among others, due to the adverse effects of typhoons Karen and Lawin.

- Meanwhile, based on the Rice and Corn Situation Outlook of the Philippine Statistics Authority, *palay* is projected to increase by 15.2 percent in Q1 2017 and 7.9 percent in Q2 2017 due to adequate water supply and favorable weather conditions.

- The Food and Agriculture Organization (FAO) Food Price Index (FPI) averaged 171.8 points in December 2016, almost unchanged from the previous month's 171.9 points. The uptick in the prices of vegetable oils and dairy products offset the fall in sugar and meat prices, which led to the steady movement of the index. For 2016, the FPI averaged 161.6 points, down by 1.5 percent from 2015.

- As of 12 January 2017, most El Niño-Southern Oscillation (ENSO) prediction models indicated an imminent transition to ENSO-neutral conditions, which is forecast to last until August-October 2017.

<u>Oil Price Developments</u>

- Dubai crude oil prices remained above the US$50-per barrel level, sustaining an increase in January as the market continued to be upbeat about the Organization of the Petroleum Exporting Countries (OPEC) and non-OPEC agreement to reduce oil output. However, oil prices were tempered amid reports of rising US commercial oil stockpiles. In the January 2017 report of the US Energy Information Administration (EIA), oil supply-demand could narrow but will remain in surplus in 2017-2018.

<u>Developments in the Utilities Sector</u>

- In 2016, electricity rates were generally on a downward trend due largely to lower generation cost. The decline in generation cost could mainly be attributed to improved supply situation for the whole year and fewer power plant outages.

- Meanwhile, overall electricity rates continued to ease in January 2017 due to lower generation cost. According to Meralco, the decline in the generation charge was largely attributed to the reduction in cost of power supplied by the Power Supply Agreements. At the same time, generation charges from Independent Power Producers posted a slight reduction on improved dispatch. Meanwhile, generation charge from the Wholesale Electricity Market had a slight upward adjustment.

F. Financial market developments

- In the domestic financial markets, the peso appreciated in January 2017 relative to the average in December 2016 following the release of the Federal Open Market Committee minutes that indicated a gradual increase in interest rates in 2017. Meanwhile, the Philippine Stock Exchange index traded above the 7,300 mark in January 2017 following the release of strong manufacturing data from the US and China and the less hawkish tone of the US Fed in the FOMC December meeting minutes.

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 12.4 percent (y-o-y) to ₽9.5 trillion in December 2016. This was slightly slower than the 12.7-percent expansion recorded in November 2016. On a month-on-month seasonally-adjusted basis, M3 increased by 0.5 percent.

    - Outstanding loans of commercial banks, net of reverse repurchase (RRP) placements with the BSP, grew by 17.2 percent in December 2016 from 18.6 percent in November 2016. On a month-on-month seasonally-adjusted basis, commercial bank loans net of RRPs increased by 0.7 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 ₽235.2 billion for the period January-November 2016, about five times higher compared to the ₽46.5 billion deficit incurred in the first eleven months in 2015. Excluding interest payments from NG expenditures, the primary surplus amounted to ₽50.2 billion, which is about 21 percent of the ₽241.3 billion primary surplus recorded in the same period in 2015.

I. External developments

- Indicators of growth show an improvement across the globe, led mainly by advanced economies. By contrast, economic activity in the emerging economies remains mixed. These developments form the economic backdrop for the latest WEO projections by the IMF, which point to a modest recovery in 2017. However, risks to the growth outlook remain tilted to the downside owing to a possible shift toward inward-looking policies in some advanced economies as well as to a sharper-than-expected tightening in global financial conditions. The outlook also incorporates firmer oil prices following the agreement among major oil-producing countries to limit supply, although price pressures are still broadly seen as manageable.