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HIGHLIGHTS OF THE MEETING OF THE MONETARY BOARD ON THE MONETARY POLICY STANCE HELD ON 21 SEPTEMBER 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 monetary policy settings steady was based on its assessment that the inflation environment remains manageable. Latest forecasts show the future inflation path will continue to be within the target range for 2017-2019. Meanwhile, inflation expectations remain firmly anchored close to the midpoint of the Government's 3 percent ± 1 percentage point target over the policy horizon.

- The MB also recognized that the balance of risks to the inflation outlook continues to be on the upside. While the proposed tax reform program may exert potential transitory pressures on prices, various social safety nets and the resulting improvement in output and productivity will likely temper the impact on inflation over the medium term.

- At the same time, while prospects for global economic growth have stayed broadly upbeat, geopolitical tensions and lingering uncertainty over macroeconomic policies in advanced economies continue to pose downside risks to external demand. The outlook for domestic economic activity remains firm, supported by positive consumer and business sentiment and ample liquidity. Moreover, as credit for production activities continues to expand in line with output growth, the economy's improving absorptive capacity is likewise seen to be sustained, thus mitigating inflation pressures over the long run. Nonetheless, the Monetary Board remains watchful over evolving economic growth and liquidity conditions and their implications for price and financial stability.

[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 21 September 2017 monetary policy meeting were approved by the Monetary Board during its regular meeting held on 5 October 2017. The next meeting of the Monetary Board on the monetary policy stance is scheduled on 9 November 2017.

III. Recent Developments and Inflation Outlook

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

A. Domestic price conditions

- The year-to-date inflation of 3.1 percent (as of August 2017) remained well within the National Government's (NG) inflation target range of 3.0 percent ± 1.0 percentage point for 2017. August headline inflation rose to 3.1 percent from 2.8 percent in the previous month on higher prices for both food and non-food items. The higher August inflation was driven by increases in non-food items such as electricity, domestic petroleum products, and air and sea passenger fares. Likewise, food inflation went up as prices of fish, corn, and vegetables increased due to some tightness in domestic supply caused by adverse weather conditions during the month.

- Core inflation—which excludes certain volatile food and energy items to better capture underlying price pressures—rose to 3.0 percent from 2.6 percent. Likewise, alternative measures of core inflation were generally increasing – the trimmed mean, net of volatile items, and principal component analysis accelerated while the weighted median was steady during the month.

B. Inflation expectations

- Inflation expectations—based on forecast surveys of private sector economists by the BSP—continued to be in line with the BSP's within-target inflation outlook. Results of the BSP's August 2017 survey of private sector economists showed a lower mean inflation forecast for 2017 of 3.1 percent (from 3.2 percent) while mean inflation forecasts for 2018 and 2019 remained broadly steady at 3.4 percent.

C. Inflation outlook

- Average inflation was projected to settle near the midpoint of the NG's target range of 3.0 percent ± 1.0 percentage point in 2017-2019. The latest average baseline inflation forecasts for 2017-2019 were slightly higher compared to the previous forecast round due to the depreciation of the peso, higher global crude oil prices, increased domestic liquidity growth, and the higher-than-assumed increase in the minimum wage.

- The risks to future inflation remained weighted toward the upside. The transitory impact of the government's fiscal reform program and the pending petitions for adjustments in electricity rates were considered as the main upside risks to the inflation outlook. Meanwhile, slower global economic growth due to policy uncertainty in advanced economies and geopolitical tensions continued to be the main downside risks to inflation.

D. Demand conditions

- Domestic demand conditions remained firm, with GDP growth momentum sustained in Q2 2017. GDP expanded by 6.5 percent year-on-year in Q2 2017 and 6.4 percent in the first half of the year. Growth in the second quarter was supported by sustained growth in household consumption and capital formation, particularly durable equipment and construction. On the production side, the faster growth of the industry sector (particularly manufacturing) and the recovery in agriculture mainly contributed to the overall expansion in output. Domestic demand expansion meanwhile was driven by private consumption, government spending, and capital formation.

- Prospects for aggregate demand in the next few quarters are expected to remain positive. Consumer sentiment for Q3 2017 remained upbeat but turned more optimistic for Q4 2017 due to respondents' expectations of additional income, an improvement in peace and order situation and availability of more jobs. Meanwhile, business sentiment turned less optimistic in Q3 2017 but rose for the quarter ahead (Q4 2017) due to anticipated holiday spending and harvest season.

E. Supply-side indicators

<u>Developments in Agriculture</u>

- Agriculture, Hunting, Forestry and Fishing sector expanded by 6.3 percent in Q2 2017, a turnaround from the 2-percent contraction in Q2 2016 and faster than the 4.9-percent growth in Q1 2017. In particular, the agriculture subsector grew by 7.9 percent during the quarter brought about by output increases in *palay*, corn, coconut, sugarcane and other various crops.

- The National Food Authority (NFA) reported that the country's total rice inventory as of end-August 2017 stood at 1,984.9 thousand metric tons, estimated to last for about 63 days from 73 days in the previous month. The decline in NFA rice stocks was due to low *palay* procurement during the harvest season, as the prevailing farmgate prices were higher than the NFA buying price. Likewise, the lower rice inventory in the commercial and household sectors was attributed to the ongoing lean season.

- Weather forecast models (as of September 2017) predicted an increasing chance of a La Niña phenomenon in Q4 2017.

<u>Oil Price Developments</u>

- Global crude oil prices were higher in September 2017 amid production outages in Libya and lower US crude oil inventory. At the same time, the MB noted several factors contributing to the uncertainty in global oil prices including weather-related supply disruptions, global geopolitical tensions and US commercial crude stockpiles. Meanwhile, generally tracking the movement of international oil prices, prices of domestic petroleum products were adjusted upward in August 2017.

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

- The overall electricity rate slightly increased by around ₱0.86 per kilowatt hour (kWh) in September 2017 due mainly to the rise in generation charge brought about by the increase in Wholesale Electricity Spot Market (WESM) prices, peso depreciation, and the end of the refund from over-recovery on pass-through charges from January 2014 to December 2016.

F. Financial market developments

- In the first two weeks of September 2017, the peso depreciated on a year-to-date basis due to the following factors: (i) geopolitical tensions between North Korea and United States of America; (ii) hawkish comments of New York Fed President William Dudley supporting another rate hike in the US and the planned unwinding of the US Fed's bond holdings; and, (iii) investor concerns following a terror attack in Spain. Meanwhile, the Philippine Stock Exchange index (PSEi) increased despite geopolitical concerns in North Korea, closing at 8,180.85 index points as of 15 September 2017.

G. Domestic liquidity and credit conditions

- Prevailing credit and liquidity conditions continued to support the appropriateness of present monetary policy settings. As of July 2017, domestic liquidity increased by 13.5 percent while bank lending grew by 19.7 percent. Demand for credit remained the principal driver of money supply growth, offsetting the slowdown of net foreign assets. Broad-based bank lending growth reflected solid demand for loans across key economic sectors and households.

H. Fiscal developments

- Fiscal spending remains on track as NG expenditures (excluding interest payments) increased by 11.0 percent year-on-year in January-July 2017. The NG also recorded a fiscal deficit of ₽205.0 billion for the period January – July 2017, higher by 20.0 percent compared to the ₽171.0-billion deficit posted in the previous year. After excluding interest payments from NG expenditures, the primary deficit amounted to ₽8.8 billion, a turnaround from the ₽22.7-billion primary surplus recorded in the previous year.

I. External developments

- The recovery in global economic growth appears to have broadened. Economic activity in the US, euro area, and Japan expanded faster while GDP growth in China was stronger than expected. Based on the PMI indices, global economic activity improved generally due to the stronger growth of manufacturing production in developed economies.

- The US Fed maintained the target range for the federal funds rate at 1.00 – 1.25 percent during its September 2017 meeting as inflation in the US is projected to remain below 2 percent despite continued strengthening in economic activity and labor market outcomes. The US Fed also announced the start of its balance sheet normalization program in October 2017.