HIGHLIGHTS OF THE MEETING OF THE MONETARY BOARD ON THE MONETARY POLICY STANCE HELD ON 8 FEBRUARY 2018[1]

I. Monetary Policy Decision

The Monetary Board decided to:

a) maintain the overnight RRP (borrowing) rate at 3.0 percent; and

b) maintain the current overnight deposit and overnight lending rates.

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

- The Monetary Board's (MB) decision is based on its assessment that while latest baseline forecasts show higher inflation outturns for 2018, the inflation path is expected to moderate and settle within the inflation target range of 3.0 percent ± 1.0 percentage point in 2019. The MB also noted that prospects for domestic activity continue to be firm on the back of robust domestic demand, manageable growth in credit and liquidity, and a sustained recovery in global economic growth. The higher inflation in January is also due to better enforcement of tax laws on tobacco as well as temporary increases in prices of selected food items, such as fish and vegetables.

- Nevertheless, the MB observed that the risks to the inflation outlook remain weighted toward the upside owing mainly to price pressures emanating from possible further increases in global oil prices. At the same time, the MB saw that inflation expectations continue to be anchored within the inflation target band over the policy horizon. The BSP is watchful against any signs of second-round effects and inflation becoming broader based.

- Given these considerations, the MB reiterated that it remains committed to the BSP's price stability objective and will continue to closely monitor the evolving conditions for prices and output for any threats to the inflation target. The MB stands ready to take appropriate measures as necessary to ensure that the monetary policy stance continues to support 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 8 February 2018 monetary policy meeting were approved by the Monetary Board during its regular meeting held on 1 March 2018. The next meeting of the Monetary Board on the monetary policy stance is scheduled on 22 March 2018.

III. Recent Developments and Inflation Outlook

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

A. Domestic price conditions

- Headline inflation for January 2018 accelerated to 4.0 percent from 3.3 percent in the previous month. The higher inflation outturn was at the high end of the Government's target range of 3.0 percent ± 1.0 percentage point for 2018. The uptick in headline inflation for January was traced mainly to higher prices of food and non-alcoholic beverages, alcoholic beverages and tobacco items, and domestic petroleum products.

- Food inflation went up as most food commodities, particularly corn, meat, and milk, cheese, and eggs, posted higher prices during the month. Likewise, weather-related production disruptions pushed up prices of rice, fish, and vegetables in many regions. Non-alcoholic beverages and alcoholic beverages and tobacco inflation rose as a result of the implementation of the Tax Reform for Acceleration and Inclusion (TRAIN) Law and better tax enforcement. Transport inflation also increased due to adjustments in gasoline and diesel prices, largely influenced by higher international prices of crude oil and the excise tax on petroleum as prescribed by the TRAIN Law.

- Official core inflation—which excludes certain volatile food and energy items to better capture underlying price pressures—accelerated to 3.9 percent in January from 3.0 percent in the previous month. Alternative measures also increased in January but remained close to or below 3.0 percent.

B. Inflation expectations

- Inflation expectations—based on private sector economist forecasts surveyed by the BSP—continued to be in line with the BSP's within-target inflation outlook. Results of the BSP's survey of private sector economists for December 2017 showed that the mean inflation forecasts were slightly higher for 2018 at 3.6 percent (from 3.5 percent in the November 2017 survey) and for 2019 at 3.5 percent (from 3.4 percent).

C. Inflation outlook

- The latest baseline forecasts show that inflation could likely exceed the high end of the government's target range of 3.0 percent ± 1.0 percentage point in 2018 before settling above the midpoint of the target range in 2019. The forecast for 2018-2019 are higher compared to the previous forecast round due to the implementation of the first package of the government's Tax Reform for Acceleration and Inclusion (TRAIN) program and higher global crude oil prices. The impact of TRAIN law was included as risks to the inflation outlook in the previous forecast round, but is now directly incorporated in the latest baseline forecasts.

- The risks to future inflation remain on the upside. The potential second-round impact of the fiscal reform program, pending petitions for adjustments in transport fares and electricity rates, and faster-than-expected monetary policy normalization in the US are the main upside risks to inflation. Meanwhile, the slower global economic growth due to policy uncertainty in advanced economies and geopolitical tensions along with the proposed reform in the rice industry involving the replacement of quantitative restrictions with tariffs and the deregulation of rice imports continue to be the main downside risks to inflation.

D. Demand conditions

- The economy grew by 6.6 percent in the fourth quarter of 2017, slower than the revised third quarter growth of 7.0 percent, but unchanged compared to the same period in 2016. On the expenditure side, growth continued to be supported by private consumption as well as higher public spending and stronger exports. On the production side, the industry and services sectors continue to be the primary drivers of growth. This brings full-year 2017 growth to 6.7 percent, which is slightly slower than the 6.9 percent growth registered in 2016, but within the 6.5 – 7.5 percent GDP growth target of the government. This represents the sixth consecutive year of above 6.0 percent annual GDP expansion.

- Domestic growth fundamentals are expected to remain solid and within potential. Prospects for the domestic economy continue to remain favorable supported by the positive outlook of businesses and consumers. Private capital formation should likewise contribute to economic growth with construction and investments in durable equipment expected to remain solid as the government's projects and other infrastructure programs get underway.

E. Supply-side indicators

Developments in Agriculture

- The latest Rice and Corn Situation Outlook Report (January 2018) of the PSA projected possible year-on-year increases in *palay* output in Q1 2018. *Palay* production is projected to grow by 5.7 percent while corn is seen to post a 5.1-percent expansion. Prospects are favorable for *palay* output given expectations of sufficient water supply and good weather conditions during the cropping period in Q1 2018. Historical *La Niña* episodes in the Philippines have tended to result in higher total agricultural, *palay*, and corn production relative to production during neutral conditions

- Weather forecast models (as of January 2018) of the International Research Institute for Climate and Society – Climate Prediction Center predicted an increasing chance of La Niña weather conditions up to April 2018. This is consistent with PAGASA's latest climate advisory, wherein a weak La Niña condition could last until March 2018, with the possibility of either extending or transitioning to a neutral condition in April 2018.

Oil Price Developments

- Global crude oil prices averaged higher in January 2018, at around USS$65 per barrel following the extension of the Organization of the Petroleum Exporting Countries'-led production cut agreement, geopolitical tensions, and unplanned supply outages. Nevertheless, crude oil prices are expected to ease over the near term as a result of expectations of a resumption of shale oil production in the US.

Developments in the Utilities Sector

- The overall electricity rate decreased in January 2018 due mainly to lower generation charge. The lower charge from the Wholesale Electricity Spot Market (WESM) was due to lower spot prices resulting from a reduction in power demand in the Luzon grid. At the same time, the decrease in Power Supply Agreement (PSA) charges was brought about by a reduction in capacity fees as a result of the annual reconciliation of outage allowances done at the end of each year under the PSAs approved by the ERC. The decline in charges from the WESM and

PSA largely offset the increase in charges from the Independent Power Producers which was due to lower average plant dispatch.

F. Financial market developments

- The Philippine Stock Exchange index (PSEi) rose to 8,910.48 index points as of 30 January 2018 from the end-December 2017 level of 8,558.42 index points amid expectations of an above 7-percent growth for 2018 following the enactment of the TRAIN law, expectations that the next tax reform package will cut corporate income tax rates, and optimism over the entry of a third player in the telecommunications sector.Meanwhile, the peso depreciated against the US dollar in January 2018 amid intact expectations of three more Fed interest rate increases this year, higher Philippine trade deficit, and slower-than-expected Q4 2017 Philippine economic growth.

G. Domestic liquidity and credit conditions

- Prevailing credit and liquidity conditions continued to support the appropriateness of present monetary policy settings. Domestic liquidity increased by 14.0 percent (from 14.8 percent) while bank lending growth decelerated to 19.2 percent (from 19.9 percent) in November 2017.

- In January, the offered volume for the 7-day TDF was kept at ₱40 billion and zero for the 28-day tenor. However, the return of liquidity at the end of the holiday season and NG disbursements resulted in oversubscription in the 7-day TDF, bringing down the WAIR to 2.7785 percent on 31 January 2018. The return of the 28-day TDF should gradually lock in the oversubscriptions.

H. Fiscal developments

- Fiscal spending remains on track as NG expenditures (excluding interest payments) increased by 10.0 percent year-on-year from January-November 2017. The NG also recorded a fiscal deficit of ₱243.5 billion for the period January – November 2017, higher by 4.0 percent compared to the ₱235.2-billion deficit posted in the previous year.

I. External developments

- The global economy continued its broad-based recovery in 2017 and is expected to sustain its momentum in 2018-2019. In its January 2018 World Economic Outlook (WEO) Update, the IMF noted that global economic activity rose by 3.7 percent in 2017 from 3.2 percent in 2016 due to faster growth in Europe and Asia. Furthermore, growth forecasts were raised by 0.2 percentage point to 3.9 percent for both 2018 and 2019.

  The upward revision to the global economic outlook could be attributed to favorable global financial conditions as well as the positive prospects due to the tax reform program in the US, which could carry positive spillovers to its major trading partners. The IMF maintains its view that the risks to the growth outlook as being broadly balanced in the near term, but remains skewed to the downside over the medium term. In the near term, the confidence in the global economy's momentum and easy financial conditions could result in upside surprises to growth. On the downside, a correction in financial markets, which have registered a sustained rise in asset prices with low volatility, could lead to tighter global financial conditions. In addition, a modest response of investments to the US tax reform program could result in more subdued external trade conditions for its major trading partners.