HIGHLIGHTS OF THE MEETING OF THE MONETARY BOARD ON THE MONETARY POLICY STANCE HELD ON 23 JUNE 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 decision to keep its monetary policy settings unchanged is based on its assessment that the inflation environment continues to be manageable.

  - Average inflation is expected to settle near the lower edge of the 3.0 percent ± 1.0 percentage point target range in 2016 and rise toward the mid-point of the target range in 2017 and 2018. Meanwhile, inflation expectations remain broadly consistent with the inflation target over the policy horizon.

  - The overall balance of risks surrounding the inflation outlook is now deemed to be broadly balanced. With global oil prices recovering, the risk of second-round effects from lower oil prices is likely to recede in the period ahead. Nevertheless, slower global economic activity remains a key downside risk to the inflation outlook. Given improved rainfall conditions and the shift to neutral weather conditions in the May-July period, the upside risks to food and utility prices due to El Niño are also seen to recede in the coming months. However, pending petitions for adjustments in electricity rates remain an upside risk to inflation.

- The Monetary Board also observed that prospects for global economic growth have remained subdued since the previous meeting, but with increased downside risks to global activity. On the other hand, domestic economic activity continues to be firm, supported by solid private household consumption and investment, buoyant business and consumer sentiment, and adequate credit and domestic liquidity. Higher fiscal spending is also expected to further boost domestic demand.

[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 23 June 2016 meeting were approved by the Monetary Board during its regular meeting held on 7 July 2016. The next meeting of the Monetary Board on the monetary policy stance is scheduled on 11 August 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 an 11-month high at 1.6 percent in May from 1.1 percent in April due largely to price increases in key food items offsetting the continued decline in rice prices. Food inflation went up due largely to tighter domestic supply caused by drought; this resulted in higher prices for key food items, particularly meat, fish, fruit, milk, cheese, and eggs as well as vegetables during the month. In contrast, year-on-year rice inflation remained negative in May. At the same time, non-food inflation rose slightly as the negative inflation rate for electricity, gas, and other fuels was counterbalanced by the higher inflation rates recorded for other non-food items.

- All indicators of core inflation increased in May: trimmed mean, weighted median, and net of volatile items rose to 1.5 percent (from 1.2 percent), 1.7 percent (from 1.4 percent), and 1.3 percent (from 1.2 percent), respectively. Moreover, the number of CPI items with inflation rates *below* the threshold dropped in May relative to the previous month.

- By geographical location, inflation for both National Capital Region (NCR) and areas outside NCR increased by 1.0 percent (from 0.4 percent) and 1.7 percent (from 1.3 percent), respectively. Likewise, the weighted average inflation rates for the major island groupings Luzon, Visayas and Mindanao were higher in May compared to April.

B. Inflation expectations

- Inflation expectations remain broadly consistent with the within-target inflation outlook. Results of the May 2016 BSP's survey of private sector economists yielded a lower mean inflation forecast for 2016 while mean inflation forecasts for 2017 and 2018 were steady and within target. Likewise, results of the May 2016 Consensus Economics survey showed lower mean inflation forecasts for 2016 and 2017 from last month's survey. Meanwhile, the Q2 2016 Business Expectations Survey indicated that more respondents expected inflation to increase for the current and next quarters compared to those who said otherwise.

C. Inflation outlook

- The latest baseline inflation forecasts show that inflation could settle near the low end of the government's target range of 3.0 percent ± 1.0 percentage point in 2016 and the midpoint of the target in 2017-2018. Inflation is projected to steadily increase towards the target range in the middle of this year, driven by impact of election spending, increase in non-agriculture minimum wage in June 2016, and positive base effects.

- The risks to future inflation are deemed to be broadly balanced. Slower global economic activity remains a significant downside risk to the inflation outlook. Global growth is expected to remain gradual due to modest recoveries in advanced economies and weaker prospects for emerging market economies. Meanwhile, pending petitions for adjustments in electricity rates continue to be viewed as an upside risk to inflation.[2]

D. Demand conditions

- Recent demand indicators continued to show that domestic demand conditions remain firm. The economy grew by 6.9 percent in Q1 2016, faster than the quarter- and year-ago growth rates of 6.5 percent and 5.0 percent, respectively. GDP growth is supported by household spending, capital formation, and public spending on the expenditure side and services and industry sectors in the production side. Moreover, the Philippine composite PMI remained above the 50-point expansion threshold at 55.3 in April due to the faster rate of expansion in the manufacturing sector. Consumer confidence was broadly steady for Q2 2016 while the Philippine Business Cycle (PBC) indicator continued its upward trend for the fourth consecutive quarter and exceeded the trend rate of growth (of 5.9 percent) in Q1 2016.

E. Supply-side indicators

Developments in Agriculture

- Agriculture, Hunting, Forestry and Fishing (AHFF) contracted by 4.4 percent in Q1 2016, a reversal of the 1.0-percent growth in Q1 2015. In particular, the agriculture subsector declined by 4.3 percent in Q1 2016, down from a 2.3-percent growth in the same period last year. Declines in production were noted for commodities such as *palay*, corn, coconut including copra, sugarcane, banana, mango, rubber, and other crops. Lower agricultural production for the above-mentioned crops was due mainly to dry weather conditions brought by El Niño and the adverse effect of typhoons *Nona* and *Lando,* as well as pest infestation in several crop-producing areas.

- International food prices increased in May. The FAO food price index (FPI) averaged 155.8 points in May 2016, up by 3.2 points (2.1 percent) from last month's average of 152.5 points. The increase in the index could be attributed to the higher prices of cereals, dairy, meat, and sugar which outweighed the decline in the price of vegetable oil.

- According to the Climate Prediction Center (CPC) and the International Research Institute (IRI) for Climate and Society, measured sea surface temperatures (SST) across the equatorial Pacific averaged near zero in end-May 2016, indicating that El Niño has ended. Recent forecasts by CPC and IRI now point to neutral conditions for May-June-July 2016 and for La Niña conditions to develop in the third quarter of the year.

Oil Price Developments

- Dubai crude oil prices continued to rise in the first week of June 2016 due largely to production disruptions, lower US crude inventory, and market speculation on the prospects for target quotas of the Organization of Petroleum Exporting Countries (OPEC).

[2] Various petitions for rate adjustments by Meralco and the Power Sector Assets and Liabilities Management (PSALM) Corporation are considered as upside risks to inflation. These include Meralco's petitions based on generation and transmission charges, among other things, and the December 2013 rate adjustment, which remains under judicial review. Meanwhile, PSALM's petitions are based on adjustments for fuel and foreign exchange costs.

- Latest estimates by the US Energy Information Administration (EIA) suggest that the global oil oversupply is likely to continue in 2016 but could narrow in 2017 with demand exceeding supply in the Q3 2017. The EIA has reported higher supply forecasts for 2016 and 2017 upward due largely to rising crude production from Iran and Saudi Arabia as well as project commitments of investors. Meanwhile, demand forecast for 2016 was adjusted upward which can be attributed to increased demand from China and India particularly for transportation use. Overall demand estimates were generally steady for 2017 as lower consumption from OECD Europe and Japan is offset by increased demand from the US and South Korea.

Developments in the Utilities Sector

- Electricity rates dropped in June due to lower generation costs. According to Meralco, the reductions in generation charges from the Wholesale Electricity Spot Market (WESM) and Independent Power Producers (IPPs) were driven mainly by lower fuel costs, higher dispatch of power plants, and fewer power plant outages during the month.

F. Financial market developments

- Recent movements in domestic financial markets were largely in response to economic developments overseas. In early June, the local stock market rallied while the peso strengthened against the US dollar on improved investor sentiment on emerging market assets following the release of weaker-than-expected US jobs data, which raised expectations of a continued delay in the US Fed rate increase. Moreover, the sustained inflows of foreign exchange from overseas Filipino remittances, foreign direct and portfolio investments, BPO and tourism receipts, as well as the ample level of the country's gross international reserves and the country's robust economic growth provided stability to the peso.

G. Domestic liquidity and credit conditions

- Liquidity and credit conditions indicate that overall monetary conditions remain sufficiently accommodative to support domestic economic activity.

  - Domestic liquidity (M3) grew by 12.7 percent year-on-year in April to reach ₱8.6 trillion. This was faster than the 11.7-percent expansion recorded in March. On a month-on-month seasonally-adjusted basis, M3 increased by 1.7 percent.

  - Money supply expansion was supported largely by sustained demand for credit. Outstanding loans of commercial banks, net of reverse repurchase (RRP) placements with the BSP, expanded by 15.6 percent in April from 14.8 percent in March. Similarly, bank lending inclusive of RRPs grew by 14.8 percent in April from 13.5 percent in the previous month. On a month-on-month seasonally-adjusted basis, commercial bank lending increased by 1.5 percent for loans net of RRPs and by 1.7 percent for loans inclusive of RRPs.

H. Fiscal developments

- The National Government (NG) recorded a fiscal deficit of ₱112.5 billion for the period January-March 2016, higher by 236.0 percent from the ₱33.5 billion deficit incurred in January-March 2015 as fiscal authorities increased government spending. Excluding interest payments from NG expenditures, the primary deficit amounted to ₱9.9 billion, a reversal of the ₱67.1 billion primary surplus recorded in the same period a year ago.

I. External developments

- Global growth remains subdued. Indicators of economic activity showed a modest pace of growth in the US and the euro area, while manufacturing activity continued to decline in Japan and China.

  - In the IMF's April 2016 World Economic Outlook Update report, downside risks to the global growth outlook have become more apparent. While market sentiment has calmed down in recent months, the renewed episodes of financial market volatility earlier in the year point to a need for policy-makers to further bolster confidence.

  - Risks associated with the upcoming elections in the US, the ongoing refugee crisis in the Middle East and Europe, and the possible exit of the UK from the European Union have also been identified as key downside risks to the global economic outlook.

- Most central banks, including the US Federal Reserve, maintained their monetary policy settings.

  - On 15 June 2016, the Federal Open Market Committee (FOMC) left unchanged the target range for the federal funds rate at 0.25 percent to 0.50 percent. The FOMC noted that although growth in US household spending has strengthened and the unemployment rate has declined, the pace of job creation has slowed and inflation has continued to run below its 2-percent objective.

  - Meanwhile, on 4 May 2016, the Reserve Bank of Australia reduced its cash rate by 25 bps to a record low of 1.75 percent on concerns over inflation following the release of its CPI, which turned out to be lower than expected. Australia's inflation eased anew in Q1 2016 to 1.3 percent from 1.7 percent in the previous quarter. Downward price pressures were traced to temporary factors, though growth in wage earnings has also been subdued.

  - On 16 June 2016, Bank Indonesia (BI) decided to reduce its (12-month) BI rate and 7-day reverse repurchase (RR) rate by 25 bps each to 6.50 percent and 5.25 percent, respectively, to help strengthen the country's growth momentum. Indonesia posted real GDP growth of 4.9 percent year-on-year in Q1 2016, lower than the announced 5.0-5.4 percent projection for 2016. Inflation also eased for the second consecutive month to 3.3 percent in May from 3.6 percent—at the low-end of their 4.0 ± 1.0 percent target.