HIGHLIGHTS OF THE MEETING OF THE MONETARY BOARD ON THE MONETARY POLICY STANCE HELD ON 12 NOVEMBER 2015[1]

I. Monetary Policy Decision

The Monetary Board (MB) decided to:

a) Maintain the BSP's key policy interest rates at 4.00 percent for the overnight RRP (borrowing) facility and 6.00 percent for the overnight RP (lending) facility;

b) Maintain the current interest rates on term RRPs, RPs and SDAs; and

c) Maintain the current reserve requirement ratios.

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

- The Monetary Board's decision was based on its assessment of inflation dynamics and the risks to the inflation outlook over the policy horizon.
  - Latest baseline forecasts continued to indicate that inflation could settle below the target range of 3.0 percent ± 1 percentage point for 2015. However, notwithstanding the recent low inflation readings, inflation is projected to return steadily to a path consistent with the inflation target for 2016-2017. Meanwhile, inflation expectations remained anchored within the inflation target band over the policy horizon.
  - Risks to the inflation outlook remained broadly balanced. On the one hand, potential upside pressures could come from the impact of protracted *El Niño* dry weather conditions on food prices and utility rates. On the other hand, downside risk could arise from possible slower-than-expected global economic activity.

- The Monetary Board observed that domestic demand conditions have stayed firm, as business and consumer sentiment continue to be buoyant and domestic liquidity remains adequate.

- The Monetary Board noted that the challenging external environment and uneven growth prospects in advanced and key emerging economies supported a steady policy setting.

[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 on the 12 November 2015 meeting were approved by the Monetary Board during its regular meeting held on 3 December 2015. The next meeting of the Monetary Board on monetary policy issues is scheduled on 17 December 2015.

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 was stable at 0.4 percent in October. Meanwhile, other inflation indicators showed an uptick such as the official core inflation, two of the alternative measures of core inflation estimated by the BSP (weighted median and trimmed mean), and the seasonally-adjusted 3-month moving average annualized headline inflation. The number and weight of the above-threshold CPI items were unchanged relative to the previous month.

- Inflation held steady as price declines for bread and cereals, as well as the downward adjustment in electricity charges were counterbalanced by higher prices of selected food and non-food items. Food inflation was unchanged as lower prices of rice, corn, along with oils and fats were accompanied by price increases of meat, fish, and vegetables—partly due to some tightness in domestic supply caused by recent weather disturbances.

- Meanwhile, year-on-year non-food inflation was nil in October after decreasing in the previous month as the slight uptick in inflation for clothing and footwear—as well as those in the services sector, particularly transport, outpatient, and hospital services—was enough to offset the negative inflation outturns in electricity, gas, and other fuels along with operation of personal transport equipment.

- By geographical location, inflation for both the National Capital Region (NCR) and areas outside NCR advanced to 0.2 percent (from 0.1 percent) and 0.5 percent (from 0.4 percent), respectively.

B. Inflation expectations

- Results of the Consensus Economics inflation forecast survey and the BSP's survey of private sector economists both yielded lower mean inflation forecasts for 2015 and 2016. The mean inflation forecasts for 2015 and 2016 in the October 2015 BSP's survey of private sector economists were lower at 1.5 percent (from 1.7 percent in September) and 2.6 percent (from 2.7 percent), respectively. Likewise, the 2017 mean inflation forecast was lower at 2.8 percent (from 2.9 percent). Similarly, the October 2015 Consensus Economics inflation forecast survey for the country showed lower mean inflation forecasts for 2015 at 1.7 percent (from 1.9 percent in September) and at 2.8 percent for 2016 (from 3.2 percent).

- Meanwhile, respondents for both Consumer Expectations Survey (CES) and Business Expectations Survey (BES) expect inflation to increase for the current quarter up to the near term. Results of the CES for Q3 2015 indicated that inflation is expected to be stronger over the next 12 months, with more respondents anticipating higher inflation for the year than earlier predicted. Similarly, results of the BES for Q3 2015 indicated that more respondents expected inflation to increase for the current and next quarters compared to those who said otherwise.

C. Inflation outlook

- Inflation could settle below the government's target range of 3.0 percent ± 1.0 percentage point for 2015 and approach the midpoint of the target in 2016 – 2017. The reduction in the forecasted inflation path for 2015 – 2017 relative to the previous policy meeting could be attributed mainly to the lower-than-expected inflation in September 2015, decline in global crude oil prices, and the slight appreciation of the peso.

- The risks to the inflation projections remain broadly balanced. The possible slower global economic activity poses downside risk to the inflation outlook. Meanwhile, potential adjustments in electricity rates given pending petitions and the impact of stronger-than-expected El Niño conditions are seen as the key upside risks to inflation.

D. Demand conditions

- Various indicators of demand affirm the assessment of favorable domestic growth dynamics. Consumer sentiment has turned positive and broadly steady over the next 12 months while business outlook appears to be more upbeat for the fourth quarter. Government spending is likewise seen picking up in the second half of the year. While there are some tentative signs of slowdown in industrial activity largely reflecting regional trends, the monthly survey of purchasing managers suggests that the Philippine economy was still in an expansion phase in the third quarter while manufacturing companies continued to operate above the long-term average capacity utilization of 80.0 percent since 2010. Solid consumer demand is likewise driving vehicle sales which continue to post very robust growth.

E. Supply-side indicators

<u>Developments in Agriculture</u>

- The average retail price of regular-milled rice decreased slightly as the complete arrival of rice importations increased the National Government's buffer stocks and helped keep local prices stable amid the ongoing lean season. Meanwhile, the average retail price of well-milled rice remained stable.

- However, domestic food supply prospects will need to be assessed given the agricultural damage brought by typhoon Lando on one hand and the government's intervention measures against protracted *El Niño* weather conditions on the other. Notwithstanding ample domestic rice stocks, there is a need to review the supply conditions in the near term.

- The Food and Agriculture Organization (FAO) Food Price Index (FPI) averaged 156.3 points in September 2015, up by one point (0.8 percent) from the month-ago level. The increase was a reversal from the 10 successive months of declines since November 2014. Higher prices of dairy and sugar products in September outweighed the slight decline in the price of vegetable oil. Meanwhile, cereal and meat prices were relatively unchanged.

Oil Price Developments

- Low oil prices are seen to continue over the near term, with prices expected to remain below 2014 levels as suggested by futures prices of oil and forecasts by multilateral agencies, with only modest projected gains over the medium term. Global oil supply continues to outstrip demand as a result of stable supply from OPEC, Iran's additional production in the global market, and lower demand growth due to possible weaker demand from China, a key driver of non-OECD oil consumption growth. Nonetheless, crude oil price volatility remains elevated as uncertainties surrounding the oil market emanate from the reentry of Iran in the global oil market, the strength in oil consumption growth, and the responsiveness of non-OPEC production to low prices.

Developments in the Utilities Sector

- Electricity rates went up in November due to higher generation cost. According to Meralco, the increase was mainly driven by the higher settlement prices at the Wholesale Electricity Spot Market (WESM), power plant outages during the supply month of October and lower dispatch of plants.

F. Financial market developments

- Renewed expectations that the US Fed may delay increasing interest rates following weak data on labor, consumer spending and inflation improved investors' appetite for risk assets in October. Moreover, China's decision to cut rates anew on 23 October for the sixth time since November 2014 also boosted regional markets. In early November 2015, mixed domestic corporate earnings results for the third quarter and the 6.9 percent drop in merchandise exports for the first nine months of the year, combined with external headwinds (i.e., on renewed expectations that the US Fed will finally be increasing interest rates in December, disappointing Chinese export data in October, and the absence of fresh stimulus from Europe and Japan) dampened sentiments and fueled profit-taking.

- The peso appreciated in October on continued risk-on sentiment amid rising expectations that the US Fed would raise interest rates next year (instead of December 2015). However, the peso depreciated towards the early part of November on safe-haven trade due to better-than-expected US labor market data, supporting the case for an US Federal funds rate hike by year-end. Furthermore, the weak inflation data in China and lackluster exports data in the Philippines boosted the demand for the US dollar. Nonetheless, the sustained inflows of foreign exchange from overseas Filipino remittances, foreign portfolio and direct investments, as well as the ample level of the country's gross international reserves provided support to the peso.

- Debt spreads slightly eased in October as the global economic and financial environment calmed down. Moreover, the Federal Open Market Committee (FOMC) decided to maintain Fed funds rate during the October meeting forcing investors to trade on a wait-and-see stance. This investor sentiment continued in the first few weeks of November given the uncertainty in the timing and magnitude of the US Fed normalization. However, there is still a possibility that an interest rate hike will happen this year since economic indicators such as unemployment rates have been improving. The FOMC also assured market participants that it will maintain the holdings of long-term securities at sizable levels to keep accommodative financial conditions which made debt spreads stable during the period.

G. Domestic liquidity and credit conditions

- Domestic liquidity (M3) grew by 8.5 percent year-on-year in September 2015 to reach ₱7.8 trillion. This was slightly slower than the 9.0-percent expansion recorded in August. On a month-on-month seasonally-adjusted basis, M3 increased by 0.1 percent. Money supply continued to expand due largely to sustained demand for credit. The sustained expansion of M3 indicated that money supply remains sufficient to support economic growth.

- Outstanding loans of commercial banks, net of reverse repurchase (RRP) placements with the BSP, expanded by 12.5 percent in September from 14.1 percent in August. On a month-on-month seasonally-adjusted basis, commercial bank lending increased by 0.5 percent for loans net of RRPs. Majority of banks' outstanding loans continued to be directed to key production sectors of the economy.

H. Fiscal developments

- National Government (NG) recorded a fiscal deficit of ₱25.55 billion for the period January-September 2015, lower by 18 percent compared to the ₱31.07 billion incurred in the same period in 2014. Netting out the interest payments in the expenditures, the primary surplus amounted to ₱230.2 billion, ₱3.9 billion or 2 percent higher than the level recorded in the same period a year ago.

I. External developments

- Output growth in the US, euro area, and Japan remained firm, while activity continued to soften across emerging markets, particularly in China and Brazil. Moreover, growth prospects across economies remain uneven. Economic activity in the advanced economies is expected to continue to pick up. By contrast, growth in emerging markets is generally projected to weaken further, reflecting a more bearish outlook for major emerging market economies such as China, Brazil, and Russia.