Nestor A Espenilla, Jr: Monetary policy and inflation dynamics

Speech by Mr Nestor A Espenilla, Jr, Governor of Bangko Sentral ng Pilipinas (BSP, the central bank of the Philippines), at a luncheon meeting of the Rotary Club of Makati, Makati, 14 August 2018.

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Distinguished Rotarians, ladies and gentlemen, good afternoon. Thank you for inviting me to share the Bangko Sentral's views on the recent developments in inflation. It is my pleasure to join you today, my second time over a year.

My presentation will be in 3 parts. First, we examine trends in headline inflation with focus on key drivers behind recent price movements. Next, I will present the BSP's outlook for 2018 and 2019 based on available data and as well as market expectations. Finally, I will discuss the BSP's policy responses.

The year-to-date (January-July 2018) headline inflation averaged at 4.5 percent year-on-year, which is above the government's announced target range of 2 – 4 percent for the year. The BSP continues to see supply-side factors as the main drivers of overall inflation. These supply-side factors relate to rising international oil prices, higher excise taxes, and weather-related supply disruptions. These factors are generally considered to be outside the scope of monetary policy.

In this slide, we show the contribution of each CPI subcomponent to overall month-on-month inflation. Headline inflation fell in month-on-month terms for July 2018. We also see the tapering off of month-on-month changes of CPI items related to excise tax adjustment in the first five months.

The month-on-month changes for electricity, tobacco and sweetened beverages are also slowly tapering off as we pass 7 months of 2018. This supports our view that the impact of excise tax adjustments are transitory.

Latest baseline forecasts have shifted higher over the policy horizon, suggesting that inflation will remain elevated in 2018, with the peak occurring sometime in the third quarter, and will revert to the inflation target of 2-4 percent in 2019.

We have dealt with similar inflation dynamics during supply shocks in the past. Notably in 2008, international oil prices and food prices increased and inflation averaged 8.3 percent year-on-year (based on 2006 CPI series) but subsequently dropped sharply to 4.2 percent in the following year. This is depicted in the right-hand side chart, where actual inflation during this period showed a hump-shaped path. This shape is similar to the forecasted path for the remaining 2018 to 2019, as shown in the fan chart.

In 2008, the BSP was aware that the initial rise in prices was primarily supply in origin and that commodity shocks are transitory in nature. Therefore, following an approach consistent with the widely accepted principle that supply-side developments are best addressed by non-monetary measures, the BSP kept its policy rates steady. The BSP considered the rise in prices during the first half of 2008 to be a supply shock episode and accommodated the first-round effects, allowing them to "pass through" in the form of higher prices.

However, as supply shocks from rising food and energy prices continued over a longer period, these contributed to second-round effects, affecting the wage and price-setting behavior of businesses and households by the end of the second quarter. A rise in inflation expectations was also evident from surveys and financial market data, while the BSP's forecasts showed the risk of inflation exceeding targets for 2008 and 2009. The BSP responded to these second-round effects with decisive action and strong anti-inflation pronouncements. It raised key policy rates by

a total of 100 basis points from June to August 2008 while strengthening its anti-inflation commentary.

Moving back to our current inflation outlook, based on our latest assessment, upside risks continue to dominate, as the sustained increase in core inflation suggests broadening price pressures amid resilient aggregate demand conditions.

The following are the key upside risks to the baseline inflation path:

(1) additional wage adjustments;

(2) pending petitions for adjustments in transport fares and electricity rates;

(3) faster-than-expected monetary policy normalization in advanced economies; and

(4) the proposed increase in the NFA's buying price of rice from farmers.

Slower global economic growth due to protectionist policies in advanced economies and geopolitical tensions along with potential price adjustments from the proposed reform in the rice industry involving the replacement of quantitative restrictions with tariffs and the deregulation of rice imports are seen as the main downside risks to inflation.

Meanwhile, the BSP keeps a close eye on developments in the foreign exchange market and note their potential impact on inflation in the coming months.

Surveys of private sector forecasts as of July show elevated inflation expectations for 2018 but within target inflation projection for 2019. Private sector expectations range from 4.2 – 4.5 percent (based on BSP and AP Consensus) in 2018 and 3.6 – 3.9 percent in 2019.

The increase in inflation expectation of private sector economists is attributed to higher projections to volatile global oil prices, a weaker peso, and the transitory effects of recent tax measures on the prices of domestic goods and services.

As an inflation-targeting central bank, our decisions on the monetary policy stance are data-dependent and guided by our inflation forecasts over a given policy horizon. As a matter of discipline, we refrain from reacting to short-term market fluctuations or commentaries but instead focus on obtaining comprehensive information and making reasonable assumptions about the future.

In responding to the recent uptrend in inflation, the BSP follows the standard approach among central banks in responding to supply-side factors. In a supply shock episode, central banks would typically not react, as these historically tend to be transitory or short-lived in nature, but remain vigilant and undertake action against incipient signs of second-round effects.

This was the case early this year when economic data indicate the country's inflation environment was driven by supply-side factors and our forecast continued to show inflation upticks as transitory and moderating within the target in 2019. Thus, adjustment in policy rate was not yet warranted.

Nevertheless, recognizing increasing volatilities in world oil prices and interest rates, the BSP adjusted monetary conditions by adjusting auction volumes and allowing the term deposit facility (TDF) rates to rise, creating an effective tightening in the market. This allowed the BSP a channel to provide guidance to short-term market interest rates which have firmly anchored to the BSP's interest rate corridor.

Starting in Q2 2018, the Monetary Board (MB) noted that latest baseline forecasts have shifted higher over the policy horizon. Upside risks also continue to dominate the inflation outlook.

Meanwhile, inflation expectations remain elevated. Therefore, in response to dynamic economic and market conditions, the BSP raised the policy interest rate by 25 basis points each on 10 May 2018 and 20 June 2018 and by 50 basis points on 10 August 2018.

In the latest policy meeting, the MB noted increased risk of inflation exceeding the target in 2019. Thus, a stronger monetary action is necessary to rein in inflation expectations and prevent sustained supply-side pressures from driving further second-round effects, even as we expect average inflation to ease to within the inflation target of 2-4 percent in 2019.

Overall, the three rate hikes are meant to signal the BSP's strong commitment to ensuring macroeconomic stability and will help reduce further risks to inflation, including those emanating from ongoing normalization of monetary policy in advanced economies and its impact on the foreign exchange market, and bring inflation toward a target-consistent path over the medium term.

Favorable conditions arising from sustained domestic growth suggest that the economy can accommodate monetary policy tightening. It should be noted that the Philippine domestic economy has experienced sustained expansion for the past 78 quarters (or a period of more than 19 years).

In 2017, the domestic economy posted an annual growth rate of 6.7 percent. This growth has been increasingly broad-based, thereby providing more opportunities across all segments of society.

In the first half of 2018, output grew by 6.3 percent year-on-year on higher government spending as well as capital formation, supported by resilient domestic demand.

In the meantime, the overall external position of the domestic economy remains resilient, supported by sustained foreign direct investments, overseas Filipino (OF) remittances, and business process outsourcing (BPO) receipts. These provide additional buffers to the domestic economy.

Our external debt metrics have also improved as external debt to GDP ratio continues to decline.

Gross international reserves of US$76.9 billion as of July 2018 remain more than adequate, covering 7.4 months of imports of goods and payments of services and income.

Meanwhile, on the current account, two factors are motivating the modest shortfall. One is the surging growth of the Philippine economy which requires higher imports of capital goods like machineries and equipment and the other is the continued softness of the global economy particularly in 2015–2016.

The current account shortfall indicates that the economy is, on a net basis, importing what is required to continue its expansion. Our imports are mostly comprised of capital goods, raw materials, and intermediate products which together account for more than 80 percent of total imports.

The peso also continues to be flexible and has maintained its external price competitiveness against baskets of currencies of all trading partners and trading partners in advanced and developing economies.

The BSP likewise strongly supports the carefully coordinated efforts of the National Government (NG) to further temper the potential adverse impact of inflation on households via the full implementation of various safety-net programs (e.g., targeted cash transfers, Pantawid Pasada program, etc.)

All of this is by the way of saying that when it comes to responding to inflation, monetary policy is

not the only game in town; non-monetary intervention can go a long way towards addressing inflation pressures especially in the face of strong supply shocks.

Ladies and gentlemen, our recent policy actions demonstrate our strong resolve to ensure inflation returns to target by 2019. We have likewise demonstrated that with the development of auction-based instruments complementing our policy rate, the BSP has expanded its option for maintaining firm monetary control.

We continue to pursue refinements in our monetary operations. This includes shifting reliance on reserve requirements to more market-based instruments. To date, we have reduced reserve requirement ratio (RRR) by 200 bps, an operational adjustment to promote market development.

I reiterate that the RRR cuts are not intended to be expansionary. Data suggest we were able to neutralize the immediate liquidity impact through open market and FX operations. Following the cuts, the level of domestic liquidity actually grew at a slower rate. M3 expanded by 11.7 percent year-on-year (y-o-y) in June 2018, slower than the 14.3-percent growth rate in the previous month.

We are ready to continue reducing the RRR next year as inflation returns to target based on our latest forecast. Ultimately, the goal is to reach single-digit RRR at the end of my term. This can be pursued without compromising effective monetary control.The Philippine economy remains resilient supported by its strong fundamentals. Prospects for the domestic economy continue to remain favorable as domestic growth fundamentals are expected to remain intact. Private demand is expected to remain firm, aided mainly by sustained remittance inflows and a manageable inflation environment.

At the same time, macroeconomic stability will be supported by strong policy response in terms of fiscal policy (i.e., tax reforms), monetary policy, and flexible exchange rate policy. The policy agenda of the government to strengthen both hard and soft infrastructures supported by the increase in revenue from tax reforms is expected to further increase the country’s potential output.

Equally important are the strong buffers in place which continue to support the positive outlook on the macroeconomy. Sufficient capitalization of the Philippine banking system along with a comfortable level of gross international reserves provides buffers to mitigate shocks.

In closing, let me emphasize that while the recent inflation outturns are underpinned by factors outside the scope of monetary policy such as higher global oil prices, weather-related supply disruptions, and increased excise tax, the BSP stands firm in its intent to take immediate and appropriate measures to ensure that the monetary policy stance continues to support the BSP’s price stability objective.

Thank you for your attention!