Nestor A Espenilla, Jr: Ensuring price stability through monetary policy

Presentation by Mr Nestor A Espenilla, Jr, Governor of Bangko Sentral ng Pilipinas (BSP, the central bank of the Philippines), during the Forum of the Economic Journalists' Association of the Philippines (EJAP), Manila, 28 August 2018.

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Secretary of Finance Carlos Dominguez III, DBM Secretary Benjamin Diokno, NEDA Director-General Ernesto Pernia, DOTr Secretary Arthur Tugade, DPWH Secretary Mark Villar, esteemed guests, ladies and gentlemen, a pleasant morning to all of you. I would like to thank EJAP President Louella Desiderio, the Economic Journalists' Association of the Philippines for inviting me to share the Bangko Sentral's views on inflation, as well as our game plan to address it.

In the first part, I will dissect the numbers to identify the real drivers of the recent spike in inflation. I will then explain the BSP's inflation outlook, or how we expect the inflation environment to evolve over the next two years. Casting inflation against this proper context helps put into sharper focus the policy measures needed to address the issue. I maintain that not only have the BSP's monetary responses been timely and appropriate, but that tempering inflation and its side-effects will require the coordinated efforts of various government agencies as well.

Let me begin with the recent inflation numbers. In the first seven months of 2018, year-on-year headline inflation averaged 4.5 percent, well above the government's target range of 2 – 4 percent for the year. As this chart shows, supply-side factors are the main drivers of overall inflation. These include rising international oil prices, higher excise taxes, and weather disturbances that affected food supply.

Meanwhile, in this next chart, we see how supply-side forces drive inflation on a month-on-month basis, with factors such as the recent increase in jeepney fares and utility rates contributing to the July inflation print.

There are two important points that I need to highlight in this chart. The first is that the inflation momentum is slowing down, as headline inflation has generally declined in month-on-month terms from 0.9 percent in January 2018 to 0.5 percent in July 2018. In particular, after spiking in the first quarter of 2018, the month-on-month changes for electricity, tobacco, and sweetened beverages are seen to be slowly tapering off as we head deeper into the third quarter of the year. This supports our analysis that the impact of the excise tax adjustments is transitory.

The second point is that supply-side factors have tremendous implications for monetary policy. In particular, central bankers generally consider these supply-side forces as beyond the direct influence of monetary policy, which limits the effectiveness of monetary interventions. This is why central banks typically look through commodity price increases in a transitory supply shock episode. Instead, central banks undertake action when there are incipient signs of second-round effects, like when price pressures spill over to the demand side, as we shall also see later.

Now, what do all these imply for inflation and monetary policy in the next few months?

Our baseline forecasts as of the recent Monetary Board meeting in August have generally shifted higher relative to the forecasts during the policy meeting in June. Inflation is expected to remain elevated in 2018 with the peak occurring sometime in the third quarter. Nonetheless, we expect inflation to revert to the inflation target range of 2 – 4 percent in 2019, as the effect of the transitory supply shocks dissipate.

We have seen similar pattern in the past. For example, in 2008, international oil prices and food prices rose sharply, resulting in a year-on-year average inflation rate of 8.3 percent during the year, before easing sharply to 4.2 percent in 2009.

What did the BSP do to ensure price stability during this period? As the rise in prices was primarily supply-driven in origin, the BSP kept its policy rate steady and accommodated the first-round effects.

However, supply-side pressures persisted and gave rise to second-round effects in terms of wage and price-setting behavior. The BSP subsequently delivered timely and decisive action by raising the key policy rates by a total of 100 basis points between May and August 2018 while also strengthening its anti-inflation commentary.

Similar to what happened in 2008, we see from our assessment that upside risks continue to dominate the inflation outlook, as the sustained increase in core inflation points to a possible broadening of price pressures. Key upside risks include additional wage adjustments; pending petitions for adjustments in transport fares and electricity rates; faster-than-expected monetary policy normalization in advanced economies; and the proposed increase in the NFA's buying price of rice from farmers.

Conversely, the main downside risks to inflation are the following: slower global economic growth due to protectionist policies in advanced economies; geopolitical tensions in the Middle East, along with potentially lower rice prices resulting from the proposed replacement of quantitative restrictions with tariffs and the deregulation of rice imports.

At the same time, the BSP recognizes the potential price pressures of excessive volatility in the foreign exchange market and remains vigilant on the impact of sustained peso depreciation on inflation expectations.

In sum, the BSP held the policy rate steady in the first quarter of 2018 amid the supply-driven inflation outturn. However, information beginning in the second quarter suggests incipient signs of second-round effects, given the potential broadening of price pressures, the continued dominance of upside risks to the inflation outlook, and the elevated inflation expectations over the policy horizon. These considerations prompted the BSP to raise the policy rate by 25 basis points (bps) in May 2018. To enhance our anti-inflation signal and help bring inflation toward a target-consistent path over the medium term, we followed this up with another 25-bps hike in June, and a stronger 50-bps hike earlier this month.

These monetary responses were necessary to help rein in the public's inflation expectations and prevent sustained supply-side pressures from giving rise to further second-round effects, even as we continue to expect average inflation to ease to within the inflation target of 2–4 percent in 2019. Further, the hikes are meant to ease excessive market pressure on the peso and address the potential impact of excessive peso volatility on inflation.

Looking ahead, the BSP's decisions on monetary policy will continue to be data-dependent and guided by our inflation forecasts.

Sustained domestic growth also suggests that the economy can accommodate monetary policy tightening. This growth is broad-based, thereby providing more opportunities across all segments of society.

In the meantime, our external position is strong. 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.

Our external debt metrics are also favorable as external debt to GDP ratio continues to decline.

On the current account, the moderate deficit is driven by robust growth of the Philippine economy which requires higher imports of capital goods. Our imports are mostly capital goods, raw materials, and intermediate products, which are necessary for the economy's sustained expansion.

The peso continues to be flexible and market-determined, which allow us to conduct independent monetary policy focused on domestic conditions. The peso has likewise maintained its external price competitiveness against baskets of currencies of all trading partners and trading partners in advanced and developing economies. Nevertheless, we are cognizant that the peso can also be subject to excessive volatility especially in light of global interest rate and exchange rate developments. We have to take these into account.

At the same time, the BSP recognizes that because monetary responses do not fully address the root causes of inflation, addressing inflation will require mitigating measures from other government agencies in order to temper the impact of supply-side forces on prices and social welfare.

Before I end my presentation, let me stress out that while the recent inflation outturns are underpinned by factors outside the direct influence of monetary policy such as the higher excise tax, the rise in international oil prices, and adverse weather conditions, the BSP reiterates its strong commitment and readiness to take all necessary policy actions to safeguard the government's inflation targets and deliver on our primary mandate of price stability.

Thank you and good day!