Philippines: Central bank to hold off on rate hike as inflation slows

The decision will likely go down to the wire but we think authorities will probably keep rates unchanged on Thursday

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Market divided on BSP

The Bangko Sentral ng Pilipinas (BSP) is set to meet on 15 November with current market consensus divided on the central bank's next move (7-10 in favour of hiking). After whipping out a cumulative 150 basis points worth of rate hikes year to date, the monetary authorities will take a hard look at the data to make their decision.

2.8%

Growth in food consumption

Slowest growth in 28 quarters

Tale of the tape: decelerating but still elevated inflation and slowing growth

Household spending and food consumption are softening. Economic growth as of the 3Q showed a slowdown to 6.1%, from 6.2% in the previous quarter and 7.2% in the same quarter last year. Most glaring was the deceleration of the mainstay subsector of household final consumption which posted only a 5.2% expansion, the third straight quarter of sub-6 % growth for that sector, which accounts for 56% of the entire economy. In another telltale sign of decelerating growth momentum, food consumption, which comprises 23% of overall GDP, grew a mere 2.8%, the lowest print since 3Q 2010. With households expected to continue to struggle under the weight of the twin challenges of decelerating but still elevated inflation and higher borrowing costs, GDP is now projected to slow to 6.0% in 4Q.

Philippine inflation remains elevated as of October, at 6.68%, slowing slightly from the September reading of 6.70% but the month-on-month change in prices dipped to 0.3% from the high of 0.9% for the year. BSP continues to point to a deceleration of prices over the policy horizon with the latest inflation forecast for 2019 at 4.3%. The BSP has indicated that inflation could fall even faster if non-monetary policy measures, such as rice imports and the rice tariffication bill, continue to take root and mitigate supply-side pressures. Risks to the inflation outlook remain but appear to be moderating, with oil price shocks lurking while weather disturbances may disrupt supply chains in the coming months. In the geopolitical sphere, the Fed is projected to continue its gradual rate hike cycle in 2019 while emerging market contagion could foment further peso weakness to boost imported inflation.

Why they can hike

Market analysts cite the need to anchor inflation expectations to close out the year, pointing to still elevated inflation at 6.68% and the inability for price pressures to dissipate very quickly. Recently implemented transport fare adjustment and wage increases, meanwhile, signal the possibility of more pervasive price pressures, due to second-round effects. The BSP governor's recent statement indicated that the bank is weighing the "need to do at least one more modest rate hike to seal the deal and firmly anchor inflation expectations".

Why they won't

The BSP could argue that it can take a break from raising rates as the need to anchor inflation expectations is less urgent given that its forecasts show inflation below 4% by mid-2019. Deputy Governor Cyd Tuano-Amador has indicated that the headline number could decelerate further if non-monetary policy measures are deployed effectively. The central bank is likely mindful of the sharp deceleration in its all-important consumption component, with recent dovish undertones coming from several key voting members, indicating that they had "done quite a bit already (Medalla)" and that "if numbers prove helpful, we can afford to pause (Tolentino)".

Data dependent

Monetary authorities have stuck to the script in saying that any decision will remain data-dependent. So even if the BSP opts to keep its powder dry at the 15 November meeting, further rate increases could very well be in the offing should inflation resume its upward path, or if the BSP looks to limit the impact of imported inflation in the coming year given the projections for up to three more rate hikes by the Fed.

Gift of the magi and BSP's primary objective

The BSP's primary mandate is to provide price stability, carrying out inflation targeting via its use of the various monetary policy tools such as its policy interest rate, the reserve requirement and the interest rate corridor. Stated in Republic Act 7653, the BSP's main objective is "to promote price stability conducive to a balanced and sustainable growth of the economy". BSP is now faced with the decision to adjust monetary policy further with inflation decelerating but still elevated. However, the economy appears to be groaning under the twin effects of inflation and higher borrowing costs.

If the BSP chooses to hike rates to assure its inflation path, it could run the risk of sapping even more momentum from economic growth. This decision would champion price stability but run the risk of seeing its sterling growth print fade very quickly. Meanwhile, a decision to pause to help ensure economic growth could expose the BSP to moderating price pressures and threaten its price stability objective. From here, it looks like Thursday's decision will go down to the wire. The dilemma faced by monetary authorities is perhaps best summarized by Monetary Board member Felipe Medalla who said, "depending on your point of view on other contributors to inflation, it can go either way".

Verdict: BSP does a "hawkish pause"

Successive aggressive rate hikes by the BSP have pushed borrowing costs higher by a whopping 150 basis points in the span of only six months as the central bank looked to curb concerns about above-target inflation. The BSP's interest rate barrage has apparently done its job by slowing economic activity substantially, manifested in the decelerating trend in both consumption and investments. Thanks to the government's 14.3% growth in spending, overall GDP managed to avoid slipping below 6% but other sectors appear to be creaking under the weight of the rate hike salvo. Meanwhile, measures undertaken by the government to address supply-side constraints have reduced month-on-month inflation to a third of what it was in September. Both demand and supply side pressures appear to be abating and given that it could take a full nine months before policy actions take effect, increasing rates in November 2018 will only take effect only in August 2019.

Thus, we believe BSP will leave policy rates unchanged given that inflation is expected to return to target, even without action on Thursday. Despite the pause, we also see BSP retaining its hawkish stance to indicate that it remains vigilant against any build-up in price pressures and that it stands ready to act if necessary. The "hawkish pause" would have a positive offshoot in that it affords the real economy some breathing room, limiting the likelihood that growth would slow substantially as the Philippines looks to maintain its above-6% growth trajectory.

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