Philippines: Central bank to pause as inflation drops

Decelerating inflation could open the door for central bank easing in 2019

4.75% BSP policy rate

Market consensus is for a pause

Bangko Sentral ng Pilipinas (BSP) meets on 13 December with current market consensus widely expecting the central bank to keep rates unchanged (Bloomberg: 18 of 18 in favour of a pause, Reuters: 11 of 13). The BSP has hiked by a cumulative 175bp over the last seven months in its last five meetings, in a bid to anchor inflation expectations and address stubbornly above-target inflation.

> *With November inflation reflecting a significant deceleration in price pressures, the market expects the BSP to finally hold off on adjusting policy rates after five straight hikes.*

November headline inflation saw a notable year-on-year drop – to 6.0% from 6.7% and translating into a month-on-month contraction of 0.40%. The main reason behind the lower print was the slowdown in food inflation, which slipped to 8.0% from 9.4% in the previous month as supply-side bottlenecks were ironed out. Furthermore, the reversal in the direction of global oil prices has also helped limit price pressures for household utilities and transport. After seven consecutive weeks of declines in pump retail prices, the government rolled back its PHP1 increase in minimum jeepney (commuter bus) fares, mitigating second-round effects. With BSP lowering its inflation forecasts substantially to 3.5% for 2019 and 3.3% for 2020, inflation expectations appear to be well-anchored with the majority of analysts expecting the BSP to keep policy rates unchanged on 13 December.

Why BSP might hike: accelerating core inflation

Despite market consensus for a pause from the BSP, monetary authorities might opt to increase the main policy rate by another 25 basis points, with Governor Espenilla flagging accelerating core inflation and the need to "pay close attention to the core inflation trend". The Governor also indicated that "managing inflation expectations remains crucial", with the central bank on the lookout for any unwarranted price increases. Should the BSP believe that accelerating core inflation reflects a worrisome build-up in unwarranted price increases, the central bank may look to enact another "proactive" tightening. The Governor still expects growth to remain "strong". However, with food and energy costs dissipating, BSP concerns over rising core inflation might not be warranted - inflation is expected to edge back within target over the policy horizon, with the base effects of tax adjustments for alcohol, beverages and tobacco fading in 2019.

Why BSP won't hike: a drop in headline inflation and anchored expectations

The BSP might decide to hold off on hiking policy rates as price pressures have continued to dissipate. Roughly 703,000 MT of rice has been secured via National Food Authority (NFA) bidding while private traders are lined up to import up to 572,278 MT for next year. Furthermore, the all-important rice tariff bill is set for passage while oil prices are expected to be constrained in the short term on concerns of a global supply glut. Inflation expectations remain well-anchored, with Bloomberg inflation forecasts reported in December showing headline inflation settling at the 3.8%

level by 2019. Furthermore, domestic liquidity conditions remain constrained, as evidenced by the latest M3 growth print of 8.2%. This should also limit demand-side inflationary pressures in the coming months. Lastly, despite expectations of strong economic growth, 3Q GDP numbers point to a stark weakening in growth momentum with household final consumption growth slowing to 5.2% year-on-year. A BSP pause would give the Philippine economy some breathing room to maintain its current growth trajectory, all the more so given expectations for slowing global economic growth in 2019.

Verdict: BSP to go for a "hawkish pause"

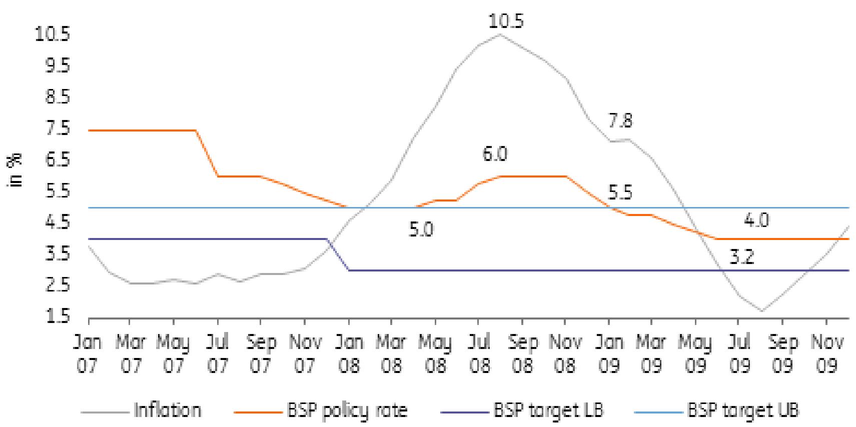
After hiking rates by a cumulative 175bp over the course of its last five meetings, the BSP is likely to go for a hawkish pause. We expect it to keep rates unchanged while simultaneously retaining its hawkish bias by pledging to act against signs of price pressure if these become apparent. Pausing on 13 December will give the general economy some breathing room. It would also keep the market on its toes by displaying the BSP's readiness to act to safeguard the inflation target.

Hump-shaped inflation: sounds like 2008

The sharp drop in November headline inflation supports the BSP expectation that cost-push induced inflation in 2018 will exhibit a hump-shaped curve just as it did in 2008, the last time the BSP breached its inflation target.

Back in 2008, inflation surged to 10.5%, more than double the BSP's inflation then target of 3.5-4.5%. Supply-side factors were also behind the breach (with peaks of 17.3% for food inflation, 15.6% for transport and 6.4% for utilities). After peaking at 10.5% in August 2008, inflation quickly fell to 7.8% by December 2008 and to 1.7% by August 2009. The BSP response in 2008 was to hike three times (cumulative: +100bp) in mid-2008 followed by a quick reversal in stance by 4Q08, cutting reserves by 200bp in November and slashing policy rates by 50bp in December, with growth slowing to 2.9%.

Philippine inflation, inflation target and BSP policy rate (2007-09)

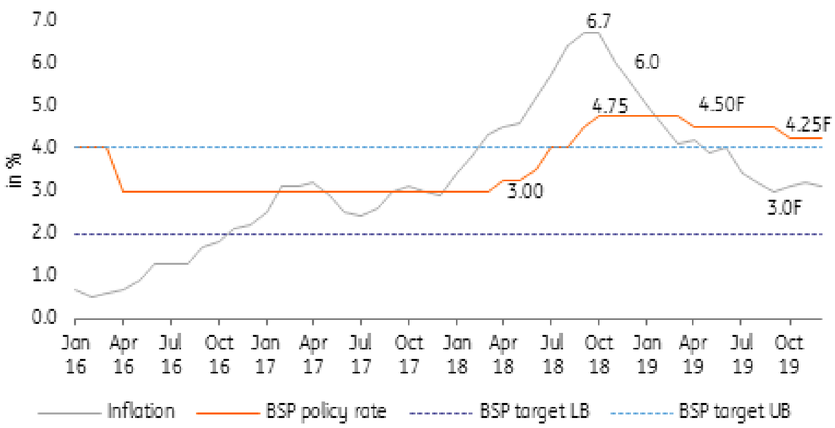


Source: Bloomberg

BSP could ease in 2019 if stars align

With 2018 inflation also driven largely by supply-side pressures, we can expect headline inflation to follow a sharp decline similar to that of 2008. Food supply bottlenecks are being addressed and oil prices are sliding. Should headline inflation continue to slide in coming months, growth slow to sub-6% levels in coming quarters and the Fed adopts a more dovish stance, then the likelihood that the BSP reverses its stance to easing by 2Q19 will have increased. Back in 2008, the BSP moved swiftly to bolster failing growth momentum once it judged the inflation objective to be well within reach. If the stars align then the BSP may follow the same path that it did during the most recent inflation-breach episode (2008), slashing policy rates to give the economy a much-needed break.

Philippine inflation, inflation target and BSP policy rate (2016-19)



Source: Bloomberg and ING

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