Amando M Tetangco, Jr: Recent economic developments – challenges and policy implications

Remarks by Mr Amando M Tetangco, Jr, Governor of the Central Bank of the Philippines (Bangko Sentral ng Pilipinas), at the Fund Managers Association of the Philippines' Induction of Officers, Makati, 13 February 2008.

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President PJ Garcia, other officers and members of the Fund Managers Association of the Philippines, friends, ladies and gentlemen, good afternoon.

I am pleased to join you today during your general membership meeting. The FMAP has a unique role in mobilizing investments of institutional investors, particularly at this time of ample liquidity in the system. The BSP continues to look forward to your support in helping to channel these resources to funds that will support economic development.

I also welcome from you initiatives that would enhance and promote professional standards of fund management in ensuring that the funds are managed in accordance with the tenets of fairness, accountability and transparency. As fund managers, you play a significant role in the development of the domestic capital market.

I have been requested to share with you today our macroeconomic outlook for 2008. In the process, I will try to provide policy insights on the current domestic and global developments, what their implications are for the BSP's monetary policy, and how these will affect the country's economic outlook.

Recent economic developments

2007 was marked by what I have called as the "convergence of high growth and low inflation." The Philippine 7.3 percent growth rate for 2007 is the highest growth achieved in 31 years. At the same time, this broad-based economic expansion was realized in an environment of low and stable inflation, with full year inflation at 2.8 percent, the lowest in 21 years. Meanwhile, foreign investment was strong due to upbeat investor sentiment on the country's improving macroeconomic fundamentals.

There was also positive news coming from the external sector. The country's balance of payments posted a record surplus of US$8.6 billion in 2007, buoyed by the sustained strong remittance of overseas Filipinos as well as higher net services receipts, and capital inflows.

The country's gross international reserves (GIR) also continued to post record highs. At the end of January 2008, it amounted to US$34.4 billion, which could cover 6.0 months' worth of imports of goods and payment of services and income.

The external debt situation has likewise improved and remained manageable.

The peso remains firm, providing a mitigating effect on inflation, while broadly maintaining its external competitiveness.

The banking sector has remained fundamentally sound. The banking system sustained a steady asset expansion for the last seven years supported by continued growth in deposit base. The continued asset clean-up of banks, accomplished through market-oriented schemes and without the use of public funds, boosted the banking system's overall asset quality. The banking system's NPL ratio is now closer to the pre-crisis level of around 4.0 percent.

Banks also remained capitalized at levels above both the BSP-regulatory requirement and the BIS standard. The banking system's capitalization is expected to improve further with banks' increased issuance of hybrid financial instruments to strengthen their capital base.

As a footnote to banking performance last year, I would like to mention that the banking system was not significantly affected by US subprime mortgage market problems. First, because Philippine bank exposure to the CDO market was only 0.2 percent of total bank assets as of mid 2007, and none of these have subprime mortgages as underlying assets. Second, the country has been less dependent on external borrowing and has, therefore, become less vulnerable to external shocks. Third, there is ample liquidity in the system and hence, any credit squeeze could be manageable.

The fiscal sector likewise performed well, with the National Government posting a P9.4 billion budget deficit in 2007, its lowest in ten years. This was achieved through enhanced revenue collections and privatization efforts.

Moreover, for the first time in more than a decade, the consolidated public sector financial position registered a surplus in 2006. This continued on in the first nine months of 2007 with the public sector posting a surplus of P52.7 billion.

Gains brought about by the government's fiscal consolidation efforts were evident in the material reduction in the public debt burden.

All in all, one could say, 2007 has been marked by an auspicious alignment of the stars – what should be going up, went up, what should go down, went down.

Key challenges ahead

While we have implemented in recent years prudent macroeconomic policies and structural reforms, which allowed us to achieve these important milestones in the previous year, the Philippine economy continues to face challenges from both the global and domestic fronts. These include: (1) the US economic slowdown; (2) further disruptions in the global financial markets; and (3) continued volatility in oil prices and the uptrend in non-oil commodity prices.

One of the major challenges is the slowdown of the US economy.

There is consensus that the US economy is poised for a downturn in 2008. The current tightening of credit conditions in the US could exert downward pressure on investment and consumption. The sharp decline in US real estate market could also weigh in on consumption via wealth effects.

What does this mean for the Philippine economy?

A slowdown of the US economy could directly impact the Philippines via two key areas: (1) the country's export receipts; and (2) remittances from overseas Filipinos.

The Philippines is not immune to a US slowdown, although there are factors that may limit any adverse impact. For instance, although the US is still one of the country's top trading partners, US dominance in Philippine trade has diminished. The share of Philippine exports to the US decreased from 30 percent in 2000 to 17 percent in 2007.

The IMF has also found that the sensitivity of Philippine growth to US growth has declined overtime. However, the sensitivity is still palpable. The IMF estimates that a 1 percentage point reduction in US growth reduces Philippine growth by 0.5-0.6 percentage points.

Moreover, the persistent reliance of the Asian region on US trade and the increasing relative dependence of the Philippines on Asian trading partners, indicate the absence of full decoupling. The net impact of a US downturn on Philippine growth will depend on how the Philippines' other major trading partners are affected by developments in the US.

Remittances are another important channel through which the US economic slowdown could manifest itself in the Philippines. Latest data show that about 1/3 of our land-based workers are in the US.

The diversification in deployment in terms of destination and quality of skills, could temper any expected slowdown in remittances from a weakening of the US economy.

A second major concern for us is the possibility of further global financial market turbulence.

The IMF has noted that while coordinated credit operations by the major central banks, together with rate cuts, have helped ease liquidity tensions, wider problems in the financial system still persist. These include problems in the valuation of complex products, credit deterioration, counterparty mistrust, and balance sheet pressures.

Of great concern, however, is that a possibly deeper economic slowdown in the US or elsewhere could serve to widen the crisis beyond the subprime sector. Problems in the financial sector have started to spill over to the real sector via reduction in domestic demand particularly in the advanced economies.

The third key challenge is the continued volatility in oil prices and the uptrend in non-oil commodity prices.

The elevated price of oil, particularly if this continues for a protracted period of time, would be a concern as this could threaten our currently within-target inflation outlook.

However, crude oil price forecasts indicate a moderate downtrend in prices in 2008-2009, albeit to levels higher than the average seen in 2007. In addition to the forecast of tapering oil prices in the second half of this year, a more structural shield against a surge in high oil prices is the country's reduced dependency on imported oil. Our dependence on imported oil has steadily declined from over 50 percent in the mid-1990s to 37.3 percent of the total energy consumption as of 2006.

Meanwhile, the increase in global food prices could continue due to a number of factors, such as the rising incomes in China, India, and other emerging market economies that could drive up further the demand for food products, and increased biofuel production.

Implications for monetary policy

Against these risks, monetary policy will need to maintain the right balance in order to address inflationary risks while allowing the economy's growth momentum to continue.

With the BSP's adoption of the inflation targeting framework, the achievement of price stability becomes its ultimate objective in the conduct of monetary policy. An inflation-targeting central bank, therefore, should not be bound by multiple objectives unless these are necessary to achieve the goal of price stability. Nonetheless, the BSP is firmly committed to promoting price stability that is conducive to a balanced and sustainable economic growth.

In particular, monetary policy needs to be watchful of the emerging risks to inflation and inflation expectations. The BSP needs to be on the lookout for second-round effects of supply-side pressures, particularly on wages, utility rates and transport fares.

BSP's policy thrusts

Against these major developments and challenges, the BSP will continue to pursue initiatives aimed at maintaining sound macroeconomic fundamentals supportive of a vibrant economy.

We will, thus, remain focused on our inflation target. As you are aware, a low and stable price environment allows economic agents to plan better. It also allows us to maintain a low interest rate environment that would help support domestic demand.

Relative to the external sector, our policies are: to ensure the sustainability of the country's external debt; maintain a market-determined exchange rate with scope for occasional action in cases of extreme movements in the exchange rate; maintain a comfortable level of reserves; and improve further the foreign exchange environment.

On the financial sector, our policy thrust shall be to continue our reform efforts towards further strengthening the banking system. Our banking sector reforms shall focus on: further enhancing the regulatory framework through the implementation of the BASEL II roadmap; improving corporate governance by promoting compliance with international accounting and financial reporting standards; accelerating implementation of risk-based supervision technology; encouraging the development of the domestic capital market; and strengthening ties with other financial regulators.

In line with these thrusts, you may recall that towards the end of last year, the BSP approved two important reform packages:

The further liberalization of outward investments of residents. Highlights that may be relevant to the FMAP are: (1) allowance of outward investments by residents funded with foreign exchange purchased from the banking system not exceeding US$30 million per year no longer need prior BSP approval; and (2) qualified investors may now apply for a higher annual outward investment limit. QIs include, among others, insurance and pre-need companies, collective/pooled funds such as mutual funds, unit investment trust funds and variable insurance.

The amendments to BSP regulations governing derivatives activities of banks and trust entities, including guidelines on risk management and sale and marketing of derivatives.

Both these reform packages are intended to help make the domestic market more able to quickly adapt to any further changes in the global financial markets.

Philippine economic outlook

On the basis of these policy directions, the outlook for the macroeconomy continues to be favorable.

Average inflation is expected to be within target in 2008 and 2009. The volatility in world oil prices and uptrend in non-commodity prices remain the key risks to the inflation outlook. Nevertheless, these potential risks to inflation are seen to be tempered by some downside risks such as the firm peso and reduced dependence on imported energy sources.

Meanwhile, the fiscal positions of the National Government and the entire public sector are expected to continue to improve, taking off from their performance in 2007.

Finally, we expect the BOP to continue to be in surplus although at a level that is smaller compared to the previous year. The liquidity impact of the external surplus will have to be managed such that the amount of money in the system remains consistent with the inflation objective.

Concluding remarks

Ladies and gentlemen, the Philippine economy’s current fundamentals are at the strongest they have been over the past two – three decades, providing us reasons to be optimistic about the future.

But there are headwinds, mainly coming from external developments.

This time around, we believe that the Philippines is better able to withstand the shocks due to the following reasons…”buffers” as I would like to refer to these: the underlying growth momentum due to improving fundamentals; we have a stronger external liquidity position; we have gained dividends from our structural reforms in the areas of fiscal policy, power, banking, and capital market; and we have better information disclosure, which encourages markets to look at Philippine-specific risks and not be prone to herding behavior.

But we cannot afford to be complacent.

Even as we have built up “buffers”, we must continue to be mindful of the potential risks, particularly the possibility of unforeseen ones that could impede our path to further progress.

The primary task ahead of us is to focus on strengthening the economy while also preserving the momentum for economic reforms to ensure sustained growth in the long run.

The implementation of appropriate reforms by the government and active participation of the private sector, in promoting economic development will be powerful forces in the fulfillment of this challenging task.

In this endeavor, the BSP looks forward to FMAP’s continued support.

Maraming salamat at magandang hapon sa inyong lahat!