# Amando M Tetangco, Jr: Competitiveness, growth, and equity in a globalizing economy – a central banker's view

Welcome remarks by Mr Amando M Tetangco, Jr, Governor of the Central Bank of the Philippines (Bangko Sentral ng Pilipinas), at the 46th Annual Meeting of the Philippine Economic Society, Manila, 14 November 2008.

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The distinguished officers and members of the Philippine Economic Society led by Dr. Aldaba, fellow central bankers, our friends from the media, special guests, good morning.

On behalf of the Monetary Board, I welcome all of you to the Bangko Sentral ng Pilipinas, the venue of the 46th Annual Meeting of the Philippine Economic Society(PES). To us, the annual meetings of the PES have always served as an invigorating collegial setting among professional economists in the Philippines for the dissemination of research, incisive debate, and careful consideration of critical policy issues.

This year's meeting is being held in conjunction with the 11th International Convention of the East Asia Economic Association or the EAEA. This marks the first time that our country is hosting EAEA.

It is therefore with keen anticipation that we look forward to the discussions ahead, especially in light of the timeliness of this year's PES theme of "Competitiveness, Growth, and Equity in a Globalizing Economy." At the same time, EAEA's theme of "Regional Risk Management in East Asia" is particularly relevant given the present global financial crisis that is likely to be the deepest in decades.

Given the broad-ranging impact of the financial market turmoil, the scope of the conference papers addresses varied issues: this includes the need for complementary interventions in the areas of energy and infrastructure; human capital investments; governance; competition policy; and the need to integrate the poor into the mainstream of development. In other words, there would be much food for thought along these lines in subsequent discussions.

On my part, I will focus on the conference theme from the point of view of a monetary policymaker.

## Globalization and the Great Moderation

Ladies and gentlemen. Prior to the current economic and financial turmoil, the world had experienced a prolonged period of above-trend growth. An important driving force behind this is globalization – as manifested by an unprecedented increase in the trade in goods and services around the world, coupled with an even greater expansion in the cross-border movement of capital flows.

In fact, between the 1990s and the current decade, global trade grew almost twice as fast as world GDP, while the stock of foreign direct investment grew almost five times faster than GDP growth. For emerging market economies (EMEs), in particular, foreign trade rose from 40 percent of GDP in 1990 to almost two-thirds of GDP by 2006, while private capital flows to EMEs increased tenfold during the same period.

Globalization has also meant the relocation of many production processes to the most cost-efficient firms across countries, so that the contestability of domestic production is now greater than what appears from the trade figures alone.

The dampening of price pressures as a result of increased competition has worked synergistically with a major transformation in monetary frameworks that was also taking place at the same time. In particular, central banks have come to focus on price stability as

their primary policy objective and on the role of the monetary framework in establishing the credibility of policy.

This shift in monetary policy – along with globalization, productivity gains, and complementary institutional factors such as increased central bank independence – helped bring about a period of decreasing inflation, above-average economic growth, and the dampening of the business cycle that has come to be known as the "Great Moderation."

The hope then was that this benign weather would continue, that the global imbalances would be resolved with soft landings, and that EMEs could now focus and turn their attention from macroeconomic management toward ensuring more meaningful participation in the economic mainstream of all the segments of the population, no matter the income levels. Since then, talk has shifted from the "Great Moderation" to what a senior IMF executive describes as a "financial storm of historic proportions".

What went wrong?

## Crisis and rethinking

As events continue to unfold in the global arena, it may be too early to draw conclusions. Nevertheless, the ongoing crisis should be a catalyst for change. It is imperative that we try to distill even at this stage some fundamental lessons from this episode with a view to strengthen the underpinnings of the economy, reduce its vulnerabilities and rigidities, and unlock its productive potentials.

This will also help us avoid the same policy missteps that contributed to the environment of increased risk-taking that has severely bruised the stability of financial systems worldwide. It is in this context that I will discuss some important policy issues.

First, the crisis underscores the importance of flexibility in the implementation of monetary policy, and inflation targeting in particular. The need to cast a broad eye on the horizon was emphasized in a cautionary note made by US economist Hyman Minsky more than a decade ago. Minsky – as you may remember – has written extensively on financial market fragility, and is well known for the phrase "Minsky moment", which refers to the slow movement of financial systems from stability to crisis. He said that economic stability and prosperous times can encourage excessive leverage and risk-taking, eventually setting the conditions for a financial crisis.

Related to this, there is renewed debate on whether monetary policy should react directly to changes in asset prices. The majority view is it should not. For example, US Federal Reserve Chairman Ben Bernanke wrote that changes in asset prices should affect monetary policy only to the extent that they affect the central bank's forecast of inflation. After all, central banks are not likely to have informational advantage over the market in assessing to what extent asset price movements are due to fundamentals and to what extent they are following what is called a "pathological path."

Moreover, central bank stabilization of asset prices can generate moral hazard problems; that is, the implicit "safety net" created by the central bank could provide an incentive for greater risk-taking in pursuit of returns. Furthermore, monetary policy tends to have a weak linkage with many asset prices. We know for instance that most fluctuations in equity prices occur for reasons unrelated to monetary policy.

Nevertheless, recent events support the need for flexibility in this thinking. Preemptive measures against the build up of asset price bubbles need not be incompatible with inflation targeting, which is an information-intensive approach.

The need to monitor a broad range of variables is supported by the possibility that globalization may have further complicated the role of the Consumer Price Index as an indicator of price pressures. For instance, increased competition from abroad can dampen

the prices of tradables, so that the first symptoms of an overheating economy can show up in the prices of some non-tradables – including real estate – that may not be reflected in the CPI basket. In this respect, a flexible exchange rate can help maintain the proper balance of relative prices.

Second, there is a need to carefully examine present incentive structures to minimize, if not avoid, the emergence of moral hazard that can abet inappropriate risk-taking behavior. For example, analyses of the roots of the expansion of the US subprime mortgage market have focused on the confluence of several driving factors, including a loosening of US monetary policy at the beginning of the decade; an easing of standards for mortgage lending, encouraged in part by a range of legislative and policy changes that aimed to make home ownership more accessible to households that had been historically underserved by mortgage lenders; the rise of complex structured products, the overall riskiness of which proved to be difficult to properly monitor and assess; fragmented and loose supervision of financial institutions which, among other things, kept US investment banks outside Fed oversight; and the inaccurate ratings of credit rating agencies.

In the case of the Philippines, the restructuring of our banking system in the aftermath of the Asian financial crisis was achieved without the infusion of public funds. This helped avoid moral hazard issues mentioned earlier and actually promoted greater prudence in banking activities. And since most of our financial institutions were still in the process of strengthening their balance sheets when securitization began to be popular among investors abroad, their exposure to these structured products is relatively limited.

Thirdly, I cannot overemphasize the importance of a strong supervisory and regulatory framework. The fundamental rationale for banking regulation is to guard against moral hazard, as banks use and lend out funds sourced from deposits.

In the Philippines, the banking system has benefited from our continuous efforts to better monitor, mitigate, and manage risks. A package of banking reforms was implemented in the areas of risk management, corporate governance, capitalization, and information disclosure practices – such as rules to disclose detailed information on banks' restructured and non-performing loans.

Going forward, our focus will be on further enhancing the regulatory and supervisory framework; promoting market discipline in financial markets through enhanced reporting and disclosure requirements; improving corporate governance through promotion of compliance with international accounting and financial reporting standards; enhancing the implementation of risk-based supervision; strengthening ties with other regulators; continuing support for the development of a deep and efficient capital market, as well as the passage of necessary legislative reforms.

## Globalization and financial liberalization

Much as the "Great Moderation" has highlighted the benefits of globalization, the recent global turmoil has also highlighted its challenges.

There is no question that freer trade in financial products and services confers significant benefits – direct as well as collateral ones – to those countries that are prepared for it. These benefits come in the form of – among other things – portfolio diversification, greater access to foreign exchange, financial depth and technological transfers. At the same time, however, global financial integration has also enabled the cross-border trading of complex and potentially risky financial assets. It also brings about the possibility of sudden stops in capital flows in times of market stress.

Excessive financial openness therefore raises important policy concerns relating to the monitoring and surveillance of the flow of capital, as well as the formulation and

implementation of appropriate policy responses. The latter concern provides important food for thought as we pursue efforts to reform our foreign exchange regulatory framework.

As we noted earlier, economic literature holds that the freer flow of capital confers several important benefits to the economy. However, the realization of these benefits depends critically in part on threshold effects related to the level of development of domestic financial markets, the quality of institutions and corporate governance, the nature of macroeconomic policies, and the extent of openness to trade. In other words, reaping the growth and stability benefits of financial globalization requires prudent macroeconomic policies, appropriate prudential regulation, and sound institutions. The BSP therefore must remain vigilant on all these fronts when pursuing financial openness.

## Monetary policy imperatives

For us at the BSP, vigilant and sound policymaking necessitates keeping a watchful eye on price developments, since price stability is the BSP's primary mandate. The BSP will therefore remain vigilant against the threats to inflation and inflation expectations. To the extent that risks to inflation are reduced by easing supply-side pressures, we will have more flexibility in determining appropriate monetary policy settings that will promote price stability that is conducive to balanced and sustainable economic growth. We will watch closely for future signs of easing inflationary pressures as well for price pressures that are still in the pipeline, since their pass-through is expected to continue for sometime. The challenge is to ensure that monetary policy settings are calibrated as appropriate so that there is sufficient confidence that inflation would be on a declining path over the near- and medium-term to keep inflation expectations well anchored.

At the same time, the BSP also remains strongly committed to provide necessary liquidity in the financial system for banks that may need funds to ensure the normal functioning of credit and financial markets.

## Conclusion

Indeed, important lessons have emerged from the ongoing global crisis. Nevertheless, Asian economies continue to face difficult policy questions on how best to manage risks, individually and collectively. This represents fertile area for research, particularly on what Asian economies can do outside of existing institutional arrangements.

Similarly, the region's economies continue to grapple with questions of how best to achieve competitiveness, growth, and equity amidst the tide of globalization. As economists, we must use every opportunity not only to ask the important questions but also to try to piece together answers that would help our economies.

But while attempting to do so, and as we engage in elegant and animated discussions in the days ahead, let us be mindful that no one has a monopoly over wisdom. Even the venerable Alan Greenspan now projects newfound humility, admitting to a lapse in judgement. And so, fellow economists, let us ask the questions – as we should, keeping in mind that it is the collective wisdom of this group that we should mine.

Let us live up to the challenge before the participants to this 46th annual meeting of the PES: to have a fruitful meeting on "Competitiveness, Growth, and Equity in a Globalizing Economy." May this PES annual meeting be remembered as a complete success. On this optimistic note, I welcome all of you, once again, to the Bangko Sentral ng Pilipinas.

Mabuhay ang Philippine Economic Society! Mabuhay ang Pilipinas! Salamat sa inyong lahat!