Amando M Tetangco, Jr: Philippines – navigating through the global financial turmoil

Speech by Mr Amando M Tetangco, Jr, Governor of the Central Bank of the Philippines (Bangko Sentral ng Pilipinas), at the Australian-New Zealand Chamber of Commerce Philippines Annual General Membership Meeting, Makati-City, 14 April 2009.

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Introduction

President Richard Barclay, distinguished members of the Australian-New Zealand Chamber of Commerce, ladies and gentlemen good evening.

First, let me thank ANZCHAM for inviting me to your monthly members' meeting. If I remember correctly, the last time I graced a similar event of ANZCHAM was in July 2005 – as I was just beginning my term as central bank governor.

Much has transpired during the nearly four years since then. As this particular slide shows, our economies have experienced ups and downs – riding on record growth rates, and now recessionary trends, historic low inflation, and then some episodes of highly unstable prices, stock market gyrations, as well as periods of volatility in our exchange rates.

Our journey in the last four years has taken us through good roads, so to speak. But we also went through road blocks and speed bumps along the way. Now, the global financial and economic turmoil presents our economies with, perhaps, our biggest challenge yet.

The current crisis has been described as a "crisis unlike any we have seen in our lifetime". We have seen much of the crisis' adverse effect on our economies, but we know that much is still to unfold. For my remarks tonight, I thought I would follow the outline flashed on the screen right now. I will begin by quickly running through three themes that I have seen surrounding the current crisis:

First, that "the law of unintended consequences" has been at work in this crisis. Second, that a global crisis needs global responses. Finally, that no economy is immune from the effects of this crisis, but those which have built up buffers are more likely to fare better than others.

I shall then conclude my remarks with a description of the policy actions and initiatives that the BSP has so far implemented to allow us a less bumpy ride to the not-so-distant period of economic recovery.

Unintended consequences evident in the crisis

I am sure many of you have heard of the term "law of unintended consequences". Some have defined this as "the proposition that every undertaking, however well-intentioned, is generally accompanied by unforeseen repercussions that can overshadow the principal intention."

Let me illustrate, continuing with my road analogy. In road development, one option to deal with a traffic-congested road is to build a bypass or an alternate road. Unfortunately, building a bypass may decongest the existing road, but as often happens, with new developments in the area of the bypass, we would now have, instead of just one congested road, two traffic congestions.

Many analysts have said that "the law of unintended consequences" was working spectacularly in the run up to this current crisis.

One evidence of this is the benign macroeconomic environment created by the low interest rate regime prevalent during the first half of this decade. This should be a good thing.

However, this environment led to the search for higher yields, that fueled unprecedented asset price increases and at rates faster than the growth in household incomes. This further led to a loss of rationality (individuals believing house prices would never fall) and extension of credit by financial institutions to sectors of the economy that normally would not qualify to borrow (in other words, the so-called "subprime" borrowers).

Sounds familiar? This was what transpired in the United States – low federal funds rate fueling a boom in mortgages with borrowers having doubtful credit histories, housing prices bubbled and burst, with the negative feedbacks affecting both the U.S. domestic economy and financial markets.

Another example is in line with risk spreading through financial innovations.

The ability to spread risk should also be a desirable goal. However, the fast-paced evolution of financial products and services, along with the seemingly "loose" financial regulation – later on gave way to the unfortunate reality that risks were eventually "concealed". Through securitization and deleveraging, those hidden risks were effectively multiplied in the process.

Thus, while financial innovations have good intentions, they also have some side effects… if not prudently monitored or given appropriate form of regulation.

These developments, together with a host of other factors, fueled the current crisis, which from all angles, can be considered our first truly global crisis. From what was first believed to be a US-centric subprime mortgage problem, the crisis has since transformed into financial turmoil and further into an economic growth crisis. From the US and Europe, it has spread to the rest of the world. Economies in the periphery suffered market failures characterized by sudden stops as sentiment turned, despite sound policies. Even countries that did not have strong financial links with the core nations are now being affected through real flows and financial losses on trade activities.

Global crisis requires a global responses

This brings me to my second theme – "A global crisis requires a global response."

When it had become evident that the economic events were not going to remain localized at the epicenter, advanced and emerging economies implemented policies and strategic actions, in concert and at the national level. Some economies that have more monetary space have eased policy interest rates, reserve requirements and credit facilities. Some that have more fiscal space boosted spending via stimulus packages and prioritization of important infrastructures. Many have pursued both expansionary monetary and fiscal policies. Some countries like Australia and New Zealand have implemented unlimited but temporary deposit guarantees and opened up US dollar swap lines with the Fed.

Finding the right policy mix poses a continuous challenge, as economic managers and policymakers would have to deal with varying conditions, magnitude and depth of the crisis' effects. Thus, the worldwide crusade to mitigate the impact of the current global financial and economic crisis continues its experimentation but with utmost caution for a wrong policy could eventually take its toll on the economy over the long-term horizon.

No economy is immune, but buffers and cushions help lessen the impact

The crisis has shown that no one is immune. This leads me to my third theme. No economy is immune but some economies fare better because of buffers built from past reforms and behavior. While our countries have been affected, it is noteworthy that the cushions we have painstakingly put in place before the current crisis unfolded have helped us weather the blows. Allow me to name a few of these buffers.

In the case of Australia and New Zealand, these economies have grown strongly for the past 10 years and inflation has been largely within the 1 to 3% target band; this has resulted in low unemployment, and a strong fiscal position. They also have good institutions. They scored highly on measures of ease of doing business, as well as measures of corruption/transparency. They also have flexible labour markets. They both have an established track record for transparency in regulatory institutions, sound management of the public accounts, and a forward-looking monetary policy are well-regarded internationally. Finally, their banking system remained sound and well-capitalised. The large Australian banking groups, of which the major New Zealand banks are a part of, are now among the largest and highest-credit-quality banks in the world. Australian parents of the big 4 NZ banks are some of the best-rated in the world (4 of the remaining 13 AAs and in the top 20 biggest).

The openness of your economies has indeed left you quite vulnerable during this crisis, but your strong institutions have certainly helped to mitigate the crisis' adverse impact.

How about in the Philippines? What are the buffers we have built?

With the easing of oil and other non-oil commodity prices in the world market and the moderation in inflation expectations, inflation is now expected to further decelerate – and be within the target ranges – in 2009 and 2010. Actual headline inflation has decreased to 6.4 percent in March from 7.3 percent in February 2009. (Core Inflation in March also declined to 5.6 percent from 6.4 percent in February 2009)

These developments opened the opportunity for BSP, during its last three policy meetings, to cut its policy rates by a total of 125 basis points. The reduction in rates makes more funds available for lending to corporations, including small and medium business enterprises, as well as for consumer loans. We will continue to monitor developments to ensure that our policy settings remain appropriate.

In October 2008, at the height of the uncertainty surrounding this crisis, the BSP implemented several measures to boost liquidity. We were witnessing at the time the freezing of credit markets in the major economies. So, even as we were aware there was ample liquidity in the system then, the BSP took preemptive steps to avert a similar situation developing here.

These measures, which I will discuss shortly, have helped to raise domestic liquidity and allowed banks to continue to extend loans. The continued liquidity and credit growth is shown in this slide.

Demand for money remained strong in February as domestic liquidity or M3 grew by 14.6 percent year-on-year, higher than the 6.8 percent expansion during the same month a year ago but lower than the 16.1 percent growth in January 2009. The continued strength of domestic liquidity indicates that there are funds available in the system which could be tapped for investment and other productive activities.

Outstanding loans of commercial banks including reverse repurchase agreements (RRPs) increased in February 2009 by 22.5 percent year-on-year, an acceleration from the previous month's growth of 18.8 percent. Net of RRP placements with the BSP, lending also increased by 22.6 percent year-on-year in February, slightly slower compared to the 24.5 percent expansion in the previous month.

We have allowed liquidity to grow faster than we would normally tolerate since we see that these funds are being used in productive sectors. Nonetheless, we are mindful that while liquidity fuels economic growth, excess liquidity could fan inflation. In view of this, we always keep in mind that balance is necessary to ensure that we are able to support growth in an environment of stable prices.

One of the lessons we learned from the 1997 Asian Financial Crisis was the value of managing external debt and building up FX reserves for self insurance. This chart shows that we have indeed learned this lesson well.

Based on preliminary data, as of end-March 2009, our reserves have remained broadly steady and close to record level at US$38.9 billion. This suffices to cover about 6.2 months of imports of goods and payments of services and income, or alternatively, it could cover our short-term external debt based on residual maturity about 2.9 times. (What's interesting to note is this level of reserves is more than fourfold our reserves level in 1997 of $8.8 billion!)

We were able to continue building reserves because our external payments position has remained in surplus in 2008 (in fact for nearly 5 years now). The healthy external balance has been supported by remittances of overseas Filipinos as well as higher services receipts particularly from business process outsourcing. In February 2009, our balance of payments position posted a surplus of US$ 469 million, resulting in a year-to-date surplus of US$2.2 billion in 2009.

Thus, even as we face a slowdown in external demand and capital flows, the stronger external liquidity position that we currently enjoy will make us less vulnerable to the moods and swings of international financial markets.

This slide shows that (1) The banking system's asset base has been expanding steadily, supported by sustained growth in deposits. Our banks have continued to perform their central role of efficiently channeling funds to productive uses and managing and distributing risks; (2) Banks have been offloading their non-performing assets and problem loans. As a result, the NPL ratio is now at the pre-Asian crisis level of around 4.0 percent.

Furthermore, the profitability of the banking system has continued to increase, although with some moderation as of late. Banks have remained capitalized at levels above both the BSP-regulatory requirement and the international (BIS) standard. In addition, let me also assure you that the rural banking industry remains strong and healthy despite the recent closures of some rural banks which have been found to have been suffering from severe solvency problems.

BSP initiatives and policy thrusts

Amidst this global crisis, the Philippines has indeed remained resilient and steadfast. How have we been able to accomplish this?

Let me quickly go over the BSP's initiatives to mitigate the impact of the crisis. And then conclude with our policy thrusts going forward.

To ensure liquidity in the financial system, the BSP opened the US dollar repo facility to augment dollar liquidity in the foreign exchange market and ensure the ready availability of credit for imports and other legitimate funding requirements. The BSP also increased the budget for the peso rediscounting facility to P60 billion. Regular reserve requirements on bank deposits and deposit substitutes were reduced by two percentage points. To ensure continued access to financing of small businesses, the BSP launched its Credit Surety Fund (CSF) Program which provides guarantee to small cooperatives with good track record but without credit history.

The BSP was also quick in bolstering confidence in the financial system, through timely communication with financial institutions and market participants on the minimal exposure of the banking system to troubled financial assets, such that the impact of the global financial crisis on the Philippines has not been significant.

Monetary policy in 2009 will continue to pursue prudent rate movements mindful of price stability as the primary mandate. With the easing in the prices of oil and non-oil commodities in the world market, inflation is expected to further decelerate and be within the target range

of 2.5-4.5 percent in 2009. This will give some flexibility to monetary policy to support growth. An accommodative monetary policy stance is expected to help ensure greater availability of credit and reinforce market confidence. However, given possible upside risks to inflation, a more measured adjustment of policy rates is appropriate.

Banking sector policies will be geared towards improving the regulatory framework, mindful of the need to protect consumers and investors. Key financial and banking sector reforms will be sustained in pursuit of greater efficiency, better risk management, stronger capital base, improved disclosure and transparency practices, and enhanced corporate governance standards in the banking system.

The BSP's external sector policy will remain focused on ensuring our external vulnerabilities are limited. We expect to continue to post a surplus in our BOP, mainly still due to steady OF remittances and receipts from the BPO sector. This will give us the opportunity to further beef up reserves for self-insurance. We will continue to pursue a market-determined exchange rate to allow us to maintain external price competitiveness. We will also engage in policies that would sustain a manageable external debt profile.

The current turmoil underscored the importance of comprehensive and globally coordinated policy responses. Recognizing this, the BSP has been actively consulting with its regional peers to share information and discuss emerging developments and policy alternatives.

Conclusion

As I mentioned when I began my remarks, an overarching theme of this crisis is the law of unintended consequences. Is it possible to avoid this going forward?

Frederic Bastiat, a 19th century French economic journalist, once said, "there is only one difference between a bad economist and a good economist: the bad economist confines himself to the visible effect; the good economist takes into account the effects that can be seen and those effects that must be foreseen".

It may be difficult to perfectly foresee things but this should not discourage us from trying. Thus, I encourage all of us in this venue to remain positive, yet vigilant for any circumstances that could come our way. The BSP, for its part, will remain committed and continue to put forth monetary policy actions and banking reforms that will allow our economy to withstand the road blocks comprising panics, crises and other changes in the horizon.

Let us keep our eyes steady on the road ahead and gear up. The BSP looks forward to continued partnership with the Chamber. This will certainly help enable our economies navigate the global financial crisis towards an economic recovery of renewed confidence and regained trust in markets.

Thank you very much.