Amando M Tetangco, Jr: Policy actions and risks going forward

Keynote remarks by Mr Amando M Tetangco, Jr, Governor of Bangko Sentral ng Pilipinas (the central bank of the Philippines), at the FinanceAsia 4th Annual Corporate Treasury & CFO Summit, Manila 23 August 2012.

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Ladies and gentlemen, good afternoon.

Let me begin by thanking the organizers and sponsors of this Summit for this opportunity to connect more closely with those directly involved in our financial markets – the CFOs, corporate treasurers and senior treasury professionals…

Treasury professionals are always an interesting audience to address… You are known to be sharp and analytical. It is in your DNA to be direct in your communication… You use very few words and yet everyone understands. You say "yours", "mine", "give", "take". …You follow simple rules. For instance, in fixed income, you buy high (in terms of yields) and sell low… in foreign exchange, you buy the swap points in your favor… and in origination, you dot every I and cross every T… In this respect, there are no two camps of treasury professionals.

But when it comes to patience, there are generally two diametrically opposed groups among treasury professionals – 1) the notoriously impatient and 2) the unflappably patient. Some of you coolly follow trends (the trend is your friend!), while some either calmly or feverishly wait for the inflection points (this is where you make the one-time big bucks), and yet quite a few trail blaze and themselves radically create the trend.

Knowing this, I thought that for this afternoon, I shall try to speak squarely on the issues that interest you – from the perspective of the BSP – Where do we think interest rates are headed? Will we see further peso appreciation? Is there an asset bubble? Are banks safe? What can you expect from the BSP in terms of policy when dealing with these issues?

This approach is for the impatient side of this Summit… However, it is in my nature as a central banker to provide an appropriately balanced operating environment… Therefore to equally address the patient constituents of the Summit, I shall first provide the fundamental basis for our policy actions including the risks that we see going forward.

I hope this broad outline works for everyone here. I was quite pleased to see that in the sessions preceding this, particularly the one at 9.30 am, there would already have been discussions of the macro trends that can be expected—strong economic growth, manageable inflation, robust external position, sound banking system…. So I shall no longer repeat those. Instead, I shall deal directly with the risks in our operating environment that fall from those trends.

The first risk… Global headwinds will continue to be formidable. Despite collective efforts to address systemic weaknesses, Europe continues to struggle with economic and socio-political obstacles to the implementation of much-needed rehabilitation and reform measures… The economic outlook in the US is also uncertain, as unemployment remains elevated and private sector demand continues to be weak… and the so-called "fiscal cliff" continues to limit the room for fiscal stimulus.

Even for Asia, less-than-favorable indicators in major emerging Asian economies as of late – in particular, slowing growth in China and India – suggest a vulnerability to the global slowdown, as weak external demand from advanced economies exerts its impact across the region.

As a result, the IMF, in its World Economic Outlook update in July, cut its global economic growth projections for both 2012 and 2013 to 3.5 pct and 3.9 pct, respectively.

For the Philippines, however, it is of some comfort that the economy has been resilient against the global downturn. Growth continues to be driven by a vibrant services sector, robust private demand, and accelerating government consumption… The Q2 GDP is expected to be released at the end of the month (30 August). Let us therefore see if the second-fastest growing economy in Asia would continue to beat market expectations.

Second risk… Europe's apparent deleveraging – or the shrinkage of assets in light of the current stream of global regulatory reform – may result in squeezes in the rest of the world, particularly Asia. For instance, in response to Basel 3, some international banks, instead of raising more capital, have resorted to reducing their risk-weighted assets as a way of increasing their capital adequacy ratio or CAR. In the CAR build-up recently required by the European Banking Authority (EBA) on 71 banks, this form of deleveraging seems to be recurring. It is thus no surprise that some quarters estimate that complying with Basel 3 alone will reduce bank profitability and/or impair GDP. The 2011 study of the OECD led to a result that Basel 3 implementation would mean up to a 15 basis point drop in GDP growth per year due to higher interest rates passed on to borrowers. McKinsey (2011), on the other hand, suggests that the return on equity of US banks can fall by as much as 320 bps as a result of Basel 3.

These are not very encouraging thoughts but the upside is that we do not believe right now that such is the case for Philippine banks. With industry CAR of between 16% and 17% of which Tier 1 capital is 13% to 14%, there should be no reason to deleverage for the sake of hitting the capital standards of Basel 3.

All these notwithstanding, the weaknesses in the US and the eurozone as well as the displayed strength of the Philippine banking industry will have capital flow implications as investors seek destinations for the freed up assets, or for funding sources, as a result of deleveraging. This brings us to the third risk.

Third risk… Capital inflows to EMEs, including the Philippines, could continue in light of prolonged easy monetary policy in the advanced economies and as growth prospects and financial markets remain relatively healthier in EMEs. Yesterday, we reported a US$3.2 billion surplus in BoP in July 2012, a large part of which was due to portfolio inflows on top of the current account surplus. From a macro perspective, the broader concern with continued foreign inflows is that it could encourage more leveraging or risk-taking activities beyond the economy's absorptive capacity for risk. This complicates monetary policy and more particularly, strong and rapid inflows of capital are often associated with asset price bubbles that could potentially undermine financial stability.

What are BSP's policy thrusts in light of these three risks? To answer this question, let me first give you four lessons from the recent past.

One key lesson we, at the BSP, have drawn from the last few years is that achieving price stability is no longer enough to ensure macroeconomic stability. As we witnessed during the "Great Moderation", an extended period of price stability can also plant the seeds of future distress by causing agents to take on a disproportionate amount of risk. In short, price stability must go hand-in-hand with financial stability.

Another lesson we have learned is this – Capital can move freely across borders. Thus, policymakers must maintain a delicate balancing act between ensuring a relatively stable currency and sustaining the use of independent monetary policy to offset macroeconomic shocks.

Together, these two lessons have taught us that it is prudent to use a wide set of available policy instruments to achieve low and stable inflation, prevent undue volatility in the exchange rate, and maintain broad financial stability. Our policy toolkit has till now encompassed, in addition to the policy rate and bank reserve requirements, mechanisms to better understand the nature of the flows, international reserve accumulation and the associated liquidity management, financial and foreign exchange reforms, and macroprudential regulations. By employing this strategy, the BSP has thus far been able to keep inflation in check while containing the risks associated with strong capital inflows.

A third lesson we have learned is that policy responses must be oriented towards preventing a build-up of system-wide risks that may be brewing underneath the growth momentum. We need to keep an eye on the broader objective of maintaining financial stability. The regulator can no longer simply look at transactional risks, but we need to also consider how these individual transactions impact on other financial transactions. Our commitments to the Basel 3 Accord exemplify this belief as we have placed greater scrutiny on linkages between our financial institutions and the non-banking corporate sector.

This now brings us full circle. For financial stability to translate fully to solid and durable economic growth, the BSP must continue to enable different stakeholders to participate confidently in the financial system. This is where our continuing reform initiatives toward greater consumer protection come in. The fourth lesson we can draw from recent experience is that consumer protection complements financial stability. These twin goals ultimately help address the expanding needs of the growing economy.

I have given you the lay of the land, so to speak…Clearly, the coming months are likely to continue to prove to be challenging for the Philippines… As such, our strategy in addressing potential threats to the economy continues to revolve around using a broad-based policy tool kit that aims to bolster our domestic sources of resilience.

Ladies and gentlemen, I have noted that many of you (the patient side of the Summit) have been listening intently… But for the "other side" of the Summit, you may anxiously ask, what do all these mean for the economic variables that matter to us? Quickly, three guideposts:

1. On the policy rate – We continue to see the average inflation rate falling within the lower half of the target range. With this relatively favorable inflation outlook and our still-positive real interest rate structure, we continue to have the policy space to, should it be needed, respond to sudden changes in the global and domestic environment.

2. On the exchange rate – We will continue to pursue the policy of a market-determined exchange rate. But while we don't expect drastic moves, the market should bear in mind that the exchange rate is no longer a one-way bet. The BSP is carefully monitoring market behavior. So the market would be the wiser if it acknowledges that the BSP has several tools up our sleeve to ensure that market dynamics do not result in misalignments in the fundamental value of the exchange rate.

3. On asset prices – We don't see stretched asset valuations at this time, but we will continue to watch out for build-ups in asset price pressures. The experiences in the US sub-prime and in the European debt crisis have given rise to the "lean" vs. "clean" debate. We now know that it could be expensive to "clean up" after an asset price mess. Therefore, the market could expect the BSP to cautiously "lean against" such price pressures. The BSP will carefully calibrate policy rates, being cognizant that our first line of defense is still the use a mix of macroprudential tools to address potential excessive risk taking among market participants.

Just last week, the Monetary Board approved the introduction of a more comprehensive method of measuring the real estate exposures of banks. This measure will include, among others, not only bank loans but also investments in debt and equity securities, the proceeds of which are intended to finance the activities of real estate companies. The objective is to get a more complete picture of the amount of funds going to the property sector.

If you have been observing the BSP, one thing should be pretty clear to all of you by now… The BSP considers any situation with circumspection and addresses it in a gradualist and market-consultative fashion. We always aim to provide clear guidance to the market. I hope over the past few minutes, I have been able to convey to you that the BSP will continue to craft policy with the broader objective of financial stability in mind.

The theme that you have chosen for this Summit is “Excellence in Optimizing Your Treasury”. This is a point worthy of discussion. The phrase “Optimizing Treasury” brings to mind the debate between the efficient market hypothesis proponents and the advocates of behavioral finance. To believers of efficient markets, the price contains all relevant information to make a decision and market forces will trade away arbitrage opportunities. Believers of behavioral finance, on the other hand, look at a trader’s psychology and how he values “prospects” and “gambles” as the drivers of prices. To its supporters, behavioral finance explains market overshooting, over/under-reaction and loss aversion. Well, the jury is still in out on this debate… but whether you believe in one school of thought or the other, one thing is clear – to be able to maximize your treasury potential, you need information… correct and timely information. I hope that by having distilled our current market environment into three risks, four lessons and three policy guideposts, I have moved this discussion further to help you optimize your potential.

As I close, let me point out that your chosen theme is not limited to parochial bottom-line optimization. Your theme calls for “Excellence”. To me, that is a call for you to be responsible stakeholders. If you are on the sell-side, sufficient disclosure and transparency are central in your dealings. If you are on the buy-side, bounded risk taking is relevant in your investments. As you perform your jobs, I hope you appreciate that you are an invaluable partner of the BSP in transmitting the impact of our policies to the real economy….I hope also that you bear in mind that as participants in the financial market, you have a responsibility to the broader community that you are in… Finally, I trust that you will remember that your reason for being is to finance activities in the real sector.

On that note, let me once again thank the organizers of this conference and wish all of you a productive and rewarding afternoon.

Good day to all!