Amando M Tetangco, Jr: Sustaining growth while riding the uncertainty

Speech by Mr Amando M Tetangco, Jr, Governor of Bangko Sentral ng Pilipinas (the central bank of the Philippines), at the Bloomberg's Foreign Exchange Forum, Makati, 13 August 2014.

*   *   *

Introduction – caution in a time of uncertainty

Good afternoon. Seeing all of you here once again validates my theory that indeed there is a strong correlation between volatility and attendance in a forum like this one – to listen to the central bank talk about uncertainty. From a smaller function room downstairs where we used to hold this forum, we have been kicked upstairs to this ballroom. Holding this discussion now also shows Bloomberg's knack for getting the timing right.

Your interest confirms that the most common reaction to uncertainty is caution. Think about it, if you are about to undergo your annual physical, don't you modify your eating habits and hold off on that last piece of "lechon"? However, how long you feel you need to deprive yourself depends on your "initial conditions". If you are in fairly good health, maybe you would only skip one craving for that savory bite and you would still be confident to walk into the doctor's office.

The same reality applies to the financial market. 1) When market participants sense uncertainty, they proceed with caution and 2) The impact of uncertainty on your behavior will depend on initial conditions. If uncertainty finds you at a time of high market volatility, you are likely to be more nimble, than when uncertainty finds you at a time of low volatility.

Right now we are in a low volatility environment. Some analysts say volatility is "eerily" low. There is even an assessment that markets have become "too" complacent. Is that the case among market participants in the Philippines?

I hope not. See, the thing with "uncertainty" is that the degree of uncertainty is itself uncertain. Therefore, we really cannot, and should not be complacent. Because however quiet markets seem to be now, risks remain.

Risks remain

What are these risks that we face today? Let me name four that are top of mind:

1) Monetary policy normalization in advanced economies.

The consensus, as I understand it, is that the Fed would continue with its current pace of tapering. The operative question now therefore is when will the Fed "lift off" be? Will it be mid-2015, as many market analysts project? Or earlier? The next critical question we must ask ourselves is – how far should we take the "risk on" trade?

Unfortunately, because of possible spillovers and contagion, the answer to this question may actually depend on the answer to yet another question, i.e., how far will the global investor take the "risk on" trade?

As price takers in the global market, we are often at the mercy of how the global asset managers behave. Indeed, the behavior of global asset managers has caught the attention of central banks in all jurisdictions, particularly, how their "herd" behavior tends to amplify volatility. Quite often, because 1) they hold superior information to that of retail investors, 2) they have similar risk management frameworks, and 3) they have a common goal to outperform their benchmarks, global asset managers are able to (and often do) get out of trades more quickly and nearly at the same time, leaving the small institutional investors and retail investors "holding the bag", when the music stops.

If global investor sentiment shifts because of a misappreciation of Fed pronouncements, as what happened during the "taper tantrum", the current low volatility in the market could quickly turn to a high volatility environment.

2) We should also consider the monetary policies in the ECB and BOJ. These central banks have both said they are willing to extend accommodative monetary policy longer than the Fed. While this asynchronous exit could help assure the market that global central bank liquidity would not suddenly dry up, a prolonged QE from these two central banks could also present a drag to global trade, if the QE in these jurisdictions is perceived to be ineffective in stimulating growth. Furthermore, prolonged QE could create distortions in financial risk assessments.

3) Geopolitical risks

Happenings in the Middle East, retaliations between the West and Russia – all these could raise the volatility in commodity prices, affect global trade as sanctions continue to be hurled from both sides, and quite possibly, economic activity. In addition, geopolitical risks could lead to "flight-to-quality" trades, which could adversely affect EMEs.

4) Natural disasters

These could affect the domestic supply chain of food and other important commodities and exacerbate supply of power. These can directly feed into our inflation and growth dynamics.

Normalization of monetary policies in advanced economies, geopolitical risks, and natural disasters – these are some of the major risks that bring about uncertainty in our operating environment. How these could ultimately impact all of us, depends on our initial conditions.

Initial conditions and what has the BSP done so far

This snapshot is not unfamiliar to you, so let me just quickly run thru these:

On monetary policy – As you know, the BSP has carried out a series of actions. Each to address an evolving condition. First to contain domestic liquidity that continued to be very high in the system through two 100 bps increases in our reserve requirements; then an increase in our SDA rate of 25 bps to help contain financial stability pressures from the excess liquidity, and finally 25 bps increase in our RRP rate, to help manage inflation expectations.

These show our shift to a tightening bias. Our view is that it is important to guide the market to better appreciate market risk in the context of normalization. Because continued low volatility in the financial markets may promote further undue risk-taking attitudes. Equally important, the series of policy actions helps ensure that inflation expectations do not get disanchored.

Now you may ask, would you be seeing further action from the BSP? Let me just say that all the tools available to us in our "expanded tool kit" remain on the table. I reiterate that the BSP is fully committed to the inflation target and is prepared to deploy all policy tools as warranted.

At the same time, we will continue to coordinate with other agencies of government to address pressures from the supply side, including the timely importation of certain food products and tighter price monitoring to prevent speculative trading, to help ease price pressures. Other measures include: lowering logistics and shipping costs, increasing agricultural productivity.

On the exchange rate – The exchange rate will continue to be market-determined. But BSP will not hesitate to come into the market if there is a need to smooth out too much volatility in exchange rate movements.

On the banking sector – The Philippine banking system continues to maintain a strong performance. We will remain on track in adopting international standards, taking into account domestic market conditions, to ensure that the banking system becomes more resilient and is able to intermediate funds safely, efficiently, and effectively.

On external liquidity dynamics – We will retain a pragmatic approach to handling foreign exchange so that our current account continues to be in surplus, supported by overseas Filipino remittances, business process outsourcing (BPO) revenues, tourism receipts and exports. We will also manage international reserves as appropriate. Our strong external liquidity position will continue to provide a cushion against external shocks.

All these would help enable the Philippines to remain competitive and be able to hurdle the challenges as well as reap the benefits from the numerous opportunities of the forthcoming ASEAN integration of financial and goods markets. Granted, much more needs to be done to make the ASEAN story "whole", we find the initial conditions and our policy thrusts conducive to make this story come true.

Assessment:

Given such sound initial macroeconomic conditions, should we/you worry? Would any uncertainty rock us/you? And the million dollar question – What can you expect from the BSP?

A tilting in any/or all of the risks I enumerated could tip the balance of volatility from low to high. For certain, the sound macro conditions we walked through earlier would help to temper the impact of a significant and sudden shift to greater volatility. But, how each of your individual bottom lines would ultimately be affected would depend on your specific circumstances.

Clearly, the Philippines is in a good spot, and the prospects are bright. Our sound fundamental story is intact. This should not, however, lull us to complacency. I admonish each of you to use this time of low volatility wisely – take stock of your positions and carefully reassess these against the risks.

It is a fundamental truth – in everything we face, there are two circles of concern that confront us: 1) those concerns that are within your control, and 2) those outside of your control. Quite often, the latter circle is larger than the former. As market practitioners, you need to be mindful of these two circles. What can you control? Certainly your risk appetite. Controlling this when greed gets the better of you is very difficult. So in a period of low volatility such as what we have been experiencing, practice the discipline of setting limits.

This discipline will not only help you to avoid the pitfalls of "chasing the market". More importantly, this discipline will help you take advantage of the obvious opportunities, as well as unearth those that are hidden. Discipline set during the sober low volatility period will guide you when you are confronted with factors that are not within your control, especially during a frenzied high volatility period.

The BSP practices the same discipline. For the things that are under the BSP's control, the BSP takes conscious effort to act on these. For those that are not – we sharpen our surveillance, monitoring and analysis. We also coordinate with other government agencies which may have influence over the situation and dialogue with our peers in the region and beyond.

You can therefore expect the BSP to continue to 1) keep our ears on the ground for inflation impulses and changes in inflation dynamics, 2) act preemptively as appropriate when we see financial stability pressures rising, 3) keep a market-determined exchange rate, and 4) use all monetary and macroprudential tools under our disposal to shield the gains we have achieved so far.

The BSP will also continue to work to strengthen the consumer protection practices of banks. I believe it is incumbent upon you, particularly those on the marketing side, to fully disclose the risks of transactions or products to your clients – making it clear that price history is not necessarily a predictor of future price behavior. Related to this, we are about to roll out a new comprehensive consumer protection framework, which will cover what is expected of financial professionals such as yourselves with respect to the public whom you serve.

You have heard me say, on numerous occasions – the best policy is "to keep your own house in order". This is what you can expect the BSP to do. And that is also what we expect each of you to do. It is our hope that the BSP's actions and policy intentions are clear enough to you and that I have helped to articulate these better this afternoon.

The BSP's objective is to help you plan better, prepare and ultimately prosper even in times of uncertainty. Our vision is for the BSP to be, consistent with our mandate, the "tide that lifts all boats".