Amando M Tetangco, Jr: Convergence in a divergent world

Speech by Mr Amando M Tetangco, Jr, Governor of Bangko Sentral ng Pilipinas (the central bank of the Philippines), at the ACI Phils-FMAP-IHAP-MART-TOAP Joint General Assembly, Makati, 23 September 2014.

*   *   *

Introduction

Last time I addressed your General Assembly, I did a little "word association" game with you. I don't know how many of you recall that, but I did that last year to highlight the fact that often, the same words we hear have different meanings to us. Often, this is so because of our individual "positions" in the market. In other words, that adage "where we stand depends on where we sit" is very true among you.

Last time, I highlighted the BSP's desire to get everyone on the same page, wherein the same words would mean the same thing. Because clearly that ideal situation of common understanding makes for more effective and efficient BSP policy implementation.

This year, I will not do that game anymore. Rather, let me focus on just two words. Can anyone hazard a guess as to what these two words would be? Any guesses?

The first word

The first word is DIVERGENCE.

I chose this word because of late, it has become quite an important word that describes some of the remarkable features of the current global economic environment.

First. Divergence in the growth paths among major economies.

We have seen that in the US there continues to be a sprinkling/sputtering of positive economic indicators, while both the EU and Japan are still struggling for their economic growths to gain traction.

Second. Divergence between the current growth path of emerging market economies and the previous forecasts for the growth path of these economies. EME growth has broadly slowed down from the earlier anticipated growth trajectories.

Together, these two "divergences" have important implications for the speed and manner of global growth rebalancing and policy normalization.

Third. Divergence in the monetary policy stances among the AEs.

Major central banks' policy rates have remained at historic lows. But while the Fed has kept the phrase "considerable length of time" in its statement, it raised its expectations on the future path of the target rate (i.e., those infamous dots). It also reiterated its exit plan – stating that depending on data developments, it could raise its target rates sooner than earlier expected.

My sense is that the markets have taken these statements from the Fed to be of a relatively hawkish tone, and therefore USD supportive. Particularly so when the market would contrast these statements against:

1. the ECB action of offering liquidity directly to banks under its TLTRO (which, subsequently received only a weak take-up by banks), and,
2. the BOJ preparing for further QE.

This apparent divergence in the monetary policy postures among AEs is not necessarily a bad situation. It should give you in the market some comfort that global liquidity will not be drying up anytime soon. In the BSP, we refer to these as "countervailing forces".

But it should also give us cause to pause… as this sentiment could very well lead to the perpetuation of low volatility in the financial markets.

For while there is disparity in the expected directions of policy among the AEs, this disparity is transpiring at very, very low levels of interest rates.

With the forward guidance provided by the Fed, EU as well as Japan, helping to reduce some of the uncertainty about interest rate changes, the low volatility may actually lead to further investor complacency.

This leads to a Fourth Divergence.

The possible divergence in the "true state" of the global economy and the financial system against that which the low volatility in financial markets is portraying.

Those of you have been "around the block" a few times and (I see a number of you in the front row!)… You have witnessed that serious episodes of market stress are often preceded by unusually low volatility, which oftentimes signal the gradual build-up in risk-taking.

What then does this current global backdrop of divergence mean for us? For our domestic markets?

Our monetary policy stance – the reasons behind

Our last policy action speaks to this issue.

Keenly aware of how our domestic market, i.e., your industry associations, is extremely reactive to US rate movements, the BSP acted "pre-emptively" against the expected rise in US interest rates.

Ladies and gentlemen, I have maintained for some time now that, early, measured action is superior to belated, large, discrete re-actions. The latter could create more volatility in the markets in general, and on your own P/L in particular.

Therefore, as we prepare for the eventual Fed "lift-off", you may wish to also consider making only gradual, non-chunky adjustments in your own portfolios.

Let me now spend just a few more minutes to speak about our current stance of monetary policy.

The BSP has done a number of things over the past few months. We have raised reserve requirements, hiked the SDA rate, the RRP rate and then, recently, both the SDA and the RRP rates together.

These we did in response to various factors to achieve the following results:

1. To rein in domestic liquidity growth. M3 growth is now down from above 30 percent to just above 18 percent in July this year. We expect M3 growth to continue on its deceleration path and reach more normal levels later this year.;

2. To help manage the financial stability risks of the over-all low interest rate environment. While we have not seen broad-based asset mis-valuations, the BSP remains cognizant that keeping rates low for too long could result in mis-appreciation of risks in certain segments of the market, including the real estate sector and the stock market as markets search for yield. So far, coupled with changes in reportorial requirements and macroprudential measures, the monetary policy actions appear to have achieved some success in moderating the buildup of "irrational exuberance" in certain market segments.;

3. To help steer inflation expectations.

Our most recent Business Expectations Survey showed that the number of those who expected inflation to go up in the current and next quarters has increased. In addition, our survey of private sector economists shows inflation forecasts that are precariously close to the upper end of our target range. This is particularly true of forecasts for 2015, for which the NG target is lower at 2–4 percent.

Further, our own forecasts are also now higher. We now see 2014 inflation to average 4.48 pct, up from previous 4.33 pct, and 2015 inflation to average 3.79 pct, up from previous 3.72 pct.

While most of the reasons cited for the heightened inflation expectations are due to supply side pressures, elevated expectations need to be addressed sooner rather than later. These could fuel second-round effects, which may be more difficult to arrest once they have set in; and

4. To reduce the possible financial stability impact of extended periods of negative real interest rates.

Right now because of excess liquidity in the system, the industry doesn't seem to mind much that real interest rates are negative. But ladies and gentlemen, when the tide turns, those projects that you may have "approved" based on a specific expected value may not provide you the "return" you anticipated. With this in mind, our policy actions have been aimed at helping you manage your own risk appetites.

Given all these fundamental reasons for the series of BSP actions so far, what can the market expect from the BSP going forward?

As I have always said, the BSP will remain watchful. We will keep our ears to the ground while we have our eyes on our price and financial stability mandate. And we will remain flexible to use all available tools in our now enhanced tool kit, including our strong external liquidity position.

Validating our position of strength

Indeed, in addition to:

(1) a disciplined monetary policy framework,

(2) a deep enhanced policy tool kit,

(3) a healthy level of gross international reserves, and

(4) ample monetary policy space

we have built other buffers that make us confident we would be able to withstand the impact of the "divergences" in the external environment that I had just outlined.

Of significance among these other buffers is our sound banking system.

We have had numerous occasions over the last few years to point to the strength of our banking industry.

Even before the sovereign attained investment grade, the Philippine banking system had already been cited for its resilience in the midst of global dislocations.

Total assets held by universal and commercial banks increased by a little over two trillion pesos from end-2012 to July 2014. This translates into an annualized double-digit growth rate of 16.9% over this 19-month period.

The same two trillion-peso increase can be seen in deposit liabilities, equivalent to an annualized growth of 23.1%. Asset-side accounts have also increased, with Loans growing at an annual rate of 14.3% and another 10.6% for Financial Assets.

What is most impressive is that universal and commercial banks have continuously strengthened their balance sheet for possible exigencies. The Capital Account of U/KBs has increased by around Php156 billion in the past 19 months, driven by improvements in Retained Earnings (Php94 billion) and Paid-In Capital (Php46 billion).

To top it all, our U/KBs appear to be purposely leaning on the side of caution. The account "Cash and Due From Banks" has significantly increased. Since end 2012, U/KBs have recorded an increase of Php867 billion or a staggering annualized growth of 37%.

Reforms: How strength can be further enhanced

As these numbers validate, there is definitely every reason to believe that we are in a position of strength and finding ways to sustain it.

This is a feather on our cap. But we also must be circumspect enough to accept that strength is neither absolute nor eternal. Financial markets continuously evolve and the same position of strength can be a marked weakness at another time and under different market circumstances.

This is why the BSP has made it clear that we support the principles underlying the espoused global reforms. We believe that there is reason to the global reforms. But we are open to both the timing and execution of the reform details.

Bank capital – the very core of banking supervision principles – must always have the capacity to absorb losses from risk taking behavior. These are no longer from your plain-vanilla credit, market and operational risks. Instead, we need to be more cognizant of such issues as liquidity pressures, excessive leverage, interconnectedness, and the bar of governance applicable to each entity with a public franchise to operate as a bank, including and especially for those which are deemed systemic by virtue of their operations, market reach and the unique products and services that they provide. These are all enshrined in the Basel 3 reform agenda.

And while we support the basic prudential intent of these reforms, we have also been very deliberate in our roll out of the reform components.

Within the ASEAN-5, we were the last to implement the capital reforms for Basel 3. To-date, we have issued exposure drafts for the treatment of counterparty credit risk, domestically-operating systemically important banks, the data aspect of OTC derivatives and of leverage. And while the exposure draft for liquidity risk has yet to be issued, this too has been simulated, much like our prior efforts on capital, D-SIBs and leverage.

Apart from the global reforms, we have quite a bit in the pipeline for things that we consider home-grown issues. It is a long wish list, and I shall not go through each of them here. I am fully aware that your industry associations are in constant conversation with the BSP on these topics through the BSPC.

For all these to "work", we need the plumbing. Just like in a house, the financial markets need to have efficient plumbing. This is why the BSP is currently reviewing, not just Philpass, but the whole financial market infrastructure as well. In market infrastructure, the BSP is a vested stakeholder – for whether it is wholesale or retail payments, securities transactions or the transfer of liquidity from one account to another, the backroom of our banks must ultimately meet at PhilPass to effect final and irrevocable settlement. For the BSP this goes well beyond the issue of efficiency. For us, it is about ensuring the flow of financial transactions through the appropriate management of liquidity across financial institutions and for the system as a whole.

Do we really need all these now?

Ladies and gentlemen, I just went through 5 compacted slides of reforms... There is much that is already on the table as far as change is concerned. And the honest truth is that the market should expect more. We have been asked quite often: Do we really have to do all these now?

In response, I ask those who can remember what it was a decade and a half ago.

I believe quite a few of those on the presidential table were already here then!

A few years removed from the immediate impact of the Asian Financial Crisis, the Philippines was strong enough to be as devastated as some jurisdictions around us but not strong enough to be deemed resilient. Before then was the so-called Tequila crisis and the Philippines figured in several publications as among the "most likely jurisdiction" to fall next.

During those years, changes were also introduced. Back then, the question was also raised: Do we have to do these reforms now?

The point of the matter is that reforms are inconvenient because they introduce change and change needs to be managed. The strength that we see around us in the industry is the by-product of calibrated change. And as the Central Monetary Authority, we have every intention to continue enabling the operating environment within the context of a pro-active culture of risk management and financial governance.

The point, ladies and gentlemen, of all these is that the "position of strength" that we so cherish today is the result of reforms. This is the reward for introducing the facets of change that we needed, even when it was unpopular to do so.

But in the end, it cannot be just the standards that have made a difference. Instead, we do recognize that the market has – to a large extent although not absolutely always – conducted itself in a prudent and professional manner.

It is this combination of prudential governance and market conduct that has gotten us this far. As a community, we clearly value it. It is to our best interest to sustain and also find ways to enhance it.

Final thoughts

At the beginning of my remarks, I said I had TWO words… I have only given you one – DIVERGENCE. Let me conclude with the second word – CONVERGENCE.

In this divergent world, where each is driven by his own bottom line considerations, we come to realize that there is no exercise that does not leave us short of breath. Whether it is a pro-active effort or an intervention to address parochial concern, the intention to make us better requires deliberate effort. There is no short cut to this and there cannot be easy wins if it is longer term competitiveness that is our objective.

Strength is achieved, not granted. Reforms are consciously laid out, not wantonly enforced.

Our efforts therefore need to CONVERGE towards purposeful reforms. If we value what we see around us in the industry today, let us actively find ways to improve ourselves and our operating environment. We are all vested parties and the future is a collective interest.

This is the message I would like to share with all of you today. Be part of the pro-active change. Reforms are never convenient. But, with the right mix, they make us better.

Indeed, we must find convergence in this divergent world we operate in.