Amando M Tetangco, Jr: Progress and challenges in the Philippine financial system

Speech by Mr Amando M Tetangco, Jr, Governor of Bangko Sentral ng Pilipinas (BSP, the central bank of the Philippines), at the General Membership Luncheon Meeting of the American Chamber of Commerce of the Philippines, Manila, 3 June 2015.

* * *

It's a pleasure to address the Chamber during your General Membership Meeting, at a time such as this, when we are seeing US economic growth continuing to gain traction, US labor conditions improving and the USD sustaining its appreciating trend. Even in Europe, there is emerging optimism that economic conditions are beginning to show improvement. Will all these developments, there is indeed much to discuss regarding the implications of recent events for the Philippines.

I've been requested to share with you my thoughts on the progress and challenges in the Philippine Financial System.

Let me start by saying macroeconomic stability hinges on the strength of the financial system. This is for certain. You cannot have a strong macroeconomy when your financial system is in disarray. In the most basic of modern economics, the financial sector is the life-force of any economy. It allocates resources to productive sectors and in the process, promotes investment and job creation. In the advent of increased cross-border transactions and heightened interconnectedness of economies, however, this very same financial system which enables economic growth could also be the channel for transmitting vulnerabilities. Financial systems have become a way by which contagion is amplified. Indeed, this feedback loop relationship has never been more evident than during the Global Financial Crisis and its aftermath.

As we all know, the Philippine economy survived the GFC relatively unscathed. That, in large part, was due to our sound and stable financial system. Seven years since the GFC, the Philippine banking system continues to stand strong. And, since 2012, the Philippines has been the only jurisdiction whose banking system has been given a positive rating outlook by Moody's Investor Ratings Services. In fact, the only one from among the 69 jurisdictions it rated in 2014.

The metrics that describe the banking system which are shown in this slide are among those often cited by credit rating agencies – steady growth of resources, healthy balance sheets with NPL ratios for U/KBs down to under 2 percent, capital at 16.2 percent that more than meets the national requirements of 10 percent and is more than 2x the Basel standard of 8 percent, and healthy increase in loans going to the key productive sectors which stands at around 15 percent. Our survey of Senior Loan Officers has consistently indicated also that the lending standards of banks have not been weakened by the global trend toward "search for yield."

Friends, this position of strength which we now enjoy did not materialize overnight. It is the product of a firm commitment to progressive structural reforms that include the institutionalization of risk-based banking supervision, the calibrated adoption of global reforms, the raising of the standards for disclosure, risk management and governance of banks especially with respect to the expectation for the banks' boards of directors. At the same time, we are also fully aware that this strength is not absolute nor is it permanent. Therefore we continue to be watchful and anticipate changes that are likely to occur moving forward.

With this in mind, I'd like to spend the next few minutes to look at three key risk factors that could challenge our position of relative strength: 1) divergent monetary policy in advanced economies, 2) weaker growth prospects in Asia, and 3) volatility in oil prices.

First risk is the market interpretation of the Fed's actions. Of course the Fed's action is important. But often, it is the knee-jerk reaction by the market that complicates matters. The US Federal Reserve will raise interest rates. The market, analysts and other policy makers are in agreement on this. However, as markets vacillate between 1) complacency as data releases are mixed, raising the specter that the Fed might hold off raising rates and 2) "waiting-game fatigue" as the market sees the Fed shifting from forward guidance towards greater flexibility and data dependence. This could trigger higher market volatility, raising the risk of disorderly adjustments, and the possibility of a sudden liquidity squeeze wherein markets retreat during the transition period.

Our experience from the taper tantrum episode of May 2013 was that fickle funds can quickly retreat away from EMEs (including the Philippines) with even the slightest hint of Fed tightening. The QE by the European Central Bank (ECB) and the Bank of Japan (BOJ) could somehow mitigate the resulting tight conditions. Nevertheless, these liquidity infusions from the other AE central bank are not expected to fully offset the impact of Fed tightening, given the dominant share of USD in trade and external debt financing, and the soft pegs of many EM currencies to the USD. As portfolios rebalance, EMEs, including the Philippines, can experience capital flow reversals, strong currency depreciation pressures, and a shake in market confidence. This is the first major risk our financial system faces.

Second, the possibility of getting stuck in what the IMF calls the "New Mediocre" referring to economic growth. As China has become central in Asian trade, any significant slow down in the Chinese economy would cast a cloud on its trading partners' growth. China's economic slowdown could have a knock-on impact on Asia (including the Philippines) through trade, investment and financial linkages with the region. Although the People's Bank of China (PBOC) has announced a series of easing measures, financial conditions in China appear to remain fairly tight due to the effects of reforms on credit growth.

Third, the uncertainty in the path of oil prices. Lower oil prices have provided a boost to Asia's overall growth (including that of the Philippines') because most countries in the region are net oil importers. But a prolonged period of cheap oil combined with an already low global inflation environment begets expectations of increased deflationary risk. Such a scenario could render global economic recovery difficult. On the other hand, there is also the risk that oil prices could reverse in the same speed at which they fell. If the reversal is rapid, that could dislodge inflationary expectations.

Like most economies in Asia, the Philippines is in a good position to withstand these risks, particularly, should the market respond by way of capital outflows.

Our mantra in the BSP, particularly since the GFC, has been to "keep our own house in order". To operationalize this, we have kept our ears close to the external world, and our eyes on our primary mandate. In other words, we are mindful of what is happening in our neighborhood, but at the same time vigilant to watch out for stresses within.

Our improved fundamentals and ongoing reform efforts have anchored investor confidence, and helped us achieve investment grade status. As you can see from the slide, we have been able to manage our external liquidity position. We've been running current account surpluses for over 10 years now. We have FX reserves that are ample by traditional yardsticks. And short-term external debt-to-foreign reserve ratios have remained healthy in recent years.

All that said, you may be asking yourself, what can go wrong? Friends, the Philippines has come a long way and we want to go farther, higher. We want to be a stronger, more inclusive economy. Surely, the report on the 5.2 percent Q1 GDP growth came as a surprise to many of us here – is this cause for worry? I would tend to agree with what Sec. Balisacan said that it's too early to abandon our 7–8 percent growth target. After all this is just one data point.

From the side of the BSP, we see that with sufficient liquidity, and as domestic credit remains healthy, there are developments that should boost economic performance going forward. For instance, spending for the forthcoming election should boost growth. The government initiatives to mitigate El Niño can push agriculture, FDI inflow associated with liberalized entry of foreign banks and their corporate investors should boost manufacturing, construction. The government has also vowed to utilize the fiscal space that is available to it and ramp up investments in infrastructure. And on the demand side, sustained growth in remittances should support domestic consumption.

Let's not forget that despite this surprise to the downside, the reality is, the economy continues on a sound growth path and we remain one of the faster growing jurisdictions in Asia. What is even more noteworthy is that this growth has been happening in a low inflation environment. A positive convergence indeed. This slide shows that in the last 6 years, the BSP has been able to keep average inflation within the government's target range. This year, we are again looking at within-target inflation. With inflation expectations well-anchored, and the risks to this forecast broadly balanced, we foresee average inflation at lower than the midpoint of our target range of 2–4 percent.

What more can the Chamber expect the BSP to do to lessen our vulnerability and ensure that we are on a higher growth trajectory?

The BSP will continue to utilize the tools in its expanded toolkit and sharpen its surveillance capacity. Over the course of the crisis, we learned that relying on the interest rate instrument alone could lead to perverse results and unintended consequences. For example, keeping rates low for too long could lead to excesses in certain segments of the market. While, we will make sure policy rate settings are pre-emptive and calibrated, we will also continue to use the full range of macroprudential measures available to us to enhance the economy's resilience against systemic shocks and deter the build-up of aggregate risks.

At the moment, our assessment is that there is no compelling reason to shift the stance of monetary policy, with growth still on a positive path and inflation expectations well anchored.

The BSP will continue to be reform-minded, adopting global standards as appropriate to the unique domestic conditions and pushing forward with the capital market reforms that are already in the pipeline.

The BSP will vigorously leverage off technology to improve the reach of our financial services, strengthen consumer protection and deepen financial education. After all they say, "technology is the great equalizer". Next month, we will launch the National Strategy for Financial Inclusion, which is envisioned to be a platform for inter-agency collaborative work between the public and the private sectors to achieve a truly inclusive eco-system. We are excited about this, and we hope that when we begin to invite the private sector to pledge its support, we would see the Chamber among those who would partner with us in this endeavor.

Ladies and gentlemen, I said earlier on that the financial sector provides the life-blood for economic growth. In reality, however, the sound/solid macroeconomic picture I presented also supports the development of the financial sector. Clearly, the causality is two-way.

I also said at the top of my remarks that the financial system has a double-edged role. The main challenge therefore that faces us right now is ensuring that the wheels of the Philippine financial system continue to run smoothly and that the economy stays in the course of healthy expansion.

Key to this is striking a balance between encouraging financial innovation, which is critical for economic advancement, and curtailing excessive financial risk-taking. There are no rule books for this, however, for this is both an art and a science.

The BSP has laid down some of the groundwork in this area through years of pursuing relevant reform initiatives. But despite the gains achieved thus far, there is always room for more and better things to do to ensure that the domestic financial system remains responsive to an ever-evolving financial landscape. It is our hope that in this effort of building a more inclusive and stable economy, we could continue to look to the strong support of the AMCHAM.

Thank you for your attention and good afternoon.