Amando M Tetangco, Jr: Sustaining the country's economic gains through monetary stability

Remarks by Mr Amando M Tetangco, Jr, Governor of the Central Bank of the Philippines (Bangko Sentral ng Pilipinas), at the ACI Phils-IHAP-Mart-TOAP Joint Gen. Assembly, Manila, 9 October 2007.

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I. Introduction

Distinguished officers and members of The Financial Markets Association (ACI Phils), Investment Houses Association of the Philippines (IHAP), Money Market Association of the Philippines (MART), and the Trust Officers Association of the Philippines (TOAP), Colleagues from the Bangko Sentral, friends from media, ladies and gentlemen, good evening.

I thank ACI, IHAP, MART and TOAP for this invitation to speak at your joint general membership meeting on the topic "Sustaining the Country's Economic Gains through Monetary Stability". Its an interesting topic as it suggests movement, evokes a sense of continuous motion in the right direction. Indeed, the economy has chalked up impressive gains this year and the Philippines is experiencing its most stable macroeconomic environment in a decade.

II. Current state of economic gains

Let me begin by having a few cracks at describing the headway that has been made in consolidating macroeconomic gains this year.

- The economy has been expanding quite briskly. In the second quarter of 2007, GDP expanded by a faster-than-expected rate of 7.5 percent, outperforming the 5.5 percent growth achieved in the same quarter in 2006 and bringing the first semester 2007 growth to 7.3 percent.
- This strong growth has been achieved against a generally benign inflation environment. The headline inflation rate was 2.7 percent in September, bringing the average inflation rate for the first nine months to 2.6 percent, lower compared to the 6.8 percent recorded during the same period last year.
- Lower inflation meantime has allowed interest rates to decline. The average 91-day T-bill rate was at 3.3 percent in September, lower by 2 percentage points compared to its year-ago figure.
- The NPL ratio of U/KBs at 5.18 percent (July 2007) has been in single-digit territory since June 2005 and is close to the pre-1997 crisis level of 4 percent. (For banks, the latest NPL ratio for July was at 5.6 percent.)

Essentially, I'd say, so far, so good.

Which brings to my mind Newton's First Law of Motion: Does anyone recall?

> *Every object in a state of uniform motion tends to remain in that state of motion unless an external force is applied to it.*

This is often termed simply the "Law of Inertia".

We are all hopeful that our macro fundamentals will continue to be in the same state. That is, that our fundamentals would remain sound, with all the indicators pointing in the right direction, and the economy experiencing steady growth.

But, many of you have been in the market long enough a quick sweep of the room tells me I am correct indeed, many of you have been around long enough to know that markets are never really at inertia for very long periods there are always agents who are constantly looking for opportunities, driven by what Adam Smith called “animal spirits” (although these days, the politically appropriate characterization for this is that “there is always an incentive to do better for oneself.”)

In addition, there have recently been events in the global arena which, as they continue to unfold, pose risks to any steady and uniform pace of economic growth and decelerating inflation which we may wish for or be envisioning.

Let me extend the analogy to Newton’s second law of motion, by suggesting that these global events could be the forces (F), which could alter the velocity of the moving object. Recall that Newton’s second law states that $F = ma$, where m is mass, and Force F and acceleration a are vectors that go in the same direction. By extension, we can say that any external force that is applied to a moving object could alter the latter’s direction to coincide with that of the force. In our analogy, this force could alter the path of an economic variable, such as inflation.

There are several of these recent global forces. Tonight, however, allow me briefly to talk only about two of these: 1. the increase in global liquidity, and 2. the changing nature of financial risk.

III. Increase in global liquidity

Over the last few years, a significant contributor to global growth has been the expansion in the real GDP of the Emerging Market Economies. The large surpluses generated by the phenomenal growth in emerging markets, particularly in Asia, have contributed to the rise in global liquidity. In Asia alone, foreign reserves excluding gold have risen from just over $680 billion at end 1997 to almost $3.4 trillion as of latest available 2007 data. Add to this, the dramatic increase in both trade and financial integration in the Asian region. Intra-regional trade in Asia has gone up from 43 percent in 1990 to over 55 percent in 2005. Together, these have facilitated cross border flows in the region.

At the same time, halfway around the globe, the Fed (and the other major economies) set out on an easing mode. This, coupled by greater global financial integration caused the movement of capital across borders, raising global liquidity.

Recently, moves of major central banks to help stabilize the markets during the height of the subprime mortgage problem in the US, have also served to further increase global liquidity. These official moves seem to have produced their intended effects by halting further sell-offs in the markets, which subsequently showed a recovery. At the same time, we also know that, what I sometimes refer to as “liquidity upon liquidity” or the rising wall of liquidity, may eventually find its way again into emerging economies as investors search for higher yields, causing the cycle to continue.

Further, we need to watch out for the scenario when this wall of liquidity would have risen to the point that it begins to negatively impact on inflation in the US and other countries. How the Fed and other major central banks would deal with that scenario; more precisely, the speed and extent of any change in their monetary policy stances, would definitely have an impact on liquidity and interest rates in the rest of the world.

A possible slowdown in the US would also affect global liquidity. On the one hand, a slowdown could trigger a further round of easing from the Fed, which could again raise liquidity. On the other hand, it could also cause a slump in demand for goods from this part of the world, depressing current account surpluses here. A study by the ADB, however, shows that the impact of a downturn or recession in the US is likely to be modest and short-lived. This is expected to trim growth in developing Asia by 1-2 percentage points. Nevertheless, economic policy makers have to closely monitor any potential impact of the financial turmoil on the growth of the real economy.

Given the Philippines' improved macro fundamentals, the upshot of the dramatic increase in global liquidity for our country has been a strong external position, which has allowed us to build up our international reserves to an all-time high of $30.7 billion as of end September and, consequently prepay over US$3 billion in debt in 2006 and the first half of 2007. This has also resulted in an appreciation of the peso, which in turn has helped to temper inflation. The challenge brought about by strong foreign exchange inflows, however, is the increase in domestic liquidity which, if unchecked, could undermine the inflation process including inflation expectations of agents.

Capital inflows are often seen as a "mixed blessing". Foreign direct investments provide an opportunity to boost long-term growth and portfolio flows may allow a global diversification of risk. Hot money flows, however, are prone to sudden reversals, especially in the short-term when the changing conditions of perceived risk reversal could outweigh the fundamentals of the recipient economy. Central banks of emerging economies, including the BSP, should therefore find the appropriate mix of measures to maximize the benefits and minimize the costs brought by these capital inflows.

IV. Changing nature of financial risk

Let me now go to the second "force" I wish to discuss. In this era of financial globalization, risks transcend national borders. The international rules of the game are changing. Financial innovation, for instance, has created credit risk transfer instruments that allow banks to offload credit risk without affecting their relationship with borrowers. Banks no longer have to keep in their books loans which they originated. These can now be offloaded to final investors, depending on investors' risk appetite. The complexity of some, if not many of these, new credit instruments, however, renders the assessment of their riskiness rather complicated. Blurred risk pricing, enveloped by complacency and topped by the need for greater and greater yield is the perfect combination for the cycle to feed on itself.

Clear examples are the financial products that evolved because of the growth of the subprime mortgage market in the US. As the issues surrounding the subprime market unraveled, and risk had to be repriced, aversion towards other higher-yielding and less transparent issues/credit increased. It is important to realize that just because banks and other financial agents are able to offload risk, doesn't mean that the overall risk in the market has diminished. The risk is just redistributed to those who are willing, and hopefully, equally able to take on such risk.

Market discipline becomes very important for the orderly unwind of not just a few of these structures and to avoid widespread contagion to other markets.

Effective risk management, therefore, now requires a better understanding of risks by the borrower and lender, the recipient and investor, as well as the supervisor.

V. BSP's policy responses

These global forces necessitate action from central banks. This leads me to Newton's third law of motion, which states that "For every action there is an equal and opposite reaction."

A. Monetary policy

For the Philippines, the first of the two forces I mentioned, i.e., increased global liquidity, poses a risk to BSP's inflation target.

If a force is threatening to alter the course of a variable under the BSP's control, in this case, inflation, it is incumbent upon the BSP to act in order to keep inflation in check and the public's inflation expectations well-anchored.

Let me briefly trace our monetary policy action during the course of this year, to see how we have responded to our assessment of the risk of global liquidity.

The period December 2006 to May 2007 was marked by six consecutive months of domestic liquidity growth of more than 20 percent y-o-y. Continued foreign exchange inflows from export receipts, foreign investments and OF remittances fanned the surge in domestic liquidity. Understanding that if unchecked domestic liquidity growth could stoke inflation, the BSP implemented additional liquidity management tools in May this year. These included the expansion of the coverage of entities that could access our SDA window. Indicators show that these tools are producing the desired effects as M3 growth has slowed down to below 20 percent in the last three months, with the latest figure at 14.9 percent as of August.

To improve the transparency of our monetary tools, the BSP implemented, in July, two complementary moves which effectively kept the monetary policy stance neutral. The tiering system on placements with the BSP was lifted and the BSP's key policy interest rates were adjusted to 6.0 percent for the overnight borrowing or reverse repurchase (RRP) rate and 8.0 percent for the overnight lending or repurchase (RP) rate.

Just last week, the Monetary Board decided to reduce key policy rates by 25 basis points effective October 5, 2007. With the risk coming from liquidity moderating, benign inflation readings over the policy horizon provided room for a reduction in policy rates. The continued appreciation of the peso, meanwhile, provides a buffer against rising global commodity prices, including food and oil.

The move can also be expected to help support domestic demand, increase lending to productive activities, and shield the economy from any potential slowdown in global output growth that could occur as a result of the correction in the global financial markets.

Earlier moves by the BSP were also geared toward coping with the surges in capital inflows as well as easing the pressure on the exchange rate. These included the liberalization of the foreign exchange regulations to allow the markets greater access to foreign exchange for outward investment and over-the-counter transactions.

B. Financial sector reform

With regards the second global force, that of the changes in the nature of financial risk, we believe that our suite of banking and financial sector reforms would equip the banking system to better appreciate, monitor and mitigate risks.

Among the most critical of these, are:

1. The continued drive towards speedy asset clean-up;
2. The implementation of the Basel II capital adequacy framework, with the steady enhancements from the standardized approach to the use of internal models;
3. The adoption of international accounting standards;
4. the enhancement of corporate governance structures, particularly in developing oversight capacity of the Board of Directors to promote proper risk management environment;
5. The enhancement of the transparency of the system through improved disclosure requirements;
6. The implementation of risk-based supervision and continuous capacity building.

We will also continue to support the development of the financial markets, including the derivatives market, and we will be unwavering in our push for legislative reforms, particularly the Credit Information System.

An important lesson that could be learned from recent crises, including the risk aversion that resulted from the subprime mortgage fall out in the US, is that in order to minimize contagion, transparency is a key principle. When markets become frantic and fear dominates, the absence of transparency could foster a herd behavior and could considerably magnify the initial impact of the disturbance.

VI. Conclusion

I have only briefly touched upon two of the risks that challenge the sustainability of our economic gains. To address these as well as the other challenges we face, the BSP's policy thrusts will remain as follows:

1. To nurture a resilient economy by ensuring this is anchored on sound macroeconomic fundamentals; in particular, we will stay focused on achieving our inflation target while maintaining a policy of flexible exchange rates;
2. To build a strong financial system that is flexible in the face of global competition and innovation; in particular, we will continue to ensure that the banking system is adequately capitalized, well-governed, profitable and efficiently managing its risks.

Let me end by answering the question, can the country's economic gains be sustained?

The answer is YES. Our macroeconomic fundamentals are sound. We have undertaken significant macroeconomic, fiscal, banking and financial sector reforms which make the economy more resilient to domestic and global uncertainties. We are mindful though that there are risks to this outlook. Thus, even as our assessments show that the risks are manageable and moderating, we continue to monitor these carefully.

Going forward, the challenge lies in continuing the reform process to sustain the growth momentum and improve the country's competitiveness.

I continue to look to all of you, our partners in this endeavor, for your support as we move this country forward.

Thank you very much.