Amando M Tetangco, Jr: Pushing ahead through headwinds

Speech by Mr Amando M Tetangco, Jr, Governor of the Central Bank of the Philippines (Bangko Sentral ng Pilipinas), at the regular membership meeting of the Rotary Club of Manila, Manila, 3 January 2008.

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Distinguished officers and members of the Rotary Club of Manila led by your President Benny Laguesma, my colleagues from the Bangko Sentral led by Monetary Board Member Raul Boncan, friends from the media, ladies and gentlemen, good afternoon.

Thank you for this opportunity to address your group on your first Membership Meeting in 2008. I know it is customary, having just moved into a new year, to begin a speech like this by looking back at the year past and taking stock of the positive outcomes that we had achieved. But for today's remarks, I thought I would begin by considering instead the year ahead and anticipating the challenges we face amidst the uncertainty in the global arena. I liken this beginning to how one would probably wish to commence a round of golf on a course one has never played before. (I hope you would pardon my reference to golf. But I know many here share my passion for the game.) "Know your course. What hazards are around the corner? At midday, in which direction does the wind blow? etc, etc. In other words, let's first consider the "lay of the land" ahead of us.

Then, after a quick review of these challenges, which I see to be manageable, let me put forward reasons why I believe the Philippine economy would be able to ride out the headwinds that threaten to confront us and the steps we have taken and intend to take toward this end.

Challenges

Since the third quarter of last year, a good deal of attention has been focused on the turmoil in the financial markets in the US and Europe and the sudden plunge in credit market confidence triggered by the US sub-prime mortgage crisis. Since then portions of the underlying forces at work have been revealed – the complex nature of derivatives used, the high degree of leveraging on poor (or even absent) collateral, the underestimation of risk that had been prevalent in the financial markets and the surprisingly sizeable exposures of large financial institutions to some of the debt instruments and derivatives in question such as CDOs. Much, however, still needs to be uncovered for the general public to appreciate the full import of these recent events.

What has been evident so far, however, is that this crisis has been more financial than macroeconomic in character and effect. Let me illustrate. In the US, despite all the concern with the subprime woes, the real GDP growth in 2007 looks to be 2.6%, the same as in 2006. In Asia (ex India and China), the region is expected to grow at 5.9 % in 2007 compared to 5.7% in 2006. And in the Philippines, as you know, we are expecting 2007 full year GDP growth to be around 7 percent, our highest rate in three decades. The financial impact of the crisis, on the other hand, has been increased volatilities in ALL the equity markets and spread widening ACROSS credit markets.

Nonetheless, more market analysts now believe that the risks are tilted to an outcome in 2008, particularly in the US, wherein the financial market volatilities would begin to more noticeably filter through to the non-financial portion and non-housing portion of the economy. As the real sector becomes affected, this is an event that could prove to be critical to the Asian growth story. The region has become less dependent on the US, but it is still not immune to a US slowdown. Clearly, intra-Asian trade has grown, but most of the growth in intra-Asian trade has been an increase in trade with China and India, a portion of whose imports from the region are also re-exported to the US.

The success of the US, and the other major economies, in avoiding a prolonged economic slowdown therefore becomes of particular importance to Asia. The concern goes beyond merely whether the major economies succeed in containing the slowdown, but also the speed and manner in which this is accomplished – whether this is done through market prices or through structural reforms. Which instruments are chosen could, in turn, impact whether there would be an orderly adjustment in capital flows and exchange rate movements as well as the behavior of asset and equity prices. As you must be aware, the region, including the Philippines, has been grappling with the impact on exchange and interest rates of the tipping of liquidity into our region. In the Philippines, the BSP had to put in place our own policy package (that includes the build up of reserves, prepayment of external debt and the liberalization of the foreign exchange system) to contain the impact on the peso of the strong foreign exchange inflows into the country.

A further challenge from the global front is the elevated price of oil and other non-oil commodities. Several market analysts share the belief that inflation this year would be higher than in 2007, primarily because of volatilities in global commodity prices due to supply constraints.

Impact on the Philippine economy

The unraveling of the impact of subprime on financial markets, the growing prospect for a slowdown in the US and other major economies, the uncertainty of how monetary authorities will react to arrest the economic slowdown, volatilities in oil and commodity prices. These are just a few of the potential challenges that could determine the complexion of macroeconomic policies in the Philippines this year. The manner by which we will calibrate our response to these challenges will define how much the economy will grow, how much we will be able to limit inflation and up to what extent we can maintain the stability of our financial markets. Are we up to these tasks? I certainly believe we are.

For two reasons. First, while the challenges appear staggering and mainly beyond our control, the Philippines is in the best macroeconomic shape it has been in two decades as a result of the significant structural and policy reforms undertaken over the recent years, making it more resilient in the face of global challenges.

Inflation has been on a trend decline, with average headline inflation for the first 11 months of 2007 at 2.7%, way below last year’s 6.2% as well as the target of 4-5%. The external position is in substantial surplus of around $8.5 billion, more than double last year’s level, due mainly from the continued strength of the current account. The GIR, at an all-time high of $32.7 billion, remains adequate and within internationally accepted benchmarks. The peso, supported by the strong external position, has been one of the top performing Asian currencies. The banking sector in the meantime continues to improve as evidenced by near pre-crisis NPL and NPA ratios, double-digit growth in assets and profitability, and capital adequacies way above the international standards, even after we implemented Basel II in July last year.

Economic outlook

Is the recent performance a short-term phenomenon? Is the country’s reduced vulnerability a passing episode? I don’t believe so. Our model on the Philippine business cycle shows that the downward phase of the country’s business cycle reached its turning point in the last quarter of 2006. Thus, we are now in the continuing upward phase of the business cycle, as validated by the strong growth of the economy posted in the first three quarters of 2007. Moving forward and barring any unforeseen risks, economic growth is expected to continue.

This will be driven by the combined acceleration of the industry and services sectors on the production side and consumption and investments, both private and government, on the expenditure side.

Average inflation was below the target of 4-5 percent in 2007, is projected to fall within the 4 percent ± 1 percentage point target for 2008 and within the 3.5 percent ± 1 percentage point target for 2009. This benign inflation outlook would in turn allow us to maintain an environment of low interest rates. The external payments position is seen to remain as a source of strength for the economy over the near term. Dollar inflows particularly from remittances and foreign investments are likely to remain robust. This should enable us to further build up our cushion of international reserves, and continue to provide support to the peso.

We also envision a more resilient and profitable banking system as banks improve their ability to anticipate and manage risks, perform their functions of intermediating funds to the broadest set of users, and providing alternative investment vehicles to savers.

Policy directions

This brings me to the second reason why I am convinced we are up to the task – Ladies and gentlemen, we are focused on our reform agenda. The BSP's main policy thrusts in 2008 will involve nurturing a resilient economy by ensuring that this is anchored on sound macroeconomic fundamentals and building a strong financial system that is flexible in the face of growing global integration and innovation.

Managing risks to inflation and inflation expectations will remain the key policy priority of the BSP. In this regard, the BSP will maintain an appropriately prudent monetary policy stance supportive of non-inflationary growth. This will require relentless environmental scanning, continuous surveillance of key macroeconomic variables and regular sharpening of our inflation forecasting models.

On the external front, our policies will be geared toward: (1) ensuring sustainability of the country's external debt, (2) maintaining a market-determined exchange rate, with scope for occasional official action in cases of sharp movements in the peso, and (3) maintaining a comfortable level of reserves as market opportunities will allow.

Reforms in the financial sector will be aimed at maintaining a strong banking system and a vibrant capital market, with the support of other government agencies and the private sector. This should help spur credit and investments, and contribute in providing the basis for a more sustainable economic activity in the medium term. I am confident that when the National Government goes full swing into the implementation of its "Ready to Go" infrastructure projects, the banks would be at the center of that endeavor.

We will also continue to push for the passage of key legislations intended to develop a deep and efficient capital market, including the Credit Information Systems Act. This will make credit more accessible to a broader set of users and ensure a more efficient mobilization of resources.

Ladies and gentlemen, the biggest challenge before us is to sustain the country's strong economic performance. And we will be able to do this by continuing to focus on our reform agenda, while at the same time ensuring that this agenda remains relevant in the face of the changing global landscape.

We are aware that headwinds from the uncertainties in how the global financial market volatilities would unravel still remain. To help contain these, the Monetary Board approved, just last month, two important reform packages. First, the second phase of reforms in the foreign exchange regulatory framework, aimed at promoting greater integration with international capital markets and enhancing risk diversification in support of an expanding economy with global linkages. The idea is to ensure that both corporates and individuals are given more latitude in accessing foreign exchange and expanding their portfolio of options. By making the FX environment more open, some of the pressure on the exchange rate could also be alleviated.

The other set of reforms approved by the Board covers the amendments to BSP regulations governing derivative activities of banks and trust entities, including the guidelines on risk management and sale and marketing of derivatives. The amendments seek to provide a framework whereby banks could expand opportunities for financial risk management and investment diversification through the prudent use of derivates. It would also help promote growth in the domestic capital market by expanding the range of available derivatives which a bank can originate, distribute or use, without need for prior BSP approval.

Both these reform packages are intended to help make the domestic market more able to quickly adapt to any further changes in the global financial markets.

Concluding remarks

In closing, our experience in the past year has demonstrated that sound monetary and fiscal policies, complemented by key structural reforms, have a salutary effect on the economy. Today, the Philippine economy stands on solid fundamentals that have been strengthened in recent years. These will serve us well in withstanding the "pockets of vulnerability" coming from the global financial markets.

The key challenge will be to lock in the recent gains while steering the economy in riding out the current uncertainties, and then moving on to a higher and more sustainable growth path. The commitment to fiscal prudence and appropriate monetary policies and the intention to tackle policy challenges boldly through purposeful reforms should ensure that this path is sustained. This we hope to eventually translate to a reduction in poverty and improvement in the living standards of our people.

I began these remarks by saying that a good strategy in playing a golf course for the first time is to know the "lay of the land". But information about it is not sufficient to ensure that you win the game. To secure victory, you must play well. Nay, you must play consistently and hopefully, better than others. All winners know that to have a consistently good golf swing, there are two important things to remember – 1. keep your eye on the ball, and, 2. follow through. Don't lose sight of your objective and make sure you execute a good follow through to deliver a successful outcome. Do this throughout the game and you could guaranty a victory (or at least a pleasing outcome).

2006 was a good year, 2007 was an even better year. What do we foresee in 2008? I predict that we will continue to push ahead, despite significant headwinds. We have shored up an ample buffer in terms of our sound macro fundamentals and stable banking system that we are now more resilient and able to meet challenges.

In the last few minutes, I hope I have been able to show you our roadmap for the new year and into the medium term. We hope to ride out this route together with you, confident that with solid economic fundamentals, we will prevail in our journey to a higher ground.

Thank you and good day.