Amando M Tetangco, Jr: On the road to sustaining economic stability and growth

Speech by Mr Amando M Tetangco, Jr, Governor of the Central Bank of the Philippines (Bangko Sentral ng Pilipinas), at the Management Association of the Philippines' Economic Briefing, Manila, 27 February 2008.

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MAP President Edgar Chua, MBC, other distinguished officers and members of the Management Association of the Philippines and the Makati Business Club, friends, ladies and gentlemen, good afternoon. It is a pleasure to join you on the occasion of the induction of MAP's new members and Joint Economic Briefing.

To the newly inducted members of MAP, congratulations! While you look forward to breaking new ground within this organization, the Philippine economy appears to be moving toward a more challenging environment – One, which on several occasions, I have characterized as fraught with headwinds. The rough patches that surfaced in the second half of last year, appear to have intensified.

You may have heard it asked: "Can the Philippines ride out these rough patches and push past the headwinds?" Our assessment at the BSP is that, NOW more than at any other time in at least a decade, the Philippine economy COULD. Quite a number of analysts, rating agencies, market players even Ciel himself (or shall I say, ALSO Ciel) agree with the BSP on this.

2007 was a remarkable year for the Philippines. Can we do a repeat? With the patchy road ahead, we may not see the same "highs" (and "lows"), but we certainly have built up "buffers" that would allow us to press on the road ahead of us.

Let me quickly run through some of the "patches" or challenges that I see ahead of us.

First, further turbulence in global financial markets. SUBPRIME. There is probably none here in this room who hasn't yet heard of the term. You were all witnesses to the volatilities it created in the second half of 2007. I won't go into the genesis of the problem, but clearly, what began as a home-grown housing mortgage market problem in the US has become a global problem and what was first manifested as difficulties in the financial market is starting to seep into the real economy. The coordinated credit operations by the major central banks and policy rate cuts have helped ease credit tensions, but wider problems in the financial system still persist.

At the heart of this problem is uncertainty. First, there is continued uncertainty about the size of losses from defaults on US subprime mortgages that the global financial system will eventually have to absorb. Second, there is uncertainty about where these exposures will end up. Third, this lack of information breeds fear of ratings downgrades, of steep sell-offs and of other unknown consequences.

In sum, the global financial turbulence stoked by the subprime mortgage problem in the US has intensified and is expected to be protracted.

While the Philippines has limited direct exposure to CDOs, none of which have subprime mortgages as underlying assets, we do not expect a significant direct impact on the local financial system. However, the ongoing global financial volatility could affect the market via a rise in risk aversion.

A general retreat from risks by global investors could affect the direction of capital flows.

The second challenge is the slowdown in the US economy.

The current tightening of credit conditions in the US due to risk reassessment in financial markets and the sharp decline in the US real estate market threaten to exert further downward pressure on investment, consumption, and, consequently, output growth.

Many economists have adjusted their US growth forecasts for 2008 downward. Some have made downward adjustments by as little as 0.4 percentage point or as much as 2.4 percentage points. What is unknown, really, is the length and depth of this slowdown. Some have characterized this is possibly SHORT and SHALLOW, others SHORT and SHARP.

Nonetheless, we continue to monitor developments in the global growth picture as the weakening of domestic demand in the US and other advanced economies could create significant spillovers into developing and emerging economies such as the Philippines.

There are at least two channels through which a sharper-than-expected slowdown in the US could directly affect the domestic economy.

One, through the trade channel.

The prospect of decoupling from the US is not clear cut. Even as our dependence on the US has diminished as shown by the drop in our direct exports to the US in recent years, and that trade with China, India and other emerging markets has increased, we must remember that portion of our increased exports to these new markets is really re-exported to the US. Thus, as economic activity slows in the US, our exports would possibly show a decline also.

One significant mitigant, however, is if, indeed, as expected by many analysts, the domestic demand in emerging markets holds up. This situation could result in the country maintaining or even increasing the level of our exports to these markets. Such could thus prop up the overall exports.

Remittances is a second important channel through which a slowdown in the US economy could impact on the domestic economy.

Latest data show that 1/3 of our land-based overseas Filipinos are in the US. The diversification in deployment in terms of destination and quality of skills could, however, temper any slowdown in remittances.

Let me now turn to the third major risk that we face: the rise in global food and energy prices.

Food prices have gone up as a result of strong demand from China, India, and other emerging market economies that are experiencing rising incomes. Poor harvests due to adverse weather conditions and increased biofuel production have also ratcheted demand for certain related food items.

Furthermore, just recently we saw oil price breach the $100-a-barrel level. Geopolitical tensions in the Middle East, refinery bottlenecks, speculative activity, the weak US dollar, and the continued strong demand for crude oil all exerted an upward pressure on global oil prices.

However, as global growth slows, we may see commodity price volatilities abate in the second half of the year.

With these risks that I have just described being primarily global and largely not directly within our control, why do we believe that the Philippine economy will be able to ride out these patches?

The short answer is we have built up domestic buffers.

What are these?

One, we have built up buffers in our domestic financial system.

The Philippine banking system’s asset base has grown steadily over the last 6-7 years.

The overall asset quality of banks continued to improve as well, with the NPL ratio now moving closer to the pre-crisis level of around 4 percent.

Banks' overall capital adequacy ratio was also maintained well above regulatory and international standards, shored up by the increased issuance of hybrid financial instruments to strengthen their capital base.

Last year, we rolled out two reform packages aimed at improving the system's ability to manage risks and competitiveness in a more globally integrated market environment – here I refer to the further liberalization of our FX market and the new derivatives circular.

Amid the heightened risks in the global financial markets last year, the banking sector has showed resilience.

Two, the fiscal picture has improved considerably.

The National Government posted a P9.4 billion budget deficit in 2007 equivalent to less than 1 percent of GDP, its lowest in ten years. Moreover, for the first time in more than a decade, the consolidated public sector financial position registered a surplus in 2006. This has continued on in the first three quarters of 2007 with the surplus reaching P52.7 billion.

Gains brought about by the government's fiscal consolidation efforts were also evident in the material reduction in the public debt burden.

Three, our external position is strong, making us less vulnerable to external shocks.

The country's balance of payments posted a record surplus of US$8.6 billion in 2007, buoyed by strong inflows of overseas remittances, higher net services receipts, and direct and portfolio investments.

This has allowed us to build up the country's gross international reserves to record highs. Consequently, we were able to prepay external debt. In fact, in the BSP, we have prepaid all that we could. The NG, other GOCCs and the private sector have all taken advantage of our strong BOP and prepaid external debt.

Thus, the country's external debt and debt service burden have also gone down.

At the same time, the steady inflow of foreign exchange has kept the peso firm, broadly maintaining its competitiveness in real effective terms over this period, and providing a mitigating effect on inflation.

Finally, the sturdier policy framework and broad-based structural reform that we have put in place, have helped promote a more coordinated and productive economic environment.

This is evidenced by the economy achieving in 2007 the highest GDP growth rate in 31 years of 7.3 percent against a backdrop of low and stable inflation. The 2007 full year average inflation of 2.8 percent was the lowest in 21 years.

This combination has allowed market interest rates to generally trend downward.

Those, in brief, ladies and gentlemen, are our buffers. How can we further build these to ensure that we can ride out any unforeseen bumps in the road?

Well, my friends, like any good driver, we must keep our eyes on the road and follow the map that we have set out on.

This brings me to the BSP's policy thrust for 2008.

The BSP's monetary policy thrust will involve a balancing act between managing the risks to inflation and inflation expectations, and seeing to it that the economy's growth momentum continues over the policy horizon. We will continue to focus on our core mandate of promoting price stability. This will require intensified environmental scanning and continuous surveillance of key macroeconomic developments, particularly those that indicate emerging risks to the inflation outlook.

Relative the external sector, our policies will be geared toward: ensuring the sustainability of the country's external debt; maintaining a market-determined exchange rate, with scope for occasional action to keep orderly market conditions; and 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. Specifically, we will focus on: further enhancing the regulatory framework through the implementation of the BASEL II roadmap; improving corporate governance by promoting compliance with international accounting and financial reporting standards; accelerating the implementation of risk-based supervision technology; and continuing support for the development of a deep and efficient capital market, including by supporting necessary legislative reforms.

In sum, we will continue to be focused on our primary mandate. "More of the same" is what you may have heard me say before. More of these which have served us well in the past.

On the basis of these policy directions, the outlook for the macroeconomy continues to be favorable.

Although we are seeing a hump-shaped inflation path in the first half of 2008, whereby monthly inflation rates are expected to rise to around the top end of the target range, we forecast full year average inflation to be within target in both 2008 and 2009. The volatility in world oil prices and uptrend in non-commodity prices remain the key risks to the inflation outlook. Nevertheless, the emerging scenario is for commodity prices to taper towards the end of this year. This within-target outlook will allow us to maintain a low interest rate environment.

We expect the BOP to continue to be in surplus, although at a level that is smaller compared to the previous year. The liquidity impact of the external surplus will have to be managed such that the amount of money in the system remains consistent with the inflation objective.

Ladies and gentlemen, the Philippine economy has travelled a remarkable distance in recent years. Responsible economic policies and purposeful reforms have resulted in significant economic dividends for the country.

But equally significant patches are now threatening the sustainability of the gains we have achieved thus far.

Yes, we have built up "buffers", but we cannot afford to be complacent. Much is yet to be known about the size and depth of the patches that lie on the road ahead.

The critical task for us now is to preserve the momentum for economic reforms so as to ensure sustained growth in the long run. Just as important to sustaining growth is delivering growth that casts a wider net.

These require focus as well as commitment. To this end, it is my hope that the MAP and MBC community will continue to be our partner in the thrusts and the reform agenda that I had outlined. I look forward to your support as together we tread the road to sustained economic growth.

Thank you and good day to all!