Amando M Tetangco, Jr: Overview of the Philippine economy against the background of a difficult global environment

Remarks by Mr Amando M Tetangco, Jr, Governor of the Central Bank of the Philippines (Bangko Sentral ng Pilipinas), at the Foreign Correspondents Association of the Philippines (FOCAP), Manila, 23 July 2008.

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Ladies and gentlemen of the Foreign Correspondents Association of the Philippines, special guests, good morning. Thank you for inviting me again to speak before you today.

The last time I was here in February, I discussed with you the challenges that the Philippine economy would be facing this year. These challenges include the US economic slowdown, the global financial market turbulence and the rising and volatile prices of oil and other commodities. Since we are now in the middle of the year, allow me to provide you with an update of how the economy is doing in the midst of an admittedly more difficult global environment.

Indeed the economic environment has turned more challenging for reasons that are well-known. Global growth has decelerated as a result of a weak US economy, the credit crunch, and the high and unstable oil and food prices. Official statistics on 1st quarter GDP of the US showed a 1 percent expansion, higher than previously expected but still below par.

Meanwhile, the strains in global financial markets have persisted and are likely to continue for some time. The coordinated credit operations by the major central banks and the policy rate cuts by the US have helped ease market tensions, but wider problems in the financial system have remained. This makes the operating environment difficult.

The main 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.

The biggest and most immediate challenge is the sharp spike in global oil and food prices. World oil prices continue to be volatile at elevated levels. Global food prices remain high though the increases have moderated. These concurrent and interrelated shocks to the economy have contributed to the acceleration of domestic inflation.

As a result, as with most – if not all – countries, the domestic inflation environment has become more challenging. In June 2008, inflation stood at 11.4 percent compared to 2.3 percent in the same period last year, bringing the average inflation for the first six months of 2008 to 7.6 percent. Of late, we have started to see stronger signs of second-round effects, with core inflation rising and inflation expectations trending upwards.

To prevent these inflation pressures from further feeding into the price- and wage-setting behavior of economic agents, we raised our policy rates by 25 basis points on 5 June and 50 basis points on 17 July. In both instances, the BSP's baseline inflation forecasts showed more elevated inflation numbers for 2008 and 2009. Sustained high inflation can unseat inflation expectations and potentially create a repeating cycle of lingering inflation and wage pressures that could prove costly to the economy. In response, we believe that the series of policy adjustments will help in steering inflation towards its desired path for the medium term.

It is important to note that the challenges facing us are largely external in origin. A key issue therefore is the Philippines' ability to weather these shocks. On the upside, the country was able to build up cushions that serve as sources of resilience for the economy against potential shocks. Let me cite some of these buffers and how exactly these have insulated the economy from external risks.

First, the Philippine economy continued to grow notwithstanding the tougher operating environment. In the first quarter of 2008, GDP grew by 5.2 percent, led by the strong performance of services on the production side, and by consumption spending, on the expenditure side. The strong growth of net factor income from abroad (NFIA) pushed GNP to grow by 7.3 percent. There is resilience here because growth is broad-based and notwithstanding the difficult times, the magnitude of growth is quite respectable.

Second, the banking sector has become stronger as a result of the reform measures that have been implemented over the past years. There is resilience here because our major financial intermediaries have remained strong enough to continue channeling savings into investment, and therefore supporting production and more sustainable employment.

The Philippine banking system's asset base has grown steadily. 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. With healthier balance sheets, banks have been able to post a steady growth in lending.

The banking system's overall capital adequacy ratio remained strong, shored up by the increased issuance of hybrid financial instruments to bolster their capital base. The average CAR of the banking system was maintained well above regulatory and international standards despite some decline caused by the new requirements of the revised capital framework which is patterned after the Basel 2 Accord. The revised framework is considered a more risk-sensitive measure of a bank's solvency position.

However, we continue to closely monitor developments, particularly on the spillover effects from the slowdown in the US and the global economy as well as higher risk aversion brought about by the financial market turmoil in the West. These could pose downside risks to output growth that could impact negatively on the banking system's growth.

Lastly, the country's external payments profile remains a major source of strength for the economy. For the first six months of 2008, the BOP surplus has been sustained at US$1.9 billion. There is resilience here because the existence of a BOP surplus provides space to accommodate the volatilities of both the export and investment markets.

We acknowledge that there are risks given the increase in the trade deficit but remittances and income receipts from services coming from a vibrant BPO industry should provide the needed support. For the first quarter of 2008, the current account remained in surplus of about 3 percent of GDP despite a wider merchandise trade deficit due to higher oil and food costs. The stability of the current account is due to the sustained expansion in remittances. Latest data show remittances for Jan-May 2008 totaled US$6.8 billion, growing year-on-year by 14.7 percent from the comparable period a year ago.

As a result of the BOP surplus, our gross international reserves (GIR) increased further to US$36.7 billion as of end-June 2008. At this level, the GIR is equivalent to 6.0 months' worth of import cover and 2.9 times short-term external debt based on residual maturity.

The external debt ratio has also improved. With the build-up in the GIR, the BSP, together with the National Government as well as private corporations, were able to prepay some obligations. This has led to the appreciable decline in the country's total external debt to 35.5 percent of GDP as of end-March 2008 from 72.9 percent in 2001.

What is the outlook in the near-term?

Reflecting the impact of the slowdown in the US economy and the higher oil and food prices, economic targets have been revised. The government now projects GDP to grow by 5.7-6.6 percent while the forecast for inflation is at 9-11 percent. The BOP surplus will reach US$2.5 billion. Exports are seen to grow by 5 percent while imports will expand by 10 percent due to higher prices of oil and food imports.

What can you expect in terms of the BSP's policy thrusts?

The policy thrust of the BSP is aimed at ensuring that the headway that we have achieved in nurturing a resilient economy and a strong banking sector will continue.

The BSP's key monetary policy thrust will remain focused on promoting price stability. In its latest policy move, the BSP recognized the need for a more decisive monetary action to reduce the risks to inflation expectations and the long-term cost to output growth from prolonged high inflation. So our eye is on inflation because price stability is critical to sustained, durable economic growth.

In the external sector, our policies will continue to be directed at maintaining a market-determined exchange rate with scope for occasional official action to address sharp volatilities in the exchange rate; maintaining a comfortable level of reserves as self-insurance; and ensuring the sustainability of our external debt.

In the financial sector, we remain firmly committed to institute key reforms that will lead to greater efficiency, effective risk management, stronger capital base and improved corporate governance standards in the banking system. Given these reforms, we expect to see the continued expansion of bank resources and capital, as well as a further improvement in bank asset quality. We also envision a stronger and more resilient banking system as banks improve their ability to anticipate, price and manage risks.

We will also continue to push for the passage of key legislations intended to develop a deep and efficient capital market as a complementary source of funds. This will make credit more accessible to a broader set of users and ensure a more efficient mobilization of resources.

In summary, the BSP is prepared to take all necessary actions to address the threat of high inflation and promote price stability. We also continue to be mindful of the impact of any policy action on the economy's growth momentum. The resiliency of our economy allows us to have greater flexibility in responding to the challenges that come our way.

I am now ready to discuss the issues of particular interest to you. Thank you.