Amando M Tetangco, Jr: The Philippine economy – building resilience in a time of uncertainty

Remarks by Mr Amando M Tetangco, Jr, Governor of the Central Bank of the Philippines (Bangko Sentral ng Pilipinas), at the Consular Corps of the Philippines' Monthly General Luncheon Meeting, Makati City, 29 October 2008.

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Minister and Consul General Sobashima, Acting Dean of the Consular Corps of the Philippines, honorable consuls-general, officers and staff of the Philippine Consular Corps, ladies and gentlemen, good afternoon.

It is a pleasure to finally address the diplomatic community. Your organizers would recall that we have been trying to get our schedules "together" since January this year.

In fact, we were first set to meet in February, but something came up on my side. Then in August, but something came up on your end. Then, today. (I suppose the "stars" have all finally aligned today, so to speak, so here we are.)

What's interesting is during all this time, the markets have moved quite significantly.

Consider the table shown. I've compared some important financial indicators for Feb 27, Aug 27 – the two previously scheduled dates – and yesterday.

You will note that all of these have turned "south" as they say. But more dramatically so in the last two months.

The peso dollar exchange rate has moved from P40.33 to P45.73. Yesterday it was quoted at P49.105. At close of morning trade today, the peso stood at P49.14.

The 5-year credit default swap spread, which is a measure of the market's perception of the country's credit worthiness, has more than doubled from 248 to 660 bps. The same can be observed on the spread over the ROP30, which moved from 260 to 649 bps.

The PSEi, on the other hand, lost close to half its value from 3,105 in February to 1,704 pts at yesterday's close.

The regional financial markets followed the same trends – regional currencies weakened, credit spreads widened, and stock markets declined.

Before any, or all of you cry "the sky is falling" – like the little chicken in that children's fable who got hit on the head by a falling acorn, – let me share with you some good news:

- Even as the numbers I showed you earlier appear to have "run away" or fallen sharply, there has been some reprieve in them. In other words, what we are experiencing is not a "free fall", rather there has been some "traction" in the markets lately.
- Our macroeconomy has remained fairly resilient and stable, owing to the buffers we have built up over the past years.
- Our banking system continues to be sound, despite some contagion – as reflected in the deterioration of the financial indicators since the beginning of the year.
- Our policy structure has so far been flexible. We have instituted significant reforms in the past, and we continue to fine-tune our policy tool kit to ensure our policies are responsive, targeted and therefore effective during these difficult times.

So, hold that urge to cry "the sky is falling" lest you meet the same fate as that chicken, who got fooled and eaten by the wily fox.

My presentation will be of four parts.

I will begin with a brief discussion of recent events in global financial markets.

I will then focus the major part of my discussion in assessing the Philippine economy's resilience in the face of what the former Fed Chairman Alan Greenspan calls the "credit tsunami". In particular, I will discuss how these external developments impact on the Philippine economy, why I believe the Philippines is well-positioned to withstand the crisis and what the Bangko Sentral's policy responses are to bolster the economy's foundations in the face of the enormous strains in the global financial markets.

I. Recent developments in the global financial market

I will no longer go into the genesis of the financial turmoil, as I am sure you have already heard a number of expositions on that.

But I think it is important to highlight that this crisis has evolved and continues to do so in its FORM.

It began as a liquidity seizure in the financial markets when the credit boom came to an end after the subprime mortgage collapse, leaving US investment banks heavily strapped for cash.

Then moved on to be more of a solvency crisis, when we began to see the rapid turnover of marquee names in the global financial stage.

Then a confidence crisis. Increasingly, investors and creditors are losing confidence in the ability of certain firms to meet their obligations leading to a general distrust in the global financial markets.

The financial market turmoil has further changed its FACE.

It has moved from its epicenter in the financial markets in the US and has begun to affect the US real economy.

Its impact has also now crossed to the financial centers in Europe, as well as the European real economy.

Now we are seeing it impact the Emerging Markets. So far, the effect on emerging markets has mostly been on the financial sector, and generally indirect through risk aversion.

Indeed, the financial market turmoil has changed into a wider-spread contagion.

Nonetheless, the three-pronged approach of the US and European governments aimed at: (1) repairing damaged financial systems through capital infusion; (2) providing a liquidity lifeline; and (3) enhancing deposit insurance, appears to have some effect in terms of shoring up confidence.

This has been evident in the recent improvements in the LIBOR-OIS and TED spreads. The LIBOR-OIS and TED spreads are viewed as an indirect measure of funds availability in the market. A decrease in spreads typically signals an increased willingness to lend.

A similar slowdown in the widening of CDS spreads in Asia has recently occurred as certain regional central banks also lowered policy rates and injected liquidity to their markets through repurchase facilities.

These are "tractions" that we are seeing in the markets. I believe these will eventually constrain markets from doing a "free-fall".

Pockets of the financial markets are slowly adjusting, perhaps in confident response to the recent display of concerted, collaborative and cooperative action from officials of both the major and emerging economies.

If these tractions continue and broaden in scope, we may begin to see a further unfreezing of credit and a muting of the negative feedback from the financial turmoil to the real economy.

Having said that, however, much depends on whether the slowdown in the US and other major economies would be shorter or shallower than first expected..

II. Impact on the Philippines

How do all of these developments impact on the Philippine economy?

The Philippine financial markets have not been spared from the ripple effect of the worsening global financial strains.

As I noted in my introduction, the peso has weakened, credit spreads have widened and the stock market has fallen, like in the other countries.

What concerns us now is that a negative feedback loop from the financial markets to the real economy cannot be fully discounted.

In the Philippines, the macroeconomic impact of the current turmoil will depend, in part, on the linkages between the Philippine economy and that of the US. These linkages are in the areas of trade, remittances and investments.

- Trade. There is no decoupling. The US accounted for about 17 percent of total RP exports in 2007. Although this is lower than the 30 percent in 2000 and has been declining since, the US slowdown poses a downside risk to the country's export earnings as some exports to other countries are subsequently redirected to the US market.
- Remittances. Remittances are another important channel through which the US economic slowdown could manifest itself in the Philippines. More than 30 percent of overseas Filipinos (OFs) were based in the US as of 2007.
- Investment. Moreover, more than 30 percent of net foreign direct investment (FDI) in the Philippines came from the US (in 2007). Slower US economic activity may, therefore, cause a reduction in inward foreign direct investment. The expected slowdown in other advance economies, including those in Europe and Japan, dampens further the country's FDI prospects.

III. Sources of resilience of the Philippine economy

While the Philippines is not immune to the contagion from the global financial turbulence, underlying strengths or buffers in the economy remain that can help it ride out the storm.

The Philippines is in a good position to withstand the crisis for the following reasons:

- First, the country's macroeconomic fundamentals are sound and the economic growth potential remains good;
- Second, domestic demand remains a major contributor to growth;
- Third, the external payments position is stable;
- Fourth, dividends from structural reforms adopted by financial institutions since the Asian crisis have helped mitigate the impact of external shocks; and
- Fifth, information disclosure practices have improved.

Let me highlight some of these factors in greater detail…

Favorable growth dynamics

The economy has continued to expand despite a difficult external environment. In the second quarter of 2008, gross domestic product (GDP) grew by 4.6 percent on the back of relatively strong performances of manufacturing, agriculture and fishery, trade, private services and construction. On the expenditure side, the main drivers of growth have been private consumption and, to some extent, investments.

Domestic demand has proven to be fairly resilient in previous episodes of global slowdowns and should be helpful once again in buttressing the economy from the fallout of the ongoing global slowdown.

Stable external payments position

The country's external payments position remains favorable.

The balance of payments – although it is beginning to come under pressure from global developments – has remained in surplus for the first nine months of 2008 at US$1.5 billion. The continued strength of the BOP is underpinned by the sustained strong remittances of overseas Filipinos as well as higher services receipts, particularly from business process outsourcing.

Let me go into some specifics:

- Remittances. Overseas Filipino remittances reached US$11 billion in the first eight months of 2008. OF remittances are expected to grow on the back of improvements in the quality of workers deployed. In addition, the geographical diversification of our deployments as well as the relatively inelastic demand for our growing deployed workers in the medical related fields, should form a buffer against a global economic downturn.
- BPO revenues. Revenues from BPO services also provide some lift (actual revenues for 2007 reached US$5 billion according to the BP Association of the Philippines). The BPO industry is poised to grow by 39 percent for 2008 on account of strong demand for back office, engineering and financial services. In a period of slowdown, our BPO centers may benefit as they remain cost-competitive relative to the other regional centers.

The country also continued to build up sufficient international reserves to cover import payments and to service external debt. The current GIR level of US$36.7 billion as of end-September 2008 covers about six months of imports of goods and payments of services and income and is equivalent to nearly three times the country's short-term external debt based on residual maturity.

Stable banking system

Going to the banking sector.

You must have heard me say that direct exposure of Philippine banking system to the financial institutions currently in trouble is limited. Our banks continue to be innately conservative, domestically-oriented, and have not moved to the business model of "originate and distribute", which has propelled the popularity of structured products in the major economies.

In addition, the reforms implemented to clean up bank balance sheets, strengthen bank capitalization through Basel II, improvements in governance structures, enhancements in risk management systems and adoption of international accounting standards have all come together to create a steadily growing, adequately capitalized, significantly stronger banking system.

In particular –

- Banks remained capitalized at levels above both the BSP-regulatory requirement and the BIS standard. This provides a buffer to banks to absorb more "shocks" going forward.
- NPL Asset-quality has been enhanced – NPL ratio has been going down and is at its best level since the Asian crisis level. As of Aug, NPL ratio for UKBs stood at 3.88%. The asset clean-up of banks was accomplished without the use of public funds.
- Profitability has been sustained. As of 2007, return-on-equity and return-on-assets were posted at 10.8 percent and 1.3 percent, respectively, and were on increasing trend since the post-1997 Asian financial crisis period. During this period, however, there may be a dent in banks' profitability as banks provision for potential losses from affected investments.

IV. Policy response to the turmoil

Despite these buffers, the BSP has not remained complacent in the face of the turmoil.

What have been the BSP's responses to the current turmoil?

The BSP's approach to the financial turmoil has consisted of the following:

1. Shoring up confidence through timely communication and transparency.
    - Immediate release of information on bank exposures to troubled financial institutions.
    - Continuous messaging on developments and policy changes.
2. Ensuring that there is adequate peso and dollar liquidity.
    - Enhancing existing peso repo facilities through relaxed valuation and broader acceptable collateral.
    - Establishing the US$ repo Facility.
    - Maintaining a presence in the spot and swap markets by selling dollars.
    - Keeping the e-rediscounting facilities and emergency loan facilities open.
3. Providing directed relief to banks by allowing reclassification of financial assets from categories measured at fair value to those measured as of 1 July 2008.
4. Engaging with its regional peers to share information, discuss emerging developments, and pool resources, particularly foreign exchange reserves.
    - BSP has supported the proposal in the ASEAN+3 to enhance the existing swap arrangements as a means of boosting confidence in the region.

The BSP is also considering other possible measures to help stabilize the financial markets, including a possible reduction in bank reserve requirements. We are also in constant touch with the Bankers Association of the Philippines to discuss other steps that can be taken under the evolving market conditions.

Further, the BSP supports the proposed legislation that seeks to increase the maximum bank deposit guarantee to be provided by the Philippine Deposit Insurance Corporation, although under the context of a general restructure and recapitalization of the PDIC.

V. Conclusion

Ladies and gentlemen,

While the Philippines is not immune to the impact of the financial market turmoil, it is relatively better insulated now to ride out the crisis. The continued resilience of the economy and soundness of the banking system, buttressed by gains achieved from purposeful reforms (past and present), puts us in a good position to deal with adversities in the global environment.

In addition, we are seeing pockets of improvement in the financial markets, which can help to build confidence and prevent a “free fall”. Nevertheless, there is no room for complacency. We must continue to be mindful of the risks that could impede the growth of the Philippine economy.

We can learn a lesson from the little chicken in that children’s fable – like the chicken, we must be watchful of our surroundings. But, unlike the chicken, we must take courage. These are difficult times. If, however, we are armed with the correct information and an appropriate plan of action, we should be able to get out of this crisis stronger.

In this endeavor, the BSP looks forward to the continued support extended by the Consular Corps. Your work of promoting the dissemination of correct information about our country takes on a more critical dimension as we try to cope in these very trying times.

Thank you very much and Mabuhay tayong lahat!!