Amando M Tetangco, Jr: Antecedents of the global financial crisis – a multi-factorial phenomenon

Speech by Mr Amando M Tetangco, Jr, Governor of the Central Bank of the Philippines (Bangko Sentral ng Pilipinas), at the Sixth Sec. Alfonso Yuchengco Policy Conference, Makati City, 2 February 2009.

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Secretary Alfonso Yuchengco, distinguished guests and fellow stakeholders from the business sector, the government and the academe, ladies and gentlemen good morning.

First, let me thank the Board of Trustees and Secretary Yuchengco for inviting me to your sixth policy conference. It is my pleasure to be able to share with you today some thoughts on a subject which has occupied global attention, especially since the last four months of 2008 – when marquee financial institutions in Wall Street started to crumble, and “bailout” became a buzzword in global financial markets.

Let me put in a nutshell the Philippines’ economic situation in 2008. What we had seen as an ideal convergence of low inflation and high growth in 2007 was clearly disrupted by the highly volatile oil and food prices, the spread of the subprime mortgage woes of the US to international financial markets, and the recession in some key advanced economies and economic slowdown elsewhere. Forecasts for this year and 2010 continue to be revised downward, as more concrete data become available. A bleaker outlook is in the offing, with the impact of the crisis trickling down to the real and external sectors, affecting trade, investment and consumer demand.

But before we get into the details of the extent and implications of the crisis on our country’s development momentum, I suppose it is important to ask the question:

How did the current global financial crisis occur in the first place? What led to the creation of “bubbles”?

I believe that there are two layers to the reasons for the crisis. The first layer I will refer to as the “superstructure” or the physical – what is happening and visible to the naked eye. The second layer is the “microstructure” or the psychology – what is underlying those that can be seen.

Let me talk about the “superstructure” first.

The roots of the US financial crisis can be traced back to the early years of this decade when the United States aggressively eased its monetary policy to facilitate recovery from the dotcom bubble and the September 11 terrorist attacks.

If you will recall, the US Federal Reserve began a cycle of cuts in the Fed funds target rate from 6.5 percent in May 2000 to as low as one percent by June 2003. On the fiscal front, large public deficit spending beginning in 2001 was pursued to prop up the economy which was then on the brink of recession.

The low interest rate regime fueled a boom in mortgages, including among borrowers with doubtful credit histories or those fancifully called NINJA loans – that is, loans to No Income, No Job or Assets loans. Thus, house prices in the US began rising in 2000, surpassing the growth of disposable income.

The excessive lending itself would not have brought in such great financial distress because if the borrowers turned out to be poor borrowers, then foreclosures would just have followed.

However, what made this risky behavior turn into a crisis event was the bundling of mortgages by various financial institutions into complex securities such as collateralized debt obligations (CDOs) which were largely unregulated.

These complex transactions were designed in search for yield and new markets. The securitized products were sold to banks, Wall Street firms and overseas investors. The continued appreciation of house prices ensured attractive returns for these mortgage-related securities.

With too much liquidity in the US economy and with the price level creeping up, the US Federal Reserve started to rein inflation in.

In June 2004, the Fed began a cycle of hikes in the Federal funds target rate, lifting the Fed funds target rate from one percent to as high as 5.25 percent just two years later (or by June 2006).

When interest rates were raised, an asset bubble burst became imminent. The elevated interest rates discouraged availments of mortgage loans, which led to a build up in unsold homes. This precipitated the steep descent in house prices from their peak in 2006. As of end-November 2008, the S&P/Case-Shiller index of 20 major metropolitan areas showed that home prices in the US had fallen by around 25 percent below their July 2006 peak.

The immediate damage was felt in sub-prime mortgages – not only the most highly leveraged sector in the economy but also that with the weakest capital support, least transparency, and on which the poorest due diligence had been done. Initially, market participants and policymakers felt the damage was an isolated case that could be "fixed". This belief partly mirrored the (over) reliance on the most modern risk management techniques related to derivatives and structured products. It also partly reflected inadequate information on the extent to which sub-prime exposures had infected the balance sheets of financial institutions.

With the glut in supply and as housing prices fell, the value of the collaterals supporting mortgage loans eroded. Higher delinquency rates on sub-prime mortgage loans triggered a wave of bankruptcies of sub-prime mortgage lenders. As bankruptcy filings by mortgage lenders mounted, unnerved investors began draining liquidity from financial markets.

With banks holding on to their cash to cover losses, credit markets started to seize up. Even creditworthy borrowers began experiencing difficulty in borrowing. Firms/ households cut back on investment and consumption, causing a slump in economic activity, precipitating a recessionary cycle.

Moreover, since the loans were securitized and sold to other investors as credit derivatives, the defaults in the mortgage lending market spread to the wider credit markets, multiplied several-fold by leverage. Eventually, losses in subprime mortgage lending and credit derivatives would spill over to the broader financial markets and to financial institutions elsewhere that invested in US mortgage bonds and structured products.

There were other factors that could have contributed to the credit crisis.

Mark-to-market accounting standards exacerbated selling pressures during the period of deflating house prices as banks were forced to recognize valuation losses in their balance sheets.

The fragmented supervision in the United States led to lack of regulation over segments of the financial system.

Even credit rating agencies have gone under scrutiny for giving investment-grade ratings to securitization transactions that were backed by sub-prime mortgage loans. These high credit ratings encouraged the flow of investor funds to these securitized instruments. Critics claim that conflicts of interest were involved, as rating agencies were paid by firms, such as investment banks, that originated and sold the debt to investors.

However, beneath what can be seen by the naked eye is the "micro structure" or the underpinning of the crisis.

There is a quote from Robert Shiller. He said "too little attention has been paid to the most fundamental cause (for the housing crisis): the contagious optimism, seemingly impervious to facts, that often takes hold when prices are rising. Bubbles are primarily social phenomena; until we understand and address the psychology that fuels them, they're going to keep forming".

I am a believer that all these over-structures could be explained by underlying market psychology – Greed. Ignorance. Herd mentality. Disregard for or misuse of information. Exuberance. Irrationality.

If we look back at the 1997 Asian financial crisis, and the other crises during the last three decades, the pattern seems to be quite similar: crisis was preceded by rapid credit expansion, which manifested itself in asset prices. These gains, of course, provided the collateral to justify even more lending. The euphoria generated by such gains also seemed to affect both the perception of risk and the appetite for risk-taking, on the side of both lenders and borrowers. As a result, leveraging increased even as the general quality of credits deteriorated – unfortunately, this was commonly “not perceived” at the time.

And, as we realize now, the so-called “Minsky moment” invariably comes. At a certain point, usually when earlier expectations about profits or future income growth begin to look unrealistic, the whole endogenous process goes into reverse. In effect, boom turns to bust, with the stress in the financial system commonly, but not universally, aggravating the economic damage on the downside.

Together, the superstructure and the microstructure of the crisis would explain the bubble that just burst.

In hindsight, it is clear that global financial activities had outpaced the financial systems’ ability to manage these activities in an orderly manner. Thus, the air of uncertainty and vulnerability as well as a general sense of eroded confidence now looms in both industrial and emerging market economies.

One could even call this a Black Swan Event – a large-impact, hard-to-predict and rare event beyond the realm of normal expectations.

While the epicenter of the financial turmoil is in the US, tremors have been felt worldwide. The slowdown in growth spread to Europe, amid weak business and consumer sentiment, terms of trade losses, and tightening credit conditions.

The impact on Asia has come through risk aversion as evidenced by: 1) the reversal of equity capital inflows; 2) widening of sovereign credit spreads; and 3) heightened volatility in exchange rates.

Apprehension has also risen in the Asian economies, particularly in terms of reduced production, and weaker consumer demand.

These developments necessitated coordinated policy actions among major advanced economies to support the global financial system on a scale not seen for decades.

Many central banks have taken strong actions to cut interest rates and expand liquidity provision both in local and foreign currencies. Other measures taken include capital injections into financial institutions, expansion of deposit insurance and purchase of distressed assets.

On fiscal policy, many countries have announced and are already implementing sizeable stimulus packages.

Evidently, there is no “one-size-fits-all” policy mix. Some countries have more fiscal and monetary space than others.

This brings me to the next – and to most of us here – the central question – how will the Philippine economy fare amid this highly challenging global economic turmoil?

Admittedly, we are not immune to what is happening around the world, but there are insulations, cushions, buffers that can serve the Philippine economy in good stead in this challenging period.

Let me provide some details on these buffers.

Output growth has continued at a respectable pace and it continues to be demand-driven. The 4.6 percent GDP growth for 2008 was a respectable growth performance vis-à-vis those of our Asian neighbors. It is noteworthy that the country's GDP growth for 2008 is within the country's long-term growth trend.

Domestic demand continues to be the main driver of growth in the economy, specifically personal consumption. Demographics – particularly in the form of the Philippines' young and economically active population – underpins the view that consumption will continue to propel economic growth even in these difficult times. Moreover, income levels are such that majority of the population has a greater propensity to consume.

Weakening global demand is causing commodity prices to retreat. Reflecting the global economic downturn, oil prices began to ease starting July 2008.

Partly because of this, headline inflation dropped sharply lower in December 2008 to 8.0 percent year-on-year. This brought the average inflation in 2008 to 9.3 percent. Lower fuel prices and slower price increases of food and light, as well as of transportation and communication services accounted for the retreat of inflation.

With the easing in the prices of oil and other non-oil commodities in the world market and given moderating inflation expectations, inflation in the Philippines is expected to further decelerate – and be within the target range – in 2009 (2.5-4.5%) and 2010 (3.5-5.5%).

This gives some flexibility to monetary policy to support growth and stabilize financial conditions, while being highly attentive to price pressures.

Fiscal reforms, particularly the VAT reform, have strengthened the Philippines' ability to cope with externally-induced challenges, as fiscal consolidation has improved our debt profile and markets' view about the commitment of our authorities to difficult but much-needed fiscal rectitude.

Recent adjustments in fiscal targets could also provide policy space to support growth. The postponement of the balanced-budget objective due to the expected slowdown in the global economy will provide countercyclical fiscal space for the government to boost infrastructure spending and enhance social safety nets to support the most vulnerable segments of the population.

The fiscal stimulus – provided that it adheres to best principles of what some would call the 4 T's (spending that is timely, targeted, transparent and temporary) or as some would say "spending that gives the most bang for the buck" – should be supportive of durable, robust growth.

On the external front, we have continued to build up our international reserves for self-insurance to reduce our vulnerabilities to the inevitable moods and swings of international financial markets.

At year-end 2008, our reserves rose to US$37.6 billion. This suffices to cover about 6 months of imports of goods and payments of services and income, or alternatively, it could cover our short-term external debt based on residual maturity about three times over.

We were able to do this because our external position remained in surplus in 2008, supported by remittances of overseas Filipinos as well as higher services receipts (including from tourism & business process outsourcing).

Meanwhile, the Philippine financial system remains stable notwithstanding the challenges brought about by the global financial crisis.

The Asian financial crisis of 1997 had imprinted valuable lessons which provided the needed cushion for our banking system to weather the current turmoil. For instance, we regulated the real estate sector in relation to housing and mortgage markets; we implemented stronger bank supervision anchored on managing risk exposures; we reduced non-performing loans via asset vehicles; we implemented macro-prudential surveillance with due diligence in implementing internationally accepted standards via the Basel II accord; and we participated actively in implementing collaboration among Asian neighbors for coordinated responses and information-sharing to mitigate contagion effects and spillovers.

Importantly too, the Philippines is relatively well-insulated from key transmission channels of the global financial strains that are affecting other emerging market economies (EMEs). This is so for the following reasons:

Reasons:

- Philippine financial institutions have relatively limited exposure to structured credit and related derivative products which were the main cause of the large losses of crisis-affected international banks. It is helpful to point out that derivatives licenses in the Philippines have been given out prudently.
- Philippine banks are more domestically oriented, and rely more on traditional banking services such as deposits than on complex products like derivatives as sources of funds. Corporate sector bond financing is also minimal and private sector reliance on external loans is limited.
- Lastly, while credit growth has been steady and significant, it has not fueled concerns of overheating or asset price booms.

What should we expect in 2009?

Even though we could lay claim to the “island of calm” status mentioned by economists in evaluating the Philippine economic situation amidst the crisis, and even though we have buffers that we could rely upon as we brave the current financial storm, we should not rest on our laurels for the effects of the crisis are just beginning to show their fangs and just starting to bite into our pockets.

The real and external sectors are yet to experience tougher challenges so let me share the policy thrusts of the BSP this year:

Monetary policy in 2009 will continue to focus on our primary mandate of price stability. As inflation risks moderate, the BSP will carefully consider opportunities for monetary policy easing amidst a possible tightening in financial conditions. We will also continue to ensure appropriate levels of market liquidity to maintain the efficient functioning of the financial markets. Through these, we hope to provide the necessary conditions that will allow economic growth to continue. We will at the same time endeavor to keep inflation at manageable levels as this creates the environment for sustainable long-term growth.

The BSP’s external sector policy will remain focused on ensuring our external vulnerabilities are reduced. We expect to continue to post a surplus in our BOP, mainly due to steady OF remittances and receipts from the BPO sector, coupled with a reduced level of imports. This will give us the opportunity to further beef up reserves for self-insurance. We will continue to pursue a market-determined exchange rate to allow us to maintain external competitiveness. We will also engage in policies that would sustain a manageable external debt profile.

Banking sector policies will remain geared towards the financial system’s soundness in terms of greater risk management, stronger capital base, bolder disclosure mechanisms, and better corporate governance standards. Since most of the experts point to the lack of regulation as one of the root causes of the US subprime market crisis, it is therefore tempting to swing to the other extreme of over regulation. I don’t believe that we should move towards that direction. Instead, what I believe should occur is a move towards greater accountability.

Thus, the BSP will sustain its reforms that would lead to improved disclosure practices, better risk management and higher standards of governance in the banking system. We will continue to pursue regulation that would make the markets work more efficiently and advance consumer protection.

Realizing that the current crisis has taken on a global nature, we will further strengthen engagements with our regional peers to share information, discuss emerging developments, and pool resources, if necessary even foreign exchange reserves. It's interesting that the current financial turmoil took on a turn for the better once the major economies began to act in concert. Confidence had been quickly eroding until then. The coordinated and cooperative policies that were put in place by the US and European central banks and finance ministries beginning October last year, have helped restore some traction in the markets and subsequently improved market confidence not only in the major economies, but also in emerging markets.

Ladies and gentlemen, 2009 will be a critical year for our economy. But we should look at this crisis as like the gift of fire of old. Fire is important in all facets of our lives including the need for light, power and heat. Yet fire is not without risks to life and property. What is important is to be able to master it and harness it to serve human needs. Thus, this crisis should pose a challenge to us to put together and implement policies this year and beyond that would enhance the resilience and the flexibility of our economy.

Without a doubt, this crisis shall test our resiliency and character, and it shall determine whether our buffers would keep us afloat amidst troubled waters. The Philippines is not a newbie in terms of facing crises, for we have hurdled quite a number of these in the past. Each crisis we encountered was unique in its roots and causes. But we have learned from each, every time. It's too early to make prescriptions and judgments, given that much is still to unfold. I trust that the audience could share my vision in seeing a glass half-filled with water as "half-full" rather than "half-empty". Let us also remain vigilant and prepared for any circumstances that could come our way.

Let me end my remarks this morning with a quote from John D. Rockefeller. He said *"These are days when many are discouraged. In the years of my life, depressions have come and gone. Prosperity has always returned and will again."*

Thank you very much. *Mabuhay ang Pilipinas!*