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

Speech by Mr Amando M Tetangco, Jr, Governor of the Central Bank of the Philippines (Bangko Sentral ng Pilipinas), at the Economic Forum "Philippine Economic Outlook – Prospects and Challenges", hosted by Security Bank, Manila, 11 February 2009.

* * *

Distinguished officers and staff of Security Bank led by its Chairman Mr. Frederick Y. Dy, President and CEO Mr. Alberto S. Villarosa, other distinguished speakers, guests, ladies and gentlemen: good afternoon!

It is my pleasure to join you for today's economic briefing. I laud the efforts of Security Bank for making this gathering possible. I welcome opportunities such as this to help shed light on our current economic and financial environment, from the vantage point of the central bank, which I hope is not far removed from how it is in the "real" world.

Much has already been said and written about the current environment we are in – it has been described as being "a tsunami of historic proportions" to being the "the worst crisis since the 1930s". Every writer or speaker seems to want to paint a picture direr than the one before.

Today, I don't want to be included in that list – rather, I hope I can more candidly share with you a balanced (realistic) view.

Let's begin with what we now know against what is still uncertain.

Three things stand out.

First, we have clearly seen that, on the one hand, the crisis has moved from its epicenter – the US and Europe – and has begun to manifest itself in Emerging Markets, including our part of the world. On the other hand, however, we don't know how much further or deeper the crisis' reach and breadth would be once the dust, as they say, finally settles.

Second, so far the policy prescriptions from the major economies have been "unconventional" – untested (so to speak) in these unchartered territories we now trek. Unfortunately, the very nature of these prescriptions requires patience not only from those in the major economies but also from those at the periphery such as the Philippines. The policy prescriptions clearly need time to filter to the markets and achieve the necessary effects. Question is, how much patience and tolerance do the markets have? Other questions that are perhaps racing in stakeholders' minds are: What is the exit strategy? How would all these new policy tools be unwound? How would any exit strategy impact other economies, including the Philippines?

Third, the impact on the Philippines of the global financial crisis has (so far) been limited, but we know we are not totally immune. We know the potential channels for weakness – exports and remittances (then consequently consumption). Yet again, we don't know how deeply these could and would be penetrated by external factors.

I arrived yesterday from Kuala Lumpur, after attending a series of meetings with other central bank governors in the South East Asian Central Banks (SEACEN) and the Bank for International Settlements (BIS) including the heads of the International Monetary Fund (IMF) and the BIS. The assessment was unanimous – the crisis we are in is unlike any other we have so far faced. Why so?

1. It is the first truly global crisis. Earlier crises were generally localized with the contagion fairly limited to nearby regions. For example, the debt crisis in the Latin Americas in the 1980s and then the foreign exchange crisis in Asia in the 1990s –

neither affected the major economies in any significant way. This time, however, it is the developed economies that were first affected with the claws of the crisis reaching the rest of the world.

2. The linkages are now more enmeshed, more difficult to define and therefore more difficult to disentangle. The crisis began as a US subprime mortgage market problem that US policymakers first considered a situation which could be "fixed" with a single stimulus package. The mortgage problem, as we now understand it, was triggered by search for higher yield and new markets and perpetrated by the opacity in financial markets that resulted from rapid financial innovation. This has since evolved into a seizing up of liquidity in major financial centers, rapid deleveraging by banks and other financial institutions, generally lower asset values, unprecedented wealth destruction and therewith a significant decline in consumption and contraction in global trade. The turmoil in the financial markets has indeed translated into a slowdown in the real sector. More recently, the downturn in the real sector is adversely impacting on the availability of domestic and international credit.

I share these assessments by the major central banks with you, not to show you how "bad" things are but to show you that there is now among global policy makers a better appreciation of what has happened and what is happening, including a fostering of a higher level of coordination and cooperation.

Let me now move on to where we are now and what we have done so far.

The Philippine banking system was not significantly directly impacted by the global financial crisis. This is because the direct exposure of Philippine banks to the troubled international financial institutions was minimal. Nevertheless, the BSP moved preemptively to ensure the Philippines didn't experience the situation of credit markets seizing up and liquidity in the financial system drying up that characterized the international financial markets at the height of the crisis in September 2008.

The BSP was aware that there was ample liquidity in the system even at the height of the crisis. That was evident from the fact that credit growth was still at double digit (even up till now) and that interbank markets continued to operate smoothly with no prolonged periods of high interest rates. What the BSP witnessed, however, were some kinks in the distribution of the liquidity.

To address these, the BSP expanded the allowable collateral for its repo facility; relaxed the valuation on these collaterals, increased the budget of its e-rediscounting window, reduced reserve requirements, and provided dollar liquidity in the spot and swap FX markets. We believe these moves, in tandem with extensive and comprehensive communication of our policy intent to key stakeholders, helped to shore up confidence in the financial markets during that critical period.

That relative stability exhibited by the financial markets then was critical in cementing the environment that allowed the economy to post a within-trend GDP growth and single digit inflation in 2008. Understandably the numbers are nowhere near the ideal convergence of historic high growth and historic low inflation that we saw in 2007, nevertheless these were respectable especially when pitted against those in our region.

The Philippine economy continues to be resilient. The 4.6 percent GDP growth rate for 2008 was broad-based with the major domestic sectors providing positive contributions to growth. I am confident that both domestic private and public consumption on the expenditure side, and services and agriculture on the demand side would continue to lift the economy in 2009. For this year, the GDP is expected to grow between 3.7 to 4.7 percent.

Inflation continues to decline. For January this year, inflation went down further to 7.1 percent from 8 percent in December 2008. This supports our view for within-target inflation rates for both 2009 and 2010, and provides the BSP with room for monetary policy maneuvering to counter the effects of the global financial crisis on the domestic economy.

The external position continues to be strong. As of end January, the country's international reserves registered almost $40 billion, equivalent to six months' of imports of goods and service and three times external debt based on residual maturity. We are still projecting a surplus in the BOP for this year, supported by steady remittances and BPO receipts as well as a lower import bill due to the significant decline in international oil prices.

The banking system remains stable with very robust solvency. The industry's capital adequacy ratio (CAR) as of end-June 2008 stood at 15.3 percent. Moreover, results of stress-testing done by the BSP showed that despite adverse shocks to asset quality and income, banks' CAR would still be well above both the international standard of 8 percent and the BSP's minimum regulatory requirement of 10 percent.

The banking system as a whole also remains very liquid. Proof of this is that bank lending continues to post significant growth. As of end-November 2008, bank lending, inclusive of interbank loans, registered a year-on-year growth rate of 22.9 percent. We expect some slowdown in credit expansion going forward as banks tighten credit standards. Nevertheless, loan growth could still be at double-digit, if banks remain keen to spot lending opportunities.

Avoiding the negative feedback loop

What do all those numbers and data mean? How do they fit into our daily lives? We all know there is a key link between a stable macroeconomy and a sound financial system. On one side of this link, we know that an efficiently functioning financial system is critical to the effective transmission of monetary policy and fuels economic activity and growth. On the other side of this, we know that a vibrant real economy encourages the further development of the financial system. In essence they "feed" on or reinforce each other. [I leave the discussion of the direction of causation for another day!]

The numbers and data I walked you through show that both our macroeconomy and our financial system have remained sound and stable against the tide of the financial turmoil. But there is risk that if one of these weakens, perhaps due to further external stress, it could drag the other one with it. In other words, the feedback loop is negative.

This is now occurring in the major economies – the financial turmoil has caused economic recession in the US, UK, Europe, Singapore, Hong Kong and Australia, to name a few. And we have also seen the credit markets in these economies freezing up.

We haven't come to this yet and we will make sure that we don't. How shall we manage that? The BSP can contribute by:

1. Calibrating monetary policy to ensure that there is ample liquidity in the system. The trend decline in inflation and our within-target inflation outlook have given the BSP room to be accommodative. We will, therefore continue to look for opportunities to be supportive of economic growth.

2. Keeping our banking system safe. Our banks have benefited from the series of reforms implemented in recent years, which have included cleaning up of banks' balance sheets, the strengthening of bank capitalization through Basel II, and the improvements in governance structures. We will continue to enhance our macro-surveillance capabilities and further improve supervisory oversight of risk management. To operationalize these, the BSP recently approved the guidelines for Internal Capital Adequacy Assessment Process (ICAAP). The ICAAP provides a prudent framework that would force banks to consider their own assessments of business lines and the prospects for these, determine their risk profile and then actively decide the appropriate level of capital to hold. This formalizes the requirement for banks to have a more-forward looking approach to risk management and make them directly link risk to capital. This would improve accountability on the

part of banks for their actions and hopefully avoid the situation of poor appreciation of risk that was at the heart of the financial turmoil in the US.

3. Creating a stable macro environment, i.e., stable interest rates and exchange rates. This would encourage long-term business planning and lending by banks. Economic agents and banks need to continue to be keen to seize opportunities during this downturn and be ready for the upturn.

4. Continuing to encourage financial innovation and capital market development. I am often asked whether the BSP would clamp down on financial derivatives and financial innovation, given pundits are pointing to their proliferation as one of the reasons for the current financial turmoil. My answer to that is this – I believe there is a place for financial innovation in market development. Its presence provides avenues to address varying risk requirements of investors and users of funds. What I always emphasize, however, is that embracing financial innovation must be coupled with appropriate prudential regulation, including appropriate disclosure and transparency standards. These would ensure that all stakeholders are fully aware of the risks that they are taking on. As I have said, we shouldn't go to the extreme of over regulation. Rather, we should move towards greater accountability for our actions.

How do we see things going forward?

I had made a point earlier of saying that no one knows how deep or how much longer this crisis would last. But I want to stress now, this will not go on forever. There will be an upturn – sooner or later. (As they say, the light at the end of the tunnel.) What is crucial is we must be ready for that time. Slowly, we are seeing some traction in the markets. The most visible manifestations of these are: the exchange rate level consolidating, the credit spreads narrowing, the stock market steadying.

At the meetings I attended in Kuala Lumpur. The IMF analysis showed that recovery in Asia could be faster – given our relatively stronger position coming into the crisis. They point to lessons on building up reserves for insurance, managing debt levels, setting up prudential standards and cleaning up bank balance sheets – all lessons astutely learned from and implemented by the Asian economies since 1997 Crisis. However, in the same breath, the IMF admitted that an Asian recovery may not occur without a recovery in the US. The recent events have indeed debunked the myth of Asia decoupling from the U.S.

I see a three-fold hope in that irony. First, the strong and aggressive policy actions by the US could move it closer to a recovery than without such action. Second, individual economies outside of the US are also doing their part to shore up confidence in their own economies. Third, there is a heightened desire to improve the coordination and cooperation among national governments to resolve the current global financial crisis, including more openly sharing information and the thinking behind policy actions. This would help fuel policy actions forward.

The current crisis has brought to fore that, with its good points, globalization also brings many challenges. The world's economies and financial markets have become highly integrated that any solution to the problems we currently face must necessarily also be of a global nature.

Conclusion

I tried to bring into my remarks this afternoon a more international/regional flavor. I have also tried to share the risks we face, our policy moves and our outlook – both the bad and the good that at the same time envelope this crisis.

I have emphasized that the resolution strategies necessary to address the current crisis must have an international dimension. But this is not to say that, that is where it ends.

Indeed the difficulties we are experiencing are broadly external (global) in origin. But building resilience against external vulnerabilities resides in all of us. Building resilience in a time of uncertainty is not just BSP's task. Even as I outlined actions that BSP is undertaking to avoid the negative feedback loop, avoiding this is not just BSP's task. If there is anything that this crisis has taught us, it is that there should be greater accountability among all market players.

On the part of the banks, there needs to be a better appreciation of the risk of their businesses and true diligence in disclosure and transparency to stakeholders, while at the same time remaining adept at seizing lending opportunities.

On the part of the corporate sector, there needs to be a broader, more critical long-term view of their operating environment, realizing that is necessary to ensure their own viability.

On the part of the financial consumers, there needs to be a move to be better informed. The BSP has been actively undertaking its financial literacy campaign. The long-term goal is to instill among the financial consumers the responsibility of informing themselves about the risks involved in financial decisions. Better informed consumers would mean lesser instances of market instability caused by loss of market confidence due to failed investment schemes.

Indeed, building resilience of our financial system, and the economy in general, requires appropriate action from the government, the central bank, the financial institutions, businesses, down to the individual private citizens. By doing our respective responsibilities, we can build a financial system and economy that can withstand not only the impact of the current crisis, but also of other future crises.

Thank you very much for your attention.