Amando M Tetangco, Jr: The Philippine economy – facing up to the challenges

Speech by Mr Amando M Tetangco, Jr, Governor of the Central Bank of the Philippines (Bangko Sentral ng Pilipinas), at a meeting, Makati, 11 August 2009.

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Executive Director Robert Sears, executives of the American Chamber of Commerce of the Philippines, distinguished guests, ladies and gentlemen, good morning to all of you.

It is a pleasure to be here this morning to share with you the experience of the Bangko Sentral ng Pilipinas in responding to the challenges posed by the recent global financial crisis, taking into consideration the current global and domestic scenarios and emerging outlook.

My short presentation will basically cover three parts:

- First, a quick look at the global and domestic economic situations;
- Second, the latest outlook for the economy and some key challenges; and
- Lastly, the responses that the BSP undertook to mitigate the impact of the crisis and the BSP's policy directions moving forward.

Let me start with a quick review of what is happening globally and domestically. In its latest World Economic Outlook (WEO) Update released in July 2009, the International Monetary Fund reported that the world economy is stabilizing, helped by unprecedented macroeconomic and financial policy support by fiscal and monetary authorities worldwide. However, the recession is not yet over and the recovery is likely to be sluggish.

As a result, global economic growth during 2010 is now projected to be about 0.5 percentage points higher than projected in the April 2009 issue of the WEO. However, the advanced economies as a group are projected to show a sustained pickup in activity only beginning the second half of 2010.

A closer examination of some high-frequency indicators like industrial production and merchandise exports point to a return to a modest growth in global GDP beginning in the 2nd quarter of 2009.

Similarly, we also see a favorable outlook for prices in general. The continued weakness of the global economy for the past several months has put a downward pressure on prices. Measures of both headline and core inflation are on a downward trajectory, for the global economy as a whole as well as for advanced economies and emerging market economies.

Although there are stronger disinflationary forces in some regions of emerging economies, the risk of a sustained deflation is expected to be small, as core inflation and inflation expectations in most major economies are still holding in the 1-2 percent range.

Any sharp movements in commodity prices bear some watching if sustained. To date, food prices have been subdued so far, oil has been range-bound but metal prices are still surging.

Based on a composite index which captures credit conditions in three financial market segments (banking, securities markets, and exchange markets), there has been a marked decline in financial stress for advanced and emerging economies since the beginning of 2009.

Across Asia, output growth performance was mixed, with more open economies – such as Taiwan and Singapore – experiencing the brunt of the global economic downturn.

Domestically, the story has been that of economic resilience. The slowdown in economic activity in the Philippines thus far has been moderate relative to that of some other economies in the region.

This resilience has been acknowledged by ratings agency Moody's Investors Service when it upgraded the Philippines' credit rating by one notch, citing the country's healthy financial system and resilience against the impact of the global recession. The country's outlook was also changed to "stable" from "positive."

The slowdown in the growth of domestic output to 0.4 percent, in the first quarter of 2009, was due to lower growth in private spending, coupled with a contraction in exports and capital formation (year-on-year).

Inflation has continued to ease. The slowdown in global demand has led to lower international oil and food prices, which have dampened inflation pressure domestically as well.

Headline inflation had fallen to 0.2 percent in July, the lowest since March 1987. This brings the year-to-date average down to 4.3 percent which is within the target range for 2009.

Similarly, core inflation, which excludes specific food and energy items to measure broader price pressures, also declined to 3.6 percent (July 2009) from 6.9 percent in January 2009.

The downward trajectory of inflation was driven primarily by two factors: (1) base effects due to record-high prices of commodities last year and (2) relatively subdued demand. This trend may have reached its trough in July, as inflation is expected to rise gradually during the remaining months of this year and the next, but still remain within target ranges for the policy horizon.

Our external payments position continues to be manageable. The healthy external balance has been supported by steady levels of remittances of overseas Filipinos as well as higher services receipts, particularly from business process outsourcing. In turn, this has allowed us to build up our dollar reserves. One of the lessons we learned from the 1997 Asian financial crisis was the value of building up our international reserves for self insurance.

Based on revised data, as of end-July 2009, our reserves have risen to US$40.0 billion. This is enough to cover about 6.9 months of imports of goods and payments of services and income, or alternatively, it could cover our short-term external debt payments about three times over.

Thus, even as we face a slowdown in external demand, the stronger external liquidity position provides us some cushion against shifts in capital flows.

Our financial markets are showing some signs of recovery. Credit spreads have narrowed, the peso has stabilized and its volatility has decreased, and the stock market is on an upswing.

Our banking system has remained sound and stable.

The banking system's asset base has been expanding steadily, supported by sustained growth in deposits. As of end of April 2009, the total resources of the banking system stood at P5.8 trillion.

Banks have been offloading their non-performing assets and problem loans. As a result, the NPL ratio is now at the pre-Asian crisis level of around 4.0 percent.

Furthermore, the profitability of the banking system has remained resilient, although with some moderation of late.

Banks have remained adequately capitalized at levels above both the BSP-regulatory requirement of 10 percent and the international (BIS) standard of 8.0 percent.

Bank lending growth has remained healthy, in part reflecting the easing of monetary policy since the fourth quarter of 2008. Credit flows continued to support the productive sectors of the economy even against the backdrop of tight liquidity conditions in global financial markets.

It is the BSP's commitment to ensure that liquidity conditions are supportive of the spending and investment needs of firms and households, while keeping a watchful eye on price stability.

The recent lowering of the risks to inflation allowed the BSP to cut its policy rates by a total of 200 basis points since December 2008. The BSP's decision to ease the monetary policy stance was based on the Monetary Board's assessment that inflation would stay within target over the course of the policy horizon.

This 200 basis-point cumulative reduction in the policy rate will help stimulate economic growth or help moderate the slowdown by bringing down the cost of borrowing and reduce the financial burdens on firms and households. This will help us avoid or at least mitigate the negative feedback loop from weakening economic conditions to the functioning of the financial sector. Lower policy rates would also have the effect of shoring up business and consumer confidence.

The latest inflation forecasts continue to show subdued price pressures, with headline inflation expected to settle at around the middle of the target range for 2009 and at the lower bound of the target range for 2010. On balance, downside pressures on prices predominate due mainly to expectations of a marked deceleration in global economic activity, which is expected to continue to dampen imported inflation and inflation expectations, and weaker domestic demand conditions.

In addition to the reduction in its policy rates, the BSP also moved to ensure that there is sufficient liquidity in the system. The BSP:

1. Enhanced the existing peso repurchase agreement (repo) facilities through relaxed valuation and a broader list of acceptable collaterals;
2. Established a US dollar repo facility to augment dollar liquidity in the foreign exchange market and ensure the ready availability of credit for imports and other legitimate funding requirements;
3. Reduced the regular reserve requirement by two percentage points on 14 November 2008;
4. Liberalized rediscounting guidelines which include increasing the rediscounting budget to P40 billion in 14 November 2008 and to P60 billion on 02 March 2009, aligning rediscounting rate with the RRP rate, easing the NPL ratio requirement and increasing loan value of all eligible papers; and
5. Launched the Credit Surety Fund (CSF) Program which provides guarantee to small cooperatives to ensure continued access to financing of small businesses.

The BSP has also acted swiftly to bolster confidence in the financial system, through timely communication and greater transparency.

Moreover, to safeguard the confidence in the banking system, the Monetary Board approved on 30 October 2008 the guidelines allowing financial institutions to reclassify financial assets from categories measured at fair value to those measured at amortized cost. Financial institutions were allowed to reclassify their investments in debt and equity securities from their Held for Trading or Available for Sale categories to the Held to Maturity or the Unquoted Debt Securities Classified as Loans.

The BSP also allowed banks not to deduct unrealized mark-to-market losses in computing for the 100 percent asset cover for FCDUs, effective until 30 September 2009). This reduced the need for banks to source dollars from the foreign exchange market.

What lies ahead for the Philippine economy? In the succeeding frames, we examine the outlook for this year and the challenges ahead of us.

This table shows the domestic outlook for 2009, based on the macroeconomic assumptions agreed upon by the Development Budget Coordination Committee.

With the bottoming out of the crisis, the economy is forecast to grow moderately at a range between 0.8 and 1.8 percent in 2009 (GDP) to provide the backdrop for the improvement in growth prospects in the coming year.

As mentioned earlier, inflation is expected to further decelerate in 2009. This has given some flexibility to monetary policy to support economic activity, as long as inflation remains on target.

In 2009, the BOP is expected to again post a surplus, supported in part by three factors:

- **Remittances** which are expected to stay at the 2008 level, or possibly even surpass it a bit;
- **Revenues from BPO services** which will also provide some lift to the current account (actual revenues for 2008 reached US$6 billion). The BPO industry is poised to grow on account of strong demand for back office, engineering and financial services; and
- **Export revenues**, while still expected to contract, are showing some signs of life, i.e. the book to bill ratio has increased since February 2009.

The GIR as of end of July 2009 has already surpassed the target range for 2009.

The peso which is assumed to stay at an average of between P46 to P49 per US dollar will be supported by the favorable external payments position.

Inflation expectations remain well-anchored.

The BSP survey of private economists indicates that the mean inflation forecasts to be at 3.5 percent for 2009, 4.8 percent for 2010 and 4.8 percent in 2011. These were all lower than the forecasts in the previous quarters.

Broadly, similar numbers are yielded by the Asia Pacific consensus forecasts: at 3.6 percent for 2009 and 4.4 percent for 2010.

Given this scenario, what are the likely directions of the monetary policy going forward?

The BSP's policy thrusts will continue to be aimed at ensuring that the headway achieved in nurturing a resilient economy and a sound banking sector will be sustained even in the face of the challenges.

First, on monetary policy, we will maintain vigilance over price developments, since this is the BSP's primary mandate. As the risks to the domestic economy move away from inflation toward economic growth, we have had more flexibility in our policy settings. The BSP will continue to pay close attention to signs of global demand recovery as well as to a possible build-up in commodity price pressures over the medium term, with a view to undertaking timely action towards a non-inflationary recovery in economic activity.

Moreover, the BSP stands ready to undertake policy actions that will strengthen the public's confidence in the financial system. We will sustain key reforms that will strengthen capitalization, supervision and market discipline for greater efficiency, more effective risk management, stronger capital base and improved corporate governance standards in the banking system.

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 movement in the exchange rate; maintaining a comfortable level of reserves as self-insurance; and ensuring the sustainability of our external debt.

Let me add a few notes on the likely path of monetary policy in the near term.

As the global economy recovers, the eventual strengthening in domestic economic activity will require a controlled shift in the direction of the policy stance from the current easing mode.

The timing and speed of the shift to a tighter or less accommodative policy stance will depend on the inflation outlook as well as on the sustained pick-up in real sector activity, as the full impact of prior fiscal and monetary stimulus takes effect.

It is important to remember that the type of monetary easing undertaken so far by emerging-economy central banks like the BSP has been more conventional compared to that by the central banks of advanced economies. Central bank balance sheets in advanced economies have grown more sharply in the past year as a result of unprecedented "quantitative" easing and significant credit measures. By contrast, we relied largely on conventional easing measures such as lower policy interest rates and reserve requirements – although we did implement liquidity enhancing measures as well.

Looking further ahead, however, one important risk that we are seeing for monetary policy – apart from the volatility of commodity prices – is the potential resumption of cross-border capital flows, which may complicate the shift to a tighter policy stance.

The emerging signs of stabilization of global financial markets and economic conditions are expected to encourage the gradual return of capital flows to Asia. With the ongoing realignment in risk perceptions, flows to emerging economies – particularly those with sound macroeconomic policy and good growth prospects – are expected to improve in the second half of 2009 and in 2010.

Capital inflows help relax the foreign exchange financing constraint of the domestic economy. For this reason, they can have a positive impact on the external accounts, contribute to liquidity expansion and help lower domestic interest rates. However, policymakers will also need to be prepared to face the possibility of exchange rate appreciation and increased liquidity growth, along with associated concerns. The key challenge is to conduct monetary policy so as to ensure that the additional resources provided by rising foreign capital inflows do not lead to inflationary pressures or to asset price bubbles.

As economic conditions improve and we enter another phase of the business cycle, policy imperatives come into the fore.

The challenge is to address the inherent procyclicality of the financial system by strengthening the macro-prudential framework for monetary policy. The long-term commitment to price and financial stability imposes the need to require better risk management within the financial system. On its part, the BSP has already issued its Internal Capital Adequacy Assessment Process (ICAAP) guidelines which aim to strengthen the risk culture within banks. Likewise, the BSP is in the process of beefing up its macro-surveillance capabilities. Mindful of the lessons brought by the global financial turmoil, the BSP has stressed the need to operationalize the guidelines on liquidity risk management. Moreover, the BSP will continue to monitor proposed further enhancements* and adjustments in the Basel II framework to make capital requirements countercyclical.

Another challenge is to sharpen the central bank's communication toolbox to include not only management of expectations but also management of risk aversion. The key point is to maintain and enhance the credibility of the monetary and financial policies such that expectations are well-anchored and concerns of risk aversion do not become self-fulfilling.

Finally, I want to conclude my presentation by emphasizing that:

- The full recovery of the global financial system may take some time;

- With the global economy likely to be going at a sub-par rate for some time, the key challenge is to continue to provide support domestic demand. As monetary policy has eased, fiscal policy will also play a key role in sustaining domestic economic activity.
- The BSP will continue to calibrate its actions appropriately to help achieve faster recovery of the domestic economy always taking into consideration the inflation outlook.

- Moody's Investors Service upgraded the Philippines' foreign and local currency government ratings to Ba3 from B1, the country ceiling for foreign currency bank deposits to Ba3 from B1 and the country ceiling for foreign currency bonds to Ba1 from Ba3. The change in the foreign currency bond ceiling is based on a revised assessment of the risk of an external payments moratorium to low from moderate.
- The outlook on the ratings is stable. The upgrade was prompted by the relatively high degree of resiliency exhibited by both the country's financial system and external payments position in the face of the global financial and economic crises. International reserves of the central bank are at a historic high and exceptional policy measures have not been required to shield the banking system from global shocks.