Amando M Tetangco, Jr: Taking the next steps at a time of change

Speech by Mr Amando M Tetangco, Jr, Governor of Bangko Sentral ng Pilipinas (the central bank of the Philippines), at the Philippine Financial Market Forum "The way forward: building opportunities – riding on the wave of emerging market growth", Makati City, 18 June 2012.

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Distinguished guests, my colleagues in the financial market, friends from media, ladies and gentlemen, good afternoon.

I am happy to join you again and have this opportunity to discuss the prospects of our financial market. Forums such as this seem to be occurring more frequently these days. To me, this is a strong indicator of interest in the Philippines.

This interest is not without basis. Consider this…. despite the volatility in oil prices and global uncertainties, domestic inflation has remained manageable. Interest rates have been at historic lows. This has had the upside of sustaining consumption expenditures which in 2011 accounted for 70.8% (in real terms) of GDP. Government spending has since picked up while the fiscal deficit has remained under tight control. With the balance of payments remaining positive and remittances sustained, we now find gross international reserves at record highs.

Such an economic environment translated to a 3.7% growth in GDP for 2011. Building on this, our first quarter GDP growth rate has been reported at 6.4% year-on-year. This is the highest in Southeast Asia thus far and second only to China's 8.1 percent in all of Asia.

It is important to point out that these are not one-off gains. The sovereign rating and the accompanying outlook have been upgraded by various rating agencies in the last two years, re-affirming the consistency of our economic gains. We are likewise heartened to read of recent public comments by a number of analysts who see the Philippines getting another upgrade this year.

I believe we would all be in agreement when I say that, these favorable indicators have come from our collective investments in focused policy reform and implementation, post-1997. As policy makers kept their eyes on the inflation ball and sustained the will to reduce our dependence on external debt, the private sector also remained engaged in policy development and prudently sought growth opportunities. For certain, this partnership has brought our country to its current position of relative economic strength.

You have aptly chosen as your theme "The Way Forward: Building Opportunities – Riding on the Wave of Emerging Market Growth". Data from the BIS shows that the growth pattern in the EMEs has changed since the height of the crisis. Overall, exports and industrial production are weakening while household consumption continues to hold up well. In emerging Asia, consumption contributed 4.25% and investment 2.75% to growth last year. The Philippine experience certainly reflects this. The shift in focus to stimulating domestic demand has certainly made emerging markets more resilient than advanced economies.

This is not to say, however, that we should be complacent. Markets can turn quickly and difficulties can be protracted. Was it not only 48 months ago that the sale of Bear Stearns was finalized (on May 30, 2008) to stem the tide of market collapse? Yet when Lehman Brothers announced nine days later that it incurred a USD2.8 billion loss for its second quarter results, the chain of ensuing global difficulties could not have been rationally foreseen by any model or analysis. In other words, ladies and gentlemen, things can quickly change.

If institutions and the sovereign are to be best positioned at a time of change, we need to be cognizant of what's driving the momentum for change…From our perspective, three main themes stand out.

First, liquidity. In thinking about the growth agenda, we need to pay particular attention to both the potential capital flows and the movements in domestic liquidity, as these are closely related to maintaining stable monetary conditions.

Europe is said to be deleveraging. As central Europe deleverages away from peripheral Europe, it is likely that at least some of the funds would be headed towards Asia. However, if core Europe deleverages absolutely, then we might see a liquidity squeeze, not only in Asia but across the globe as well. Capital flows impact exchange rates, interest rates, trading volumes and future demands on currency withdrawals. These are not small concerns, as these can quickly become the stimuli for systemic risk. The BSP is thus always watchful.

On the other hand, there is sufficient domestic liquidity. You may have heard me say this on a number of occasions in the past. As I see it therefore, the issue of a liquidity squeeze and contraction of trade credits because of deleveraging in Europe is not our primordial concern. The strength of the Philippine banking system at the height of the global financial crisis was precisely the ability to source deposits, create loans while at the same time continuously improving the quality of the credit portfolio. There is always of course that temptation to deploy funds to cover costs. Ultimately, it is an issue of credit underwriting for banks. So, I say to our banks, now is not the time to put our avowed strength at risk.

What I would, however, encourage our banks to do at this time is to seriously consider channeling liquidity to productive investments, such as the PPP program, instead of simply placing funds in financial instruments or engaging, even indirectly, in activities like shadow banking. Communication lines, roads, bridges and airports… these are the kinds of investments that affect the quality of growth and define our competitiveness.

Second, financial stability. Through the crisis, we managed continued real GDP growth because our financial markets were broadly in order. This is why financial stability is now the overarching policy issue. Instead of looking at growth only as a higher number, we need to go beyond the bottom line and the balance sheet. Specifically, we must appreciate how things relate to one another, arresting any buildup of system-wide risks that may be brewing underneath. This leads to an agenda that oversees corporate leverage, nonbank sources of credit, real estate expansion, and corporate governance as much as it does for managing liquidity, yield curves, loans, and bank capital.

For banks in particular, your relationship with other financial institutions and with nonbank corporates will be under increased scrutiny under Basel 3. Consistent with the stability agenda, the new Basel Accord covers a lot of ground on counterparty risks and systemic connectedness. While many have complained that this will likely increase the cost of doing business, we must remind the market that there is a price for taking on more risk, because ultimately, the costs of a financial blow-out are borne not just by the banks, but by the economic community as a whole.

The third theme is the issue of economic integration, which is high on the agenda of Asia. ASEAN is consolidating to take a collective approach from capacity building to capital markets to liberalization. One may wonder why this should be high on the Asian agenda, given the experience in the Eurozone. The answer is simple – we need to learn from others in the region, we need to understand how individual markets work, so we can better appreciate what opportunities (and threats) reside in our own backyard. Integration is not just the usual line that markets will be extended or that market guidelines will be harmonized. Rather, this goes to the heart of regional policy cooperation. During a time of crisis possible conflicts could arise between sovereign policy packages and regional stability efforts. It is therefore imperative that before that time comes, practicable regional safety nets are already in place. Often, the problems an individual country faces are the same problems faced by the region as a whole, regardless of the individual country circumstance. The efforts to strengthen regional cooperation in Asia are steady. The recent enhancements in the CMIM, of which the Philippines is a part, certainly move the region closer to this goal.

Friends, these three themes comprise a full list of things to consider as we mull the way forward. While there are a number of clear opportunities that the country's current position of relative strength affords us, there remain serious storm clouds in the external environment. Europe continues to struggle to find the appropriate policy balance – between the short-run remedy to stop the contagion and the long-term cure to ensure sustainable growth. Today, the market welcomed the results of the Greek vote. But participants remain cautious and watchful of the next steps of the ECB, other major central banks, as well as the IMF towards reaching a credible resolution to the EU debt crisis. As for the US, the economic fortunes there are just as unclear. These two are not inconsequential jurisdictions. Taken together, the US and the EU represent 14% of incremental global GDP between 2007 and 2011, increasing to 16% if measured in purchasing power parity terms.

As Europe and the US face increased financial market difficulties, the feedback loop will take the Philippines through episodes of volatile capital flows, adjustments in liquidity, stresses in credit underwriting – all of which could affect economic growth. Ladies and gentlemen, this simply highlights that the challenges in offshore markets should be onshore concerns.

In our role as bank regulator, our concern is with respect to the potential ramifications of all these developments on banks. We have been doing a lot of pencil pushing. Under different simulated stress scenarios, the banking system CAR falls but still remains above the national standard of 10%. The numbers may be reassuring, but these should not lead to complacency.

Friends, while uncertainties surround us today, there are many things that are looking up… Business confidence is rising… Private consumption continues to be resilient… Unemployment remains low and is declining… Inflation expectations continue to be firmly anchored, with the forecast close to lower end of target range of 3–5%, so interest rates can be seen to be stable… BoP is seen to post a surplus of $2.6 billion. Foreign reserves are projected to continue to rise to about $77.5 – 78 billion in 2012 while debt service is expected to remain stable, or even decline… With these, the peso can be expected to trade within reasonable ranges.… Banks are seen to remain in good health.

Ladies and gentlemen, if you are to build opportunities and ride on the wave of our current position of strength, you need to recognize that the choices you make today will have lasting consequences…. This was what your policy makers did in 1997. We took on the difficult reforms to correct structural vulnerabilities then. Thus we developed the defenses that ensured resilience through the crisis of today. It hasn't been easy getting to where we are today. So your role in this uneven operating environment is to safeguard the gains so far, for it is these hard-earned gains that will allow you to take advantage of the opportunities going forward. In support, you can be assured that the BSP will craft the requisite enabling monetary, external and banking sector policies.

There is no magic formula that will allow us to accomplish all these effortlessly. The key, however, remains to think of the bigger picture – no longer just in terms of individual pay-offs but rather on how our respective actions can produce the shared goal of a strong, steady and upward economic growth trajectory that benefits the greater majority.