Amando M Tetangco, Jr: Crafting policy in a shifting operating environment

Speech by Mr Amando M Tetangco, Jr, Governor of Bangko Sentral ng Pilipinas (the central bank of the Philippines), at the 2012 FINEX National Conference, Manila, 5 October 2012.

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It is a pleasure to join you on your 44th National Conference. FINEX is unique in our market because you are an organization of professionals – rather than of specific institutions. In your vision/mission statement you declare you are the "leading national organization of financial professionals and practitioners". As such, you represent the financial expertise across several industries. Let me underscore the term ..."expertise".

Therefore, it can be said that the "psyche" that moves financial markets is determined among your membership. I use the term psyche here to refer to both the "expert knowledge" accumulated through facts and figures and the "raw gut" that brings those facts and figures to life in the financial world... The trader instinct. The hunt for the gain. The "animal spirits" as John Maynard Keynes refers to.

Risk taking behavior complicates policy

I was reflecting on your chosen topic – "Driving Growth and Competitiveness Through Innovation". Three big words… Growth, competitiveness and innovation. At first I thought of how broad the topic was, especially when taken against the very specific mandate of the BSP. And then it dawned on me that because market innovation is driven by your members' "animal spirits", this topic squares quite well with the motivation to our work as a central bank…which has to do with the channels of transmission of monetary policy. Let me explain.

The better known or more familiar channels of transmission of monetary policy are – interest rate, exchange rate, credit, asset prices and expectations. But there is one more channel that is less-talked-about but which has recently become prominent both in the literature and in global real world practice. This is the "risk taking channel of policy", which has gained ground during this prolonged period of low global interest rates.

Let me illustrate why this has been so. First, the low interest rate environment encourages agents to take more risk than they normally would…just to enhance yield on their portfolio. Second, low interest rates affect asset valuations… and therefore modify credit worthiness of some corporates. These in turn encourage the structuring of financial products (through derivatives) for projects that may not normally meet credit standards.

A global example of the risk taking channel is the now-familiar story of the mortgage crisis in the US. While a bank that securitized its mortgages freed up liquidity trapped in its non-tradable long-term receivables, the value chain of continued securitization and re-securitization proved to be very vulnerable to price shocks. Nobody quite imagined that the loss in the value of that single underlying collateral could become wholesale. Nobody quite foresaw that we would get a global crisis, the socio-economic dislocations arising from which would not have yet fully abated nearly five years since it began.

Closer to home, the example we can cite is market behaviour reflected in the magnitude and speed of capital flows into the country. Accommodative monetary conditions in advanced economies, the weak US employment picture, and the still-unresolved European crisis continue to direct investors to re-balance their portfolios... And, Emerging Markets (including the Philippines) are currently an attractive target. This puts the peso under pressure of sharp swings against global currencies.

Using the right tools for the job

The peso appreciation has been recent topic of interest in news columns of academics and former government technocrats. A few have encouraged the BSP to “print more money” instead of sterilizing, as a response to capital inflows. They would like the BSP to be more “resolute in our pushback” on the exchange rate lest we lose more jobs to competitor countries like India.

My response to this is that doing so would be inflationary. “Printing money” to absorb the expected capital flows would lead to a tremendous expansion in domestic liquidity that would fan price pressures. In addition, the peso’s strength is largely fundamentally supported. So, official BSP action should only be to reduce excessive volatility in the rate movements.

Capital flows are fickle and crafting monetary policy to address them is even trickier. It seems quite simple to prescribe monetary easing. But that seemingly simple construct could fan inflation pressures, lead to asset bubbles and create more “problems” beyond what we thought we were trying to solve to begin with. It is easy to let money lose, but it is not easy to “clean up” afterwards.

Ladies and gentlemen, let me emphasize that risk taking complicates monetary policy formulation and implementation. To address this, the BSP has had to use a menu of policy actions. We have not limited ourselves to the policy rate. But we have used an enhanced policy tool kit. The kit includes allowing some exchange rate appreciation to account for the structural inflows and macroprudential regulations such as the increased risk weight on NDF transactions. The toolkit also includes a careful build-up of our reserves. Reserves are for insurance. But it is not easy to determine an “optimal level” as some have suggested. The risks we are now insuring against are also evolving. That said, our experience in the recent crisis and its aftermath has taught us that it is critical to use the right tools for the job.

Competitiveness is more than the price

Moving to the second big term in your theme – Competitiveness. The BSP’s contribution to competitiveness is maintaining a stable macroeconomic environment and banking regulatory framework. Within these, the market can plan well ahead, consider expansion, innovate and find market-based solutions to address risks.

The BSP’s primary mandate is price stability. It’s noteworthy that since 2009, the BSP has been successful at keeping inflation well-within the Government’s official target range. And it appears that we would be able to do the same in 2012 and 2013. Our forecast for inflation is that over the policy horizon, inflation should be manageable. Therefore our current policy stance remains appropriate. In other words, you can expect interest rates to remain low over this period. But we will make adjustments should circumstances warrant, including, among others, in the event tensions in the Middle East escalate and more weather-related supply chain disruptions occur.

On the external front, the country’s external position is likely to remain robust, which in turn should fundamentally support the peso. Our experience has taught us that allowing the market room to determine the exchange rate is equitable and efficient. So far, (looking at the REER), the peso has maintained its competitiveness and volatility has just been in line with the region.

Ladies and gentlemen, the BSP fully appreciates that when finance executives consider the macroeconomic operating environment, your ultimate unit of analysis is the corporate bottom line. You consider every transaction and how it would increase the value of the firm. This is well and good. But the complication arises when these individual “animal spirits” do not behave as the “invisible hand” of Adam Smith would have determined. Oftentimes, an act that may be beneficial to a firm may actually turn out to be harmful when all other firms are engaged in the same transaction.

This is a newer appreciation of the complexities of financial markets. In order to create a stable macro operating environment, the BSP must now go beyond stable interest rates and exchange rates. The BSP must now also ensure that the financial market accounts for how risk exposures interact with one another.

In other words, ladies and gentlemen, monetary stability must now be pursued alongside financial stability. So far, through the series of reforms we have instituted, we have been able to keep the banking system in a position where its capital is able to absorb significant external shocks… and we are ready for the adoption of Basel 3 capital standards starting 2014. But this is not enough.

At the BSP, we have formally taken on financial stability as a prudential task. A high-level committee has been operating for this purpose, working on an agenda consistent with international reform initiatives. Although still at the early stages, we have already initiated some prudential policies and built quantitative models for the singular purpose of mitigating the build-up of systemic risks.

At the national level, the Financial Stability Coordinating Council or FSCC has been convened as well. Composed of the DOF, IC, SEC, PDIC and the BSP, the FSCC is to identify areas of brewing pressures and to take pro-active measures before these risks spillover. The agreed upon agenda of the FSCC covers quite a bit of ground. Many elements of the agenda are of direct relevance to the financial executive, regardless of whether you are in banking, securities, insurance or in the corporate field.

Growth has to be inclusive

The final big word in your theme is Growth. In every forum I have been invited to speak, I am always asked the question, what can BSP do to sustain growth, alleviate poverty and improve income distribution?

These questions and similar comments indicate that much is expected of the BSP... perhaps too much. Let me remind everyone that the mandate of the BSP is price stability, and we are now moving more towards price and financial stability. We have the tools to pursue these. But, monetary and financial stability cannot be expected to do everything. It has been said, one cannot push on a string. There are other government agencies that are more specifically geared for stimulating and maintaining growth.

What we have done so far is endeavour to make credit and funding accessible at reasonable prices, commensurate to the risks agents are willing to take. For the needs of Main Street, we are in partnership with other government agencies on the capital market agenda. On servicing the unbanked and marginalized, the BSP has 1) put together a regulatory environment that has encouraged banks to design suitable financial products, and 2) expanded our financial education and enhance consumer protection efforts.

Innovation, competition, growth – role for Finex?

Putting all three big words together – innovation, competition, growth – there is clear recognition that the government agencies cannot possibly handle the tasks alone. We need the private sector to be our active partner.

Here is where FINEX can play a major role. I mentioned at the onset that you are unique in your representation. As such, FINEX should be called upon to drive growth and competitiveness by pushing innovations that go beyond the bottom line, that consider the bigger picture, that contribute to financial stability. There are many ways by which you can pursue this in your own work.

- You can avoid the temptation of leveraging finance through carry trades. The pay-offs may look enticing but compounded risk exposures are created in the process which often cannot be unwound without significant loss.

- Credit underwriting standards need to be kept high. This ensures that credit is allocated based solely on the merits of the prospective economic activity and the counterparty's ability to pay.
- Binding market conventions and redress mechanisms should be pursued. Such conventions set the bar on market conduct which then translate to uniformity in behaviour and practice.

Other avenues may be considered. When your individual creativities are pooled together under the FINEX umbrella, the opportunities are limitless.

Final thoughts

I have covered quite a bit of ground this morning. But much of the breadth has been dictated by the call of the times.

Ladies and gentlemen, the best financial investments today are those that build bigger markets in the future. Markets wherein stakeholders are better aware of financial opportunities. Markets that are best able to withstand the build-up of system-wide risks.

This, in my view, is the unique opportunity that is presented to a unique organization of financial executives. Will FINEX rise to this challenge?

Thank you and good morning to all of you.