Amando M Tetangco, Jr: Bangko Sentral ng Pilipinas' policy directions in a challenging landscape

Speech by Mr Amando M Tetangco, Jr, Governor of Bangko Sentral ng Pilipinas (BSP, the central bank of the Philippines), at the ACI Phils-FMAP-IHAP-MART-NASBI-TOAP Joint General Assembly, Manila, 24 September 2013.

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Ladies and gentlemen, good evening.

Let me begin by thanking the organizers of this event for the opportunity to speak before your membership. I sometimes have the chance to speak individually with a number of the associations and I always welcome those one-on-one exchanges, which are often very informative and insightful.

But your Annual General Meeting is a clear upside for everyone. By holding a joint general assembly, we benefit from not having to repeat messages across several forums. We also benefit from coming together as a market with a commitment towards ensuring that we continue to build on the gains we have made so far.

Introduction

Let me take you to a quick game of WORD ASSOCIATION.

Is everyone familiar with this game? For example, when I say BLUE. What comes to your mind?

I debated whether I should use words or the Rorschach Test of inkblots. In the end, I concluded "words" would be easier for a crowd like this. It should be easier to find some kind of consensus in a room full of traders than it would among economists. [Two-handed economist.]

Here goes: Uncertainty, Communication, Volatility, Normalization, P44.00, Maintain, Spread Narrowing, Market Infrastructure, Client Suitability, Client Protection, Real Growth, Inclusive Growth.

As expected there are differing appreciations/meanings associated with words. Our associations are defined by where we are right now (in dealer parlance, your current "POSITION") and what we've learned from the past (Ika nga nila – kailan, kung saan at gaano kalaki ang talo or panalo mo!)

In other words, ladies in gentlemen, your associations and ultimately your behavior are defined by facts and perception.

Tonight I'd like to lay down some "facts" before you.

After which, I'll briefly touch on some of the "risks" that could color our perception.

My goal tonight is to help ensure that there is a convergence between your appreciation and the actual intent of the BSP's policy thrust. A strong positive consonance between the two will certainly make our monetary and banking policies even more effective.

In the end, our hope is that the resulting market conditions would create wealth and prosperity not only for you, as intermediaries, but also for the Filipino people, who are, after all, the BSP's and your ultimate stakeholder.

Fact 1: We have buffers against known vulnerabilities.

First, our strong macrofundamentals yield solid growth and low inflation.

GDP growth (left slide)

- GDP grew robustly by 7.5 percent in Q2 2013, supported by strong household and government spending, as well as increased investments in capital formation on the expenditure side. These drivers of growth offset the negative contribution from exports. On the production side, GDP growth was led by the services sector.
- 4th consecutive quarter of above 7 pct growth, 58th consecutive quarter of positive growth.

Inflation (right slide)

- Inflation pressures remain manageable. Headline inflation expected to fall within the 4.0 percent + 1.0 percentage point target range for 2013–2014 and the 3.0 percent + 1.0 percentage point target range for 2015.

Second, we have a comfortable cushion of FX reserves which buffers the country against external shocks

- The country's GIR stood at US$83.2 billion as of end-August 2013.
  - adequate to cover 12 months' worth of imports of goods and payments of services and income;
  - equivalent to 8.0 times the country's short-term external debt based on original maturity;
  - 5.5 times based on residual maturity.
- Comfortable margins from historical and international standards.

Third, the BSP's consultative style and clear effort to understand market behavior have helped us calibrate regulation appropriately. The graphs prove that this proactive approach to oversight of the banking sector contributes to healthy asset quality and credit growth.

KB Lending (left slide)

- The Philippine banking system has been exhibiting strong lending growth since 2011. As of July 2013, bank lending growth stood at 12.3 percent.
- Growth in bank lending has been fueled by both supply and demand factors:
  - Supply side: encouraged by steady growth in domestic liquidity and improved asset quality
  - Demand side: explained by increased financing needs of businesses and households, plus

    Relatively low interest rates

    Attractive terms of financing offered by banks

GNPL Ratio (right slide)

- The Gross NPL (GNPL) ratio of U/KBs has broadly declined and remains low at 2.68 percent as of June 2013. While GNPL ratio has been on a downtrend, the Net NPL (NNPL) ratio has remained nearly constant. As of end-June 2013, the NNPL ratio was at 0.39 percent and the year-to-date ratios have been within a very narrow band between 0.43 percent and 0.45 percent.

Fourth, the BSP has the surveillance tools to allow us to respond pre-emptively to emerging threats. A review of our indicators shows that none of these indicators have breached set critical thresholds. None of these are emitting signals that raise alarm bells.

A. Indicators

1. The EWS on currency crisis utilizes a set of macroeconomic indicators to assess the probability of a currency crisis. Deviations of these variables from their normal threshold levels (estimated based on previous crises) are taken as warning signals of a possible crisis occurring within a specified time frame.

2. The Philippine Financial Stress Index (PFSI) measures the degree of stress in the financial system with the use of 10 high-frequency data on bonds, foreign exchange, equities markets in both external and domestic markets. A positive PFSI thus indicates that the level of financial stress is above the historical average, while a negative value signifies that the level of financial stress is below the historical average.

3. The BES Confidence Index (CI) presents the prospective outlook of the business sector on the macroeconomy. It depicts entrepreneurs' views of the general business situation in the Philippine economy.

4. The Consumer Expectations Survey (CES) is a quarterly nationwide survey of a random sample of 5,000 households in the Philippines. Results of the CES provide advance indication of consumer sentiment for the current and next quarters and the year ahead as reflected in the overall CI, as well as in selected economic indicators.

5. Senior loan Officers Survey

6. Business Cycle Analysis provides an indication of on turning points of economic activity from an expansion to a contraction and vice versa.

B. Committees

1. The Advisory Committee was established as an integral part of the institutional setting for inflation targeting. It is tasked to deliberate, discuss and make recommendations on monetary policy to the Monetary Board. Starting in 2012, the Committee will hold eight (8) monetary policy meetings in a year.

2. The Financial Stability Committee (FSC) was created in September 2010. The FSC is tasked to determine the appropriate market vision and work plan to adequately mitigate the build-up of systemic risks in the financial system.

3. The BSP believes in a holistic and well-coordinated approach in pursuing its financial inclusion agenda. Toward this end, a high-level Inclusive Finance Steering Committee was constituted on 27 February 2012. The Committee provides direction and oversight in all BSP policies and programs related to financial inclusion.

4. BSP's membership in EXTERNAL committees includes the FSF and FSCC, both of which broadly endeavor to strengthen and protect the country's financial sector.

C. Reports

1. The Inflation Report is published quarterly as part of the BSP's efforts to improve the transparency of monetary policy under inflation targeting and to convey to the public the thinking and analysis behind the Monetary Board's decisions on monetary policy.

2. The Quarterly Report on Economic and Financial Developments (Letter to the President) outlines the major developments in the real, monetary and fiscal sectors of the Philippine economy.

3. The Financial Stability Report is published two times a year. It provides a comprehensive assessment of the robustness as well as vulnerabilities of the domestic financial system against emerging economic and financial developments both in the global and domestic environment.

Fact 2: We are reform-minded and have a strong reform agenda in place.

We are geared up for the Basel 3 Capital Framework.

This slide shows a comparison of the minimum requirements under our old Basel 2 framework, the Basel 3 framework of the BIS and our own requirements in 2014.

You will see that our minimum CAR has not changed. It is still 10 pct. What has changed, however, is the composition of qualifying capital. From a requirement of minimum Tier 1 of 5 pct under Basel 2, we will now be requiring at least 6 pct of Common Equity Tier 1 (CET1). The minimum Tier 1 shall now be 7.5 pct. It's not on the slide, but we will also be requiring a 2.5 pct Capital Conservation Buffer, all of which must be CET1.

In other words, ladies and gentlemen, what has changed is the composition of capital to improve its loss absorbing capacity.

I have been asked why we appear to be in a hurry to implement Basel 3. It's true we are ahead of the Basel timeframe of 2019, but we are actually behind our EMEAP counterparts. (Australia and NZ have implemented in full in 2013.) Are we being stricter than other jurisdictions? Not really, when you consider that our minimum CAR remains at 10 pct.

I am also asked what's the benefit of implementing this now instead of later. 1) To reduce regulatory uncertainty, 2) Minimal impact on banks, because banks are ready, 3) It's a credit positive.

In addition, we are gearing up for the rest of the reform Agenda under Basel 3. This slide gives a quick view of the packages of Basel 3 reforms in the pipeline What will come into play in Jan 2014 is part of the capital framework in Basel 3.

The other major reforms will fall under Liquidity Standards and Systemic Risk and Interconnectedness. Experience has taught us that when it is crunch time, often what becomes the binding constraint is liquidity. Bank failures often result from a lack of liquidity. Moreover, this crisis has taught us that looking at individual firms is not sufficient. Interconnectedness is at times even more important.

As you can see from this slide, the capital market reform agenda is a full topic by itself that deserves its own treatment. I'll leave that as a topic for a future speech.

Another part of our reform agenda covers the ongoing efforts towards regional integration.

The BSP is supportive of the AEC 2015 and ABIF 2020 dialogue. The benefits of technology transfer and broadening of markets and market access are clear. But of course there are costs, including perhaps loss of market share and volatility if one thinks of the region as a zero sum game. We don't believe this is so. The principles are clear. The key principles are: 1) acknowledgement of various initial conditions of member states, 2) agreement on milestones, and 3) agreement that compliance with milestones is state-dependent. At the end of the day, we see this as a window of opportunity. It's a cooperative effort.

Fact 3: There is a strong show of faith from third-party recognition.

The stable macrofundamentals and sound banking system have not gone unnoticed. Our investment grade credit rating clearly reflects these.

In addition, the institutionalization of our governance reforms continues to be reflected in improvements in our international competitiveness.

Based on the results of the Global Competitiveness Ranking of the World Economic Forum, marked improvements were noted in the areas of management of our fiscal position, financial market regulation, and a turnaround in the area of labor market efficiency.

Clearly, ladies and gentlemen, the BSP has its eyes on the ball and its ears to the ground. Importantly, we have policy space to respond to the brewing pressures we observe.

Often times, however, it is in the perception of the brewing pressures where the BSP and the market could have a conceptual difference.

Let me just cite three risks that we see as possible points of pressure:

1) What comes after the Fed Action (or No Action)?

2) Liquidity and Credit Growth post IMA – Are there inflationary and financial Stability concerns?

3) Should we be concerned with the Rest of the World?

Risk 1: How prepared are we for a Fed Tapering?

The Fed taper is an issue that is quite familiar to the market. And I am sure you have read with critical interest all the analyses by eminent Fed watchers of the recent Fed pronouncements.

I don't want to stir that pot of confusion and I also don't want to comment on what the Fed should or shouldn't have done.

But one thing I know is clear, and I can attest to this: the BSP is ready to respond to "excessive" market exuberance or disappointment (whichever case will apply) to any surprise action (or the lack thereof) of the Fed.

I know I don't need to remind you, that we are watching market conduct very carefully, closely, and critically.

Should market reaction/sentiment lead to a loss of overall business confidence or a dis-anchoring of inflation expectations, the BSP has the room to adjust policy interest rates or other monetary policy tools, as appropriate.

Should market action lead to instability in the non-financial (or the real asset) markets, we can further tweak existing macroprudential measures or release new ones, as appropriate to target problem asset areas.

In other words, ladies and gentlemen, our policy actions will always be guided by our price and financial stability objectives. Barring any unforeseen threats, I think we have room to keep policy rates steady for the balance of the year.

Risk 2: Should domestic liquidity growth be a concern? And the flip-side of this, should we be concerned with credit growth?

Our assessment is that both liquidity and credit are rising consistent with the growth in the economy and financial deepening.

Strong liquidity and credit growth feeds the economy's growth potential. Structural reform milestones that began in the early 1990s and 2000s and continue to gather stronger pace today have translated to productivity gains over time, as reflected in higher potential output growth. If the current investment-led growth and institutional reforms are sustained, a 5 to 7 percent potential output growth for the medium-term is highly feasible.

There is sufficient liquidity to fuel this, and banks are able to intermediate these funds safely.

You could also ask should the market be concerned post-SDA IMA?

If the market concern is on the headline liquidity growth number of over 30 percent, my answer would be no.

The BSP has always anticipated there will be some liquidity growth after the funds under SDA- IMA are "released". That was, after all, the game plan. We fine-tuned the SDA operations so the funds could find more productive homes in industry, manufacturing and other sectors of the economy. In addition, our anticipation is that the period of high liquidity growth coming from SDA-IMA will not persist.

If the concern is whether the liquidity will fuel an asset bubble, the answer again is no.

And I think you, who know your SDA clients well, will agree with me on this one. The profile of an SDA investor is very different from the profile of a real estate investor.

Finally, Risk 3: The Rest of the World?

Because of 1) trade ties with, 2) workers deployed to, and 3) tourists expected from Europe, Japan, China, we watch these countries with great interest.

At the moment, the consensus seems to be that 1) Europe can possibly keep its growth rate level, 2) Japan will calibrate its stimulus, learning from the experience of the Fed on the problems of exit from unconventional monetary policy, and 3) China will continue to grow at a steadier pace.

We are monitoring these economies, but we are also mindful that our own domestic demand conditions, particularly consumption and capital formation, remain quite strong.

Concluding remarks

Ladies and gentlemen, I've laid out for you the "facts" and the "perceived risks" – three buffers against three vulnerabilities. I know I've gone thru a lot of information. I am not worried though because I know dealers are experts at multi-tasking, and are able to filter thru a lot of information quickly!

My bottom line is this: the country has what it takes to move forward amidst the uncertainty in the short-term, because we have put up buffers. I know you have heard this said over and over and over but ladies and gentlemen, this is not a trivial matter. It is the very presence of these buffers that has enabled you to enjoy the positions that you are currently in. We are where we are because we did our homework. To you, the vital players in the market, my message is – Do NOT get stuck in the short-term. Just because we have the buffers, doesn't mean it should be "business as usual" You should always look to enlarge your business opportunities, and not just go for the quick trade. I encourage you to think "long-term". I know LONG-TERM TRADER (unless natatalo yung position) is an oxymoron. But think about it, to survive in this business, you NEED to think long-term.

The BSP has a full market reform agenda. The agenda, as you will learn quickly enough, is not a mechanical duplication of the international reforms. Our agenda is a calibrated adoption of the principles of the international agenda to suit our idiosyncratic requirements as an economy. It is also informed by lessons learned from years of dealing with earlier crises.

The BSP needs you, the market, to partner with us, in the full development of this agenda, and in its eventual implementation. Reform will work only if we work on it together.

I avoided using "ink blots" at the beginning of my remarks. But I think for my conclusion, I shall put one up.

This picture is the word "CRISIS", written in Chinese. It is said that one character represents danger, the other opportunity.

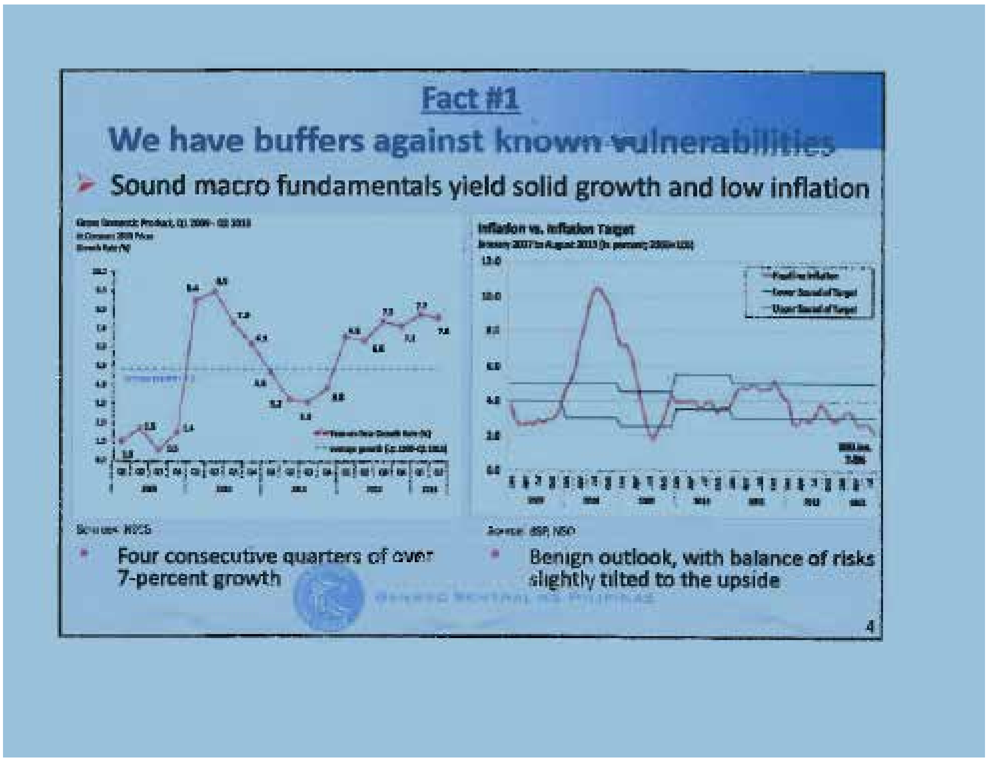
I am not an expert, but I don't think the Chinese meant to say that "Opportunity plus Danger equals Crisis".

Although to an undisciplined trader, working in a dealing room without the appropriate controls, he might see an "OPPORTUNITY" which could then bring "DANGER "to the firm, and result in CRISIS. As a true market, we don't ever want to find ourselves in a "FIX" like this. The BSP is always ready to sanction such activities to the full extent of regulations and the law.

But I digress, what I hope we all will come away with from this picture is this: that with every crisis comes an opportunity to grow. In the Philippines, we can achieve that if we look beyond the short-term volatilities, and consider the bigger picture of what lies ahead.

I hope I can count on all of you, as we work from the same page, of the same game plan.

Thank you, and have a pleasant evening.



Fact #1
We have buffers against known vulnerabilities
Sound macro fundamentals yield solid growth and low inflation
Inflation vs. Inflation Target
Four consecutive quarters of over 7-percent growth
Benign outlook, with balance of risks slightly tilted to the upside
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