Amando M Tetangco, Jr: A responsive capital market – a step on the road beyond investment grade

Speech by Mr Amando M Tetangco, Jr, Governor of Bangko Sentral ng Pilipinas (BSP, the central bank of the Philippines), at the Philippines Investment Forum, organised by Euromoney, Manila, 18 February 2014.

* * *

I am pleased to join you for this Philippines Investment Forum. Events such as this organized by Euromoney bring together the main stakeholders of our economy. Through the various panel sessions, we are able to hear and exchange views, giving us a good sense of where the market pulse lies.

It was certainly a privilege for all of us to have listened to no less than the President deliver the official Keynote Address. This shows you how serious the country's policy makers are in reaching out to you who are among our economy's main stakeholders. Your work is central in enabling the public sector to effect true, broad-based and lasting change that supports the country's continued development.

The President's address and the session before this one laid the groundwork for us to set our sights "Beyond Investment Grade".

Investment grade – how did we get here?

Indeed, we have seen that the road to Investment Grade was not easy... it was long and marked by reforms. Reforms which include, first, a critical diversification of our growth sources and drivers to exploit and take advantage of our favourable demographics... Second, a purposeful shoring up of our external position and strengthening of our banking system… knowing that a robust external position and strong bank balance sheets would allow us to ride out the turbulence from external financial shocks... And third, a resolute management of our fiscal house by steadily reducing our external debt, maintaining a healthy government debt profile, and firmly committing to reforms that would allow us to meet our intergenerational needs.

Investment grade – the near-term challenges

Our current operating environment continues to be very sensitive to global developments. Of late, we have witnessed what some analysts called the "rout" in Emerging Markets, following uncertainty in the next steps of the Fed. Since the beginning of the year, investors have indiscriminately sold EM debt, and the Philippines was not spared. We saw the peso decline, the stock market index drop and government securities yields rise in the secondary market.

Alongside the fear of contagion from EM sell-offs, some analysts are also beginning to wonder if the Philippines isn't already overheating.

Let me address the overheating concern first. Looking behind the numbers, current trends in liquidity and credit growth do not appear to be worrisome. The strong growth in domestic liquidity has been due mainly to the operational adjustments in the BSP's Special Deposit Account (SDA) facility which were completed in November 2013. This rapid growth is therefore seen as only temporary and is not expected to translate into significant inflationary pressures or asset price misalignments. The growth in bank credit, on the other hand, continues to be channelled to the productive sectors of the economy. The higher bank lending growth rates are reflective of the economy's higher growth trajectory and increased financial deepening. In addition, there is fundamental support for the growth in the real estate sector with real demand from end-users including from the growing young professionals and the BPO sector. Finally, data from Colliers International Philippines Research (Colliers) as of Q4 2013 show that property prices are not significantly out of line with their long-term trends.

As for the rout in the financial markets, I would say, some calm has returned with the market's better appreciation of the forward guidance from the Fed. Our view has always been that after the initial nervousness, markets would regain their bearing and distinguish between economies with good fundamentals (such as the Philippines) and those with more structural concerns. In the case of the Philippines, we have actually observed some funds returning to our financial markets.

At the beginning of each new calendar year or each Chinese new year, I am often asked for my "fearless" economic forecasts. There are those who ask me with such earnestness that I sometimes feel they think I have an infallible crystal ball! Friends, I don't have one. And neither am I one to pursue luck. Although before this forum, someone told me that in the year of the Chinese Wooden Horse, the numbers 2, 3 and 7 are considered lucky… Interestingly, today is the 2nd day of the 3rd week of the Year of the Horse and 7th full week of the year 2014! What a coincidence, right?

Thankfully, we don't have to leave things to coincidences. We can instead have the confidence to weather hiccups in market sentiment by planning judiciously and working earnestly.

More specifically, the gains we have achieved on the run up to investment grade have taken root. Above-trend growth, low and stable inflation within target, current account surpluses funded by structural inflows, fx reserves that are more than adequate against traditional standards, a sound banking system, banking sector regulations that are line with global best practices and comprehensive fiscal consolidation.

These are all expected to continue… and that, ladies and gentlemen, is not wishful thinking… neither is it a matter of luck… Because the reform agenda and the policy focus to support these are clearly in place. The Philippines' track record has shown that even in good times, reforms have been sustained.

Beyond investment grade: does it matter?

But is going beyond investment grade a goal we should pursue? Clearly, going beyond investment grade of itself would truly matter if it translates to real investments.

For our ultimate stakeholder, investment-led economic transformation is necessary not just for sustainable growth, but also to develop a competitive middle-class group that further boosts our domestic demand. Recognizing this, the NG has accelerated the bidding and awarding of crucial infrastructure projects and raised public investment. In addition, the government's targeted social spending, especially in education, is expected to yield broader growth in the long run by improving our human capital. These initiatives should help both our investment to GDP ratio and our national income to continue their upward trend.

Beyond investment grade: role of capital markets

To move beyond investment grade requires deliberate steps, just as we saw on the road to investment grade. One of the critical steps on this road is creating a thriving capital market in an environment of stable prices.

The latest numbers tell us that our economy remains to be bank-centric, rather than a capital market-oriented financial system. The distribution of total assets suggests that 80 percent are held by banks. In 2013, some Php84 billion in corporate securities were issued and listed while loans outstanding of the banking system increased by Php663 billion over the same period.

Being heavily dependent on one funding vehicle to raise needed capital can present challenges. For example, as global interest rates are expected to normalize and trend higher, those who have relied on bank credit to raise long-term funding face increased pressure on their cashflows to handle the requirement of higher debt servicing. In addition, with limited private sector securities plying the market, savers do not have sufficient means to migrate themselves into investors, keeping available funding to the shorter-term tenors. Short-tenors are not the natural match for the longer-term funding needs of entrepreneurs and corporate borrowers.

Our idea of capital market reform is not a question of the dominance of one product over the other. Also, we do not expect an overnight shift in the funding structure from bank credit to market securities. There are good reasons why we would like to see more securities issued relative to loans just as there are reasons why the system is currently heavily reliant on bank loans over any other funding source.

What we wish to underscore, instead, is that having the right balance between bank credit and access to capital markets is essential in order to properly manage systemic risks. This has been the key lesson from the recent global crisis. The new prudential norm of financial stability requires that we take a holistic view of how and where risks develop, keeping in mind that markets are all inter-connected.

To help create that healthy balance between bank lending and capital market as a source of funding for the corporate sector, the BSP has been working towards the development of a benchmark yield curve that has depth and breadth. Related initiatives also cover, among others, price-related initiatives such as the Overnight Index Swap (OIS), the calculation of implied zero rates, the oversight of repos and the introduction of STRIPS. We are also looking at the financial infrastructure requirement for the capital markets. From data capture within a price discovery function to the repository of all trade transactions and to auxiliary services such as central counterparties, securities settlement, trading platforms and central securities depository. These initiatives are but a portion of a long “to-do” list.

The capital market reform agenda is huge and the barriers are formidable… but… as the characters in the Broadway play, Wicked, would sing, we must go beyond our limitations and… “defy gravity.”

Concluding thoughts

Moving ahead does not happen on its own. Progress has to be moulded, packaged and timed. If we are to sustain the momentum of growth and expansion in our bid to move beyond investment grade, capital market reform must be integral to this strategy.

If tomorrow is to be better and brighter, we must ensure that we have the overall support system to reap future rewards. We have to instil real change. Only then can we really obtain the benefits of going “beyond Investment Grade”.

On that note, I wish everyone a productive conference.