Amando M Tetangco, Jr: Policy challenges amid an evolving investment environment

Speech by Mr Amando M Tetangco, Jr, Governor of Bangko Sentral ng Pilipinas (BSP, the central bank of the Philippines), at the Inaugural Philippines Investment Summit, organized by the Financial Times in partnership with First Metro Investment Corporation, Makati City, 19 May 2014.

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Good afternoon. Let me first thank the Financial Times and First Metro Investment Corporation for inviting me to address this inaugural Philippine Investment Summit.

The Summit couldn't have come at a better time. Today, emerging market economies, including the Philippines and other Asian countries, face a "new wave of market volatilities". In the first quarter of this year, many EMEs saw large capital outflows, which resulted in EME currencies depreciating, bond yields rising, and equities coming under pressure. Although some of these trends have somewhat dissipated in the last few weeks, risks from the underlying reasons for the volatilities remain.

I therefore welcome this opportunity to share some of our thoughts on the remaining risks. Against this background, I will discuss the outlook for the Philippine economy as well as financial market concerns and the BSP's approach to safeguard against financial instability.

This new wave of market volatilities

Let me begin by considering what I see are the principal sources of the impulses for this "new wave" of market volatilities.

First, the series of Fed announcements and actions. Go back to May 2013 and the "taper tantrum". Flash forward to Fed Reserve's announcement in December the same year of the start of taper. And then the eventual commencement of the taper in January this year. With additional Fed asset purchases now down to only $45B from $85B at the end of 2013, and the taper seen to be fairly on course, the market has found itself at a stage where the betting has turned to when the "lift off" would happen. In other words, markets are speculating when the Fed would begin to hike the Fed Funds target rate. Indeed, markets would like to find the next reason to put on a new trade!

A second source of impulses is the still-patchy structural reform-dependent growth paths of key trading partner Asian economies, particularly Japan and China. Although growth in Japan has picked up as the first two arrows of Abenomics have found their target, the third arrow of structural reforms still has to be firmly in place for the economy to successfully transition to self-sustained, deflation-free growth. For China, while the scenario of a hard landing is not high on many economists' radar screens, the full implementation of the reform agenda that would help accelerate economic rebalancing toward private consumption and deliver more sustained growth is yet to materialize.

Third source of volatility impulses is Europe. The markets continue to watch what the ECB would actually do to fight deflation and curb the strong euro, whether it would in fact unleash its own version of QE. Analysts say Super Mario isn't "bluffing".

There are a number of other impulses, including geopolitical concerns, but in the interest of time, let me just round out this list with this – market differentiation within the EME debt space.

Differentiation is really the market manifestation of the aforementioned macro impulses. Because the current breed of market participants are hard-wired as binary – either risk is "on" or "off", market volatility could be amplified depending on which of the earlier impulses would be stronger at a point in time. Capital flows could shift from AEs to EMEs, in general, and more strongly into specific EMEs, in particular. And depending on the news, we may see a rebalancing within the EME space, a return of flows to AEs, and the cycle could continue where funds would flow back to EMEs.

EME policy focus: how do we guard against the new wave?

Amid this “new wave of volatilities”, therefore, the key priority of policymakers in EMEs, including those in Asia, should be to continue focusing on promoting macroeconomic stability by strengthening buffers against potential risks to financial stability, and equally to the outlook for inflation and growth.

In a word, in the uncertainty created by market reaction to AEs, EMEs must develop an internal anchor. For this, there is no substitute for sound domestic macrofundamentals.

Our assessment: how would we fare during the new wave?

For the Philippines, our assessment is that the economy remains well-positioned to deal with these challenges. In the years following the global financial crisis, the confluence of strong economic growth, low and stable inflation, ample liquidity, and broad market confidence has allowed policymakers to pursue structural reforms to strengthen our buffers against external and domestic sources of headwinds.

Disciplined fiscal policy has also yielded good dividends, as the government now has wider headroom to undertake critical social and physical infrastructure that could in turn improve the investment climate for more enduring growth over the long haul. Further, prudent monetary policy has helped safeguard non-inflationary growth and financial stability, creating a predictable environment for growth in consumption and investment, thus fueling the economy’s momentum.

Indeed, the underlying story of the economy’s sound growth prospects remains intact.

Policy prescriptions: how did we get here?

In the next few minutes, allow me to briefly describe some of the principles underlying the BSP approach in dealing with the (external) volatilities the country faces.

First, to avoid policy confusion, we use tools from our enhanced tool kit distinctly. For instance, we carefully calibrate policy rates to respond to inflationary pressures. At the same time, we use macroprudential tools selectively to address financial stability pressures, including those related to potential exchange rate volatility. To illustrate, in our last two policy meetings, we raised the reserve requirements because we needed to pre-emptively address strong liquidity growth that could lead to potential asset bubbles. Meanwhile, even as the balance of risks remained tilted to the upside, we kept policy rates steady because the assessment is that inflation over the policy horizon would still be manageable. Together, these moves would make any future monetary policy move more effective.

Second, in addition to keeping our regulations in step with the global regulatory reform agenda, we work with other government agencies, like the SEC, to curb market conduct in economic transactions that are not under BSP supervision, such as those by real estate companies, other non-financial entities and asset managers. Examples of the latter are the frameworks for good governance of institutions and consumer protection that we have put in place in collaboration with co-regulators under the ambit of the Financial Sector Forum. As for the former, an example is our full shift to Basel III capital adequacy requirements – as with other countries in the region.

Third, we sharpen market surveillance. For instance, we have refined some of our reportorial requirements to allow us to see things somewhat differently, with emphasis on financial stability implications of specific activities. We recently expanded the definition of real estate exposures that banks would report to us to help us better appreciate the real estate sector, particularly in relation to the financial sector.

Finally, we aim to keep our communication simple. Not too much guidance to avoid confusion, not too little either so as to enhance credibility. Just like Goldilocks. Right now our message to our markets is that we prefer early, measured action – as opposed to chunky reactions to global developments as they happen. We believe this strategy is less disruptive, and will help insulate us from the toggle of AE normalization. The availability of good information is of course crucial in this regard.

Keeping the house in order with integration in mind

Our own goal has always been to keep our own house in order and strengthen it so that when shocks do occur, we have buffers to shield us. Recently our efforts to keep our house in order have gained more urgency in light of our preparations for ASEAN economic and financial integration.

The BSP recognizes the potential of integration but we likewise remain cognizant of the challenges that this initiative entails. We support the underlying principles of "readiness and reciprocity" espoused under the ASEAN Banking Integration Framework or ABIF. But there is need to ensure that the implementation of the principles is fair and balanced.

The BSP has prepared the groundwork by creating a stable macroeconomic environment and putting in place a sound regulatory framework consistent with the global reform agenda. We have also proposed amendments to RA 7721 (i.e., the law that liberalized entry of foreign banks into the country) that would open up the window again for the entry of foreign banks to establish their own branches or subsidiaries here. The BSP has also started discussions with the various banking organizations, which should provide further clarity and level expectations among their member-banks and give them the chance to craft their respective forward-looking competition strategy.

In response to BSP's actions, some Philippine banks have already expanded their branch networks, especially in underserved markets, to build up their domestic presence in preparation for the potential entry of foreign banks. Some are also shoring up their capital positions, further improving their risk management practices, or considering merger and acquisition opportunities to support their expansion plans. In lock-step, the BSP will continue to maintain a regulatory environment that supports growth while at the same time remaining mindful of potential systemic risks.

Concluding remarks

Ladies and gentlemen, the ongoing rebalancing of growth across the globe as well as the challenge of preparing for greater integration with our ASEAN neighborhood will require continued vigilance on the part of the BSP and more active involvement from our banks.

Most of the policy directions I have outlined are geared to sustain what we have started even before the global financial crisis. We believe that this strategy remains appropriate amid heightened volatility in the market.

Today's Summit issues a timely notice for us to be flexible and adaptive to shifting market dynamics. For investors in particular, a good strategy is to recognize and seek out new opportunities. The Philippines offers a host of them, and it is our hope that you also see and positively respond to their great, untapped potential.

Thank you, and have a pleasant afternoon.