# Amando M Tetangco, Jr: The Philippine economy – gearing up for the challenges ahead

Speech by Mr Amando M Tetangco, Jr, Governor of Bangko Sentral ng Pilipinas (BSP, the central bank of the Philippines), at the Philippine Retail Investment Conference, hosted by the Chartered Financial Analyst (CFA) Society of the Philippines, Taguig City, 28 May 2014.

*   *   *

To the organizers of the Retail Investment Conference, led by Ms. April Lynn Tan, President of the Chartered Financial Analyst (CFA) Society of the Philippines, guests, ladies and gentlemen, good morning.

I am delighted to welcome you to the CFA's first Retail Investment Conference. Coming after the country's successful hosting of the World Economic Forum last week, and before that the country's receipt of the one-notch further credit rating upgrade from Standard and Poor's, this conference dedicated to the Filipino retail investor could not have come at a more opportune time. With the WEF and the rating upgrade, we could expect greater interest from foreign investors in the country's potential as an investment destination. That being the case, we should not allow the domestic retail investor to be left "too far behind".

The CFA Institute, which organized this conference, is often thought of as an organization of math wizards and nerds who dabble in the rocket science that is called finance. Looking around the room, I think there are quite a few of you who are also investment geniuses. But to the majority of us, "commoners", who are not as "gifted", it is the discipline in informed decision-making that evens out the equation.

Whether you are in the former group, or in the latter, the fact that you are here indicates to me that you have interest in the Philippine economic story. I hope that at the end of the day, you will find yourselves armed with the correct information and able to make the right decisions to suit your personal financial objectives.

I've structured my remarks this morning, following this outline.

I'll start with the developments and outlook in the Philippines, go through some challenges – from both the domestic and global fronts – that face us and how the BSP is helping to address these challenges.

I would like you to focus on the top chart – this is the country's quarterly GDP performance. This chart tells us that since 1999 (or nearly 15 years ago), the Philippines has posted 60 quarters of consecutive, positive economic growth. Not even at the height of the Global Financial Crisis in 2008/9 did we register negative GDP growth.

What is even more noteworthy is the fact that in the last 8 quarters, GDP has consistently grown above 6 percent (with an average of 7 percent). This has led many during the WEF to call the Philippines a country turning the tide from being the sick man of Asia to the next Asian miracle. To be perfectly frank though, I do not relish that we are called a miracle. The evidence will show that we are where we are now because of hard-fought reforms.

Analysts have described the Philippine economy as being in the "pink of health". And this rosy picture is expected to continue through 2014–2015.

The charts in the bottom half of the screenshow that domestic aggregate demand – consumption and capital formation – continue to be the main drivers of growth.

Our growth story has been underpinned by solid anchors – low and stable inflation due to credible monetary policy and a sound banking system maintained through responsive regulation. Inflation has remained within target for 5 consecutive years. Meanwhile, Philippine banks continue to be well-capitalized. On both solo and consolidated bases, the capital adequacy ratio of our banks remains well-above the BSP's standard of 10 percent and the BIS's standard of 8 percent. Likewise the adoption of Basel 3 in 2014 is expected to strengthen further the financial system.

The country's external sector position and payments dynamics have continued to help shield the economy and the domestic financial market amid recent financial market volatilities following the start of the Fed tapering.

The favorable external sector dynamics is also manifested through improvements in the country's external liability management. The country's current account has been in surplus for 11 consecutive years now. Our gross international reserves remain more than adequate to meet the country's foreign exchange requirements. The country's external debt has been on the decline from around 60 percent in 2004 to just over 20 percent in 2013.

The strong macroeconomic fundamentals of the country have also been reflected in strong positive sentiment among retail investors.

As we all know, favourable sentiment is a positive multiplier. Both consumers and businesses continue to express upbeat views about the Philippine economy's growth trajectory. The positive sentiments of both consumers and businesses are indicative of the broad support to the general direction of economic policies, and this is expected to fuel the momentum of reforms moving forward.

With the sustained positive developments in almost all sectors of the economy, the outlook in 2014 remains upbeat. We are optimistic that GDP growth will reach the government's growth target of 6.5 to 7.5 percent for the year. We also expect inflation to settle within the target of 3–5 percent for 2014. In 2015, the inflation target is lowered to 2–4 percent, which is consistent with our desired disinflation path. External sector dynamics will remain favorable, as trade is expected to rebound in light of expected global turnaround while remittances are seen to remain on a steady growth path.

Let me now go to the second part of my presentation: macroeconomic issues. Actual developments and prospects all look and sound like it is all good, doesn't it? Yes, so far… All positive trends. But just like any shrewd investor, the BSP is mindful about the pockets of risks that could impinge on the country's economic growth momentum. As they say, "the trend is your friend until it bends."

Let me focus on three issues:

1. Risks to price stability;
2. Impact of the gradual tightening of US monetary policy; and
3. Concerns raised on the rapid growth in domestic liquidity and credit which, nevertheless, remain consistent with fundamentals.

The first issue is: what are the risks to price stability?

We've been able to keep inflation within the government's target for 5 consecutive years now. Is that a trend we can keep?

I know many of you are used to looking at charts and trends. The chart on the right side of the screen is something which you may not be that familiar with. It's called a fan chart. It shows the projected path of inflation and the likely area this can stray about, given certain levels of confidence.

Inflation is seen to be manageable over the policy horizon, even as the inflation path has somewhat moved higher.

The left hand side of the screen lists the potential price risks.

- Potential price pressures are still coming mostly from the supply side, notably potential increases in power rates and higher food prices resulting from an expected

El Niño episode in the second half of 2014. These factors highlight the continued risk of second-round effects, which are thus far, not yet evident.

- The downside risks to inflation are associated with the potential growth slowdown in key emerging markets and risk of deflation in some advanced economies.

Going forward, to help ensure that the BSP is able to sustain the "trend" of meeting the inflation target, we will continue to watch developments. We will deploy appropriate measures as needed to ensure sustainable, non-inflationary, and inclusive economic growth.

I know that many of you are aching to find out, "when is the BSP going to raise its policy rates?" No one has a crystal ball, even Nostradamus missed. Instead of giving you a day and date, let me give you principles.

1. The BSP is focused on inflation.
2. We will not hesitate to act pre-emptively if we believe the inflation target is at risk.
3. We are not wedded to a pre-set course of action. We will use available tools in our enhanced tool kit, as appropriate….

Now does that answer the burning question in your mind?

A second issue is the Fed taper. As sanguine as the future of the country may sound, we remain watchful of potential risks that could arise from the Fed's actions. I am sure you have been following the issue of the Fed taper quite closely. As shown in the charts, movements of domestic financial instruments in May 2013, Q4 2013 and Q1 2014 exhibited volatility. Nonetheless, the spill-over effect of the US monetary policy normalization has gradually tapered off. In particular, we could see that portfolio investments are now posting inflows following outflows registered during the latter part of 2013 to the first three months of 2014.

With the Fed taper of asset purchases in place, markets are now watching developments in growth and unemployment in the US, to see if the Fed will change the perceived path of the taper, and when the "lift-off" (or when Fed would raise rates) would be.

In this period of uncertainty and market volatility, good surveillance is key. The BSP will not hesitate to deploy contingency measures in response to sharp volatility in capital flows. With an expanded monetary policy toolkit and a broad-range of macroprudential measures to help ensure financial stability, we are optimistic that we are equipped to deal with potential market volatility.

I can sense in the room, a second burning question at the back of your minds. – will the exchange rate go below P43? Will it go past P45 again? When? Again, I do not have a crystal ball. But let me describe to you our policy. The BSP will continue to allow the FX rate to be broadly determined by the market… But because market participants often go ahead of themselves, we will be present in the market if needed to help keep a lid on these excesses. This policy has worked well, and we observe this whether the exchange rate is on an appreciation or a depreciation trend.

The country's external sector remains robust, and we are confident we will be able to absorb significant shocks originating from external sources.

The movements in the domestic financial assets – including the stock market and exchange rate – will continue to be dominated, in the near-term, by changes in the global investor sentiment. The global investor is hard-wired to be binary – he is either risk ON or risk OFF. Depending on the balance of risks between AEs and EMEs, funds can move across markets swiftly and in surges.

It is these shifts in global sentiment that we are mindful of… because often, it is the retail investor who is the most at risk when the larger investment houses go in or out of specific markets.

This is why good, credible, timely information to retail investors is critical.

The slide lists some of these risks.

Risks coming from advanced economies include:

a) weak domestic activity amid sustained ultra-low inflation/deflation;

b) sustainability of key reform measures in the euro area amid improving growth prospects; and

c) a faster than expected pace of US monetary policy normalization.

Possible risks emanating from emerging market economies (EMEs) include:

a) protracted weak growth in certain EMEs;

b) economic slowdown in China; and

c) geopolitical risks.

A third risk is the build-up of financial stability pressures from high liquidity and credit growth that could lead to potential asset bubbles.

To backtrack, in 2010–12, the country experienced strong surges of capital inflows, as the country became a magnet for capital that was looking for a home that had both good yield and excellent growth potential. As the dollars were converted to buy domestic assets, peso liquidity in the system grew. Since 2011, we have been instituting a series of macroprudential measures – including adjustments in the capital risk weights on NDF, refinements in our SDA facility and increases in reserve requirements. All these have been calibrated so that while we try and limit speculative activity, we do not stifle legitimate inflows to the economy.

The use of macroprudential measures has so far been effective. By and large, volatilities in the financial markets have been contained. We can use our enhanced tool kit to ensure that volatility in financial and real asset prices is kept at manageable levels.

Before I move on to the next slide, I know some of you may have this nagging question – are we in an asset bubble? The indicators, as of now, show that we are not in one – but because it is our job to worry, we are mindful that pressures from excessive market exuberance can lead to a bubble. Thus, we have been more closely monitoring the real estate sector (e.g., through the expanded definition of real estate exposures, stress testing on REE.)

Earlier, I had alluded to the phenomenon that when global asset managers move, there is a risk that the retail investor could bear the "heat" of the shifts. Global asset managers often move in herd – partly because they use the same benchmarks, have similar risk management systems, and are very competitive. Also, partly because the retail investor does not necessarily have the same set of information that global asset managers have. The classic dilemma of information asymmetry. Hence, the saying "It is better to be incorrect and be with the herd, than to be correct and be trampled upon by the market."

In order to help reduce that "risk" to the retail investors, the BSP is ardent in pursuing measures to promote further the development of our country's capital market by broadening available investment alternatives for you.

- Amended guidelines on rules governing Long-Term Negotiable Certificates of Time Deposits (LTNCTDs).More liberal rules on issuance and trading of LTNCDs in an exchange to enhance transparency and price discovery.
- Liberalized the framework for the cross-selling of financial products by banks. Allowing banks to use their premises to market and sell the financial products of their related parties under a banking group or a financial conglomerate provides a broader array of financial products using the existing branch network of the banking system.
- Created the environment to encourage availability of derivative products for banks and clients. We continue to enhance the regulatory environment [e.g., refinement of

benchmarks, trading rules] so that banks can offer instruments to help hedge risk and provide ways of portfolio diversification [e.g., FX options, swaps, credit derivatives, IRS]

Also contributing to efforts to deepen the country's capital market is the BSP's Economic and Financial Learning Program (EFLP) which brings together under one flagship program the key economic and financial learning programs of the BSP.

It embodies the BSP's thrust to promote economic and financial education among the public. Increasing awareness about the financial system and the financial services it offers will certainly increase retail investor participation.

As much as we are committed to promoting financial services and products, and providing financial education, we are also equally keen on ensuring that consumer rights are being protected.

This is something we take seriously in the BSP. Just two weeks ago, the Monetary Board (MB) approved the adoption of the Financial Consumer Protection Framework of the BSP to institutionalize consumer protection as an integral component of banking supervision in the country. Banks should no longer see consumer protection as a "nice to have" CSR or advocacy, but we will be rating banks in terms of the systems and procedures they have for consumer protection.

Much earlier on, the BSP already "put its money where its mouth is", so to speak. In the BSP, we institutionalized consumer protection by creating one department which sole function is to be a redress mechanism for consumer grievances and complaints. Being in the BSP's Financial Consumer Affairs Group (FCAG) is not an easy day job, as you can imagine. But it is something that we believe has been effective in giving reprieve to consumers and also bringing complaints to banks so they could make appropriate changes in their own processes.

Part of consumer protection is also giving them information. So, in addition to the EFLP of the BSP, we have worked with other members of the Financial Sector Forum (FSF), i.e., SEC, PDIC, IC, to develop "Protect Your Money" (PYM) and other advisories to raise public awareness on financial products and services, the basic responsibilities of depositors and investors, and the things to look out for when depositing or investing.

Consumer protection, financial education, and developing the domestic capital markets are all part of the BSP's strategy to help ensure that the retail investor is equipped and protected.

But more broadly and to the rest of the economy, the BSP works towards creating a stable macroeconomic environment where you can plan, participate, and help propagate the creation and enlargement of wealth, not just for yourselves, but for the greater majority.

In particular,

- The BSP remains committed to staying the course:(a) sustain appropriate monetary policy stance to maintain and promote price stability; (b) continue to initiate key reforms to promote financial stability, including financial inclusion advocacies; and (c) pursue measures (e.g., maintaining a market-determined exchange rate, keeping an adequate level of FX reserves, and managing our external debt profile) to strengthen resilience against external shocks.
- The BSP will remain as a catalyst for further development of sustainable and inclusive growth: We will continue to adopt purposeful reforms, aligning our own processes with international benchmarks, while making sure these reforms are relevant to our own domestic needs.

As you may have heard me say on numerous occasions in the past weeks,…"So far, so good."…. We have weathered the GFC, the Fed taper tantrum, the onset of the Fed taper, Yolanda and a host of other natural calamities…. We have even weathered geopolitical risks.

But this should not lead us to be complacent. The situation could, as they say, "turn on a dime". Which is why you and the BSP have to remain vigilant. I mentioned our buffers, I also mentioned the risks. But I want to end these remarks by saying, the BSP will continue to be watchful, implement appropriate and timely reforms and draw from our strengths in confronting the challenges ahead. Our support for the development of the country's financial market will not waver… We will continue to be guided by a framework that will not stifle innovation but rather promote market discipline.

This is our word, and to borrow investors' dictum: "Our word is our bond."

Thank you.