Amando M Tetangco, Jr: Animal spirits in a period of volatility

Speech by Mr Amando M Tetangco, Jr, Governor of Bangko Sentral ng Pilipinas (BSP, the central bank of the Philippines), at the Bloomberg FX Forum, Makati City, 2 September 2015.

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Good afternoon ladies and gentlemen.

Fortuitous or Good Planning?

Someone in Bloomberg must be psychic, to have chosen “Hedging World Volatility” as theme for its 2015 FX Forum and at the same time to have scheduled the Forum in Manila during this precise week. Was that sixth sense or “bread and butter” excellent market reading?

How do you hedge in a volatile market?

Indeed, market volatility of late has not been contained to just a few countries or jurisdictions. It has neither been restricted to just either advanced or emerging markets, but it has spanned all categories of countries. And volatility has not been concentrated in one market or asset class alone, but it has crossed over from the commodity to the financial, and to some extent, the real goods market as well.

With the variable forms of feedback loops and the uneven transmission mechanisms in the macrofinancial system, the relationships and correlations – as predicted by traditional models – appear to no longer be valid. Therefore, the question of how to “hedge” world volatility – as intimated by the theme of this Forum – is quite well timed.

For those of you who have been in the market for a while now. A quick look around the room tells me, there aren’t too many of you around today. Perhaps, a sign of the changing times? Those of you who have already seen a number of episodes of volatility in “your day”, may be saying, this is a “healthy” correction. To a degree, I’ll have to agree with that.

This “correction” is one good positive that is falling out of the recent market price action. We needed a tap on the brakes, so to speak, because the markets had been following one strong underlying trend for a while now, seemingly oblivious to other factors.

Each time we come to a crossroads such as this, analysts would say we are in “uncharted” territory. I also cannot disagree with that. For certain, no one can be absolutely sure about a few things:

1. The convergence between the recent pronouncements of various Fed officials and what the Fed will ultimately end up doing. Over the Jackson Hole weekend, Bill Dudley of the New York Fed said in an unscheduled interview that a September hike is “less compelling” now. For her part, Esther George of the Kansas City Fed who has repeatedly called for a hike, said “it’s too soon to say that recent market developments have altered the fundamental view” that the economy is prepared for normalization. Then Stan Fischer, Fed Vice Chair, spoke at a panel saying “there is good reason to believe inflation will move higher”, thus keeping the door open for a September hike.

Can anyone really tell with certainty when and by how much the Fed will tighten? Some are of the view that while a September lift off may not seem prudent, given market volatility, it may just be what the market needs in order to eliminate one element of uncertainty, after all, monetary policy has significant lags.

2. The next steps of Chinese authorities – whether they will continue to intervene, to what extent, in what form, and how such intervention will be funded.

Some analysts put the cumulative decline in Chinese reserves since July to be over $300B. Question is, will they sell more US Treasuries to fund intervention? And if so, how will that impact on the US yield curve, and the Fed’s projected path of normalization?

3. What the ECB still has up its sleeves – how dependent these next moves would be on the behavior of its members, such as Greece.

4. How the combination of these factors will be accounted for in the reaction functions of the other central banks and how these will ultimately all work themselves out in the currency, bond and commodity markets, and

5. What would happen to global growth if China slows down significantly, and if the touted US growth ends up to be a "false" start. What or where then would be the engine for global growth?

What concerns BSP the most?

I have been asked, what is it that the BSP is most concerned about. Of all the risks I've listed just now, which would influence monetary policy the most?

Ladies and gentlemen, it is very hard to say, with any degree of certainty, which factor would affect domestic monetary policy more, because, all these factors are interrelated.

Therefore, for the rest of the time that has been given to me, let me – instead of singling out one risk – consider each item on the list and try to address what I believe are burning questions in your mind.

Let's start with the Fed moves. You may ask, will the BSP follow the Fed's cue in terms of the timing and magnitude of the lift-off?

My answer – not necessarily. We won't have to sing the same tune, but we will certainly have to sing in harmony.

What do I mean? Recall Q2 last year when we embarked on a series of monetary tightening actions. The Fed had not yet moved, but markets were certainly talking about it at the time.

A number of factors were at play during that period last year. 1) Domestic inflation was threatening to breach the inflation target on the upside, and 2) M3 had been growing over 30 percent as a result of the operational adjustments in our SDA facility that we put in place to account for capital inflows. Fortunately, the economy was growing robustly then, and therefore there was no need to provide any monetary stimulus. In other words, it was our assessment that the economy could withstand some tightening in financial conditions at that time.

You will recall that in our communication then, we further indicated that the moves were also motivated by the anticipation of Fed normalization. It was pre-emptive monetary tightening in order to help guide the domestic markets and break any tendency to under value/appreciate risks. Our concern was that an acute/unabated undervaluation of risks would create financial stability pressures, particularly in the real asset markets.

While the risk of overhearing in the asset markets has since dissipated, we are not about to reverse that course of action yet. We will, however, consider 1) the actual and expected capital outflows that may result from the current global financial market rout and their impact on M3 growth, and, 2) carefully review the balance sheets/portfolios of the banking system to see if there is a need to adjust policy settings or tweak macroprudential measures.

We will also, and more importantly, monitor inflation expectations. We have shared with you that for 2015, inflation is likely going to be lower than the government's target band. Even so, inflation is seen to move higher and into target range in 2016 and 2017.

Mindful therefore of the significant lags of monetary policy, we will be careful in making adjustments to policy settings going forward.

Now let's talk about China. You may ask, shouldn't we also devalue the peso, after all a currency war seems to be in play?

Textbooks describe competitive devaluation as a "beggar thy neighbor policy". But that said, we know that policy makers will always do what they believe would be best for their own specific needs, sometimes without much concern for the impact of their actions on other jurisdictions.

This brings to mind a higher policy consideration – the principle of "enlightened self-interest" as espoused by the Bank for International Settlements. BIS General Manager Jaime Caruana said that while it may seem that "keeping one's house in order" is good defense, having a policy mindset of also taking into account spillovers of one's actions may lead to improved overall welfare. After all, we share the same space, so to speak, and the same spillovers may "spill back" to one's economy. My own appreciation of this principle is that seeking only one's own goals may lead us to sub-optimal results.

Given the size of our domestic market, we don't think there is compelling reason to deviate from our current FX policy of allowing the markets to broadly determine the exchange rate.

Just as we did during the period of strong capital inflows in earlier years, we will allow the exchange rate to adjust to market conditions also during this period when the potential for capital outflows may increase.

The BSP will not go against the fundamental trend in the FX market, but we reserve scope for official action to smoothen volatilities that could disrupt business planning and dislodge inflation expectations.

This policy is both efficient and equitable because the exchange rate affects different sectors of the economy, differently. Depreciation benefits exporters and other dollar earners, while it weighs on the debt burden of borrowers in foreign currency and increases the input cost of importers.

I hear some murmurs, even see some quizzical looks. Well, let me borrow a phrase from Stan Fischer when he spoke at Jackson Hole over the weekend. I don't wish to "disappoint your rational expectations" that I won't tell you whether a breach of a certain exchange rate level would worry the BSP or not.

Actually, the BSP has no "magical" exchange rate. As I have repeatedly said, the BSP doesn't target specific exchange rate levels. But, we would be concerned if the rate is going too fast in one direction or the other, in a manner that is not consistent with fundamentals.

As you may be aware, the Philippines enjoys a current account surplus. In fact, our current account has been in surplus for over a decade now supported by remittances, which continue to be "volatility-proof" and receipts from BPO services. This is important to bear in mind – because, at the end of the day, investors will discriminate. And, it has generally been the case that economies with strong external liquidity positions have been better able to minimize the impact of external shocks on their domestic economy and financial markets.

Moving on to oil price developments. The most often asked question in relation to oil is – Is the BSP concerned with deflation, especially given the latest inflation outturns have been below 1 pct. and the fact that our forecast for August inflation is 0.2 to 1 pct.?

With global growth prospects weakening, global oil prices may remain soft. Fuel and fuel-related items account for about 9 pct. of the items in the CPI. It stands to reason therefore that domestic inflation can be expected to also be soft going forward. That said, we see upside factors to inflation. These include: 1) that domestic wages are rigid downward (especially the mandated minimum and related benefits); 2) El Nino is projected to be prolonged, and may likely intensify; and 3) that potential economic output is estimated at around 5.5 to 6.5 pct. Current actual (1H 2015) output is at a respectable 5.3 pct.

In other words, there are countervailing factors against low oil prices. Our assessment therefore is that the risks to deflation are contained. But we remain watchful of the supply/demand conditions in the international oil markets.

Closer to home, let's talk about GDP. Q1 was revised downward to 5 pct. Q2 was announced to be 5.6 pct., driven by consumption. Government spending accelerated in Q2 and contributed positively to growth. With these, full-year growth is looking to be more modest than the government's growth target of 7–8 pct.

A question you may have in the back of your minds – Is there a need for the BSP to loosen policy settings to support growth, especially with the prospect of lower global growth?

From indications, there may be no need at this time for economic stimulus from monetary policy. The government has fiscal space. As they did in Q2, government should step up spending on the vital infrastructure needed for economic growth to be sustainable. The forthcoming election spending, though a one-time shot in the arm, could also provide economic stimulus.

What the BSP will do to help raise the growth trajectory – in addition to ensuring a low and stable inflation environment – is to further enhance banking sector policy to cement the strength of the banking system. The BSP will also continue to pursue market reform to help establish the financial market infrastructure for the efficient intermediation of funds between fund sources and users.

NEDA projects that a more realistic economic growth rate for 2015 is 6–6.5 pct. It is comforting that even at these levels, the Philippines would likely still be among the fastest growing economies in the region.

Conclusion

Ladies and gentlemen, I've covered a lot of ground this afternoon. Let me summarize by saying: The BSP is watchful of domestic and external conditions. And, we are ready to take the appropriate policy actions, as and when needed, to minimize the potential adverse impact of risks to the economy.

In the pursuit of creating growth opportunities for the economy, the BSP continues to look to the whole market's continued support.

I know market players live for volatility. It is what gets your juices going. But let me just provide some words of advice: These are not your typical "vols." There is not necessarily any historical price action that you could confidently go back to, to calculate your VARs. Therefore, be very careful of any new products and markets that you are looking to deal in. Be sure you understand these well. Have the necessary credit, market and operational risk mitigants in place.

Finally, this is not a bout of volatility that is likely to go away quickly. So, if you are in this game for the long haul, you need to temper animal spirits with a healthy dose of reflection and humility.

I think I've said enough for now. Let me end here. I wish you all well. Thank you for your attention.