Amando M Tetangco, Jr: Navigating thru the waters of change... and butterflies

Speech by Mr Amando M Tetangco, Jr, Governor of Bangko Sentral ng Pilipinas (BSP, the central bank of the Philippines), at the 2015 Annual Joint General Membership Meeting of ACI, FMAP, IHAP, MART, NASBI and TOAP, Manila, 29 September 2015.

* * *

I hope you share my view that meeting the six industry associations in a single general membership meeting such as this one is not only efficient but it is also hopefully more effective in developing: 1) a holistic view of events and developments – both here and abroad – and 2) a clearer common understanding of BSP policies. In the end, meetings like this should help us more expeditiously attain our shared goal of sustaining the strength and responsiveness of our financial market.

Your officers had asked me to share my views on the impact on emerging markets and the Philippine policy framework of the recent developments in China. This topic choice is quite focused. While your interest in China is understandable, I think you will concur that it is also difficult to isolate this from other developments in the global market. In any case – let me try to zero in on two things about China – its growth prospects and the recent devaluation of the Yuan.

Chinese growth:

First, growth. Some have argued that the slowdown in the Chinese economy is neither recent nor a surprise. China's GDP growth has been decelerating over the past 5 years, from 10.6% in 2010 to 7.4% in 2014. This is projected by the IMF to decline to 6.8% in 2015 and 6.3% in 2016. Yet, the IMF's August 2015 Article IV report[1] in fact states that China is moving towards a new normal of slower yet safer and more sustainable growth.

There is also the case being made about base effects to explain the slowing growth rates.[2] Since China passed Japan in 2009 in terms of economic size, China has expanded by the equivalent of "1 ¼ Japans to its output". The bigger base then will require substantially increased economic activity if the growth rate is to be maintained. But even if the GDP growth rate is closer to 5% in 2015 – a significant drop from currently reported rates – the increase in output "will add almost one and a half Thailands to China's economy this year".

These arguments simply remind us that China is already a large economy whose economic engine happens to be traditionally stronger than most. Simulations therefore of a "hard landing" are important to track. Euromonitor International reports that ten jurisdictions most at risk from a hard landing in China include HK, Taiwan, large economies like South Korea, India and Japan, as well as the 4 biggest ASEAN economies (Indonesia, Malaysia, Singapore and Thailand) plus Vietnam.

What does this mean for the Philippines? China is an important trading partner and has been, in fact, the third major export market of the Philippines since 2011, with an average share of about 12 percent from 2010 to 2014. Based on NSO data, in 2014, our exports to China reached US$8.5 billion or 13.6 percent of our total merchandise exports.

---

[1] IMF. (August 2015). People's Republic of China Staff Report for the 2015 Article IV Consultation. IMF Country Report No. 15/234, Washington, U.S.: International Monetary Fund.

[2] The following follows the points raised in "China economy: Weakened but still growing" by Joe McDonald, Associated Press. September 23, 2015.

While the Philippines is not among those listed in the Euromonitor International study, it is significant to note that almost all those countries listed are important trading partners of the Philippines. The simulated impact is a decrease in GDP growth. And the results are not trivial, ranging from just under two percentage points (Japan and Indonesia) to above 3.5 percentage points (Vietnam, Taiwan and HK which is nearly at 4.5 percentage points).

So, while the impact on our GDP may not be strong and direct, the "second-round" effect through the "other" trading partners bears watching.

What about the effect on domestic inflation? Slow Chinese growth could lead to lower global demand for commodities, including oil, which could in turn be a positive for reducing overall domestic inflation pressures. That said, where the chips will fall, so to speak, on the balance of global inflation will really be determined by country-specific dynamics.

There are other areas wherein our economy may be adversely impacted. And let me just highlight two for now – tourism and remittances. For the moment, our assessment is that the negative impact on tourism is expected to be moderate, while on remittances, it should only be negligible.[3]

Fortunately, a hard landing scenario for the Chinese economy appears to be a low probability scenario for now but, I want to emphasize, this development is worth monitoring.

The Yuan devaluation:

Let's now look at currency movements. Media reports that August 11 saw the largest single day move in 20 years for the Yuan. The same media reports point to the slowing economy and a sharp drop in exports as the factors underlying the move.

There are other analysts, however, who say the action was really more political. They believe the expected currency movements are actually too small to materially impact exports. They say, Chinese actions were really meant to accelerate the acceptance of the Yuan into the SDR. They point to the fact that the IMF has been calling for Chinese authorities to move to a more market-based financial system and monetary policy framework.

Regardless of the motivation, the decision to devalue has already had its effect on markets and jurisdictions. The impact on Chinese exports will be known in due course but the effect on the export of others is already taking shape. Commodity prices have decreased on fears of a slowing China which happens to be a significant importer of commodities.

Either coincidentally or as a result of the Yuan devaluation, we know that equity indices have seen a significant decline. Currencies could not be far behind and in the region the Vietnamese Dong, the Indonesian Rupiah and the Malaysian Ringgit have weakened.

How has the movement in the Yuan translated to our domestic markets? Since August 11, the peso has lost almost 2% (1.8 %) in value, and the Phisix has fallen almost 10 % (9.97%). These are not small numbers, but they are also not the largest moves among the markets in the region. Should we take comfort in that?

Full effect?

What I have described over the last ten minutes or so is not news. You follow the markets closely. What is certain, however, is that despite all that we have already seen and know, the

---

[3] On tourism, China provided the fourth largest number of visitors in the country from January to July 2015, equivalent to about 8.3 percent of the total visitors. China was also the third biggest contributor of visitor earnings in July 2015 (Ph. 1.3B).

On remittances, OF remittances from China (Mainland only) amounted to US$10.1 million, or about 0.1 percent of the total OF remittances, from January to July 2015.

full effect of China's slowdown and the weakening of the Yuan will likely remain to be unknown in advance. In the overall scheme of things, the linkages are difficult to assess because they involve expectations, a lot of rebalancing of financial portfolios as well as round-after-round of auxiliary consequences that are not known ex-ante.

This reminds me of how "chaos theory" is often described. As everyone here is aware, CHAOS THEORY is the study of nonlinear relationships where events that appear logically random are actually linked.

It is said, a butterfly flapping its wings in the Amazon will affect the time of formation, exact location, and path of a hurricane several weeks later in North America. This "butterfly effect" is formalized in various fields like risk management, that's why this audience knows it, right?

It underpins the very framework of Financial Stability used by the BSP but, in its simplest form, it is more commonly referred to today as "contagion".

What this means for the Philippines

Ladies and gentlemen, it is clear that there is already some impact on EMEs, including the Philippines. And the possible consequences of a hard landing could be significant to many jurisdictions. There are layers of nonlinear and changing linkages that make the prediction of full effects an impossible task. But it is precisely an evolving situation such as that in China which should provide us a good platform to think about the possible issues that prudential policy may consider.

The Philippines does not have the market impact of Greece or the presence of either China or the United States. But that does not mean that we will lie idle as market conditions are clearly shifting. We have our own butterflies to consider, not because we want to create hurricanes elsewhere but rather because we want to mitigate the contagion impact upon us and within our market.

For monetary policy, this has meant keeping a close eye on inflation and allowing the exchange rate to remain broadly market-determined. You are quite familiar with our approach to keeping economic prices stable and the factors that we consider in policy formulation. You therefore also know that we put a premium on communicating our policy actions.

In this regard, I am pleased to share with you that last week the Monetary Board approved the adoption of an interest rate corridor (IRC) system for the conduct of monetary policy. Many of you have been asking about this since I first mentioned that BSP is considering a shift to IRC. I believe you've heard bits and pieces of it, here and there. So, just to be sure we are on the same page, let me spend the next few minutes on this important shift in how we will conduct open market operations.

Let me begin by clarifying our objectives. In the most basic of terms, we are adopting the IRC to: 1) improve the signalling effect of the BSP policy rate, and 2) to create a means for better market price discovery. Having more market-based policy instruments under the IRC can also be expected to reduce reliance on blunt policy tools like the reserve requirement for sterilization. In the end, the IRC should strengthen the transmission of monetary policy.

How will this work? The IRC is a system for steering money market rates towards the central bank (CB) target/policy rate. It consists of a rate at which the central bank will lend reserves to commercial banks (CB lending rate) and a rate at which it will take deposits from them (CB deposit rate). Typically, the lending rate will be above, and the deposit rate below, the target/policy rate, forming a corridor around it.

We also intend to use a common tool of central banks for liquidity management. This is the Term Deposit Auction Facility (TDF). TDF is suitable for shorter maturities and is not supported by tradable securities. Auction results of the TDF could provide indicative short-term benchmark for the money market and will be invaluable in price discovery in the market.

By mopping up the "structural liquidity" from the system through the TDF and also through the standing deposit facility which is the SDA, we hope to see market rates moving not only within limited latitude but also inching towards the BSP's policy rate (which is the RRP). This will increase the potency of the BSP's policy rate in guiding market rates given the dynamics of inflation and monetary conditions in the economy.

BSP staff have been carefully studying the operational elements of IRC, and it is the Board's considered judgement that our current benign inflation environment, historic low interest rate levels, steady aggregate demand, and ample liquidity give us the room to make these operational adjustments at this time.

As I have described, the IRC will be a sustantial change from how we currently do OMO but you will continue to transact OMO with our Treasury Department. The BSP will conduct consultations and briefings with you and other stakeholders (possibly starting next month) before we commence conducting OMO using the IRC system in the second quarter of 2016.

In our pursuit of financial stability, we will continue to actively assess evolving market conditions while performing stress tests and network analysis. We have an uncompromising policy focus on mitigating the build-up of what we refer to internally as "C2L2" (C-L-2) or the risks of contagion, concentration, leverage and liquidity.

We put ourselves to be thought leaders in global and regional initiatives. This includes work on financial inclusion, financial literacy, and consumer protection as well as the integration of the regional financial market, including the requisite capacity building initiatives. We support the principles espoused by global and regional reforms but we do so in the form that is best suited for our requirements.

We continue to actively engage other government agencies through the Financial Sector Forum and the Financial Stability Coordination Council, and pursue interagency collaboration, for example, with DA/DAR and HLURB for Agri-Agra and housing issues, while openly collaborating with private sector entities such as the six organizations represented tonight.

Final thoughts

It is clear that we all desire to be stronger in this increasingly interconnected yet fluid world. In doing so, however, we need to go beyond the confines of trade blotters, budgets, and bottom lines because financial markets "draw" a much more intricate picture on a canvas that is much larger than one's balance sheet. For certain, how things "hang on balance" is not a trivial quest because there are many stakeholders and because financial risks evolve, comingle and recast themselves in a dynamic form.

You have heard me say, year after year, at your General Assembly that the overall picture is not simply the sum of each market player's position. There are material risks that knowingly or unknowingly fall in between desks or may look benign on everyone's balance sheet. But when these risks fester, they eventually materialize as systemic difficulties.

In this light, I want to assure you that regulatory interventions do not simply serve the purpose of making the days of market players challenging. Contrary to rumors, the BSP takes pains in crafting an enabling environment because we are able to see the intricacies of the picture that may not be apparent to each stakeholder and their balance sheet. That said, we also encourage innovation by product providers as a strategic means of furthering the interests of the general public and the financial consumer. Indeed, prudential policy is always dictated by higher-order objectives.

In your more focused request, you asked me what the impact is on us of the slowdown of the Chinese economy. My reply – So far, it's been on the whole, benign. We've so far managed well but we are not immune should Chinese growth slow more steeply and financial market volatilities intensify further.

I encourage the organizations here therefore to work as a community and create a thriving market that is premised on governance, transparency and risk management.

I encourage you to join us in the pursuit of communal objectives (such as financial system stability and consumer protection). I encourage you to be fully aware that in the hunt for what matters to you, you invariably affect others, and those ripples could someday come back to haunt you. I encourage you to be driven by “enlightened” self-interest. Ladies and gentlemen, when you are guided by these higher-order objectives you would have a better chance of covering any “blind spots”.

We may not be the butterfly that defines the next hurricane but I would like us to be a butterfly that can chart its own flight.

Thank you and good evening.