Amando M Tetangco, Jr: Philippines in 2016 – sustaining resilience amid headwinds

Speech by Mr Amando M Tetangco, Jr, Governor of Bangko Sentral ng Pilipinas (BSP, the central bank of the Philippines), at the 3rd Business Forum of The Manila Times, Manila, 23 February 2016.

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I am pleased to join you this morning for the 3rd Manila Times Business Forum.

There are quite a number of fora that tackle economic outlook and issues of the day, but I don't know of any that is organized by a private institution, which dates itself to the time the country became independent from Spain![1] In addition, The Manila Times President & CEO Mr. Dante Ang said earlier that this forum gathers various speakers, including those officials from institutions such as IMF, WB and BSP to present their prognosis for the economy this year.

Very few institutions stand the test of time – technology, innovation, and more recently, social media, among others; change the way we do things, how we perceive events, and therefore how we react.

Central banking in the Philippines is just 67 years old and yet the events of the last two decades have dramatically changed how we do things.

I am sure many, if not all of you, have heard of central banks lowering their policy rates to negative territory, of quantitative easing (QE), and of macroprudential measures. In reality, the central banker's tool box now contains other implements beyond the traditional interest rate and on-site supervision. But, I am getting ahead of myself here. I've been asked to speak on the Philippine economic outlook for 2016.

While that seems much focused, our conversation today will certainly touch upon global events of the last few years and our expectations beyond 2016. For me to speak of 2016 however, I need to take a step back.

A newspaper lives or draws interest from its public through its headlines. And since this Forum today is being hosted by The Manila Times, I thought I would frame my talk today as a series of headlines.

My first is this – The Philippines entered 2016 from a position of relative strength.

The country grew 5.8 percent for the full year 2015. If we take Q4 alone, the country grew at 6.3 percent, making us the 4th fastest growing economy in Asia, following India, China and Vietnam. That Q4 performance also brings to 68 the number of consecutive quarters of positive economic growth. The services sector remained the biggest driver of output while the resurgence of manufacturing also helped to strengthen our base for growth. Growth also continued to be buoyed by strong private spending, aided by the increase in domestic employment and the steady inflow of remittances from overseas Filipinos (OFs). The "catch up" in fiscal spending in 2015 also helped to raise domestic output.

We experienced this strong economic growth together with low and stable prices. For the full year 2015, the average inflation rate stood at only 1.4 percent, the lowest registered since the BSP adopted the inflation targeting framework in 2002. In the BSP, we characterize this "sweet spot" as – the positive convergence of strong growth and low inflation.

For certain, the country's healthy banking system founded on years of judicious reforms, including financial inclusion initiatives, aided the country's economic expansion. Our banks'

[1] The tagline of The Manila Times – "Trusted since 1898".

balance sheets have remained strong. In particular, our banks maintain high capital, with capital adequacy ratio above national regulatory and international standards and the quality of their assets continues to improve, with declining NPL and NPA ratios.

The country's external liquidity position has also continued to be robust and helped shield the economy and the domestic financial markets from the worst effects of the global shocks.

Our current account has been in surplus since 2003 supported by steady remittances and, in more recent years, strong receipts from the business process outsourcing sector. For the full year 2015, the overall balance of payments (BOP) position yielded a surplus of US$2.6 billion, a reversal from the US$2.9 billion deficit in 2014. Last Friday, we released the balance of payments position for January 2016. It was a deficit of $0.81 billion, which was due to the payment of National Government (NG) debt service and the BSP's foreign exchange (FX) operations that were only partially offset by FX inflows from deposits of the NG and BSP income from abroad. We see this deficit as temporary and we expect a turnaround in the BOP position later this year, similar to what we experienced in 2015.

Our gross international reserves continue to grow. At end 2015, our gross international reserves (GIR) stood at US$80.7 billion, over US$1.0 billion more than that registered in 2014. This level of reserves can cover 10.3 months' worth of imports of goods and payment for services and income.

These encouraging developments have helped elevate third-party assessments on the domestic economy's progress and prospects. Several indices of the country have moved up. These indices include those on transparency, governance and ease of doing business, among others. In September last year, Fitch upgraded its credit outlook on the Philippine economy to "positive" from "stable." This is important because it raises the prospect that Fitch would upgrade the country's credit rating in the next 12–18 months.

Ladies and gentlemen, the facts and figures that I just discussed provide evidence to support the first headline, that is, that the Philippines entered 2016 from a position of relative strength.

My second headline: The Philippines is SEEN to SUSTAIN resilience in 2016.

Resilience is a word that many use, but it is important to remember that this is a word that holds meaning only when it is taken in context. In other words, in a specific circumstance. Clearly, resilience cannot be tested if one is sailing over calm seas.

For us, 2015 was not at all calm. It was a challenging year. The markets and other policy makers were cautious. We were all waiting for the Fed "lift off" (or when the Fed would begin to raise its target rate). We weren't sure where oil prices were headed. We didn't know how to fully interpret the actions by Chinese authorities, including the devaluation of the Renminbi (RMB). And yet, in the face of all these uncertainties, the country stood its ground in 2015.

2016 was off to a bumpy start. While, we foresee the same risk factors in 2016 as those in 2015, it may be more difficult to predict how these factors would play out in 2016. Policy makers are being more sensitive to spill overs and spillbacks to their economies. And market sentiment continues to be "shifty." Let me quickly go through how we see each challenge evolving in 2016.

Let me begin with China. When the global financial crisis (GFC) started in 2007/2008, global growth remained afloat because the emerging markets, the largest of which is China, were growing. This time around, China's growth prospects are not as clear-cut as then. There is now debate whether China could experience a hard landing. This is creating market uncertainty, because in addition to contraction in global trade, a significant slowdown in China could also put downward pressure on global commodity prices.

Furthermore, the markets are carefully watching the Chinese authorities' next moves to liberalize their markets. You may recall the stock market rout in China in August last year. That was precipitated by the surprise RMB devaluation. That led to a sell-off in equities across the globe. Analysts say that to avoid a recurrence of such adverse reactions, markets need to see more cohesiveness in the policy measures from Chinese authorities, as well as clarity in their communication.

In the US, the Fed, in December 2015, determined that the US labor market conditions and inflation outlook already warranted “lift off”. Based on the assessment of the FOMC members then, the Fed was projected to raise its target rate by 100 basis points in 2016. But more recent statements of some Fed governors now reveal less conviction in terms of the speed and magnitude of normalization of its policy. Even Fed Chair Yellen indicated in her latest testimony to the US Congress that foreign economic developments could pose “risks to economic growth.” Some analysts have taken these recent statements to mean that the Fed may delay its next tightening moves. This uncertainty is heightening market volatility – yet again!

Turning to oil – oil price is now at about $30 per barrel (pbl). In mid-2014, it was about $108 pbl. While the rate of decline has decelerated, the price is now at levels that have triggered major oil producers to “come to the table” to discuss the possibility of “freezing” production to specific output levels. Global oil supply has overtaken demand since 2014.

Oil importers such as the Philippines benefit from low oil prices. Low oil prices feed positively towards lower inflation and encourages domestic economic activity. But low prices are double-edged in that significantly low oil prices could lead to oil-exporters cutting back on capital expenditures. This in turn may trigger a decline in global trade and growth.

The uneven global growth prospects, the differences in the policy actions across the globe, and the uncertainty in oil price movements are triggering global portfolio rebalancing. As market players flesh out their interpretation of these developments, volatility in financial markets is heightened.

According to the Institute of International Finance (IIF), emerging market economies (EMEs) experienced strong net capital outflows in 2015. It forecasts that further net outflows from China are expected to continue in 2016. These net movements of funds from EMEs in 2015 have been reflected, among others, in a decline in ASEAN stock market values and an increase in the volatility of currencies in the region.

How could these developments impact the Philippines?

I already spoke earlier about the positive impact of low oil prices on the Philippines – which it helps reduce inflationary pressures while encouraging domestic consumption. We could, however, be adversely affected if the low oil prices cause export destinations of our OFWs in the Middle East to cut back on employment.

As for the divergent growth prospects in the US and China, we could be affected via the trade channel. If US growth will continue and gain further traction, this could mitigate the impact of a slowdown in China.

Furthermore, our domestic financial markets have not been spared from the market volatility that these external developments have stirred. The Philippine Stock Exchange index (PSEi) fell, credit default swaps (CDS) and bond spreads widened, and the peso depreciated.

To complete the picture, I should mention that we have our own domestic considerations in addition to these external challenges. Most prominent of our domestic risks are the prospects of a prolonged El Niño and the persistence of the infrastructure gaps.

Ladies and gentlemen, this is the operating environment expected in 2016. As I said, while it’s the same factors, how these factors will play out may not necessarily be the same in 2016. To paraphrase the title of the book of Reinhart and Rogoff, “This time it COULD BE different.”

You may ask – How can we claim (as a second headline) that – “the Philippines will sustain its resilience in 2016?” First, because we have come into 2016 from a position of relative strength. This was my first headline. Second, from the point of view of the BSP, we have been focused in our policy thrusts.

We are forward-looking in our policy formulation. Let me illustrate using our monetary policy. In 2014, we moved pre-emptively, in anticipation of the Fed lift off. Markets had been talking about "lift off" since the Fed "taper tantrum" in May 2013. But because until 2014, the Fed had only moved to end QE and not actually raise rates, markets kept on "pushing the envelope," so to speak, in terms of maximizing the benefits of low interest rates.

Through a series of tightening measures, we communicated to the market then that players should begin to take stock of how they were assessing and pricing risk. In a way, the BSP was reminding banks (and the general public) that interest rates would not remain low forever, and that there is need to re-think business models and investment strategies. We also ensured that our tightening measures were consistent with the inflation outlook at the time. Because our actions were early enough, our markets were well-positioned when the Fed finally raised its target rate in December 2015.

We are not only forward-looking; we are also calibrated in our actions and mindful of the idiosyncrasies of our domestic economy.

Let me illustrate using our approach to banking reform. In the aftermath of the GFC, the global financial market reform agenda was thick and heavy-handed, primarily because there was much fear of a recurrence of crisis from slack regulation. The Philippine banking system was not as affected by the GFC. In part, because our bankers are inherently conservative.

Therefore the BSP adopted the global reforms in a calibrated manner and only as appropriate to our domestic conditions. We were an early adopter of the capital requirements under Basel 3, and we are now phasing in the rest of the components of Basel 3.

In addition to adopting global reforms that are suited to our particular requirements in a timely manner, we also put out regulations and guidelines that are intended to raise bank governance standards, strengthen credit, operational, IT risk management and internal control frameworks, and improve market conduct.

Our approach to regulatory reform is anchored on Financial Stability. This is an important lesson we learned from the GFC. Most policy makers have now come to realize that having strong individual banks, while that is necessary, is NOT sufficient. Policy makers need to consider the strength and soundness of the system as a whole.

Our regulations benefit from consultation with the banking industry and are evidence-based. We meet with industry associations and groups – 15 in all – through the BSP Supervisory Policy Committee.

Putting all these together, you can see that our approach to regulatory reform and adoption is comprehensive and strategic. Our goal is not only to grow strong domestic banks but also banks that can compete in the global arena, particularly when ASEAN integration comes to full swing.

BSP policy formulation is forward-looking. It is calibrated and consultative. It is also based on solid academic foundations and strong market surveillance. In policy formulation, the BSP uses various econometric and macro- models. To help ensure that these tools are current against the latest economic research, we constantly fine tune our forecasting models, stress-tests parameters; recalibrate early-warning systems and distress indices.

You may have also heard about our implementation of the interest rate corridor (IRC) in Q2 2016. As we've emphasized in our public briefings, the implementation of the IRC is an operational change. It is not a shift in our monetary policy framework. We will continue to be an inflation targeting central bank. The objective of the operational shift is to allow BSP to better steer short-term market interest rates towards the BSP policy rate. This should make the transmission of changes in the monetary policy stance to the rest of the economy more effective.

Ladies and gentlemen, while we are improving how we do things, there will be no change in our primary mandate – we will keep our eye on inflation. At our most recent policy meeting, we kept policy rates steady (at 4 percent for the reverse repurchase rate). Our view was that domestic demand continues to be quite robust and there is no urgent need to provide further monetary stimulus.

Our models showed that even as inflation is currently below our target range of 2-4 percent (i.e., 1.3 percent in January 2016), inflation will slowly move to within target in 2016 (i.e., 2.2 percent) and 2017 (i.e., 3.2 percent). Going forward, we will continue to closely monitor the inflation process.

We will also keep our FX policy of allowing the exchange rate to be determined by market forces. We are mindful that the peso is sensitive to external developments, so we will have scope for official action to limit excesses in exchange rate movements.

Ladies and gentlemen, let me reiterate, we have the policy space to respond to uncertainties in the external and domestic environment. We will therefore make adjustments to the stance of policy as conditions warrant.

Headline number 3: A stable macroeconomy should be inclusive.

Some of you in the audience may be wondering why the Central Bank Governor would speak about inclusiveness. With the many macroeconomic and banking concerns it already has, should the central bank still be involved in inclusion. Our response in the BSP is YES, we should. We cannot ignore the financial consumer. When all is said and done, the purpose of a stable macroeconomic environment is ultimately to improve the consumer's well-being.

In the BSP, we have institutionalized financial inclusion in our strategic agenda. We put in place banking regulations that leverage on technology to increase access to financial products for the underserved and unbanked, strengthen financial consumer protection, and raise financial education and awareness to these new financial products and modes of delivery.

We will also pursue the development of our National Retail Payments System or NRPS. The NRPS should move the country from being cash-heavy to being "cash-lite". The NRPS is expected to improve transparency, security, and efficiency and reduce costs in financial transactions.

Ladies and gentlemen, I presented three headlines. First, the Philippines bucked the trend in 2015. Next, we will continue to be resilient in 2016. And, finally we will endeavor to share the fruits of a strong macroeconomy to a broader cross-section of the economy. These three should be sufficient to make a full page of news.

Indeed, our country has continued to expand despite the difficult external and domestic operating environment. It has been said that difficulty or adversity BUILDS character. In a way, we can say that the challenges our country has faced so far, and continue to face, have helped BUILD our character. We have also built buffers in the interim. And have become stronger as a nation.

But, I also believe difficulties or adversities REVEAL character. The challenges and difficulties we have faced have revealed that we, as a nation, have what it takes to be resilient.

However, ladies and gentlemen, these sources of resilience and buffers, the gains that we have attained so far, all these can only be fully harnessed if YOU in the private sector will continue to do your part as well. YOU turn the wheels of industry and business. YOUR actions will help solidify these gains. I hope to see YOU make headlines of your own. Headlines that will help ensure the Philippines sustains resilience in 2016 and beyond.

Thank you.