Amando M Tetangco, Jr: Building on progress, bringing in changes

Speech by Mr Amando M Tetangco, Jr, Governor of Bangko Sentral ng Pilipinas (BSP, the central bank of the Philippines), at the Development Budget Coordination Committee briefing to the Senate Committee on Finance on the FY 2017 Proposed National Government Budget, Manila, 30 August 2016.

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Senator Loren Legarda, chair of the Senate Committee on Finance, Committee members, members of the economic team, colleagues, ladies and gentlemen, good morning.

As a resource institution of the DBCC, the BSP is pleased to provide this Committee with an update on the emerging trends in the monetary, external and financial sectors of the economy, and to present the overall rationale behind the macroeconomic assumptions underlying the 2017 budget.

Let me highlight the key themes of the BSP's presentation.

First, the country's macroeconomic fundamentals remain strong and its underlying story of resilience continues. The economy has sustained its growth above the historical average. Inflation is expected to be within the Government's target in 2017, supported by favorable supply conditions and well-calibrated monetary policy.

Second, we acknowledge that the economy faces external risks from the weak world economic outlook, uncertainty and divergence in global monetary policy settings, and volatility in oil prices. In the domestic front, weather disturbances could exact a toll on both growth and prices.

Nonetheless, policymakers have sufficient space to address these risks. Higher yet responsible fiscal spending targeted at further enhancing economic potentials could support sustained growth. Timely implementation of supply-side measures would also help keep prices manageable. The country's banking system remains healthy and fundamentally sound, serving to effectively intermediate funds to finance the needs of the various economic sectors. The BSP continues to guard against potential risks to price and financial stability, and remains prepared to implement further policy actions, as needed.

Finally, let me point out that the way forward calls for sustaining the economic gains by continuing to pursue reforms that will help boost the economy's flexibility and productivity. For its part, the BSP will remain firm in its commitment to price and financial stability through forward looking monetary policy and purposeful reforms in the financial system, as we continue to build on our progress while we bring in the needed changes.

I will end my brief presentation by sharing the legislative priorities of the BSP under the current administration.

Madam Chair, this chart shows that compared with the average performance from 2007 – 2014 and 2015, the Philippine economy remains strong and resilient. We have seen the following:

- Higher growth;
- Lower inflation;
- Lower-than-target fiscal deficit;
- Ample liquidity and credit (12.4% M3 growth and 17.6% credit growth);
- Good loan quality and capital base of banks; and
- Robust external payments position characterized by

- Current account surplus;
- Comfortable GIR; and
- Manageable external debt profile and debt burden

We will be discussing in some detail the factors that influenced the outturn for these macroeconomic variables in the next few slides.

Let me clarify that the transformation of the Philippine economy is a product of a series of policy and structural reforms in the last two decades, disciplined macroeconomic management, and improvements in governance.

The selected list of critical reforms helped us in:

- expanding the role of market forces in key sectors of the economy;
- encouraging investments;
- ensuring fiscal sustainability;
- strengthening the banking sector;
- promoting innovation and competition;
- encouraging stronger private sector participation; and
- finally, inspiring business activity

An important consequence of these structural reforms is an improvement in the economy's productive capacity. Potential output growth has been steadily rising alongside improvement in the share of total factor productivity (TFP) growth. This is consistent with a declining incremental capital-output ratio (ICOR) as well as the observed structural shift in employment and production structures that require higher levels of skills and knowledge.

It is no small measure that the country's macroeconomic progress has been achieved despite a very challenging global economic landscape. Some of the recent adverse external developments that triggered episodes of financial market anxieties and volatilities in capital flows, exchange rate, and stock market include the following:

- First is the on-going rebalancing in the Chinese economy from export-led to services and domestic consumption-driven. While this could result in slower economic growth for China, such is believed to be more sustainable. As a key trading partner, a slower growing China could, however, affect our exports.
- Second is the uncertainty in the timing of policy rate normalization in the US. The Fed Reserve first raised its target fed funds rate in December last year from 0–0.25% to 0.25–0.50% for the first time since the Global Financial Crisis. Markets have been speculating when the Fed's next move would be. The comments of Fed Reserve Chair Janet Yellen over the weekend, however, signalled that the Fed could raise rates sooner rather than later, stating that the case for a rate hike has risen in recent months. Market expectations are currently seen as too low. Nonetheless, until that next move actually happens there could still be market volatility.
- Third is the significant drop in global oil prices due to abundant supply and weak demand in the international oil market. The decline in oil prices could affect our imports in a positive way but cash remittances in a negative way.
- Fourth is BREXIT. While some of the initial negative impact on financial markets has dissipated, there is still need to see what will transpire during the transition to full implementation of the exit. If recession holds sway in the UK, global economic prospects could be diminished.

Despite these external headwinds, Madam Chair, the economy has exhibited notable resilience. Latest GDP outturn exceeded market expectations and those of other high-performing Asian economies including China, Indonesia, and Malaysia.

It bears noting that the drivers for our growth have been broadening.

- On the production side, industry, supported by manufacturing and construction, has added more growth impulses.
- On the expenditure side, higher public spending and private investments are additional growth drivers together with personal consumption.

Inflation remains benign. Headline inflation averaged 1.4 percent in January – July 2016, driven largely by supply side factors such as lower domestic rice and petroleum prices, downward adjustment in electricity rates, and the provisional rollback in jeepney fares. Meanwhile, core inflation, which excludes certain volatile food and energy items, averaged 1.7 percent in January – July 2016.

Inflation expectations continue to be broadly in line with the inflation target over the policy horizon. Inflation forecasts by International Financial Institutions, particularly, the IMF and Institute of International Finance also indicate benign inflation readings for both 2016 and 2017.

On the country's monetary conditions, ample domestic liquidity and the healthy growth in bank lending continue to support economic growth.

Domestic liquidity grew by 12.4 percent in June 2016, reflecting robust domestic credits. Bank loans, which increased by 17.6 percent, continue to flow into the country's productive sector. Data as of June 2016 show that one-fifth of the total bank loans went largely to wholesale and retail trade; motor repair; transportation and storage; and information and communication sectors.

The Philippine banking system has remained strong and stable, supporting growth across various sectors of the economy. Key banking indicators continue to indicate solid assets growth, improving quality of loans, and capitalization above international norms.

As of March 2016, the capital adequacy ratio of universal and commercial banks (15.8% on consolidated basis and 15.0% on solo basis) remained well above the standards set by the BSP (10%) and the Bank for International Settlements (8%). With adequate capitalization above international norms, and the sustained positive performance of the banking system, we believe that our banks are prepared for the entry of regional and international banks under the ASEAN economic and financial integration.

The BSP will continue to build on its enhanced regulatory framework to maintain a sound and stable financial system.

Moreover, the country continued to build up its foreign exchange reserves. As of end-July 2016, the gross international reserves (GIR) stood US$85.5 billion, adequate to cover 10.5 months' worth of imports of goods and payments of services and income. It is also equivalent to 6.0 times the country's short-term external debt based on original maturity and 4.3 times based on residual maturity. These FX indicators compare favorably with our counterparts in the Asia Pacific region.

What are the implications of these external payments numbers?

Madam Chair, the country's favorable external payments position has mitigated the adverse effects of external shocks. The flexibility of the peso has been our first line of defense against the uncertainty and volatility of the global market. Our high FX reserves have provided greater confidence to business and investors on the country's liquidity position.

However, we recognize that the Philippines is not completely insulated from the volatilities in the global market. The Philippine peso would occasionally weaken against the US dollar, moving in sync with other currencies in the region on account of sentiment change or developments outside our national borders. Nevertheless, the country's firm macroeconomic fundamentals, investment grade status, ample GIR, and steady foreign exchange inflows (including from OF remittances and receipts from the BPO sector) could support a broadly stable real effective exchange rate.

Given our assessment of current developments, what are the proposed key macroeconomic assumptions for the 2017 national budget?

- Inflation is projected to average slightly below the low end of the 2.0 – 4.0 percent target range in 2016, and to approach the midpoint of the target in 2017. Risks to the inflation outlook are broadly balanced. Downside risk could come from slower-than-expected global economic activity while pending petitions for adjustments in electricity rates could pose as an upside risk.
- In the global oil market, the per barrel price of Dubai crude oil is expected to trade within US$35 – 50 range in 2016 and to pick up slightly to US$40 – 55 band in 2017. These assumptions are consistent with current prices in the spot market as well as futures prices and forecasts of multilateral institutions.
- In the foreign exchange market, we expect that the peso would remain sensitive to concerns over global economic and financial developments. Nonetheless, steady foreign exchange inflows and the country's firm macroeconomic fundamentals could continue supporting a broadly stable peso.
- In the primary market, the 364-day T-bill rate could settle at 2.0 – 4.0 percent for 2016 – 2017. While higher fiscal deficit targets may, to a certain degree, raise domestic interest rates, we expect that the liquidity in the system could sufficiently fund requirements of households and investors and keep interest rate movement within the target range.
- Foreign interest rate could likewise remain low for 2016 – 2017. The 180-day LIBOR could range at 0.8 – 1.8 percent for 2016 and 1.0 – 2.0 percent for 2017. Many central banks and IFIs believe that prolonged period of low interest rates will continue. Lastly, despite the weakness in external demand, we expect merchandise trade to show some modest improvements in 2016 – 2017.

To help in the attainment of the targets, the BSP is fully committed to ensure stability in the monetary, financial, and external sectors of the economy.

On price stability, the BSP will closely monitor domestic and external developments to ensure that the monetary policy is appropriately calibrated.

On the financial sector, the BSP will strengthen the framework for risk governance and align supervisory policies with international standards to enhance banking reform agenda and foster greater financial stability.

On the external sector, the BSP will remain supportive of policies that moderate the impact of external shocks such as maintaining a market-determined exchange rate, maintaining ample foreign exchange reserves, and keeping the country's outstanding external debt manageable.

Besides its core mandate, Madam Chair, the BSP has pursued and will continue to pursue financial inclusion as a strategic objective.

1. Our general framework is provided by the National Strategy for Financial Inclusion.
2. We shall continue to communicate information to our general public on key economic and financial developments, to guide them properly in making financial decisions.

3. We shall continue to broaden the access of low income households to financial services.

4. We shall continue to address the financial needs of small businesses by allowing them access to bank credit without collateral.

5. We shall continue to ensure that our financial consumers are well-protected against financial fraud.

Finally, the BSP will continue to push for legislative proposals and issuances that further enhance its implementation of appropriate monetary and credit policies and strengthen its oversight functions in fostering safe, efficient, and reliable financial system.

The chart shows the legislative measures by BSP. We are prepared to discuss these with appropriate committees.

Madam Chair and Honorable members of the Committee on Finance, we would like to underscore that our country has achieved significant economic strides in recent years and has shown notable resilience amid global challenges. Despite the potential obstacles in the road ahead, we remain optimistic that our country will continue to push forward with appropriate reforms and policies. Consistent with the 10-point economic agenda of the Government, we shall continue to build on the progress we have achieved so far while implementing structural changes critical to attain sustained and inclusive growth.

Thank you very much.