Nestor A Espenilla, Jr: Continuity and change - not an either/or

Keynote luncheon presentation by Mr Nestor A Espenilla, Jr, Governor of Bangko Sentral ng Pilipinas (BSP, the central bank of the Philippines), at the 6th Annual dbAccess Philippines Conference, organized by Deutsche Bank, Makati City, 4 October 2017.

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I thank Deutsche Regis Partners for inviting me to this conference and for the opportunity to speak before capital market players and other members of the business community about BSP's initiatives for both continuity and change.

In this invitation, there is the simple but powerful recognition that new leadership does not necessarily mean the exclusion of either one of these possibilities of continuity and change… there is no need to choose one path over the other.

While there are instances when new leaders must re-write organizational strategy, gladly, when I came into the Governorship of the Bangko Sentral ng Pilipinas a little over three (3) months ago, this was certainly not the case.

I have been a Central Banker for the past thirty-six (36) years. I am proud to be part of an institution that has consistently helped provide an enabling environment for a robust and stable economy through the effective delivery of its mandates of price and financial stability. Confident of this, when I became BSP Governor, I stressed the value of building on (and working with) the foundations built by my predecessors.

This is not to say that no improvements are forthcoming or that things shall be static. Not at all. In the BSP, we value dynamism and constantly seek to level-up in the way we design and implement policy.

In the BSP, our objective is for there to be both continuity and change in the pursuit of our mandates. There is no intrinsic contradiction or hint of schizophrenia in this statement. Renowned Harvard Business School educator Michael Porter said, "continuity of strategic direction and continuous improvement in how you do things are absolutely consistent with each other. In fact, they're mutually reinforcing."

The challenge is to find the equilibrium between continuity and change. While change is necessary to remain relevant and to improve … Constant change, unguided by strategy and purpose, and pursued only for its own sake, will result in chaos, confusion and a dearth of direction.

This is why there is much value in dialogues such as these. These discussions are venues not only for us to provide latest updates on the monetary, external and banking sectors and our outlook for these sectors, but it also allows for an exchange of ideas, where feedback is welcome, and critical questions can be asked, providing us with additional input when we consider our reform initiatives and policy decisions.

I have read that to find equilibrium between continuity and change one must: first have a deep understanding of the operating context; second take a holistic approach, and third, for success and sustainability of policies, work with all facets of the environment. I will present my message following this outline.

First, the Operating Context

The Philippines is recognized among one of the fastest growing and most resilient economies in the region and the world, enjoying a sweet spot of high growth and manageable inflation complemented by a strong and resilient financial system.

GDP growth averaged 6.4 percent in the first semester of 2017. As of the second quarter of 2017, the Philippines posted 74 consecutive quarters of uninterrupted growth (i.e., Q1 1999 to Q2 2017) or a span of 18.5 years, with growth accelerating in recent years.

The government has set a growth target of 6.5 to 7.5 percent for this year, and 7.0 to 8.0 percent for 2018 up to 2022. We believe these targets are attainable, given strong macroeconomic fundamentals, rising government spending on critical infrastructure and human capital development, increasing private sector investments, and strong domestic consumption on the back of rising incomes of the country's young and educated workforce.

This strong economic performance did not happen overnight. Rather, it is the result of meaningful reforms pursued since the 1997 Asian financial crisis. The list of reforms is long and wide ranging. Among its highlights is the adoption in 2002 of the inflation targeting framework.

Since 2009, we have consistently achieved our inflation target, except only in 2015–2016 when inflation went below 2% due to unusually low oil prices. This track record has reinforced the credibility of the BSP's inflation targeting framework.

With its sound macroeconomic fundamentals, the Philippines' economic outlook in the years ahead continues to be promising. Inflation for the first 8 months of this year averaged 3.1 percent, well within the target range of 2.0 to 4.0 percent for this year.

We have often been asked why we have not yet raised policy rates given that inflation is trending higher this year and also given the signaling of monetary policy normalization in the advanced economies particularly in the United States.

Based on latest estimates by the BSP, average annual inflation in 2017 to 2019 will settle at around 3.2 percent, just above the mid-point of the target band of 2.0 to 4.0 percent. This within-target inflation outlook essentially drives our policy decision. The independent inflation forecasts of the IMF and the private sector are also broadly in line with our own estimates.

We expect the combination of high growth and low inflation to be sustained on the back of the economy's rising productive capacity and prudent conduct of monetary and fiscal policy.

With respect the banking sector, the BSP has implemented reforms to promote financial stability and foster a broad-based and inclusive growth.

First – We aligned our financial regulations with international best practices (such as Basel Core principles, and FATF recommendations) while at the same time adopting the global standards to our unique domestic conditions.

Second – we implemented macro-prudential reforms that aim to assess and mitigate risks to the financial system as a whole (or "systemic risks").

Third, we pursued financial inclusion advocacies to enable greater access to financial services, strengthened the consumer protection framework, embarked on targeted financial education programs, and provided an enabling regulatory environment for fintech; and

Fourth – of significance is the passage of a law in 2014 that allows the full entry of foreign banks. This complements BSP's other initiatives to further liberalize the industry. These reforms promote healthy competition in the banking system that drives more efficiency and better service delivery.

The Philippine banking system today is on very sound footing. It continues to be a stable anchor for the economy. Again, this is the result of deep and meaningful financial sector reforms boldly implemented.

Key performance indicators show double-digit growth in assets funded by sustained growth in deposits; expansion in lending; improved asset quality; profitable operations; and more than adequate capitalization.

On the currency – the peso exchange rate is market-determined and flexible. It acts as an effective shock absorber for the economy. Since the beginning of the year, we have allowed a modest and gradual depreciation of the peso which we consider to be consistent with economic fundamentals, complements the Philippines' gradual shift from a consumption-led to an investment-led economy and bolsters our export price competitiveness. The exchange rate has now stabilized at the present narrow range. Based on our studies, the pass-through effect of this on inflation is very minimal.

This development is reflected in the country's external payments position, wherein rising imports have resulted in a modest deficit in our current account. The country's overall balance of payments (BOP) position, nonetheless, is very manageable and can stand resilient against external headwinds as we see stable flows from remittances and receipts from BPO services as well as increasing tourism revenues and foreign direct investments in the years ahead. We estimate a moderate BOP deficit of less than one percent of GDP this year.

Providing liquidity buffers to the BOP is the country's international reserves which stand at over $81 billion, equivalent to almost 9 months of imports of goods and payment of services. In fact, the country's GIR exceeds our gross external debt of USD 72.5 billion, which has reduced to the equivalent of 23.5 percent of GDP.

I would also like to emphasize that in view of the country's strong external payments position, the Philippines has become a creditor to the IMF since 2010 from being a chronic debtor.

Strong macroeconomic fundamentals – robust economic growth, manageable inflation, healthy external accounts, and a stable banking system – these are the fruits of the sound economic management and purposeful reforms implemented in the past.

Given this very positive backdrop, continuity is not only wise but necessary. Rest assured the BSP shall stay committed to the sound conduct of its core functions – namely monetary policy, banking supervision and improvement of the payments system.

As in the past, we will also continue in our practice of crafting meaningful and proactive policy reforms that are aligned with best practices and international standards, but which at the same time are sensitive to our unique domestic conditions. In the process, we will continue to engage relevant stakeholders so that policies are attuned to what is happening on the ground.

One example of this commitment in practice is our recent enhancement of corporate governance standards among BSP-supervised institutions. The Monetary Board lately approved revised corporate governance standards, with the BSP expecting board members of its regulated entities to promote a culture of good governance. Another example is the enhancement of surveillance tools on the exposures of banks and other supervised institutions to the real estate sector. The Monetary Board approved enhancements to the prudential reporting requirements for the supervised entities in order to strengthen oversight of their real estate and project finance exposures.

Second, our Holistic and Inclusive Approach

The economy's stellar performance does not warrant complacency. There is still an important task ahead of us. While the Philippines is fast growing, about a fifth of our population still lives below the poverty line.

At the BSP, we are passionate about empowering Filipinos, especially those from lower income groups and we strive to include them in the formal financial system.

To reshape the financial system, we will leverage on digitization, to make it more responsive to the broader economy, transforming it so that no one is left behind. We encourage digital innovations and fintech solutions through an enabling regulatory environment while raising the bar for guarding against cybercrime and related risks. With digital innovation and fintech, the reach of financial services in the country will expand and at much lower cost, benefitting consumers and providers alike.

We launched the National Retail and Payments System, which aids the rise of digital innovation and fintech. With NRPS, electronic fund transfers from one account to any account will be possible, thus easing payments and financial transactions.

We intend to achieve greater financial inclusion through further liberalization of our branching guidelines and the introduction of basic deposit accounts. Further, we are closely working with the national government for the adoption of a biometric-based foundational ID system. These proposals intend to broaden financial access points and will bring millions of unbanked to participate in the digital finance ecosystem.

Third, Working with the Environment

This morning, I understand that Finance Secretary Carlos Dominguez and other ministers talked to this group about the government’s massive infrastructure program and the tax reforms being pushed to fund the huge investments necessary to fund the program.

I am pleased to inform that with these national government initiatives in mind, the Bangko Sentral ng Pilipinas has lined up additional game-changing financial sector reforms in the medium-term.

Last August, the BSP, together with the Department of Finance (DOF), Securities and Exchange Commission (SEC) and Bureau of the Treasury (BTr), presented the capital market roadmap to hasten the development of the domestic debt market. The initial phase will focus on improving benchmark markets as this is critical in pricing risk assets and other capital market instruments.

The reform package aims to: (1) increase the volume of treasury bills, (2) provide a transparent mechanism covering the issuance of government securities, (3) establish a reliable yield curve, (4) develop a set of obligations, rights and incentives of market makers, (5) introduce an efficient repo market, and (6) strengthen regulatory oversight over the repo and fixed income market.

We will follow a coordinated and deliberate sequenced approach to ensure smooth implementation of these reforms.

I am happy to report that to date, we have seen progress from these initiatives. For instance, since June, the BTr has been sending “report cards” to Government Securities Eligible Dealers (GSEDs) highlighting their performance in the primary and secondary markets. These will serve as basis for future recognition of market makers.

We have seen performance of GSEDs improve following the release of these report cards and the unveiling of the roadmap, through improved subscriptions, higher participation in pre-auction surveys, and more GSEDs providing indicative bids. Bid submissions show tighter convergence and presence of outliers are now more limited. From a difference between the highest and lowest bids of 190 bps, spread is now around 25bps.

Soon, the BTr will announce the preliminary market makers and will launch the actual enhanced GSED program early next year. By November of this year, we also look forward to the first trade in the repo market.

We are also further liberalizing and rationalizing foreign exchange rules. This is consistent with efforts to enhance the ease of doing business and facilitate job-generating investments. There is also the aim of improving data capture for effective policy decision-making. The amendments of FX regulations are part of a broader thrust for an organized FX market in order to enhance transparency, improve price discovery, and make available more FX instruments, particularly hedging products.

Finally, we will further promote competition in the banking sector by welcoming more foreign players that can bring in international expertise in customer service, innovation, and even additional FDIs. Since the full liberalization of the banking sector in 2014 through Republic Act No. 10641, the entry of ten (10) foreign banks has been approved by the BSP. We expect – and we want – more players to come in and serve the growing financial needs of our robustly growing economy.

Ladies and gentlemen, the Philippines has come a long way, achieving investment grade sovereign rating status, and becoming an economic outperformer even in the wake of external headwinds. In the next cycle of economic transformation, the BSP will continue to play an instrumental role by staying committed to its mandates of price and financial stability, and by topping this up with the pursuit of additional game-changing financial sector reforms.

Thank you very much for your kind attention.