Nestor A Espenilla, Jr: The big picture

Speech by Mr Nestor A Espenilla, Jr, Governor of Bangko Sentral ng Pilipinas (BSP, the central bank of the Philippines), at the Bloomberg FX 2017 Forum, Makati City, 30 August 2017.

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Distinguished guests, ladies and gentlemen, it is a pleasure to be here at the 17th Bloomberg Foreign Exchange Summit. It is a pleasure too to share the spotlight with Dr. Mark Mobius and Mr. John Lagman, whose insights contribute to making financial markets more efficient and effective catalysts of economic growth. Good afternoon to all.

The Exchange Rate

Developments in the foreign exchange market and the peso have garnered significant attention of late. For the first time this year, the peso breached the P51/1US$ mark, closing at P51.11/1US$ yesterday.

Indeed, if one uses the Bloomberg News Search function, one will discover that the words, “peso” and “BSP” have appeared together 7.5 times a day since May 2017. This is significantly greater compared to the frequency of 2.9 times a day in the first four months of the year.

What seems to be the concern?

I am here to share the big picture with you – to share the forest for the trees.

Under a flexible exchange rate regime, domestic currency fluctuates and acts as an automatic stabilizer to contain swings in financial markets… These fluctuations are not in themselves bad… Rather, they shield the economy from temporary shocks. In fact, there are studies showing that a flexible exchange rate better positions emerging market economies to moderate the impact of global financial and monetary forces.

Recent developments in the peso are largely brought about by strong and broad-based imports growth, reflecting the economy’s solid growth momentum. Investments by both the private and government sectors continue to expand. We are also seeing he private sector expanding their businesses overseas and actively managing their financial exposures. Additionally, the expected U.S. rate hikes and possible unwinding of the Fed’s balance sheet by year-end likewise contribute to depreciation pressures on the peso due to portfolio re-balancing.

We have responded to these developments by allowing a moderate and gradual depreciation of the peso as part of a healthy defensive adjustment process.

Amid these developments, we are confident that the country’s robust growth, stable inflation environment, strong and resilient banking system, and prudent fiscal position will continue to provide fundamental support to the peso.

Solid Macroeconomic Fundamentals

The developments we have seen thus far in 2017 point to overall economic resilience.

Economic performance in terms of GDP growth has been sustained. Real GDP rose by 6.5 percent in the second quarter of 2017. We are one of the fastest growing economies in Asia… Stronger economic activity is expected in the second half of the year due to the robust growth in the services sector and improved external trade conditions….Private consumption demand is expected to remain firm, aided mainly by sustained remittance inflows and low inflation.

As more government infrastructure programs get underway, the positive spillover effects on private capital formation will contribute to economic growth over the medium term…

The economy is on track toward achieving the government's full-year target of 6.5 to 7.5 percent… This extends our streak of uninterrupted growth to 74 consecutive quarters! …Over the past five years, the economy has expanded by an average of more than 6 percent annually, a feat not accomplished since the 1970s.

Latest data shows that domestic liquidity conditions are ample to finance the requirements of the growing economy. Domestic liquidity (M3) grew by 13.3 percent year-on-year in June 2017, faster than the 11 percent expansion in the previous month.

This expansion in economic activity was sustained without fuelling inflationary pressures… Although headline inflation rose slightly to 2.8 percent in July (from 2.7 percent in June), the year-to-date average inflation rate of 3.1 percent. This is fully in line with our 2017 forecast. This means we will once again be solidly on target.

Indeed, our latest baseline forecasts indicate that inflation is likely to settle near the midpoint of the government's 2-4 percent target range over the 2017 to 2019 forecast horizon.

Equally important, our banking sector continues to be fundamentally sound. The many reforms put in place by the BSP, along with the banks' significantly improved risk governance have resulted in clear improvements in the quality of Philippine banks' assets and loan portfolios as well as in strong capitalization. These indicate superior ability to absorb risks…

Strong balance sheets have allowed bank lending activity to remain upbeat as it continues to flow into the country's productive sectors such as real estate; power and utilities; manufacturing; wholesale and retail trade; and information and communication. The non-performing loans (NPL) ratio and non-performing assets (NPA) of universal and commercial banks (U/KBs) have significantly declined since 2001, to less than 2 percent by June 2017. At the same time, banks' Capital Adequacy Ratio (CAR) of 15.8 percent as of March 2017 remains well above the minimum norms.

Meanwhile, the external debt situation has also continuously improved. Outstanding Philippine external debt stood at US$73.8 billion as of end-March 2017, equivalent to just 24 percent of GDP. This is a significant decline from 60 percent in 2005.

At this stage, the country is seeing a reversal in its overall Balance of Payment (BOP) position which as of July 2017 posted a deficit of US$ 1.4 billion… The balance of payments deficit can be attributed in part to stronger growth in imports and as well as to rebalancing of portfolio capital flows in line with monetary policy changes in advanced economies. This is manageable and sustainable.

We shouldn't forget the positive factors going for the economy. Business Process Outsourcing (BPO) receipts reached US$5.5 billion as of Q1 2017, growing by 9.9 percent relative to the same quarter last year.

Remittances from overseas Filipinos (OFs) continue to flow in… The inflow of cash remittances from OFs coursed through banks remain steady, reaching US$ 2.5 billion in June, a 5.7-percent increase from the level posted in the same period a year ago… Merchandize exports grew by 13.6 percent in the first half of 2017, faster than projection.

As a result, the country's gross international reserves (GIR) remained ample as of end-July 2017 at US$81.1 billion. This is more than enough to cover 8.7 months of imports of goods and services and 5.5 times the country's short-term debt obligations.

Need for Vigilance: Macroeconomic Headwinds

Despite this favorable economic backdrop, the Philippine economy, like other economies, continues to face challenges on both global and domestic fronts.

After years of protracted subpar growth, the global economy is finally experiencing a "firming recovery." In its latest World Economic Outlook (WEO) in July, the International Monetary Fund (IMF) projected global output to grow at 3.5 percent in 2017 and further at 3.6 percent in 2018. This is on the back of the notable improvements seen in the Euro area, as well as the robust growth outlook in advanced and emerging Asia.

But there are downside risks over the near and medium term that stem from a number of factors. The first is growing uncertainty of economic policies as more central banks in major advance economies prepare to enter a tightening cycle at different speeds. The US Federal Reserve (US Fed) seems set on its path to normalization as it hiked the federal funds rate in June (the second time this year)… It is also set to unwind its bond purchases during the year…

The European Central Bank (ECB) has just started pondering on how to taper its Quantitative Easing (QE) Policy in 2018…Similarly, the Bank of England (BOE) has finished its latest round of QE – which it launched after the Brexit referendum last June 2016 – BOE is also considering hiking interest rates.

On balance, a well-calibrated adjustment from these major central banks should not trigger dramatic shifts in global capital flows. However, as the accommodative stance from these economies begin to unwind, there could be knock-on effects, both economic and financial, such as the potential for a capital flow reversal in emerging economies including the Philippines.

A second risk rises from global political uncertainty. Polarization has intensified owing partly to the growing discontent over globalization and the inequality perceived to have resulted from it…

If this trend gains further traction, there is likely to be greater inclination towards "inward-looking" policies. For example, the US government's efforts to implement a conservative policy agenda on immigration, offshoring/outsourcing, trade, tax reform, labor/immigration laws, and financial and business regulation, could potentially shrink external trade, and even derail the global economy's path to recovery.

Closer to home, it could dampen the country's Overseas Filipino (OF) deployment and remittances. It can also significantly affect our exports, ultimately hurting domestic consumption. The US remains the second largest market destination of Philippine merchandise exports with an average annual share of 14.8 percent in the period 2013–2016. For our BPO industry, the US remains the largest export market, accounting for nearly 80 percent of industry revenues in 2014. Nevertheless, our local BPO industry leaders remain confident that the cost advantages in the Philippines will remain a key factor in US firms' decision to outsource.

Lastly, the ongoing rebalancing of the Chinese economy as it continues to transition from export-led growth to services- and domestic consumption-driven expansion could also impact on Philippine exports given the expanding bilateral relations between the two economies in recent years. Nevertheless, the expected recovery in both advanced economies and emerging and developing economies, as projected by the IMF in its July 2017 World Economic Outlook (WEO) update, could also compensate for the potential slowdown in China.

Challenges on the Homefront

In addition to the risks emanating from the external front, we also need to contend with homegrown risks.

Challenges in the near term relate to regional and domestic security issues such as on-going tensions between the US and North Korea as well as the still on-going conflict in Marawi which may have a direct impact on business and consumer sentiment as well as on tourism, if prolonged.

Over the medium term, there is also the key challenge of addressing the infrastructure gaps in the economy.

To this end, the National Government's proposed fiscal reform package seeks to increase available resources for needed public capital spending while also encouraging private spending. The DOF is also planning to introduce other tax reforms that will include, among other things, a reduction in the corporate income tax rate, harmonization of capital income tax rates, and rationalization in the valuation of property prices.

The tax revenues from the initial package will be used to sustain higher productive investment spending for physical and human capital development, thus ultimately leading to gains for the economy in the medium-to-long run… Given a sustained increase in productive public investment and higher capital income from the gradual reduction in corporate income tax, we can expect a positive knock-on effect on private investment, resulting in a beneficial cycle of higher investment and higher potential output for the economy.

This means that the success of the country's much needed infrastructure investment relies heavily on the passage of the tax reform package.

Policy Responses: Managing Risks

Fortunately, the BSP has a broad policy toolkit for responding to some of the risks I have outlined.

These include: (i) macroprudential regulations targeted to specific sources of risks, (ii) contingency measures such as liquidity-enhancing facilities, and (iii) liquidity provision measures and regional firewalls that boost the flexibility and effectiveness of our actions. The BSP will activate these tools as appropriate.

In the context of pursuing our price stability mandate, the BSP will continue to fine-tune its implementation framework for monetary policy to make it even more market-oriented. We have already started with the deployment of the interest rate corridor (IRC) system. Over time, the IRC is expected to aid in advancing the development of the domestic money and capital markets based on greater reliance on the use of market-friendly instruments. The IRC will further align our open market operations with liquidity needs of the market, strengthening monetary policy transmission channels.

In terms of banking supervision, we continue to review and align our financial regulations and policies with international standards to improve risk management as well as ensure the competitiveness of our banks in view of ASEAN integration… We intend to further enhance our macro-financial surveillance capability by, among others, improving coordination and cooperation with other government agencies and regulators… We are also working closely with other government agencies and private sector stakeholders to accelerate the development of the domestic debt market, including the development of the necessary financial market infrastructures that provide orderly trading, clearing, and settlement of the full range of financial transactions.

Earlier last year, the Monetary Board approved the ninth wave of liberalization of foreign exchange rules. This is to encourage the public to transact their FX needs with banks, enhance market efficiency, and improve data capture. There are more ambitious FX reforms to come.

We also continue to enhance and update our financial sector regulations and policies to bring our financial system at par with international standards…Through the Financial Stability Coordination Council Committee (FSCC) chaired by the BSP, macro-prudential surveillance of the financial system is conducted on an on-going basis to enable early detection of any incipient signs of instability.

Our surveillance toolkit consists of a suite of quantitative models that attempt to address one or more aspects of systemic risks. This includes, among others:

- Early Warning Systems (EWS) that employ aggregate information from various sectors to generate early warning signs of systemic stress and at the same time, allow us to identify potential build-up of stress in specific sectors of the economy.
- Stress Tests that measure the resilience of the domestic financial system to various stress factors, including shocks from macroeconomic and financial variables like GDP, liquidity, and interest rates.
- Stability indicators that potentially contain more information on the changes in domestic macro-financial conditions such as Philippine Composite Index of Financial Stress (PCIFS), Bank Distress Index (BDI), and the Residential Real Estate Price Index (RREPI).
- Philippine Financial Markets Connectedness Indices are also being developed to provide information on the amount of spillovers to the domestic financial markets.

We are also looking at tapping new technologies such as big data analytics to further improve and widen the breadth of our surveillance.

Lastly, the BSP is reinforcing its model-based assessments with qualitative and informed judgments on current macroeconomic and financial conditions through the conduct of risk assessment initiatives similar to environmental scanning exercises.

Concluding Remarks: Strength in Partnership

Ladies and gentlemen, both external and domestic developments compel us to remain watchful in guarding against threats to growth and stability.

We have sustained reforms that have helped keep the Philippine economy on a steady growth path in spite of external and domestic headwinds. This track record of success provides us the confidence and cautious optimism in meeting the many economic challenges along the way.

This, ladies and gentlemen, is the big picture … and I am grateful for the opportunity to share it with you. Please remember it as you trade day-to-day.

Thank you for your kind attention. Good afternoon.