Nestor A Espenilla, Jr: Ready in the age of great convergence

Speech by Mr Nestor A Espenilla, Jr, Governor of Bangko Sentral ng Pilipinas (BSP, the central bank of the Philippines), at the Security Bank Economic Forum, 21 November 2017.

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SBC Chairman Alberto Villarosa; President and CEO Alfonso Salcedo, Jr.; Department of Finance Undersecretary Gil Beltran; fellow speakers/panelists, esteemed guests; ladies and gentlemen, good afternoon.

It is a pleasure to be here at Security Bank's annual Economic Forum, to discuss developments and prospects in the global and domestic economy and to take stock of challenges ahead.

At present, four key financial sector issues seem top of mind. First, is uncertainty over the pace, timing, and magnitude of tightening of global financial conditions. The potentially divergent monetary policies of advanced economies (AEs) would likely trigger bouts of volatility in the financial markets.

Second, is peso volatility with specific concern over its possible sharp depreciation.

Third, is the perceived risk of overheating in the economy.

And fourth is the challenge of disruption brought about by fintech. The use of digital technologies challenges the status quo,[1] even making an impact on monetary policy.

Anchors of stability

We can rely on several anchors of stability to manage these pressing issues.

The Philippines sustained its robust macroeconomic fundamentals. It is one of the fastest growing economies in the world, with 75 consecutive quarters of uninterrupted and increasingly broad-based growth. Annual growth has been running above 6 percent in the last five years. For the third quarter of this year, GDP picked up to 6.9 percent.

Prospects remain bright as growth is predicted to be between 6.5 and 7.5 percent this year and 7.0 and 8.0 percent over the medium-term. Growth will be increasingly investment-led as government and private sector investments ramp up.

The stable inflation environment provides support to domestic demand. Inflation has averaged 3.2 percent in the past ten months, in line with the 2017 target. Latest baseline forecasts show it will likely settle around the middle of government's target range of 2 – 4 percent in 2017 to 2019.

We are ready to deploy the full array of our monetary policy toolkit to deal with possible market volatility as policy settings evolve and normalize in the US and other advanced economies. We are also watchful of geo-political risks that could pose challenges to the country's trade, remittances, and foreign direct investments.

Recently, the depreciation of the peso has been a cause of some market unease. Such concern is overdone.

The peso's moderate and controlled depreciation mirrors bullish economic growth indicated by strong imports demand, residents' increased direct and portfolio investments abroad for expansion and risk diversification; as well as public and private sector debt prepayments to manage foreign exchange risks. There is also outflow of hot money. We see these as healthy adjustments.

The peso is expected to be broadly stable over the medium-term, backed by strong underlying economic fundamentals, ready market access, and robust international reserves. Our foreign exchange reserve buffer, as of end-October 2017 stands at US$80.6 billion. This is equivalent to more than 8 months' imports of goods and services and is greater than our foreign exchange liabilities. We have additional liquidity buffer as well from our regional safety net arrangements.

Sustained inflows from overseas Filipino remittances, business process outsourcing, tourism receipts, and the strong recovery in exports further support the peso. We can likewise look forward to increased foreign direct investments that are attracted by our growth prospects. With the country's external debt on a sustainable downtrend and ample fiscal space, there is scope to pursue high quality investments in physical and human capital that will expand potential output.

At the current range, the peso's competitiveness has improved back to 2008 levels as measured by the real effective exchange rate (REER) index.

The Philippine banking system is very stable and very dynamic, with good asset quality, sustained profitability, and adequate capitalization. For the third quarter of this year, total banking system resources expanded by 14.1 percent year-on-year, to P14.6 trillion. This was funded by sustained deposit inflows which grew by 15.3 percent, to P11.3 trillion.

The non-performing loan (NPL) ratios further improved to 1.9 percent, with adequate and prudent provisioning for credit losses.

Bank capital is being beefed up by strong earnings from core income sources particularly lending activities. Capital adequacy ratio, recorded at 16.0 percent on consolidated basis, is well above the BSP and international minimum.

The risk of economic overheating has been raised by some analysts. We do not believe we are there yet and we remain very vigilant to avoid it. The current pace of credit growth is manageable . Our credit-to-GDP ratio of 63.6 percent as of Q2 2017 is still one of the lowest by far in Asia, indicating relatively low overall leverage.

Bank loans are diversified across economic sectors and are backed by durable economic activity with 89 percent going into production sectors. Moreover, BSP monetary operations indicate just sufficient domestic liquidity to support expansion. Amid the stronger growth in liquidity, inflation dynamics remain manageable.

Key indicators of credit expansion likewise are below established international thresholds. Current property prices, as reflected by latest Colliers data and the latest BSP Residential Real Estate Price Index (RREPI), also do not show misalignment from fundamental values.

We continue to closely monitor credit growth and risks to overheating, even as we stand ready to deploy macroprudential measures if necessary, to deal with sectoral issues in a targeted way.

Staying ahead: new norm, new tools

Economist Richard Baldwin published a book in November 2016 on the four phases of global economic evolution. According to him, the fourth phase (1990 to the present) is The Great Convergence, characterized by globalization of knowledge and information resulting from the information and communication technology (ICT) revolution.

To stay abreast, we must adopt new tools and policies. As products, services, and processes evolve, the BSP constantly expands its policy toolkit to include macroprudential measures, surveillance tools, and stress indices such as the early warning system (EWS) on currency crisis and the Philippine Composite Index of Financial Stress (PCIFS).

We are upgrading our monetary operations framework: The interest rate corridor (IRC) system was deployed last year to enhance the monetary policy transmission mechanism. The IRC is also compatible with the further development of our capital market. We shall continue to enhance the IRC for a more market-friendly implementation of monetary policy.

We continue to pursue progressive prudential reforms to maintain the financial system's resilience against external shocks.

Since the start of this year, the BSP implemented reforms to upgrade corporate governance and risk management standards, and to promote financial system integrity and transparency. Good governance is the backbone of a safe and stable financial system. Consistent with this, we have also enhanced the reporting governance of banks.

We have seen significant progress in the adoption of Basel III reforms, particularly in the areas of capital, leverage, liquidity and regulation of systemically important banks. More recently, we have rolled out a four-phased program for liquidity risk management.

The first phase, which was approved by the Monetary Board through Circular No. 981, covers guidelines on liquidity risk management, including intraday liquidity. Next in the pipeline are amendments to the LCR standard and issuance of the complementary Minimum Liquidity Ratio (MLR), a simplified version of the LCR requirement for less complex financial institutions. Third, we will issue guidelines implementing the Net Stable Funding Ratio (NSFR) standard to ensure that banks have adequate long-term stable funding. Lastly, the BSP will issue intraday liquidity reporting guidelines to complement the qualitative intraday risk management guidelines under Circular No. 981.

In line with the upcoming full adoption of the Philippine Financial Reporting Standards Financial Instruments (PFRS 9), a consultative document on the "expected credit loss" model was released. In 2014, BSP started preparing banks on the use of the expected loss methodology through Circular No. 855. Parallel to this, we will enhance the Pillar 3 disclosure requirements for incorporation in banks' annual reports. The guidelines on accreditation of external auditors across sectors are also being reviewed. These reforms promote market discipline, transparency, and resiliency.

Financial market development

Part and parcel of our strategic policy reforms is to accelerate financial market development with particular focus on local currency debt and foreign exchange (FX) markets. We envision a more balanced financial ecosystem where the banking system is complemented by a deep and liquid capital market. This can support the long-term financing requirements of corporates and the Government, particularly with the "Build, Build, Build" program roll out.

As you know, the BSP, in collaboration with the SEC, DOF and the Bureau of the Treasury (BTr) is working on a package of initiatives to be rolled out in a sequenced approach to ensure smooth implementation. The reform agenda will officially start with the launch of the Government Securities Repo Program on November 27 2017, in coordination with industry associations.

Through nine waves of reforms since 2007, the BSP has undertaken measures to liberalize the foreign exchange (FX) market. Currently, we are pursuing even more ambitious FX reforms aimed at deepening the FX market and increasing resilience of our domestic economy against external shocks, even as we continue to allow greater exchange rate flexibility. This demonstrates a thrust towards greater openness given the country's increasing integration with global markets.

Soon, the BSP will release an exposure draft on the liberalized rules on foreign currency borrowings of the private sector to move away from prior BSP approval, simplify the registration process to primarily focus on information gathering, and minimize documentary requirements.

Other future amendments will address unnecessary friction on investment and other transactions.

Over the medium term, we are implementing a sequenced approach that will enhance market conduct, increase FX market transparency, and promote a market-determined exchange rate consistent with the characteristics of an organized FX market.

Taken together, the FX and domestic debt market development initiatives are complementary reforms that will deepen market liquidity, establish a more reliable reference yield curve for domestic interest rates, and strengthen market integrity. These reforms will pave the way for more innovation and increased availability of financial products that meet diverse funding requirements with more choices and more flexibility. These will also enable the creation of hedging instruments that enhance risk management capabilities of banks, corporates, government units, MSMEs, and the general public.

Dealing with disruptive technology

At the BSP, we have a very open-minded approach to Fintech. This means that we take a very active role in ensuring that our policy provides opportunities for innovation that can help advance inclusive growth and deliver more efficient financial services. At the same time, we want to ensure risks are well managed, particularly technology, money laundering/ terrorist financing, and consumer protection risks.

As far as I know, we are a pioneer among central banks in using the “test and learn” approach, now known as regulatory sandbox, to allow controlled roll-out of new financial technology.

Even as we allow fintech into our system, we are mindful of related risks. Earlier this year, we issued various regulations aimed at mitigating the effects of technology risks, as well AML/CFT concerns. These include comprehensive supervisory frameworks for money service businesses and pawnshops to ensure effective AML compliance. This also extends to entities that use virtual currency as underlying instruments for remittance. To date, there are two virtual currency exchanges registered with the BSP with several more under evaluation.

We have also allowed proportionate and technology-enabled Know-Your-Customer (KYC) procedures for low-risk clients to facilitate frictionless customer on-boarding. More recently, the Monetary Board approved the cyber security risk management framework under Circular No. 982.

Finally, we are pursuing digitization of the payment system as part of our firm commitment to the national strategy for financial inclusion.

The BSP is actively working to make universally available to all a basic transaction account in a bank or regulated non-bank financial institution, to be able to send and receive payments via any electronic device. At the same time, we are working with other government agencies and Congress to establish a biometric national ID system. These two — universal transaction accounts and a digital ID system – are key foundations of a robust and inclusive digital financial system.

We are one step closer to achieving the vision of a cash-lite economy with the recent launch of the Philippine Electronic Fund Transfer (EFT) System and Operations network, also called “PESONet” last November 8, 2017. This is the first Automated Clearing House (ACH) under the National Retail Payment System (NRPS). It supports batch payment credit transactions and will eventually replace paper check payments for most applications. Early next year, we will launch “InstaPay”, the ACH for low-value real time push payments ideal for mobile payments in support of e-commerce.

Conclusion

Ladies and gentlemen, the heightened convergence of the global and the domestic economy, fuelled by ICT revolution, is a force to reckon with. One has to catch opportunities created by these big changes and adapt to manage new risks. As economic agents seek novel ways of doing things, the role of BSP becomes more critical. In this regard, we assure of our commitment and capability to foster an enabling environment so we are ready in the age of the Great Convergence.

Thank you for your kind attention.

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[1] Manyika, J. et al. (2013). "Disruptive technologies: Advances that will transform life, business, and the global economy". McKinsey Global Institute, May 2013.