Nestor A Espenilla, Jr: Having the foresight to future-ready the economy

Speech by Mr Nestor A Espenilla, Jr, Governor of Bangko Sentral ng Pilipinas (BSP, the central bank of the Philippines), at the Management Association of the Philippines' (MAP) Economic Briefing 2018 and General Membership Meeting, Manila, 6 March 2018.

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President Ramoncito Fernandez; MAP officers and members; special guests; ladies and gentlemen, good afternoon.

I am grateful to be here at the Management Association of the Philippines' First Economic Briefing for 2018. I shall give this message in two parts. First, I will give an update on the Philippine economy and then, I will share our exciting prospects.

Updates on the Philippine Economy

We at the BSP are optimistic. This optimism is shared. According to the World Bank, "The Philippines will continue to be the fastest-growing economy in the Association of Southeast Asian Nations (ASEAN) [for 2018–2020], despite some stabilization of investment growth."

Moreover, growth projections from third-party assessors are not far from the national government's target of 7.0-8.0 percent growth in the next three years.

We note that growth achieved over the past several years is broad-based and comes from various sources.

On the production side, the share of industry output (e.g., manufacturing and construction) has been expanding and is a welcome transformation. On the demand side, growth is buoyed by both robust private consumption and capital investments.

Another source of confidence comes from sustained investments in job-creating industries. There was double-digit year-on-year expansion of approved investments for the first three quarters of 2017.

Moreover, the favorable inflation environment enables and promotes greater economic activity. For six consecutive years (i.e., 2009–2014), as well as in 2017, headline inflation has been within the national government's inflation target range.

For February 2018, year-on-year headline inflation increased to 4.5 percent from 4.0 percent in January using the 2006-based Consumer Price Index (CPI) series. Likewise, headline inflation rose to 3.9 percent in February from 3.4 percent in the previous month using the 2012-based CPI series. The uptick in headline inflation was traced mainly to higher prices of selected food and non-food items. In particular, rice prices increased due to the end of the harvest season. At the same time, inflation for transport, restaurant, and miscellaneous goods and services also went up.

The year-to-date average of 4.2 percent using the 2006-based basket was slightly above the Government's announced inflation target range of 3.0 percent ± 1.0 percentage point for 2018 while the year-to-date average of 3.7 percent using the 2012-based basket remain within the Government's announced inflation target range.

The first round price effects of TRAIN are evolving more or less as expected. We continue to see the upward inflationary effects as transitory. However, we are carefully assessing next round effects and how inflation expectations could be affected. The various social safety nets complementing the TRAIN are expected to temper these second round effects. Moreover, the resulting improvement in productivity will likely moderate inflation pressures over the medium term.

Nevertheless, the BSP will remain watchful against signs of higher inflation becoming more broad-based and persistent to ensure that inflation expectations remain consistent with the target.

Domestic liquidity and credit dynamics remain accommodating to our expanding economy. Credit expansion is accompanied by solid demand for loans across key economic sectors.

Further, the Philippine banking system capped 2017 with sustained growth in assets, deposits, and capital. This was accompanied by improved asset quality, firm liquidity position, and strong capitalization.

Overall, the Philippine banking system remains sound and stable. We expect these improvements to continue.

The Philippines' external position also continues to be manageable amid global headwinds. The BOP deficit is a reflection of an economy that is growing rapidly in a way that is sustainable. The current account balance also mirrors the saving and investment behaviour of the economy. Our savings investment gap has stayed positive since 2003 (hence the CA surpluses during this period) but has started to converge in 2015 due mainly to the rise in investments and increase in infrastructure spending. Over time, these investmentled economic activities will result in the expansion of the economy's potential capacity.

The robustness of the country's external position is anchored by our large GIR and secondary buffers such as sustained foreign direct investments, remittances and BPO receipts, along with investment grade-rating that guarantees ready market access for any equity and debt financing requirement.

Meanwhile, the peso continues to flexibly reflect the day-to-day market operations. Exchange rates act as automatic stabilizer if they move in a way that dampens the effects of shocks on domestic output. In short, the disequilibrium gets corrected automatically with the change in the exchange rate. There will be volatility, runs and corrections, but the peso is not expected to meltdown because the underlying economic fundamentals of the economy are healthy. The depreciation of the peso has mirrored the continued bullish sentiment on the economy's growth performance and prospects. These are evident in the (1) strong demand for imports, (2) residents' increased direct and portfolio investments abroad, and (3) debt prepayments by both the public and private sectors. All of these contributed to an increase in the demand for dollars and dollar-denominated assets.

Ladies and gentlemen, the Philippine economy enjoys a sustainable growth momentum. Over the medium term, the Philippine economy is expected to expand by above six percent annually in the next three years.

But this does not warrant complacency. For both the government and the private sector, disruptive forces must keep us on our toes.

Prospects for the Philippine Economy

This brings me to the second part of my message as I share our prospects for the Philippine economy. I feel right at home and in my element as I engage in sharing our plans... In this era of technological breakthroughs and radical innovation, MAP could not have chosen a more timely and relevant theme for its activities this year. BSP's planned game changing reforms and initiatives align with your theme. "Competing in the age of disruption." I like that. It shows foresight.

Foresight does not necessarily mean being able to predict the future. Rather, I believe it means having insight on relevant factors and to allow for flexibility and optionality as the future unfolds. And the future is already here. It is unfolding.

Indeed, the way governments tackle policymaking and the way businesses operate are being altered by megatrends. These include a rebalancing of the world economy, changes in demographics, and the rise of disruptive technologies, to name a few.

These trends cannot be ignored. Complexities such as these make it challenging to frame economic policy.

Acknowledging this, the Bangko Sentral under my Governorship has set its sights on game-changing financial sector reforms. These initiatives aim to gear up the financial system to be very efficient, flexible and market-driven so that it can be innovative, competitive, and ready to adjust to the needs of customers. Further, allowing markets to discover prices on their own and encouraging self-correction mechanisms will make our economy more resilient and future ready.

First - the BSP, together with other government agencies, industry associations and market participants, have rolled out initiatives to further develop the local currency debt and foreign exchange (FX) markets.

The reform agenda on debt markets officially unfolded in November 2017 with the launch of the Government Securities Repo Program. Last February 19, 2018, the Bureau of the Treasury released the implementing guidelines for the enhanced Government Securities Eligible Dealers (GSED) Program. This program aims to improve the primary debt market and increase the liquidity and depth of the secondary market. We are looking forward to further enhancements in the market infrastructure and the issuance of improved interest rate benchmark guidelines toward a more reliable yield curve.

We are also undertaking ambitious FX reforms towards a deeper and better organized FX market. This includes further liberalizing FX rules to reduce cost of doing business and improve data capture. Last January 15, 2018, new rules that lifted prior BSP approval and streamlined registration processes for purely private sector foreign currency loans took effect. A window was likewise opened for six months providing an amnesty period during which private sector loans previously obtained without prior BSP approval can register and be eligible for servicing from the banking system. To date, the BSP has received 21 loan registration under this amnesty window covering around USD489 million outstanding balances. We expect captured data to increase further as the simplified rules gain traction. Currently, we are finalizing an exposure draft amending FX rules on foreign investments. Further amendments to adopt similar measures on trade and non-trade transactions shall likewise be undertaken.

Over the medium term, we plan to enhance governance and FX market oversight that will improve transparency, price discovery and market conduct. Ultimately, we want to see a more liquid FX market that supports a flexible and market-determined exchange rate.

Relatedly, last February 15, 2018, we announced yet another major and bold financial market reform initiative... We began phased reduction of our ultra-high reserve requirement regime to allow efficient absorption and mobilization of liquidity. The Monetary Board approved the reduction in the reserve requirement ratio (RRR) by one percentage point as an operational adjustment to support the BSP's shift towards a more market-based implementation of monetary policy. This took effect last March 2, 2018.

There is a calibrated speed and a purposeful timing in carrying these reductions out. The purpose is to promote a more efficient and level financial system which is less biased against deposit-taking financial institutions. The purpose is to lessen market distortions which create inefficiencies. The purpose is to shift to market-based monetary instruments for more effective monetary policy transmission.

We have heavily relied on reserve requirements for a long time in a situation of underdeveloped banking and financial markets and limited open market operation tools. This is no longer the case for the Philippines. Our financial system is more sophisticated, disciplined, and resilient; our economy is much stronger today. Further, the BSP has attained sufficient progress since the adoption of the interest rate corridor (IRC) framework in 2016 which provides us ample space to mitigate potential liquidity impact of a phased reduction in reserve requirement via off-setting auction-based monetary operations.

There is misconception that these phased reductions in the reserve requirement signal easing of the monetary policy stance. This is certainly not the case — and I cannot emphasize this enough — this is an operational adjustment that is part of innovative financial sector reforms that we are currently implementing. Any ensuing excess liquidity is to be siphoned off by BSP's dynamic open market operations and transactions with the national government. Further, the flexibility of the exchange rate provides additional adjustment mechanism.... Therefore, analysts' fears that this will fuel more inflation is based on an incomplete analysis of the impact of this operational adjustment.

Moreover, to the extent that speculators use RRR reduction as a pretext for peso depreciation, BSP participates in the market to manage excessive volatility. We believe this can effectively drain peso liquidity from the system. There will be self-correction, which is how efficient markets work.

Ultimately, the BSP has many options to maintain firm monetary control. Shifts in monetary policy stance will continue to be signalled through changes in the policy rates. Thus, analyst concerns of ensuing looser monetary policy is really unfounded.

Second - Regulators like the BSP must foster an enabling ecosystem where competition and responsible innovations are encouraged to thrive.

We believe that regulations should not stand in the way of market developments. At the BSP, we have strategically opened up the banking system to competition. For instance, since the enactment of the Foreign Banks Liberalization Law in 2014, the Monetary Board has approved 12 foreign bank applications and 5 representative offices. Similarly, our flexible approach to financial innovation encourage competition from new players, including fintech companies.

Leveraging on safe, innovative and affordable financial instruments and channels also drives business and industry growth and serves as the gateway to greater financial inclusion.

Professor Klaus Schwab, Founder of the World Economic Forum quipped, "There has never been a time of greater promise, or greater peril." This given, the BSP seeks to continually build a regulatory environment for innovations to flourish, yet still mindful that risks to stability and integrity – including from cyber attacks, money laundering, and terrorism financing – must be effectively managed.

There are three principles that underpin our regulatory approach: First, regulation must be risk-based, proportionate and fair. Second, there is need for active multi-stakeholder collaboration. Third, consumer protection must be upheld and innovation must work for the benefit of consumers.

Our "test and learn" approach remains useful as we continue to deal with increasing digital innovations in the market.

The BSP is also on constant surveillance mode for other fintech activities by emerging market players. For example, we are monitoring industry developments on crowd-funding and peer-to-peer lending, ready to take regulatory action when necessary.

The BSP is working with the industry in implementing the National Retail Payment System (NRPS).

Lastly, the BSP is currently closely coordinating with regulators from other jurisdictions for possible information sharing and a referral system focused on fintechs. Under the proposed agreements, authorities will facilitate the entry of potential fintech players from their respective jurisdictions to minimize any duplication of efforts and further promote expansion of fintech innovations in the region.

Ladies and gentlemen, with both challenges and opportunities brought about by rapid innovation and technological disruption, economic players must adapt to changes, or else, one may find itself adrift and lost.

Rest assured that the BSP is committed to continue to pursue reforms to allow digital innovations to flourish as long as prudent standards are in place, and to ensure a level playing field for all stakeholders concerned – be it the businesses, consumers, or the general public.

On behalf of the Monetary Board and the BSP, I wish MAP a productive and collaborative year ahead. Thank you and good afternoon.