Nestor A Espenilla, Jr: Investing in sound policies towards sustainable growth

Speech by Mr Nestor A Espenilla, Jr, Governor of Bangko Sentral ng Pilipinas (BSP, the central bank of the Philippines), at the 2018 Economic Briefing of the American Chamber of Commerce of the Philippines, Inc. (AMCHAM), Manila, 24 April 2018.

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Ladies and gentlemen, good afternoon! I thank the officers and members of the American Chamber of Commerce of the Philippines (AMCHAM) for the invitation to speak today. My message has two parts. First, I will give an update on the economy and its prospects over the medium term. Second, I will talk about the government's policy directions, focusing on the BSP's initiatives to sustain the growth momentum and make the Philippines a preferred option for business and investment.

Let me pose a question you may have asked yourselves at some point: Is now a good time to invest in the Philippines?

Conventional wisdom tells us that investing requires right timing. If you get it wrong, you may fail to maximize the return on your resources, or you could be staring at significant losses.

Given the rational desire to avoid loss and reduce risk, it is easy to fall into the trap of being overly cautious and missing out on profitable opportunities. Indecision and unnecessary waiting can also be costly.

Investing will always carry some degree of risk, and we can never fully anticipate how surprises can disrupt or influence the market. The key is to not make decisions blindly. Indeed, information on potential risks and returns, as well as knowledge gained from prior experience, can be sources of confidence for any prudent investor.

So, is now a good time to invest? Do we have information to make the right call? The balance of information that we have suggests that it is indeed an opportune time.

Betting on the Philippines

We at the BSP remain optimistic about the Philippine economy's prospects, especially as economic activity continues to gain traction across the globe. According to the latest figures released by the IMF, global GDP growth reached 3.8 percent in 2017, the fastest pace since 2011 as investment and trade continued to pick up. The IMF now forecasts the global economy to grow by about 3.9 percent in 2018 and 2019, as accommodative policies support the stronger growth impulses in advanced and emerging economies alike.

However, we continue to monitor developments that could dampen this growth momentum. These include increased trade protectionism, rising geopolitical tensions, and the possibility of heightened financial stresses owing to the onset of monetary policy tightening in a number of economies especially in the U.S.

Even with these downside risks, we remain confident about our own prospects. The Philippine economy is coming off another banner year. Real GDP expanded by 6.7 percent in 2017. This is the sixth consecutive year that the economy had grown by over 6.0 percent.

The IMF also shares our optimism, as it forecasts the Philippine economy to expand by about 6.7 percent in 2018 and 6.8 percent in 2019. This is not far from the National Government's target of 7.0-8.0 percent growth over the next three years. All these paint the Philippines as one of the more dynamic and fastest-growing economies in Asia.

We have also observed that growth has become more broad-based over the years. Along with the services sector, manufacturing and construction have emerged as potent drivers of output. On the demand side, increased capital investments and public spending, especially since the past year, have complemented robust private consumption in stimulating economic activity.

Meanwhile, amid rapid economic growth, the inflation environment has remained manageable. Except for 2015 and 2016 when the decline in international oil prices tempered inflationary pressures, inflation has settled within the announced target ranges since 2009. Thus far in 2018, headline inflation has averaged 3.8 percent (using the new 2012 Consumer Price Index series). For 2018, our latest forecast estimates average inflation at 3.9 percent. This is near the high end of our target range of 2-4 percent for 2018-2019. So this bears careful watching. Nevertheless, we see inflation moderating and reverting to around 3 percent by 2019, the midpoint of the target range.

We expect the confluence of strong growth and stable inflation being sustained over the medium term. Specifically, as the National Government pours in more investments into physical infrastructure and increases expenditure in soft investments in our young population to provide them with higher quality education, skills development and better health services, the economy's productive capacity will improve further. These will help boost productivity and we can expect further accelerated growth in potential output.

Meanwhile, various safety net programs to mitigate the impact of recent tax reform measures, especially on the vulnerable sectors of society, should also help moderate inflationary pressures in the immediate term.

We also believe that these public investments in physical infrastructure and human capital are sustainable because they are supported by prudent fiscal management. The first wave of tax reforms under the TRAIN Law, in particular, should help generate additional revenues to finance the Government's programs. Reforms to encourage tax compliance, improve revenue collections, and plug regulatory loopholes, among others, are also in the pipeline to further strengthen the country's fiscal position.

At the same time, the country's healthy financial system has also continued to fuel the growth momentum, as domestic liquidity remains ample to satisfy the requirements of our growing economy, including the solid demand for loans across key economic sectors. Amid the robust expansion in credit, financial institutions have enhanced their liquidity and risk management practices to prevent buildup of systemic risks, as reflected in their improved asset quality, firm liquidity position, and strong capitalization.

The rise in investments and increase in infrastructure spending have been accompanied by stronger demand for imports. This is expected. Over time, these investments will bear fruit in the form of better infrastructure and improved domestic competitiveness. This will support high and sustainable economic growth.

Moreover, despite posting an overall balance of payments (BOP) deficit of US$863 million in 2017, the country's external position continues to be manageable with the deficit at less than 1% of GDP. Rising inflows of foreign direct investments as well as sustained overseas Filipino remittances and BPO receipts provide resilience against external shocks. Moreover, the ongoing global economic recovery bodes well for our merchandise exports. Meanwhile, the movement of the peso remains market-driven. This exchange rate flexibility will promote self-correction mechanisms and avoid dangerous build-up of unsustainable imbalances. These elements should all keep the balance of payments well under control.

Finally, as a sturdy external liquidity buffer, we have built up gross internal reserves of over $80 billion equivalent to nearly 8-months worth of imports of goods and services. We likewise have access to market financing because of our hard-earned solid investment grade rating. We have likewise developed secondary liquidity buffers from various regional safety net arrangements we have worked out with our neighbors.

To summarize, the Philippines continues to be a good bet for investing because of sound macroeconomic fundamentals. Factors in its favor are its broad-based growth, within-target inflation, prudent fiscal management, sound financial system, and manageable external payments position.

These strengths did not materialize overnight. These are well-earned dividends of our sound commitment to timely policy actions and to necessary and bold structural reforms over the years.

With this in mind, it is easy to see good policymaking as akin to investing in the country's well-being. As with any investment decision, getting the timing right requires mindfulness, vigilance, and flexibility, as economic conditions could shift at a moment's notice. Prudence also requires policies to be grounded on a reasonable assessment of pertinent information on potential costs, benefits, and tradeoffs.

Clouds on the horizon

Nevertheless, in spite of a generally favorable economic climate, there are a few clouds on the horizon that require us to be especially vigilant. There are two particularly key developments that could challenge the country's position of relative strength. We intend to address these with timely and well-informed policy responses.

One revolves around dealing with inflation and potential overheating. At our most recent assessment of the monetary policy stance last March, we determined that our prevailing monetary policy settings continued to be appropriate. Inflation has been evolving in line with our projections, as the first-round price effects of the recent tax reforms appear to have been limited. We also considered that prospects for domestic economic activity continue to be firm and within economic potential that in itself is being bolstered by investments in both physical infrastructure and social capital.

At the same time, the BSP has always been patient in analyzing data and calibrating scenarios in assessing the monetary policy stance. Our latest readings do show that the risks to inflation remain weighted toward the upside. Our surveys indicate that inflation expectations have started to rise. These could contribute to potential second-round price effects. Nevertheless, non-monetary measures such as targeted subsidies are expected to mitigate these second round inflationary pressures. We shall see. And we shall act accordingly.

Today, the BSP has many options to maintain firm monetary control. Since the adoption of the Interest Rate Corridor (IRC) system in 2016, we have gained sufficient flexibility to rely on auction-based instruments for liquidity management to complement our workhorse overnight reverse repurchase borrowings at our declared policy rate. We can adjust monetary conditions by adjusting auction volumes to move our market-determined term deposit facility (TDF) rates. This has effectively allowed us a channel to provide guidance to short-term market interest rates. In recent months, we have seen a firm anchoring to the BSP's interest rate corridor as market rates strongly trended upwards. (Note: For example, the 91 T-bill rate has increased by more than 100bps since December 2017).

Our active domestic open market operations interact in close coordination with our foreign exchange market operations, adjustments to reserve requirements, systemic macro-prudential measures and risk-based supervision of individual banks.

In sum, BSP actions remain timely and appropriate to dynamic market conditions. These actions help regulate the economy and control inflation. The signal will be continuously reinforced by other BSP actions, as deemed necessary by developments.

Looking ahead, the BSP remains watchful against signs of inflation becoming more broad-based. We stand firm on our intent to take immediate and appropriate measures to ensure that our monetary policy stance supports our price and financial stability objectives. The coming task of the Monetary Board is to carefully evaluate the appropriateness of a measured policy response to firmly anchor inflation expectations in line with our forecast that inflation targets will continue to be met in 2018-2019. Toward this end, we also note that economic growth remains solid enough to absorb some policy tightening, if warranted.

The other issue pertains to keeping the financial system sound and stable amid constant shifts in the economic landscape. In particular, we cannot ignore how so-called megatrends have changed the way businesses operate. These megatrends have made policy making more complex. These include demographic changes and the rise of disruptive technologies.

To address these challenges, the BSP trains its sights on implementing game-changing financial sector reforms to allow the financial system to be more flexible, market-driven, and innovative.

At this point, let me focus on some of the major reforms that we have already put in place.

The effective implementation of the IRC has allowed us to initiate the gradual and phased reduction of reserve requirements consistent with efficient absorption of any excess liquidity. We began with a one percentage point cut effective in March this year. Subsequent reductions — in the nature of liquidity-neutral operational adjustments — will be done with the proper pace, magnitude, and timing and will largely depend on the liquidity absorbing capacity of our open market operations.

We would like to reiterate that as with the operational shift to the IRC system, the reduction in reserve requirements is not intended to materially affect the prevailing monetary policy settings. Think of it as the BSP shifting from one instrument of liquidity management to another, as liquidity released to the market by the cut in reserve ratio will be re-absorbed through offsetting adjustments in our open market operations, as informed by our updated and comprehensive liquidity forecasts.

Another vital pillar in our financial sector reform agenda is the acceleration of financial market development and deepening. We have rolled out various initiatives to further develop the local currency debt and foreign exchange (FX) markets, including the launch of the Government Securities Repo Program in November 2017.

As part of this coordinated government endeavor, the Bureau of the Treasury released the implementing guidelines for the enhanced Government Securities Eligible Dealers (GSED) Program last February 2018. Further, the SEC is set to issue its exposure draft of the rules on administration of government securities benchmarks, consistent with recent global benchmark reform initiatives and international standards for interest rate benchmark design.

We have also undertaken various FX reforms towards a deeper and better organized FX market. This includes further liberalizing FX rules to reduce the cost of doing business and improve data capture. The latest initiative involved the removal of the prior approval requirement for private sector foreign borrowings. Instead, there is a post-transaction regulation requirement for the primary purpose of capturing data.

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

Finally, the BSP aims to foster an enabling ecosystem where competition and responsible innovations in the financial sector are encouraged to thrive. We have strategically opened up the banking system to encourage competition, particularly from new players and fintech companies. This is because we believe that leveraging on safe and innovative financial institutions can also drive business and industry growth, and likewise open gateways to greater financial inclusion.

We have also set our sights on the digitalization of the financial system. We are working closely with the industry in implementing the National Retail Payment System (NRPS) to establish a safe, reliable and affordable retail payments system, with an increase in the share of electronic payments to at least 20% by 2020. Just yesterday, the BSP launched InstaPay, the latest automated clearing house (ACH) under the NRPS, which allows for safe and affordable retail electronic payments in real time.

The BSP remains mindful of potential risks to financial stability and integrity, including those emanating from cyber-attacks, money laundering, and terrorism financing. We find that our "test-and-learn" approach remains useful as we continue to deal with increasing digital innovations and more complex threats to the financial system.

Final Thoughts

Ladies and gentlemen, as I close, let us return to the question I posed at the beginning. Is now a good time to invest?

A quick look at the current economic landscape certainly provides a compelling argument. Standing on a position of strength, the Philippines presents tremendous and worthwhile opportunities for business and investment.

While there are clouds on the horizon, the BSP continues to be vigilant and invests in the crafting of sound policies and disciplined reforms to guarantee the continuity of our economic prosperity and to further strengthen our domestic sources of resilience.

We will intensify our efforts to safeguard price stability as well as the health and stability of our financial system. At the same time, we will continue to provide a conducive operating environment for the financial sector to help fulfill its role as catalyst of economic growth.

Thank you, and good afternoon.