Nestor A Espenilla, Jr: Good governance in the pursuit of mandates

Speech by Mr Nestor A Espenilla, Jr, Governor of Bangko Sentral ng Pilipinas (BSP, the central bank of the Philippines), at the Institute of Corporate Directors 2018 Mid-Year Economic Briefing Fellows' Breakfast Roundtable, Manila, 17 July 2018.

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ICD Chairman Francis Estrada, Chief Executive Officer Dr. Alfredo Pascual, business, industry and government leaders, vanguards of good governance, ladies and gentlemen, good morning.

I thank the Institute of Corporate Directors (ICD) for this opportunity to share the corporate governance initiatives championed by the BSP for itself as an institution, in delivering on our price stability mandate, in setting an example and in giving guidelines to those under our supervision.

A plethora of literature on central banking emphasizes the importance of credibility in shaping monetary policy and in guiding the market. Credibility too is important for effective regulation.

It is notable that even in everyday personal relationships, credibility is built on established competence and character. On consistency. On integrity. On good self governance.

At the BSP, we believe that good governance should flow from the top. By this, I am not only espousing decisive leadership. Rather I emphasize that to elicit good governance, ***we must ourselves practice good governance.***

For it is only then that we will have the credibility and moral ascendancy to elicit the public's and the market's trust and guide expectations, and it is only then that we could effectively require good governance from our supervised entities.

Good Governance in the BSP

As early as 2009, the BSP adopted a principles-based governance framework.

In 2015, the BSP was recognized as an Island of Good Governance by the ICD and as of 2017 [vetted by the Development Academy of the Philippines (DAP)], two out of our five governance principles: Accountability and Transparency and Strategic Direction were assessed at "High Integration." Three of our other principles — integrity, ownership and voice; and responsiveness — were rated at "Sustainable".

These principles are set forth in our 3-year Governance Roadmap for 2017 to 2019 and are integrated into the BSP's decision-making systems, processes, and work ethic so that we can give the best possible service to our country and to our fellow Filipinos.

In the BSP, we affirm that good governance is not just about compliance with laws and regulations. Rather, good governance must frame and ground our intent so that our actions, initiatives and policies add value. Good governance results in breakthroughs in the effective delivery of our mandates of maintaining price stability, financial stability and an efficient and safe payments system.

Good Governance and Breakthroughs for The Philippine Economy

The BSP's commitment to its primary mandate of price stability has brought about a balanced and sustainable growth of the economy. Through the years, this required a delicate and courageous balancing act demanding the neutrality of monetary policy— without favoring any sector over another[1] . It required and requires the exercise of an independence that can only be achieved by a commitment to good governance.

Through the years in the exercise of this delicate balancing act — together with the country's economic managers, we have achieved 77 quarters of uninterrupted economic growth since the Asian Financial Crisis.

Our six-year consecutive growth of above 6 percent makes the Philippines one of the fastest growing investment-grade economies in the world. This growth streak is projected to continue for the medium term despite challenges in the global and domestic economic landscape.

This growth assumption is feasible due to the confluence of various factors: First, the current progress has broader support. While traditionally, the services sector has mainly pushed growth, the industry sector is emerging as a reliable source of growth, anchored on the manufacturing sub-sector's renaissance.

On the expenditure side, consumer spending is a key growth engine. This is aided by the improving employment climate, pegged at 94.7 percent of the labor force as of the first quarter of 2018. Public spending is likewise rising on the government's increased delivery of social services.

Second, our young population places us in a demographic sweet spot that enables higher productivity as a large percentage of our young population joins the labor force.

Lastly, our sound macroeconomic fundamentals and growth prospects continue to attract foreign investments. Record foreign direct investments – USD 8 billion and USD 10 billion – entered the country in 2016 and 2017, respectively.

Domestic liquidity continues to expand, in line with the BSP's outlook for inflation and economic activity. Such expansion is driven by lending to key production sectors adding further navigational mileage to the Philippine growth story.

Our external position remains manageable and we have sufficient liquidity buffers against global headwinds. We note that the country's balance of payments position has been posting deficits since 2016 on account of strong foreign currency outflows. This is a reversal from previous BOP surpluses accumulated from the large inflows due to quantitative easing since the global financial crisis. With the normalization of US monetary policy and rising global interest rates, we see significant corrections in capital flows that are affecting our BOP and exchange rate. This is compounded by uncertainties posed by the trade war and geopolitical risks.

Nevertheless, we view these as short-term macro-stability challenges. Over the medium-term, our sound fundamentals should serve us in good stead.

First, strong imports are driven by capital goods, raw materials, and intermediate products to support infrastructure development that can raise potential output.

Second, foreign investments by Filipino corporates and residents are increasing. Blue-chip companies continue to search for profitable ventures abroad.

Third, Filipinos are prepaying their foreign loans reflecting tempered risk appetite for foreign exchange exposures. These outflows indicate sound risk management.

Further, the balance of payments is reliably supported by strong structural foreign exchange inflows, specifically revenues from the IT-BPO industry and overseas Filipino remittances, as well as rising foreign direct investments.

Finally, gross international reserves continue to provide ample external liquidity buffer. The end-June 2018 GIR of USD 77.7 billion is equivalent to 7.5 months' worth of import of goods, and payments of services and primary income.

Good Governance and Credibility in our Commitment to Price Stability

Amidst headwinds brought about by domestic and global factors, we remain strongly committed to our primary mandate of price stability.

Average headline inflation as of June 2018 is above target at 4.3 percent. While we expect this to return to within target band in 2019, we nevertheless treat the inflation outlook as a concern given elevated inflation expectations and increasing risks of second-round effects from ongoing price pressures.

In achieving price stability — clear and open communication — the announcement of an explicit inflation target is central... to this, credibility is the bedrock. It reflects not only a commitment to the goal, but also to ownership of the inflation target.

Since 2002, we have been committed to the inflation targeting framework. The framework demands that monetary policy decisions be f***orward-looking and data-dependent.*** As an inflation-targeting central bank, we allow foreign exchange flexibility so that we can conduct independent monetary policy primarily focused on assessment of ***domestic conditions***, and is thus not based on actions of the Fed. Nevertheless, we consider external factors and exchange rate movements if these will materially impact the pursuit of domestic objectives especially inflation. This approach is most appropriate for a small open economy like the Philippines.

Further, since the adoption of the interest rate corridor (IRC) system in 2016, the BSP has gained sufficiently flexibility in relying on auction-based instruments for liquidity management to complement the overnight reverse repurchase borrowing rate as the policy rate signal. The IRC also allowed the BSP a channel to provide guidance to short-term market interest rates. Thus, in this manner, the ***BSP has reinforced its options to maintain firm monetary control***.

We assure that our monetary policy responses to elevated inflation pressures were, and are, ***timely and appropriate***.

Early this year, inflation forecast over the two-year policy horizon, as informed by a wide set of economic data, suggested ***no adjustment in policy rate*** was warranted at that time. This was because data showed that the uptick in prices was driven mainly by supply-side factors – which could not be influenced by policy rate hikes. Moreover, our forecast continued to show inflation upticks as transitory and moderating within the target in 2019.

Nevertheless, recognizing increasing volatilities in world oil prices and global interest rates, the BSP responded to changing monetary environment conditions by adjusting auction volumes and allowing the term deposit facility (TDF) rates to rise, creating effective tightening in the market.

There were material changes towards the end of the first quarter and the beginning of second quarter of 2018. On the global front, the attractiveness of the US economy was highlighted by both its fiscal and monetary policy adjustments, including rising interest rates. This caused a migration of portfolio investments seen in the decline in ASEAN 5 equities markets leading to increased market volatility. This likewise contributed to elevated exchange rate pressures. In addition, the continued rise in global oil prices and the price effect brought about by scarcity of the NFA rice provided key impetus for higher levels of inflation.

Our two successive rate hikes in May and June were measured and deliberate responses to the ***evolving economic environment and dynamic market conditions*** meant to help anchor inflation expectations and temper second-round effects, firmly signalling our commitment to ensuring price stability. These were undertaken even as we await full implementation of appropriate policy response to supply shocks such as the National Government's social safety net programs.

We reaffirm our strong commitment to ensure that inflation returns to target by 2019. We stand ready to take decisive action in a timely manner to address emerging risks that could threaten the attainment of this target.

Good Governance in Bringing About a Sound and Stable Banking System

As earlier mentioned, while we internally practice good governance principles, we require this too for our supervised and regulated entities. But in doing so we are mindful of the importance of their buy-in and of prior consultation. Good governance cannot be dictated. This is why we roll-out our regulatory proposals and value industry feedback prior to their implementation. This makes for successful implementation.

In August 2017, we yet again raised the bar of corporate governance for the banking industry. Aligned with the Securities and Exchange Commission's (SEC) Code of Governance for Publicly Listed Companies (PLCs), we enhanced requirements on the membership composition of financial institutions' Board of Directors (BOD) to ensure that a collective mix of individuals who possess expertise and competence effectively manage the institution.

These initiatives help maintain the soundness and stability of the financial system. This is validated by various reports from stakeholders and multilateral institutions such as the IMF and the recent upgrade in the S&P Global Banking Industry Country Risk Assessment (BICRA) of the Philippine banking system.

The outlook for the banking system remains positive given the robust macroeconomic outlook, rising credit provision coverage, adequate liquidity and rising capital buffers. Bank lending is expected to sustain its strong growth. The trajectory for profit growth will continue, driven mainly by strong growth outlook, upbeat lending activities, product innovations, and more cost-efficient and technology-enabled operations.

Good Governance in Managing Our Mandates: Price Stability and the Financial System

It is noticeable that our Charter — Republic Act. No. 7653 — puts a premium on the mandate of price stability. We are mindful, though, of lessons from the past, the Global Financial Crisis... we note the increasing interconnectedness of markets and financial systems... From this, it is also clear that price stability must not be pursued in a vacuum. Indeed, price stability is a macroeconomic goal which can be promoted via a sound and stable financial system.

Again, it is a balancing act necessitating good governance, wisdom and courage.

Safe and sound financial institutions contribute to a resilient financial system, which in turn, anchor the sustained stability of the economy. The financial system provides a framework for carrying out economic transactions and transmission mechanisms for the BSP's effective conduct of monetary policy.

We recognize that monetary policy must evolve in the context of a more sophisticated and complex financial system. Thus, all our current reform actions – reducing reserve requirements, liberalization of FX markets, deepening the debt market, as well as our macro- and micro- prudential measures do not diverge from our goals of price stability.

These are all strategically pursued to systematically build the country's resilience amidst an evolving landscape.

In this regard, we are committed to more market-based monetary operations. Our move to reduce reserve requirements ratio (RRR) supports the shift towards a more market-based implementation of monetary policy and more efficient financial intermediation. We started with 20 percent RRR, one of the highest in the region, if not the world. By default, the economy is shouldering a de facto tax burden. By slowly lowering RRR, we are reducing friction costs. This should help curb shadow banking given the rise of strong alternatives offered by fintech and financial innovations.

The BSP is deliberate in the timing of the reduction of reserve requirements. It will be gradual, moderate, and phased over the medium term with the objective of eventually bringing RRR to single-digit levels in line with regional peers. The BSP waited for alternative mechanisms to be developed before embarking on the reduction. Prior to the RRR cuts (in recent months), we have seen a firm anchoring of market rates to the IRC. Thus, there is now room for BSP to reduce its operational reliance on reserve requirements for liquidity absorption and management.

The BSP has enough market-based tools to make this operational adjustment policy neutral. The RRR cuts are not without compensating action. Excess liquidity is reabsorbed through our open market operations and significant FX operations. There is no evidence to indicate that the cut is expansionary. On the contrary, market rates have trended upwards, validating tighter market conditions.

A Call for Cooperation

Ladies and gentlemen, the BSP has been and will always be a vigilant captain of the financial system to deliver a high quality of life for all Filipinos. We value the partnership with the ICD which similarly aspires for sustainable and inclusive development through broad-based economic growth led by corporations adhering to good corporate governance principles.

Together we must leverage on the strength of the economy. This is an opportune time for government and the private industry to continuously coordinate efforts to ensure the continuity of the policy reforms that helped guide the economy and our banking system to being among the world's most resilient.

In closing, we at the BSP thank ICD for promoting corporate governance reforms from the top-down to bring the country to greater economic heights translating to a better quality of life for our countrymen.

Thank you very much for your kind attention!

Mabuhay ang Pilipinas!

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[1] 1 See S. 1235, 9th Cong. Record of the Senate 641 (May 19, 1993, enacted)