Nestor A Espenilla, Jr: Opening remarks during the chat with analysts

Chat with analysts by Mr Nestor A Espenilla, Jr, Governor of Bangko Sentral ng Pilipinas (BSP, the central bank of the Philippines), via audio teleconference, Manila, 25 July 2018.

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Good afternoon. Whether you are here with us today at the Bangko Sentral ng Pilipinas (BSP) or are participating via audio-conferencing, it is my pleasure to welcome all of you.

Thank you for joining this first by-invitation-chat we have organized for economic and financial analysts. Our objective this afternoon is to promote better understanding of the BSP's policy actions and provide background on developments that have prompted our monetary policy decisions.

Let me begin with our mandates. The BSP has three. Our primary mandate is to promote price stability conducive to a balanced and sustainable growth of the economy. We are also tasked with maintaining financial stability and developing the payments system.

Since 2002, the BSP has been committed to the inflation targeting framework. This calls for monetary policy decisions to be forward-looking and dependent on comprehensive and rigorous assessment of all relevant data and forecasts. The framework also calls for flexibility of the exchange rate so that we can conduct independent monetary policy primarily focused on domestic conditions. Nevertheless, external factors are always considered. We also react to excessive exchange rate volatility particularly if this affects inflation expectations and poses a risk to the inflation outlook.

Our IT framework has been reinforced with the adoption of the interest rate corridor (IRC) system in 2016. With the development of auction-based instruments complementing the overnight reverse repurchase borrowing rate as the policy rate signal, the BSP has expanded its options for maintaining firm monetary control.

Early this year, economic data suggested that an adjustment in policy rate was not yet warranted as the uptick in prices was driven mainly by supply-side factors. 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 interest rates, the BSP responded to changing monetary conditions and allowed the term deposit facility (TDF) rates to rise. Market rates have correspondingly risen.

Our two successive policy rate hikes in May and June were measured and deliberate responses to the evolving economic environment and dynamic market conditions. These were meant to help anchor rising inflation expectations and to temper second-round effects. The rate hikes were also made in the context of increased traction in the economic activities of advanced economies and the unwinding of accommodative monetary policy in the US and other advanced economies, driving capital flows away from emerging economies.

The balance of payments remains manageable notwithstanding significant external headwinds. Recent and planned interest rate hikes by the US Fed and brewing trade tensions among key economies have exerted additional depreciation pressures on the peso even as a flexible exchange rate policy continues to be a stabilizing mechanism against the build-up of unsustainable imbalances.

We reaffirm our strong resolve to ensure that inflation returns to target by 2019. We are certainly taking into account the potential price pressures of excessive exchange rate volatility. We remain confident that our fundamentals are solid and healthy.

We recognize that sustained pressures on the peso could adversely affect inflation expectations. Further, some demand side pressures may already be feeding into inflation considering the sustained strong economic growth. These warrant a firm and timely monetary response. We are therefore considering strong follow-through monetary adjustment at the next meeting of the Monetary Board in August.

Coming to our second and third mandates, we recognize that monetary policy must evolve in the context a financial system that is fast evolving and is becoming increasingly more sophisticated. Thus, we are pursuing game-changing financial sector reforms – the plus plus of our Continuity ++ agenda. Our current reform agenda – reducing reserve requirements, deepening debt and FX markets, digitalization of the payment system, as well as macro and micro-prudential measures complement our price stability mandate. These are all strategically pursued to systematically reinforce the country's resilience amidst a dynamic landscape.

Now let me talk about our initiative to reduce our ultra-high reserve requirement ratio to align it with other Asian jurisdictions. Reduced reliance on the reserve requirement for managing liquidity conditions signals a shift towards a more market-based implementation of monetary policy. It is an essential element of a broad financial market reform agenda. This will lower friction costs in the banking sector, create more efficient financial intermediation, and help curb shadow banking given the rise of strong alternatives offered by fintech and digital innovations. Moreover, the shift helps support the price discovery process and establishment of more accurate interest rate benchmarks.

We are also deliberate in the timing of the reduction of reserve requirements. We waited for alternative mechanisms to be developed before embarking on this journey in order for the reform to be policy neutral. With the recent firm anchoring of market rates to the IRC, we now have room for the reduction of reserve requirements over the medium-term as an operational adjustment, which we started early this year. I would like emphasize that the RRR cuts are not intended to be expansionary as these are offset by compensating actions. Excess liquidity is reabsorbed through our open market operations and significant FX operations. The upward trend in market rates validates tighter market conditions.

Finally, I would like to emphasize that the RRR cuts will be gradual and phased over a number of years. We have already achieved significant progress this year. A total of 200 bps reduction in 2018 is in line with our medium-term goal of reducing RRR from 20 percent to single-digit level over a six-year period.

Moving forward, the BSP will continue to review and improve the operational features of the IRC system to ensure greater flexibility and efficiency in conducting monetary operations.

Indeed, these are important reforms that make us very optimistic about the continued growth of the Philippine economy in a sustainable manner.

We thank you for your time and interest in wanting to hear about these initiatives. We will be happy to take your questions.