Nestor A Espenilla, Jr: Central bank evolution in the digital age

Speech by Mr Nestor A Espenilla, Jr, Governor of Bangko Sentral ng Pilipinas (BSP, the central bank of the Philippines), at "Perspectives", organized by Citi Markets, Manila, 8 August 2018.

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Citi Philippines CCO Aftab Ahmed, Country Treasurer Paul Favila, industry partners, esteemed guests, ladies and gentlemen, good afternoon.

Last month, the BSP celebrated its 25th anniversary. Our theme, "Navigating the Future," was apt and meaningful in a time of digitalization and technological advancement. Your chosen theme for this year's economic forum tells me we are on the same page.

Indeed, digitalization transforms business models. Services must level up to remain relevant and responsive to increasingly demanding needs and to cater to a more sophisticated market.

This principle applies also to central banking.

The idea that central banks must evolve appears simple. But it is actually quite controversial and fraught with debate.

Tradition and Embracing Change

The traditional notion is that since central banks are focused on maintaining stability, they must remain conservative. For the cautious mind, the notion of encouraging innovation (of embracing disruption) is not only challenging, it may even be threatening.

But all around us are drivers that compel us to evolve. We see the fast pace of technological advancement, the increasing interconnectedness of markets, globalization, regionalization and the growing technically-savvy millennial population.

These drivers make the case that to stay ahead even central banks (and not just businesses and firms) must find novel approaches to address shifts in the economic landscape and to protect developing consumer interests.

Indeed, old ideas are being challenged. For instance, central banking has historically focused the spotlight on achieving low and stable inflation. Monetary and financial stability were conventionally thought of as two separate goals. Blinders were almost always worn in the pursuit of one over the other.

In a hard and devastating way, the global financial crisis taught us that monetary and financial stability policies are inseparable as financial institutions evolve and as economic activities become more complex.

Another force that compels us to rethink how we must approach reforms and conduct policy is the advent of the "fourth industrial revolution" – the rise of the digital economy.

There is now burgeoning awareness that we must leverage on technology to conduct monetary policy and research. There is a present urgency to develop regtech to address fintech developments and their attendant risks. The rise of digitization also forces us to focus on the third pillar of central banking (which admittedly, has not received as much attention in the past!). With digitalization and technological disruption, the payment system is now seen as an essential tool for the effective implementation of monetary policy and as a critical infrastructure of a stable and inclusive financial system.

These are all exciting prospects. Allow me to talk about the BSP's three mandates in this context.

Evolution in the Pursuit of Price Stability

The BSP's constant commitment to its primary mandate of price stability has led to managed and stable inflation in an environment of high economic growth.

The Philippines has achieved uninterrupted growth for the past 77 consecutive quarters despite domestic and global economic challenges. For six consecutive years (in 2009 to 2014), as well as in 2017, inflation settled within the national government's inflation target range.

Amid this resilience, the Philippine economy is being tested by external headwinds emanating from the normalization of monetary policy by advanced economies, and the brewing trade tensions among key economies. These exert depreciation pressure on the peso even as the flexible exchange rate policy continues to be a stabilizing mechanism against unsustainable imbalances.

The overall external position of the domestic economy remains resilient. The sustained resilience of foreign direct investments, overseas Filipino (OF) remittances, and business process outsourcing (BPO) receipts have provided additional buffers to the domestic economy.

Our external debt metrics have also improved as exhibited in the continued decline in the external debt to GDP ratio.

These external transactions yielded positive results in terms of comfortable gross international reserves of US$76.9 billion as of July 2018, covering 7.4 months of imports of goods and payments of services and income.

In the meantime, the peso continues to reflect day-to-day market conditions. Over the last ten years, the peso has generally maintained its external price competitiveness against baskets of currencies of all trading partners and trading partners in advanced and developing economies.

On the domestic front, the country's inflation environment is confronted by a confluence of supply-side factors. This posed a challenge as monetary policy instruments more effectively address demand-side driven shocks. This was the case early this year when economic data suggested that an adjustment in policy rate was not yet warranted. 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 adjusted monetary conditions by adjusting auction volumes and allowing the term deposit facility (TDF) rates to rise, creating an effective tightening in the market. This allowed the BSP a channel to provide guidance to short-term market interest rates which have firmly anchored to the BSP's interest rate corridor.

The two successive rate hikes in May and June were measured responses to the evolving economic environment and dynamic market conditions. The two rate hikes signal the BSP's strong commitment to ensuring macroeconomic stability, which could help anchor inflation expectations and temper further second-round effects.

To date, inflation remains elevated as inflation averaged 4.5 percent. The latest inflation reading in July is on the high end of our forecast but remains consistent with the assessment that inflation will remain elevated in 2018 and will converge to the inflation target of 2 to 4 percent in 2019.

At any rate, we will consider latest data as we determine the strength of our follow-through response during tomorrow's policy meeting.

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. We reiterate our strong resolve to ensure that inflation returns to target by 2019.

With the recent firm anchoring of market rates to the Interest Rate Corridor, we now have flexibility to move towards market-based monetary instruments. This is one evolutionary aspect as well. We now have the opportunity to significantly reduce the reserve requirement ratio (RRR) over the medium term. To date, we have reduced RRR by 200 bps. The goal of reaching single-digit RRR at the end of my term is attainable without compromising effective monetary control.

I emphasize that the RRR cuts are not intended to be expansionary. They are an operational adjustment to promote market development. Data suggests we were able to neutralize the immediate liquidity impact through open market and FX operations. Following the cuts, the level of domestic liquidity actually grew at a slower rate. M3 expanded by 11.7 percent year-on-year (y-o-y) in June 2018, slower than the 14.3-percent growth rate in the previous month.

We are ready to continue reducing the RRR next year as inflation returns to target based on our latest forecast. As challenges evolve globally and domestically, we will further improve our open market operations and expand our policy toolkit. We are currently studying and consulting with the industry for operational refinements to further strengthen our ability to guide short-term market interest rates and the transmission of monetary policy to the economy.

As we refine our monetary operations, we also recognize that fintech has the potential to alter how central banks conduct monetary policy. Digitalization of the payments system, adoption of new forms of electronic payments and stores of value, and the issuance of digital currency fundamentally affect money demand.

In staying ahead, economic information is an integral part of the BSP's processes to effectively deliver on its core mandates. We are venturing into using big data to supplement our current data needs. We are developing experimental price measures to measure changes in prices paid by consumers as they immigrate to digital economy transactions.

Evolution in the Pursuit of Financial Stability

Parallel to our positive economic story is the steady growth of our banking industry. Reforms put in place by the BSP along with the banks' commitment to improve their ability to manage risks have resulted in significant improvements in the quality of banks' assets and loan portfolios. Reforms through the years have also bolstered capitalization – overall bank capitalization is comfortably above local and international standards. Bank loans (majority of which went to productive sectors) continues to expand at double-digit rates.

But this is not enough. As a regulator, BSP supports responsible fintech innovations given its link to increased efficiencies and financial inclusion. We have refined regulations to effectively respond to trends in digitalization, fintech and technology-related risks while still remaining supportive of financial innovation.

Innovations are allowed to flourish while ensuring risks are managed and consumer welfare is protected. We also protect the integrity of the financial system.

To achieve this, we have issued various regulations. We updated the regulatory framework for money service business to enhance the customer due diligence expectations and to re-balance the objectives of financial integrity and financial inclusion. We established a framework for regulating virtual currency (VC) exchanges. We are also collaborating with other regulators such as the Securities and Exchange Commission (SEC) for a harmonized regulatory approach to

Initial Coin Offerings and VC trading activities. We are discussing with supervised institutions on their respective plans to launch private digital currencies and other pioneering technologies.

We recognize that digital finance delivered through mobile technology alone cannot reach everyone. That is why we issued regulations enabling cash agents to provide improved “last mile” delivery of financial services to the unbanked and under-banked. The cash agents themselves can be technology-enabled by fintech solutions.

In the meantime, the BSP is likewise piloting Regtech solutions to strengthen its risk-based regulatory and supervisory activities. Our two pilots have to do with using chat bots to effectively handle consumer complaints and Application Programming Interface (APIs) to make supervisory reporting as painless as possible for banks while capturing more information for the BSP.

Evolution in the Payments and Settlements System

The BSP recognizes the fundamental need to create a secure, reliable and efficient digital financial ecosystem where all these innovations can come together to achieve the greatest synergy.

In 2015, we launched the National Retail Payments System (NRPS). It provides a policy and regulatory framework for establishing a safe, efficient, affordable, interoperable, and reliable retail payment system. The payment ecosystem envisioned to arise from this planned platform for financial innovations encourages Industry players, – from big banks to small banks to non-bank electronic money issuers – to utilize fintech solutions and provide services within an organized, commercially-viable, and efficient retail payments system.

Since the launch of the NRPS, we have already achieved critical milestones. These include establishing two priority Automated Clearing Houses (ACH) by transitioning the batch interbank fund transfer service of the Philippine Clearinghouse Corporation (PCHC) to PESO Net, and the launch of InstaPay, a new ACH which supports 24/7 low-value electronic push payments among participating member financial institutions. We are now exploring further enhancements to the large value payment system even as the private sector contemplates other ACHs for other useful retail payment schemes.

Our current efforts also include development of an inter-operable national QR code standard to accelerate the digitalization of merchants to close the loop on the digital payment system.

On August 6, 2018, the Philippine ID System (Philsys) Act was signed into law by the President. Republic Act No. 11055 establishes a biometric-based, foundational, national identification system that will provide every Filipino and foreign residents with a trusted and verifiable digital identity. This milestone can exponentially push forward our digitalization and financial inclusion agenda.

Among other benefits, this will democratize access to transaction accounts. Full participation to the digital payment ecosystem envisioned under the NRPS will be within reach. Key barriers to account opening will be removed.

This will directly benefit low-income and vulnerable sectors of our society as costs of on-boarding are lowered and the need to present acceptable identification forms is addressed. Philsys can also remove friction points and facilitate powerful use-cases for digital payments like government cash transfers. Down the road, it will allow convenient fund transfers with individual Philsys numbers as identifiers. The possibilities and prospects are endless.

Concluding Remarks

The vision of an ever-evolving central bank in this new digital age is one that comes with rewards… But it is also one that demands hard work and decisiveness. In the BSP, we are committed to staying relevant and responsive to leveling up as we deliver on our mandates.

We staunchly safeguard price and financial stability and aim to provide a safer and more efficient payments system.

We do this in partnership with you, our stakeholders, as we are open to fresh and innovative ideas and to collaboration, cooperation and consultation to drive our economy to new heights.

Thank you very much.