

Nestor A Espenilla, Jr: Optimism, commitment and reform

Speech by Mr Nestor A Espenilla, Jr, Governor of Bangko Sentral ng Pilipinas (BSP, the central bank of the Philippines), delivered by Ms Chuchi G Fonacier, Officer-in-Charge, at the Annual Reception for the Banking Community, Manila, 25 January 2019.

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The Annual Reception for the banking and financial community celebrates our close partnership over the years. It is our family affair.

Rising from 2018's Challenges

2018 began with guarded optimism nurtured early by a global economic upswing and expansion. There was higher investment and stronger private consumption in emerging market economies.

By October 2018, however, the International Monetary Fund (IMF) shifted from using phrases like “Brighter Prospects” and “Optimistic Markets” to highlighting “Challenges to Steady Growth.”

The IMF cited escalating trade tensions between the United States and China, elevated policy uncertainty, dampened business and financial market sentiments, financial market volatility, and a slowing down of investment and trade.

Global developments caused portfolio adjustments, sharp exchange rate movements, and reductions in capital inflows to emerging markets.

Domestically, we had a bout with rising inflation on account of supply-side pressures alongside firm demand conditions and implementation of important fiscal reforms.

Average inflation quickly rose above the government target in 2018. In response, the BSP raised its policy rate decisively four times by a cumulative 175 basis points beginning in May 2018 to rein in inflation expectations and prevent sustained supply-side price pressures from driving further second-round effects.

Our exchange rate had episodes of sharp depreciation and our balance of payment deficit widened due to the economy's import requirements while exports suffered from external headwinds.

Nevertheless we argued this to be consistent with our strong macroeconomic fundamentals. It is an indicator of a growing economy, reflective of dollar debt repayments, prepayments, and outward investments in the normal course of business.

The volatility in the foreign exchange market led to a reduction in our gross international reserves (GIR) as the BSP intervened to smoothen the foreign exchange market. Despite the reduction, the end-December 2018 GIR level of US\$ 79.2 billion is more than adequate and continues to serve as an ample external liquidity buffer. It is equivalent to 7.0 months' worth of imports of goods and payments of services and primary income.

To timely ease demand pressures in the foreign exchange spot market, and to provide a hedging facility for those with foreign currency-denominated borrowings, the BSP reactivated the Currency Rate Risk Protection Program or CRPP in September 2018.

Yes, indeed we had some challenges. But I believe we rose decisively to meet all of them.

The Philippine economy maintains its record of uninterrupted GDP growth for 80 consecutive quarters. This covers an impressive span of 20 years!

We continue to be one of the fastest growing economies in the region!

The resiliency of our economy can be attributed to more than two decades of sound and strategic reforms. These reforms have created buffers for the nation to withstand shocks and benefit from a more flexible policy space.

The consistently sound and stable condition of the Philippine banking system – a product not only of prudent regulation and risk-based supervision, but of earnest cooperation from the sector itself – is a key anchor of our growing economy.

Assets of the Philippine banking system continued to expand to P16.4 trillion by end-November 2018, attributed mainly to deposit growth. Most of these deposits were deployed to lending for productive activities. Loan quality remains satisfactory as banks continue to adhere to sound credit underwriting standards. Meanwhile, capitalization continues to build up, with capital ratios remaining well above national and international thresholds.

Overall, amidst the challenges of 2018, the Philippine economy has remained strong and robust. It continues to live-out its growth narrative. Congratulations everyone.

But we shouldn't also overlook the fact that 2018 was also an exceptional year in pursuit of bold financial sector reforms. We introduced several refinements in the Interest Rate Corridor (IRC) system which provided BSP with greater operational flexibility. With the resulting firm anchoring of market rates to the IRC, we were able to reduce reserve requirements ratio (RRR) by a total of 200 basis points as operational adjustments. This keeps us on track of the medium-term goal of a phased and gradual approach in reducing RRR to single-digit level.

We also continued to liberalize foreign exchange rules and pursued improvements in the governance framework of the FX trading market. We likewise implemented measures to further develop the domestic capital market. These include enhancement of rules to facilitate bank bond issuance, paving the way for more private bond issuances. The BSP also issued enhanced guidelines on marking-to-market of financial instruments in response to the adoption of a valuation methodology for peso-denominated government securities. This forms part of the domestic bond market development roadmap that aims to promote price transparency by providing basis for the establishment of reliable and market-based benchmarks.

Key legislative measures were also passed which support our digitalization and financial inclusion efforts. The Philippine ID System Act establishes a biometrics-based, foundational, national identification system that will provide every Filipino and foreign resident with a trusted and verifiable digital identity. The enactment of the National Payments System Act is vital to the country's payment systems development agenda.

High Hopes for 2019

As we enter 2019, we do so with excitement – initiatives we launched in the last year, and since the beginning of my Governorship in July 2017, shall continue with vigor.

Our latest forecasts indicate that inflation will return to the 2-4 percent target this year and in 2020.

Nonetheless, we approach the year with utmost vigilance and prudence... mindful of the unfolding global economic landscape. There are still significant lingering concerns and imminent risks particularly on the external front. But we cannot allow these headwinds from deflecting us from our deep financial reform agenda.

Another challenge is to adapt to the rapid expansion and reach of technological innovation and deployment of digital financial solutions. These developments need to meet the highest

standards of transparency, product suitability, security, and confidentiality to ultimately serve the public.

Lastly, there is the challenge of keeping an eye out for signs of excessive credit and leverage in the financial system.

While we continue to see the Philippine banking system as currently being in a position of relative strength... nevertheless, we need to push for necessary financial sector reforms to propel us towards a more sound, stable and inclusive financial system.

Commitment Reaffirmed

Now, let me suggest to you what you may expect from the BSP in terms of policy direction in the months ahead.

First, as we pursue our primary mandate of price stability, we shall continue to carefully examine and be guided by the data and our forecast models in shaping the policy responses so that these are timely and appropriate. Even as we continue to see abating pressures on prices, the BSP will remain vigilant and ready to employ monetary responses to keep prices stable and rein in inflation expectations.

We shall carry on with further refinements of the Interest Rate Corridor (IRC) system to align the conduct of BSP's monetary operations with international central banking practices, encourage active and dynamic liquidity management by banks, and afford the BSP with more operational flexibility. Consultations on the proposed IRC refinements shall continue.

We now see scope for further reduction on the RRR as we see inflation returning firmly to within target and with inflation expectations stabilizing.

Second, we stay committed to the micro and macroprudential measures we implemented to ensure financial stability. Recently, the Monetary Board approved the adoption of the counter-cyclical capital buffer (CCyB) on universal and commercial banks, as well as their subsidiary banks and quasi-banks to prevent excessive credit growth.

This policy expands our toolkit for systemic risk management. It is specifically designed to provide a steadying hand to counter the common occurrence of boom-and-bust periods within the financial cycle. Banks are to set aside additional capital as reserves during good times to prepare us for bad times.

We are also pursuing enhancements on operational risk management standards. Two key reforms in this area include issuance of standards on model risk management and reputational risk management. We will also be issuing guidelines on risk-based approach to pricing to help ensure that exposures of banks/financial institutions to risks associated with lending/financing activities are adequately compensated.

Third, 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.

As such, after the operationalization of PESONet and InstaPay, the BSP is now exploring further enhancements to the large value payment system. We do this even as the private sector contemplates other automated clearing houses (ACHs) for other useful retail payment schemes. Current efforts also include development of an inter-operable national quick response (QR) code standard to accelerate the digitalization of merchants to close the loop on the digital payment system.

In relation to this, we at the Bangko Sentral ng Pilipinas, thank you in the Banking and the Non-

Bank Financial Community for going beyond just complying with financial regulations. You proactively responded to emerging developments and challenges such as our transition from being a cash-heavy to a cash-lite economy with the implementation of the National Retail Payment System (NRPS)! *Salamat sa inyo.*

Fourth, we remain on course in promoting financial deepening, with measures to further develop the domestic capital and foreign exchange (FX) markets. We will continue streamlining documentary requirements for FX trade and non-trade transactions. The BSP will likewise issue a circular on FX market governance framework, formalizing policies that promote fair, liquid, and transparent FX market.

And we shall continue to pursue meaningful initiatives and partnerships to advance financial education and inclusion, and consumer protection. No one is dropping the ball. The BSP is here with you for the long haul.

Concluding Remarks

As you can see, there is much work to be done. So much work.

After decades of hard work, we are now at a point when we are set to update the BSP Charter to keep up with the rapid global challenges. We collectively thank the administration of President Rodrigo Roa Duterte for taking us to the finish line right in time for the celebration of 70 years of Central Banking in the Philippines. This is truly an institutional milestone.

Thank you and *Mabuhay tayong lahat!*