Benjamin E Diokno: Evolving inflation dynamics

Opening remarks by Mr Benjamin E Diokno, Governor of Bangko Sentral ng Pilipinas (BSP, the central bank of the Philippines), at the Annual Research Conference "Inflation Dynamics in Asia and the Pacific", co-hosted with the Bank for International Settlements, Manila, 19 August 2019.

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A very good morning to all and welcome to this year's Annual Research Conference.

The Bangko Sentral ng Pilipinas (BSP), which is currently celebrating the 70th year of central banking in the Philippines, is pleased to co-host this conference with the Bank for International Settlements (BIS).

The theme for this year is "Inflation Dynamics in Asia and the Pacific." For central bankers, this provides an opportunity to discuss and think about issues that have direct implications on the core mandate of central banks. For academics and research economists, this is a policy-relevant research that may be openly shared and discussed.

The global financial crisis (GFC) that started in 2008 challenged conventional monetary policy, pushed many central banks outside of their comfort zones, and dramatically altered the landscape of monetary policy. While it was a challenging time for policymakers, it provided fertile ground for macroeconomic research.

A particular topic, which received much attention among macroeconomists and central bankers after and during the financial crisis, was inflation dynamics. An advance Google search for the phrase "inflation dynamics" for pre-crisis period 1997–2007 yielded 4,490 articles. For the post-GFC period of 2009–2019, the search generated 13,000 articles – an increase of almost 190 percent.[1]

Of course, we are all well aware of the challenges faced by central banks in advanced economies after the global crisis; that despite rock-bottom interest rates and massive liquidity injections, inflation in their economies remained muted. Why this was so was the subject of many studies.

But perhaps one of the reasons for the rapidly rising of studies on inflation dynamics is the remarkable decline in global inflation, which began even before the GFC. For the advanced economies, this appears to have started in the 1990s, and for the emerging market economies, the trend became apparent in the 2000s.

On a regional basis, Asian countries show lower inflation trends among emerging markets.[2] Studies reveal that a confluence of both structural and policy-related factors have contributed to this trend in the region.

Among these include the marked increase and changing patterns of international trade, especially with the accession of China in the World Trade Organization; technological innovation; trade and financial market integration; demographic transition; structural reforms in labor and product markets that led to greater competition and lesser price rigidities; and more resilient policy frameworks in some emerging market and developing economies—particularly the successful adoption of inflation targeting as well as the more effective and transparent exchange rate, and monetary and fiscal policy frameworks (World Bank, 2019).[3]

For central bankers, understanding inflation dynamics in relation to other economic variables is crucial. Most, if not all, central bankers will agree with me that controlling infla¬tion is a demanding task. Yes, the central bank can influence inflation by tightening and easing monetary policy.

However, the transmission process involves long and variable lags and a degree of uncertainty amid the continuously evolving structure of an economy. Add to this is the increasing influence of global and regional factors on domestic inflation. Amid these challenges, central banks need to adopt a robust communication strategy to effectively anchor inflation expectations.

Case in point, the Philippines' headline inflation decelerated from an average of 15.1 percent in the 1980s to 9.7 percent in the 1990s. This slowed further to 3.8 percent from 2002 to 2018, when the country adopted the inflation targeting framework.

The implementation of the inflation targeting framework in the last 16 years has enabled the BSP to manage and keep inflation within manageable bounds. This provided support to greater economic activity, despite international and domestic shocks.

Moreover, the improved transparency, greater accountability and more effective communication, resulting from the implementation of inflation targeting, have enhanced the BSP's credibility. This led to the continued anchoring of market inflation expectations to monetary policy decisions.

However, in the first few years after the global crisis, the BSP experienced pressure in its monetary operations as short-term market interest rates diverged from the BSP's policy rate. This was mainly due to strong capital inflows arising from the highly accommodative monetary policies, the extraordinary liquidity support of central banks in advanced economies, the steady stream of remittances from overseas Filipinos, and revenues from Business Process Outsourcing (BPO).

To address this divergence, the BSP launched the interest rate corridor (IRC) system in June 2016 to enhance the transmission of monetary policy by guiding money market interest rates towards our policy rate.

To date, this objective has already been achieved as the market rate is now moving in line with the BSP's policy rate. In the long term, recalibrations and additions to the monetary policy tools will strengthen the BSP's influence on the demand and supply of money. I am pleased to note that the recently enacted amendments to the BSP charter restores our authority to issue our own debt securities (even during normal times) which further enhances our monetary policy tool kit.

Further, we will continue to pursue the reduction of reserve requirements from the current 16 percent to single digit by 2023 to promote a more efficient financial system. This is part of the BSP's broad financial sector reform agenda.

We expect that all these will aid in the further development of Philippine capital markets by fostering money market transactions and active liquidity management by Philippine banks.

Indeed, the BSP's monetary policy framework has been an effective tool in mitigating the risks emanating from here and abroad. However, we recognize that as the domestic and world economy evolve, all our tools need to be kept constantly appraised. We continually take measures to further enhance the implementation of our inflation targeting framework by improving our array of models, data, software, and the capability of our technical staff and modelers.

We likewise ensure prudent exercise of judgement by using all relevant data in our policy decisions. Moreover, we recognize the value of being able to communicate the basis of the BSP's policy decisions in a manner that is easy for the public to understand.

All these concepts, and more, will be the subject of this conference's discussions in the next two days. We can rely on an eminent group of economists, who have joined us to present their work and examine issues concerning inflation dynamics and monetary policy.

As central bankers and policymakers, we appreciate this effort to continuously expand our understanding of inflation dynamics and its implications on monetary policy. This is especially so amid the current global economic environment that continues to shift with the ongoing policy uncertainties and structural changes.

I wish you all a very fruitful conference and a pleasant stay in Manila.

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[1] Search excluded patents and citations, conducted on 24 July 2019.

[2] 2 Based on the International Monetary Fund (IMF) World Economic Outlook April 2019 database.

[3] 3 Inflation in Emerging and Developing Economies Evolution, Drivers, and Policies, eds. J. Ha, M. A. Kose, and F. Ohnsorge. Washington, D.C.: The World Bank.