Eli M Remolona: The challenges we face at Bangko Sentral ng Pilipinas

Speech by Mr Eli M Remolona, Jr, Governor of Bangko Sentral ng Pilipinas (BSP, the central bank of the Philippines), at the General Membership Meeting of the Financial Executives Institute of the Philippines, Makati City, 6 March 2024.

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I want to talk today about the challenges we face at the Bangko Sentral ng Pilipinas (BSP) and begin with what is going on in our economy.

Economic prospects remain firm

We saw in 2023, a 5.6-percent GDP [gross domestic product] growth. That is pretty good. We are still the fastest-growing economy in the fastest-growing region of the world.

As you know, Europe basically had zero growth, the US [United States] maybe 3.0 percent, which is remarkably strong, stronger than expected. China, our next biggest trading partner, perhaps maybe at 5.0 percent. It looks strong, but that is very low compared to what used to be 9.7 percent over 15 years. So, China is a very different economy now from what it used to be.

Unemployment is down to 3.1 percent, which is also pretty good. So, thanks to our economic managers, I think we are doing well.

On the monetary side, we have raised the monetary policy rate by 450 basis points in the face of a very high inflation rate. And that seems to have worked.

Our inflation rate peaked at 8.7 percent in January 2023 and is now down to 3.4 percent, which is within our target range for inflation. I think those are good, reassuring numbers. But I would say it is still too soon to declare victory.

If you look at our forecast for inflation for this year, the average is hovering near the edge of our forecast range, around 3.9 percent. We hope it will drop to 3.5 percent next year.

So, 3.9 percent is just within our target range. But there are upside risks. If you look at what we consider to be the average probability of our inflation rate exceeding our target range for 2024, the probability is over 50 percent. That is not good enough.

The upside risks are mainly electricity rates, transport charges, and higher oil prices. There are some downside risks, but the government is making strenuous efforts to mitigate the impact of El Niño mainly through drought-resistant seeds.

So, we are hoping that will work.

That is what is going on in the inflation front. Our number one mandate is to stabilize prices, keeping inflation within the target range of two to four percent.

The good news is that our banks are doing well. Suppose you look at the regulatory numbers. Our what we call the capital adequacy ratio is at 16.4 percent. The regulatory standard or the regulatory floor is 10 percent. So, we are well above the regulatory floor regarding capital.

When it comes to liquidity, 183 percent. The liquidity we are measuring here is the LCR or the liquidity coverage ratio. The regulatory standard is 100 percent. Loans have been growing briskly, 9.8 percent, and the NPL [non-performing loans] is manageable at 3.2 percent.

So, the banks are okay. So, the banks should be able to finance growth.

So, that is where we stand.

Let me now go on to talk about what challenges we face.

Conducting monetary policy in a supply-shock economy

We are facing the challenge of monetary policy in what has become a supply-shock economy. Our economy has been subject to more supply shocks than in the past, which is very unusual.

We also aspire to help digitalize the banking and payment system. We will talk about that in a little bit. We also aspire to help deepen the capital markets with your help.

So, I hope to discuss some issues related to deepening the capital market.

Let me say about how we are doing monetary policy these days. As you know, we got hit by oil price shocks, food price shocks, and fertilizer price shocks.

Globally, inflation peaked in 2022. Our inflation rate peaked in January 2023 at 8.7 percent-the highest in 14 years. As I have said, we are down to 3.4 percent, partly because of the monetary policy.

The difference between the economy we now have and the economy we used to have is the dominance of supply shocks hitting us. What happens, I think, in our analysis of the supply shocks is that supply shocks lead to inflation expectations. The oil price goes up, people think other prices will also go up because oil, of course, is an input to the production of many things, and so prices go up for those other things.

We call those things second-round effects.

So, the main effect is oil price shock, which leads to second-round effects. The thing about second-round effects is that they are asymmetric. So, the oil price will come down, but the second-round effects do not. They are sticky downwards, so it is asymmetric. And that is what we worry about.

This means we cannot just look through supply shocks. We have to worry about supply shocks because of the asymmetry of second-round effects.

What helps us is our framework for inflation targeting. We decided to target inflation so it stays within two to four percent. We made ourselves an inflation-targeting central bank.

That helps because it anchors expectations. So, when you have supply shocks, inflation expectations do not go crazy. They are kind of sticky as well. That anchoring has been a big help to our monetary policy.

Once you have a well-anchored inflation, you can more easily manage second-round effects.

We worry about whether inflation will remain well-anchored. So, we have estimates of the risks of the anchoring and worry about them de-anchoring every time we meet as a Monetary Board.

So, that is the new monetary policy strategy or the new monetary policy framework that we follow.

Digitalizing the banking and payments system

We also aspire to digitalize the financial system. We have four initiatives or four pathways to that end.

One is called the Open Finance Framework. If you are a well-established bank, you would be participating in this. If you are BPI [Bank of the Philippine Islands], BDO, or Metrobank, you will be part of the Open Finance Framework.

Open finance means working with application programming interfaces (APIs). These platforms connect you to other financial services and connect your customers to other financial services. Then, you have to figure out how to integrate that platform into your system.

But banks now are working with 50 [to] 100 APIs doing many different things.

Our role here is to make sure that when you use your customers' data, you use it with their permission. They still own the data; you do not own that data. Your customers own their data and want to ensure that when you use that data with APIs or other platforms, you get their permission first, and then you can do whatever you like.

You could also do digital banking. This means you raise deposits online and make loans online. The first part is easy; the second part is not so easy. In our culture, apparently, you need a human being to collect on loans, but nonetheless, we are hoping digital banks can figure this out. And a couple of them are figuring it out.

They are six now. We are limiting the number of digital banks to six licenses, but we are looking very closely at the industry and are going to decide if we are going to open it up again. Maybe we can attract different business models and make the industry more exciting.

We also have a regulatory sandbox. The regulatory sandbox means you try your innovation, do a proof of concept, and do a pilot, but when you do that, you work with a regulator.

The regulator is there to help you and tell you what the regulatory implications might be if you succeed. We are not there to judge whether you will succeed or not. We are just there to help you. If you grow, you know what you are getting into regarding regulations. It is about minimizing regulatory uncertainty. If you have a new idea, enter a sandbox. We will assign you a regulator. We will scold you, oh bawal 'yan, but that is for your own good.

Then, of course, there is generative AI [artificial intelligence]. That is inevitable.

If you have used ChatGPT, you know how irresistible it is.

So, we do not even have to encourage it. You guys will do it without any encouragement, but of course, we have to think of guard rails for generative AI.

As you know, generative AI leads to what we call hallucinations; it imagines things that never happened. It leads to herding; it gives the same answer to different questions.

So, we think that, for now, at least, when using generative AI, a human being should work with it and look at the answers before you decide. Apparently, it is not so hard to tell whether the answers are wrong.

If you teach at Ateneo or SMU and take a take-home exam, you are almost sure the student will use AI. A student who does not use AI is not a good student.

But apparently, it is easy to tell. When the homework comes in, you look at it, and you will know whether AI is used. The point is to use AI so that you will have reasonable answers, good answers, not just ones generated by the computer.

So, that is what we are trying to do with digitalizing the economy and the financial system.

On top of these things, we are promoting a digital payment system that serves the unbanked.

So, here, you can start with an e-wallet or a basic deposit account. A simplified deposit account is supposed to be easy to open for anyone.

We hope this will lead to people joining the formal financial system. They will have access to bank credit, other financial services, and eventually the whole financial ecosystem-access to investment instruments, access to the right kind of insurance, and so on.

That, in general, is what we are doing, and the guy in charge of that is [BSP] Deputy Governor Mert Tangonan. So, he is the guy to ask questions about digital payments.

One thing we are doing regarding cross-border retail digital payments is the Project Nexus. It is a project by the ASEAN [Association of Southeast Asian Nations] central banks. If you have a fast payment system like InstaPay, you can connect to Nexus, which is the case for ASEAN. Singapore has it, Indonesia has it, and Malaysia has it. ASEAN central banks or economies will all be connected to Nexus. We think Nexus will be operational in 2026, and this will allow remittances to come to the Philippines at no more than 3.0 percent. The nice thing about Nexus is it is designed to be completely scalable. In other words, you can connect to a country with a fast payment system.

Unfortunately, the US [United States] does not have a fast payment system yet, so hindi pa konektado ang US, but once they have it, they can connect. Brazil can connect now, and India can connect now. And I think other countries can soon connect.

Deepening the capital markets

Let me now turn to capital markets.

As you know, we have a lot to do in capital markets. But I thought as a central bank, we could focus on just three things.

First, an excellent, reliable benchmark yield curve. If you look at the existing yield curve, the BVAL [Bloomberg Valuation Service] curve, it is a choppy yield curve.

As you know, there are kinks in the curve, and the kinks are very strange because if there is a kink, it is so easy to arbitrage. You take positions on both sides of the kink, and then an arbitrage trade makes you money very quickly. But somehow, the kinks do not go away.

There may be a lack of liquidity in the yield curve. Maybe because we have been too ambitious, we designate market makers at several maturities. I think five maturities are where market makers should provide a reasonable bid-ask spread. That has not worked; bid-ask spreads have remained very wide, reflecting the lack of liquidity.

I think my proposal – and I would like to discuss with you - is do what Europe did. In Europe, when the eurozone was starting, government markets were fragmented. So, without any government initiative and without any central bank taking the lead, the swaps curve emerged as the benchmark curve.

Maybe that is the way to do it now. Use the swaps curve. You are not as exposed to price changes as you would be if you were holding government securities because swaps, as you know, are just net payments between the fixed rate and the floating rate.

If we have a swaps curve, maybe you need to make markets, perhaps in just one maturity, the five-year. Maybe that will be good enough. Somehow, this has not happened; the short end still seems problematic. We do not have a good repo [repurchase] market to tie down the short end.

I do not understand what the reason is because we have the GMRA [Global Master Repurchase Agreement], which is supposed to be so simple and so acceptable that the whole world will use it. Somehow, it has not worked here

So, I would like to revive the swaps market, the IRS [interest rate swaps] market, and insist on the market making at least the five-year maturity-which is the sweet spot for fixed-income securities, corporate bonds, and derivative contracts.

So, maybe that will work. I welcome your advice on this.

Then, we have what I call our Lake Wobegon corporate bond market. Those of you who are old enough might have heard of Garrison Keillor. Lake Wobegon is a fictional town in Minnesota, and he said in Lake Wobegon, all the women are strong, all the men are good-looking, and all the children are above average. That sounds like a good description of our corporate bond market. All the issues are triple-A. A few double A issues but no single A, no triple B. How come it becomes so hard to be an issuer of single A or triple B?

Other countries have done it. In Thailand, the median issue is single-A. So, I do not know why it is so hard for a potentially lower issuer to join the corporate bond market.

And finally, we have our missing portfolio flows. We used to fear portfolio flows because we saw them as hot money. They come in and leave at the first sign of trouble.

But these days, they are not so scary. In the first place, they are so negligible these days; they can come in and out, and it will not matter.

But the big thing is the game has changed; the intent is not into active investment anymore; it is in passive investment. Passive means you buy the index. At least at the core of your portfolio, you need an index. Maybe you can play around on the sides of your portfolio, but the core has to be an index.

Huge trillions of dollars are now flowing into the major equity indices, global equity indices, and the major primary bond indices. I think we are in a few indices. We talked to Vanguard, and they said we are about 0.1 percent of their bond index.

But we are not in any major equity indices, BlackRock or State Street. We do not know why; people say it is our withholding taxes, but we are not sure what is going on.

Bakit hindi tayo kasali? The smaller markets are in these indices. Colombia is in that index. Etsepuwera tayo, hindi tayo kasali. I do not know why they do not like us.

So, there it is. Those are my questions.

So, I have three wishes for the capital market: Build a benchmark curve, maybe using the swaps curve. Let us open the corporate bond market-single A, triple B, all investment grade onshore. Then, join the global shift to equity index in emerging market bond ETF [exchange-traded funds].

By the way, the indices are actively traded as exchange-traded funds. So, those are my three wishes, and I hope you guys can help us.

Maraming salamat po!