Felipe M Medalla: Navigating through the headwinds - the way ahead for central banks

Opening remarks by Mr Felipe M Medalla, Governor of Bangko Sentral ng Pilipinas (BSP, the central bank of the Philippines), for 3rd BSP International Research Fair, Manila, 13 June 2023.

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To our guests, especially guests from abroad, colleagues, ladies and gentlemen, good morning, and welcome to the 3rd BSP International Research Fair.

I am glad to see friends and familiar faces today. This is the first time that we are holding this Research Fair in person after virtual fairs in 2021 and 2022. Over the next two conference days, I hope you take home valuable lessons but also find the time to reconnect with old friends and make new connections.

Now, this year's theme is timely, "Navigating through the headwinds: the way ahead for central banks." As we make our way out of the pandemic, how can central banks contribute to the difficult project of rebuilding?

The importance of central bank-run research academies in contributing to economic and financial body of knowledge

As a long-time student of economics, I have always been disappointed in both macroeconomic courses and monetary economics courses because the [section discussing] banks inside them are all black boxes.

I have always thought that research done in central banks could contribute a lot to [a better] understanding [of] the macroeconomy by putting the banks front and center of the model. The reason, of course, is a lot of data on banks that we have are confidential. If you are working inside the central bank, you can go to jail for violating confidentiality [rules]. You are allowed to see the data [on banks but] when your [research] paper comes out, nothing confidential [about the banks] is disclosed. But when you are writing the paper, all of that confidential stuff would have guided the paper. That is one reason we wanted to strengthen our research academy.

The other reason is the research academy will also work closely with universities. I am so glad to see that this is exactly what is happening. We have [graduate-level] papers from UP, La Salle, Ateneo and even undergraduate papers, which I think is very good for us in the long run.

All I want to say is that I think, a strong research academy or even a stronger one in the future will be good for the Philippine central bank.

Extending unprecedented assistance to support the economy in crisis mode

Let me go back to the topic of navigating through the headwinds, the way ahead for central banks. For us to look to the future, it is important to look at where we came from. Let me provide some context on the Philippine central bank's actions during the pandemic.

[First], we reduced the policy rate to 2.0 percent. To put that in context, at that time, our inflation forecast was at least 3.0 percent so we were actually going into negative interest rate territory.

Number two, we bought P1 trillion worth of government securities. Because of COVID, banks were fleeing to cash. To our great credit as an inflation-targeting central bank, they are fleeing to pesos, not to dollars. Unfortunately, the fall in bond prices would have resulted in very high market interest rates so we [at the central bank] ended up buying 1 trillion worth of government securities relative to our balance sheet of [about] 5 trilion [prior to the pandemic].[1]

In addition, we lent money to the government – directly and as approved by Congress. It was a very transparent [form of] assistance from the central bank to the government.

Of course, we thought that every time we do something like this, something we have never done before, we must have an exit plan. Our [initial] exit plan was a beautiful one: as soon as the economic conditions improve, [we will implement] a long series of 25 basis points (bps) increases, bringing back to policy rate to 3.5 percent to 4.0 percent.

But as they say, it is very hard to predict, especially the future. What happened, instead [of our exit plan], is that global developments--the Ukraine war, the abrupt pivot of the Fed--and of course, very high inflation [changed our plans].

For 2022, when you look at seasonally adjusted month-on-month (MoM) inflation, only one month [December 2022] is it is consistent with the target at 0.3 percent, which translates to 3.6 percent [once annualized].

To make matters worse, [at] the beginning of 2023 had a huge supply shock, [resulting in] a 1.0 percent increase in seasonally adjusted MoM inflation [for January 2023].

Taking decisive action to bring inflation back to target – from the monetary and national government fronts

As a result, we have increased the policy rate by [a cumulative] 425 bps [as of March 2023].

We sold about 7.0 percent of our forex (foreign exchange) reserves [from end-2021 to end-2022] because the peso was threatening to cross what? 60 [against the dollar]. In this one, we are not that different from Asian central banks. The typical Asian central bank, more or less, sold about that proportion of their forex reserves.

Thankfully, of course, the government also relaxed import restrictions on key food items.

Easing inflation pressures point to inflation correcting to target by year-end

So, we are now beginning to see great improvements in the inflation picture. For instance, if you look at the last four months [of 2023], [month-on-month seasonally adjusted inflation for] February was 0.3 percent, March was zero, April was zero, and May was 0.3 percent.

So much so [was the improvement in inflation] that we now think that what we have done--aggressive monetary tightening, policy rate increases--has worked. At the same time, whatever we did as a response to COVID was also working because the economy was actually bouncing back very quickly when the restrictions on mobility were lifted. [GDP growth hit] 7.6 percent last year. Our forecast this year is [that the economy will grow by] another 6.0 percent.

We think that inflation is now on what we call on a target-consistent path. 2023 inflation will average 5.5 percent despite the fact that we started [the year] with 8.0 percent [inflation in January]. We expect [inflation for] the last three months of this year to be within target.

Next year, we expect inflation to average about 2.8 percent. That is right there at the midpoint of our target. Of course, a lot of new shocks could happen that could prove that forecast wrong.

Global developments pushing and pulling Philippine inflation below or above target

Nonetheless, this translates to 18 consecutive months of inflation being above target [from April 2022 to September 2023].[2]

As central banks, we know that whatever you do, there are many things that are beyond your control and you are responding to them.

By the way, the worst record in terms of [inflation] being above target was 15 straight months [from February 2008 to April 2009]. What we learned from the past is that what is happening abroad could really bring [domestic] inflation off-target for a long time. When the rest of the world was [experiencing] deflationary conditions, we actually had 23 straight months of inflation below-target [from December 2014 to October 2016]. Nobody was complaining when we [inflation] were off target for 23 months. I think this was in 2015, 2016 when inflation was 0.7 percent and 1.3 percent.

What we know, of course, is whatever the central bank does, there are so many things that can happen that can bring inflation off target. Nobody will complain when you are off target. In a country like the Philippines with a long history of inflation being above-target, nobody complains when it is below target.

When the exchange rate matters in central bank decision-making

The other thing clear to us, for a classic, textbook inflation-targeting central bank, the exchange rate should not matter until it matters. Our finding was when you have the usual run-of-the-mill exchange rate changes, the translation [pass-through] to inflation is very low. For the Philippines, the number or the change in exchange rate translation to inflation is less than 0.1 percent.[3]

Unfortunately, we think that data applies only when the change in the exchange rate is two-way and not very large. Because [in] much of the data that we are looking at, we did not have the kind of exchange rate changes that we were seeing. In the case of the Philippines, the peso depreciated by nearly 14.0 percent [in October 2022]. Clearly, that kind of exchange rate volatility could disanchor inflationary expectations.

Fortunately, we have gone through the worst of it. In fact, when I look at both yield curves and market surveys, they actually expect the central bank to cut policy rates early next year.

Reserve requirement ratio (RRR) cut, 56-day bill marks shift to market-based tools for liquidity management

We did another measure that was aimed to help medium- and small-scale industries: we made loans to medium- and small-scale industries equivalent to complying with our reserve requirements. This was more or less equivalent to about a 250 bps cut in reserve requirements. That [relief measure] is about to expire by the end of the month [June 2023]. When it does expire, we have already cut reserve requirements by 250 bps.

This [cut in RRR] will, of course, other things being equal, increase money supply. But we are now confident that because of our new powers to borrow from the public, we can easily offset the money supply effects of these cuts in the reserve requirement by increasing our issuances of central bank bills. Currently, the longest central bank bill is 28 days. We are introducing a 56-day bill to offset the effects of the cut in the reserve requirement.

Moving forward and going digital: the BSP and the post-pandemic agenda

We have laid out what we have done and at the same time, more or less said what we will do in the absence of new shocks. From here onward, the Philippine central bank will stay true to its three pillars--price stability, financial stability, and a safe, secure, and efficient payments and settlements system.

By the way, the last one used to be the most boring part of central banking. But now of course because of the very, very, rapid rise in digital payments. We have two systems, one system is called InstaPay where the maximum you can pay is 50,000 pesos or less than 1,000 dollars, almost in real-time and 24/7. Then we have another system, which is called PESONet which replaces checks. Clearing happens twice a day. InstaPay payment volumes are now more than [the volume of] ATM transactions. In a short time, we expect PESONet payments to overtake checks. Hopefully, checks will become a thing of the past. No more paper checks.

Inflation-targeting: direct link to growth?

Now, of course, what we can say is that, the Philippine experience with inflation targeting central bank in spite of all supply shocks that brought inflation outside the target, has been quite good. By and large, we were able to convince markets that when we do miss the inflation target, it is not because we [at the central bank] have created too much or too little credit but because of supply shocks. So far, our surveys show [that it is] not just the markets but also the people also seem to believe it [the BSP's credibility as an inflation-targeting central bank].

Now, we think – and this is where we have to do more research – that inflation-targeting actually increased the growth rate of the Philippine economy. It's very hard to tell because so many factors are at play. The growth of the economy was actually significantly higher during the inflation-targeting period than before. The optimistic view is when there is less uncertainty about future inflation, the more efficient the markets are. The other view is there are so many things [economic reforms] that happened that resulted in higher output.

BSP taking climate action: promoting sustainable finance

Now, into the future, we have to be focused on [other matters] and this is a very important question: the idea that the central bank should be doing other things than its three pillars.

The most important concern is climate change. Now, our view about climate change is the Philippines is one of the most negatively affected economies by climate change. We should do something about it. The other one is a very pragmatic one: we expect the rich world that caused all the climate change [greenhouse gas emissions] will punish countries that will not do anything about it. Eventually, the sovereign bonds of the Philippines will probably take a hit if we do not do anything about climate change.

In 2020, we implemented our Sustainable Central Banking Strategy as part of our contribution to the whole-of-government approach to climate change. I am glad that this issue will be discussed in one of the panels.

How exactly we will encourage banks to lend more to support sustainability? The last thing we want to do is mandate credit because we know it does not work.

We mandated credit for agriculture, the banks just decided to pay their penalties [for non-compliance]. We mandated credit for lending to medium- and small-scale industries, the banks just decided to pay their penalties. Clearly, there must be other ways of supporting sustainable finance.

One of them is lifting the single borrower's limits (SBL). The main concern there is by lifting the SBL, we also expose the banks to bigger risks.

Importance of clear communication for policymakers with expanding mandates

At any rate, the important is the central bank must communicate. This is one area where we can learn much from each other. We believe that by fostering trust and providing clear guidance, we can mitigate uncertainties and anchor expectations, thereby enhancing the effectiveness of our policies.

Working towards collaboration, innovation, and development

In closing, let me say again the great importance of information sharing, policy coordination, and knowledge exchange not just to improve the effectiveness of policies but also to improve the way we do central banking.

We must also embrace innovation and harness the power of technology. Central banks must adapt and enhance their analytical capabilities, employing digital tools and methodologies to better understand the intricacies of the modern economy. Embracing digitalization can lead to improved policy formulation, more accurate forecasting, and effective risk management.

Finally, we must not lose sight of the broader social and environmental responsibilities that accompany our role. Of course, the important question is the extent to which broadening our role does not reduce our effectiveness on [delivering on] the three pillars which are the very reasons the central bank exists in the first place.

Now, we all have a packed two days ahead of us. I hope you all pick up something valuable from the discussions. *Maraming salamat at mabuhay tayong lahat.*

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[1] The total assets of the BSP was around 5.1 trillion pesos in 2019 which increased to 7.1 trillion pesos in 2020.

[2] The 18 months from April 2022 to September 2023 refers to both actual and forecasted inflation, with 14 months of actual inflation being above target and 4 months of forecasted inflation being above-target.

[3] The short- and long-run exchange rate pass-through (ERPT) during inflation-targeting period are 0.076 and 0.116, respectively. This means that a 1-peso depreciation will raise inflation by 0.076 ppt in the short-run and 0.116 ppt in the long-run.