Eli M Remolona: Remarks - 2nd weekly membership meeting of the Rotary Club Manila and Makati

Remarks by Mr Eli M Remolona, Jr, Governor of Bangko Sentral ng Pilipinas (BSP, the central bank of the Philippines), at the 22nd Weekly Membership Meeting of the Rotary Club Manila and Makati, Manila, 4 January 2024.

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I am very happy to be here. I just realized from the beginning of the program that it will be very hard for me to become a member of the Rotary Club because, as it is well known in the Bangko Sentral ng Pilipinas (BSP), the Governor is *sintunado*.

Three challenges

I will talk about three challenges that we face in the Bangko Sentral. I do not know if you can show the slides, but we have three things over which we do things in the Bangko Sentral. The first thing is how to conduct monetary policy in what we call a "supply-shock economy." As you know, the world was hit by an unusual combination of supply shocks, especially in 2022.

We, ourselves, we are hit by those things. In fact, we are the harder-hit economies when it comes to supply shocks.
So, I will talk about that-how you do monetary policy in the face of those kinds of shocks. And then, I want to talk about digitalizing the banking system. One of our mandates is to maintain financial stability, but I feel-and the BSP feels-that part of maintaining stability is also to keep up with technological trends, especially within the banking system.

And then, I want to talk about the payments system. The challenge in the payments system for us now is how to use [it] as a gateway for financial inclusion so that we get more and more *kababayans* to become part of the formal financial system.

So, those are the three things I would like to talk about, and I would welcome any questions on these things.

Supply shocks

As I said, we were hit by supply shocks, the likes of which we have never seen before. There are shocks in oil; they were in food; they were in fertilizer; and they were not just large shocks, but they came with a high degree of frequency. This part of it is unusual.

Globally, inflation rates rose to levels that have not been seen in decades. In our case, the inflation rates that we face reached their highest peak in 14 years in January of 2023. So, the inflation rate at that time was 8.7 percent. Since then, we have brought it down to 4.1 percent. So, my discussion is how we did that.

Now, among observers, we are told that the supply shocks, you can just ignore it. You can just look through it and pretend it was not there because anyway, those shocks will dissipate. If the price goes up, it will come down. So, why bother tightening the monetary policy?

That is actually a debate in academic circles, but among central banks, we have settled the debate. We know what to do in the face of those supply shocks. I will show you the graph of inflation.

Blue is the headline inflation; this includes everything. And then, orange is core inflation; this is when you take food and energy out of the CPI [consumer price index]. The difference between the two is the consequence of supply shocks. I do not know if you notice, but when supply shocks go up, even the core goes up.

And then, when supply shocks dissipate, the core stays up for a while. That is very important to know because that means you cannot just look through supply shocks.

What happens in our experience from our statistical work is that supply shocks lead to a kind of inflation expectation that leads to second-round effects.

So, other things go up; wages go up; transportation fares go up; and then, some of the things that go up with supply shocks do not come down.

So, the supply shocks come down; the price of oil comes down; and the price of food comes down; but then, the second-round effects do not come down. Monetary policy has to do something about that, and that is the reason we have to tighten the monetary policy in the face of supply shocks.

This is challenging because this is a new phenomenon. We have models. We have statistics that are not calibrated to this phenomenon. So, we use the models, but we use a lot of judgment. And, I think, somehow, things have worked.

So, supply shocks lead to inflation expectations that lead to second-round effects. What we do in the face of that phenomenon is rely on our inflation target.

It is fortunate that we are a central bank that is an inflation-targeting central bank. That means we say, we announce to everybody that we target inflation rates so that they stay within 2.0 percent and 4.0 percent.

That is a big help. Because of those targets, we are able to anchor expectations. Otherwise, expectations may get out of control, and you get very large second-round effects.

By being able to anchor inflation expectations, we are able to manage the second-round effects. So, that is our strategy. That is monetary policy strategy in what we call a "supply-shock economy." So, that seems to be working. On Friday, the next inflation number will come out, and we are crossing our fingers that it will be a good number. But that is where we are.

By the way, people say that we are tightening too much. That is a very difficult challenge because we want to make sure that we do not tighten unnecessarily. We do not want to cause a loss of output that is not necessary.

Sometimes, we make a mistake, and we tighten too much. But even when we make a mistake and we tighten too much, the loss of output tends to be temporary. So far, I think, we have been okay. We have been doing just the right amount of tightening.

If you look at our GDP [gross domestic product] growth in 2023, [it is] 5.5 percent. That does not look so high compared to 2021 for example. But 5.5 percent is the highest growth rate within the fastest-growing region, Southeast Asia. China is doing 5.2 [percent], and we are doing 5.5 [percent]. So, that is not so bad.

There are more jobs with that kind of growth rate. The unemployment rate is down to 4.2 percent. The underemployment rate is down to 11 percent; it used to be 14 percent.

So, in terms of growth, in terms of employment, we seem to be managing reasonably well in the face of supply shock.

Strong banking system

The banking system, I think, is in good shape unlike in previous crises. Many of us remember in the 1980s, our banking system got into trouble in the 1980s along with Latin American countries. In fact, we call that the Latin American debt crisis. We were part of it.

And so, when we tried to recover around 1989 from the Latin American debt crisis, the banks were part of the problem; they were not part of the solution. The banks had to repair their balance sheets.

The same thing happened in 1997–1998. The banks got into trouble. They had to repair their balance sheets. And so, they were part of the problem.

This time around, they were part of the solution. They went through the pandemic with very healthy balance sheets.

If you look at, for example, their capital adequacy ratios (CARs)-we call them "capital buffers"-banks, on average, have a 16-percent CAR. That is capital divided by risk-weighted assets.

The international standard is 10 percent. They are well above the standard for capital adequacy.

When it comes to liquidity, we are at 183 percent. The technical word for this is the liquidity coverage ratio, [which we are at] 183 percent. The international standard is 100 percent. So, our banks are very liquid.

Banks have more than adequate capital, which means they can still support our growth. In fact, loan growth has been 8.3 percent-that is quite healthy. And then, our non-performing loan (NPL) ratio, the ratio of NPLs to loans, is at 3.4 percent. That is pretty good. Coming out of the pandemic, it was nearly 5 percent.

During the Asian [financial] crisis, it had reached 12 percent. 3.4 percent is not so bad. We want to bring it down to 2.0 percent. 1.5 percent-that is what you get during good times.

So, the banks, as I have said, have been part of the solution rather than part of the problem.

Digital efforts

But we want to do better for the banks. And so, we are encouraging them to digitalize. I think that is inevitable.

They have to digitalize, and there are four approaches to doing that. We have something called the Open Finance Framework.

This is what they are doing in Europe for example. Banks these days, they are connected to something called APIs, or application programming interfaces.

They are connected to each other. They are connected to other institutions through these APIs that allow them to do business that involves consolidating customer balance sheets, doing investments for customers, and doing data analytics for customers.

In fact, for compliance purposes, APIs are going to be used to help banks satisfy their compliance requirement with the central bank. This is the jargon in the field; this is called "reg tech" [regulatory technology].

The BSP itself is using technology to oversee regulations and compliance of banks; that is called "sup tech" [supervisory technology].

Apart from the Open Finance Framework, we have what we call "regulatory sandboxes." What this means is that if you are a fintech [financial technology] and you have a very promising innovation, then you can come to the BSP, and we will give you a regulator.

So, you can work with that regulator-you can test your idea, you can discuss the proof of concept, you can pilot your idea-and your regulator will be next to you to get your side, to tell you what might be the regulatory consequences if you bring your idea to the market.

So, it is not about judging whether you really have a good idea and whether you will succeed. It is about minimizing regulatory uncertainty so when you actually put your project into place, you will have a very good idea of what the regulations will be.

A very special case of that is our digital banking framework. We have now given licenses to six digital banks. They are doing well on the deposits side. They are able to get deposits online.

A digital bank is not supposed to have any physical, no brick-and-mortar presence. So, everything has to be done online. And our digital banks have been very successful in raising deposits online. They are, to be honest, still struggling to make loans online. And it seems to be very hard to collect on loans online.

In the Philippines, it seems that you need a human being to collect [loan payments]-but, maybe, there is a way to overcome that-and that is why we only have six licenses so far. Some are more successful than others, and there is experience in other countries that digital banks are successful in making good loans.

So, that is a special case of a regulatory sandbox.

Finally, of course, we have generative AI [artificial intelligence]. As you know, this is inevitable. Everybody will be doing generative AI. So, what we are doing is looking at risks. There are many risks to generative AI, and we want to understand those risks. For example, generative AI tends to be prone to hallucinations. They tend to imagine things that never happened. They are prone to herding. They tend to make the same recommendations to different institutions regardless of specific circumstances.

So, those are some of the dangers, but we think that generative AI will still be used. They are just irresistible to banks and to ourselves. If you used ChatGPT, you know how irresistible that is.

Serving the unbanked

And then, finally, we want to make use of the digital payment system to serve the unbanked. We have two strategies in this regard. We have a local strategy in which we are using e-wallets [electronic wallets]-you know, your GCash or your PayMaya-and what we call basic deposit accounts (BDAs), which are deposit accounts that allow you to open an account in the bank in a very simplified way.

Together, in these two things, the e-wallets and the BDAs, we have found some successes that will lead to bank credit and other forms of financial services, including investments.

Our efforts where we should get the unbanked to be part of the formal financial ecosystem-that is our domestic strategy. We have an international strategy. The one we do with our neighbors, the ASEAN [Association of Southeast Asian Nations] central banks, Singapore, Thailand, Malaysia, and Indonesia. We are working on a project called Nexus. This is to connect the fast payment systems of each individual central bank for each individual country.

We have a fast payment system ourselves; it is called InstaPay. Other countries have their own fast payment systems, and Nexus is designed to connect all those fast payment systems.

So, we can go from pesos into baht, baht into ringgit, almost instantaneously. Maybe, it will take 0.5 seconds but not so bad.

The goal is, when this is in place, to transfer money not costing more than 2.0 percent. The G20 goal is 3.0 percent; our own goal is 2.0 percent.

And the nice thing about Nexus is that it is designed to be very scalable. It is going to be easy to add more participants as long as they have a fast payment system.

The United States (US) is not ready. The US does not really have a fast payment system like InstaPay. They have the Fed [US Federal Reserve] now, but it is not the same as InstaPay. Brazil is ready; India is ready; and they have been asking to join. So, we will welcome them to the system.

Of course, we want the US and Europe to join the system. And once they are ready, it will be very easy.

So, that is my discussion. We want to enhance our monetary policy framework so we can deal more effectively with supply shocks. We want to digitalize our banks. And then, we want to get the unbanked to be included in the formal financial system-not only locally but also internationally.