STATEMENT ON THE STATE OF FINANCIAL STABILITY

18 May 2021 Meeting of the Financial Stability Coordination Council[1]

The Financial Stability Coordination Council (FSCC) continues to assess the impact of COVID-19 on the Filipino public as well as the general economy. There are continuing signs that the incremental effects are now significantly less than the sharp economic contraction in Q2 2020, but we are also mindful of COVID's lingering ill-effects. These continuing effects are the nature of systemic risks, and not only do they define financial instability, but they can also amplify to create add-on risks against future socio-economic prospects.

With a view towards the rest of the year, six risks (those in green below) are assessed to be under control. These are risks to monetary policy, risks to fiscal policy, contagion risk, concentration risk, liquidity risk and geo-political risk. They are, however, being continuously monitored and will be re-assessed as updated information becomes available.

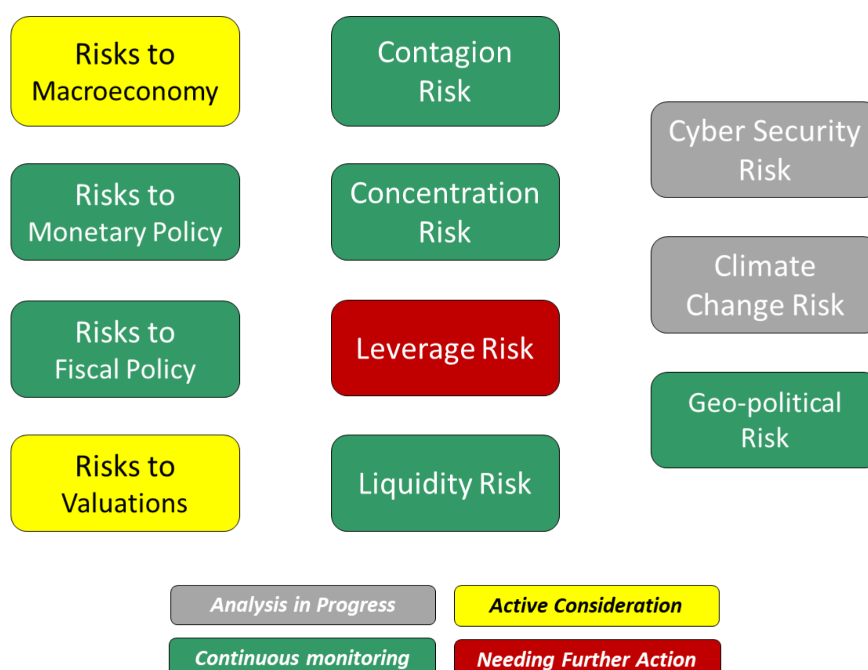
Two other risk facets are still works-in-progress (those in grey) while two other risks (those in yellow) are relatively more elevated as a result of the spillovers from other jurisdictions. The balance between income and debt is the key downside risk today.

COVID-19 has curtailed expected incomes. This is the primary risk which feeds other risks. This is more evident in sectors that depend on the traffic of consumers (e.g., retail trade, events, leisure & auxiliary activities), and on those in the less-formal sector which are heavily dependent on economic momentum to begin with. That "this crisis is different" speaks not only of the depth, but also the breadth and variability of the pandemic's impact across different stakeholders.

We welcome projections of positive global growth for 2021. However, with the pace of recovery uneven across different jurisdictions, the opportunities in the global market are tilted on balance towards Advanced Economies (AEs), particularly towards USD-denominated assets. This is creating spillover risks to Emerging Market and Developing Economies (EMDEs). These cross-border effects are disruptive to countries like the Philippines and create a layer of risks on top of the scars that COVID has already caused on the domestic economy.

As a Council, the FSCC takes a cross-cutting view of the emerging and existent risks. We have the unique vantage point of seeing how all these risks interact and how they affect the whole system differently from just the sum of individual effects.

[1] The Financial Stability Coordination Council (FSCC) is an inter-agency council composed of the Bangko Sentral ng Pilipinas, the Department of Finance, the Insurance Commission, the Philippine Deposit Insurance Corporation, and the Securities and Exchange Commission. It convenes quarterly to assess possible systemic risks and decide on appropriate macroprudential policy interventions.



Contagion and Concentration Risks

- Philippines Inc. is highly interconnected, marked by the industry leadership of identified firms.
- In normal times, the business connections between firms and across industries represent a mutually reinforcing system. However, any disturbance can also generate much larger effects.
- The Council has developed several network models to reflect the business connections between firms, across industries, and their normal activity with other jurisdictions.
- Latest data does not show any significant change in the interlinkages within the network. This indicates that the business links and/or value chains that have been formed are quite stable.
- We are currently conducting, in phases, Macroprudential Stress Tests and these network models are the defining element of these simulations.

Liquidity Risk

- The authorities have provided the market over PHP2 trillion in liquidity, ensuring that funding liquidity will not be at risk since the onset of the crisis.
- In addition to the monetary stimulus, bank deposit balances continue to increase, providing a further source of liquidity. This has been a boon to the capital market which has seen successful issuances of both private and government securities.
- COVID-19 has heightened risk aversion in financial markets and loans outstanding have been tempered. This development is being actively monitored.

- As with other authorities around the globe, we continue to support the economy in transition with liquidity, but we are also mindful of the longer-term effects of this liquidity when the economy stabilizes.

Risks to Monetary Policy

- Philippine inflation currently remains elevated and above the 4% upper bound. Our current view is that this condition is transitory, with average inflation expected to fall into the band by year-end.
- With no threat of an overheating economy and the markets already liquid, the current policy rate is appropriate given the path of growth and inflation.
- Upward inflationary pressures stem from cost-driven factors that may be outside the traditional purview of monetary policy. Since November last year, world oil prices have been moving upwards with both Brent Crude and WTI prices nearing USD70 a barrel. Unsurprisingly, transport inflation has risen as a result.

Risks to Fiscal Policy

- The country has taken a conservative fiscal stance in recent years and this has allowed the government to fund unscheduled expenditures to address the pressing needs arising from the COVID-19 pandemic.
- However, the budget deficit has certainly increased as fiscal authorities have had to provide direct assistance to households and economic sectors. It is now estimated to top off at 9.4% of GDP for 2021, then easing to 7.7% in 2022.
- Pressure points can arise from two factors: first, funding needs may still expand as the COVID-19 pandemic continues to unravel and, second, tax revenues may be tempered as income levels take time to revert to their 2019 levels. Ongoing legislative initiatives could also affect the fiscal balance.
- A more definitive view of all of the implications on the fiscal position remains unclear and we shall update our analysis as developments unfold.

Geo-Political Risk

- Economic tensions between the US and China have eased relative to the direct, confrontational stance in previous years. Nonetheless, there are new pressure points, particularly on military and democracy related issues in Asia.
- In contrast, we have seen direct escalation in the political tensions between the US and Russia, as well as between Palestine and Israel. In the oil market, disagreements between Russia and Saudi Arabia directly impact world oil prices as well as the viability of the US shale industry.
- How all of these “play out” is being actively monitored, principally because these factors may affect the economic recovery prospects in the AEs, and indirectly affect EMDEs to some extent.

Risks to Macro Economy

- Macroeconomic recovery will necessarily depend on economic activity picking up, either with or after the lockdowns, as well as the rollout program of COVID-19 vaccines. One is clearly not independent of the other.
- This is where prospects diverge. Moderna is produced in Massachusetts, USA while BioNTech-Pfizer is produced in Germany and Belgium. Wuhan may have been the epicenter of COVID-19 but China has Sinopharm and Sinovac.
- India's spike in cases and its recent decision to ban exports adds a critical wrinkle in the vaccine supply chain. Oxford-AstraZeneca is made by the Serum Institute of India, the world's largest vaccine manufacturer. In addition, the COVAX facility – the global sharing platform – likewise depends on the supply coming from the Serum Institute. India also produces Covaxin although there have been concerns over its trials and reviews.
- With access to vaccines uneven across jurisdictions, multilateral agencies have noted the "divergence" between AEs and EMDEs. The US economy, in particular, is expected to grow at 6.5% in 2021, two full percentage points higher than previous estimates. With this growth and the amount of liquidity being injected into their economy, the US dollar has been strengthening lately against benchmark currencies and long-term secondary market interest rates have risen. As a result, portfolios are being rebalanced towards USD-denominated assets.
- As a small, open economy, we are a price-taker in the global market and the current path of those global prices adds pressure on the Philippines and its recovery. In addition, the incomes already lost due to COVID-19 has sustained higher level of risk aversion.

Risk to Valuations

- Local yields are responding to the global trend. This is, however, causing trading volumes to decline, and a further decline in price discovery. The lack of actual traded prices will only fuel trading friction, which sustains the absence of "done" rates, against which both issuers and investors can make informed choices.
- A steady/strong PHP is also enticing more activity in offshore debt markets. As reported by the BIS, this is the case for NFCs and banks as well.
- If the rising trend for global secondary market rates is sustained, this will create another source of pressure on borrowers who carry debts that are subject to periodic repricing. At the current nascent stage of recovery, higher market yields pose a risk that compounds eroded incomes and impaired debt servicing capacities.
- From a market valuation standpoint, the higher yields also mean that holders of tradable securities face mark-to-market losses. Shifting tradeable assets into held-to-maturity may address valuation risks but it does come at the price of locking-in liquidity.

Leverage Risk

- Bank credit and GDP growth are naturally connected. As prospects for the economy improve, entrepreneurs wish to tap into business opportunities by expanding or creating new businesses through bank credit. Good economic outcomes, in turn, allow the loans to be repaid and sustained economic activity nurtures further demand for loans.
- As simple as this may sound, it reiterates the basic point that leverage should be understood in terms of what the proceeds will be used for and thus, indirectly, how the debt can be sustained. The difficulty, however, is when unexpected events occur.
- COVID-19's direct negative effect on incomes suggests that there will be increased pressure for servicing existing debts. Borrowers who were keen on expanding (and rebalanced their balance sheet towards more leverage and less liquidity) are thus facing increased vulnerability. With an emerging New Economy that is almost certainly and fundamentally different than the pre-COVID-19 market, expectations of one's business future also comes with notable uncertainties.
- The timing between expected revenues and when debt obligations are due is likewise critical. COVID-19 disrupted the former but contractual obligations are generally unchanged.
- Rising market yields, driven by spillovers from AEs, would also be an unfavorable complication. With incomes already impaired, raising the cost of repayment adds an unnecessary burden to debt servicing.
- For these reasons, leverage represents the key risk today. Borrowers, lenders, and financial authorities must collaborate to address an unexpected external shock that materially affects the credit standing of borrowers for reasons that are not of their doing.

Cyber Security Risk

- The digitalization of Finance – both from within the financial market and through alternative platforms outside of the formal financial market remit – is inevitably broadening. The known advantages come from both the rise of newer technologies and the sunset of more antiquated paper-based transactions. These elements of the digitalization process are well articulated.
- Nonetheless, no system can be perfect on a 24/7 basis. There will periodically arise glitches that prevent a customer from undertaking a timely transaction and, at worst, this can extend to malicious attacks via ransomware. These risks need to be periodically scoped.
- Businesses worldwide have resorted to alternative work arrangements because of COVID-19. A significant portion of the workforce is either connecting from outside the firewalls of the office system or may not be fully equipped with collaboration tools to execute business-as-usual tasks. These demands on ICT represent new challenges and impose a heavier load on the IT infrastructure that is publicly available.
- The FSCC recognizes that these challenges and cyber-related risks are covered in the Systemic Risk Crisis Management (SRCM) framework that we are presently finalizing.

Climate Change Risk

- The country annually faces considerable damage from natural calamities. The only uncertainty is the extent of the damage on any given year. Inputting this risk into debt contracts has its benefits, but the cost of insurance may be non-trivial.
- The risk that is significantly much harder to scope is transition risk. This risk will take time to unfold, but it is also certain to arise.
- Similar to cyber risks, climate related risks are part of the SRCM and represent an important longer-term agenda of the Council.