As liquidity conditions improve, expect Philippines’ central bank to cut rates in 2020

Domestic liquidity conditions appear to be thawing with previously stagnant funds now returning back to the financial system

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The Philippine financial system has previously been plagued with tightness in domestic liquidity, but things are slowly improving with additional money returning to the system.

As liquidity dried up, domestic liquidity growth slipped, forcing interest rates to spike as users bid up the price of money. The tightness in liquidity this year was seen by the gradual dwindling of so-called “excess liquidity”, measured by the funds that financial institutions park with the central bank overnight and on a term basis.

The excess liquidity was once at more than PHP 2 trillion but has gradually declined over the past few years. At the peak of tightness, excess liquidity parked with the central bank slumped to PHP 248 bn but has since recovered to PHP 559 bn as of September 2019.

Philippine excess liquidity: Funds parked with the central bank
FX spot market presence, government underspending and RRR cuts

Several factors caused the “liquidity lock-up”, forcing money supply growth to languish around single digits and force borrowing costs higher. Let’s look at them here and our expectations for going into 2020.

Central bank presence in the spot market in 2018

Last year, we saw the Philippines peso under siege with the central bank stepping in the FX spot market to arrest sharp swings in the exchange rate.

Drawing down their gross international reserves (GIR), the sale of US dollars to meet heightened demand for hard currency ostensibly led to peso illiquidity from the financial system. With the central bank restocking its cache of foreign reserves in 2019 (up to $86 bn from $82.5 bn in January) despite policy rate cuts, we expect this to help generate peso liquidity as the central bank shores up its GIR via purchases in the spot market which in turn infuses fresh peso liquidity back into the system.
The 2019 spending budget delay

The Philippine Congress and Senate failed to pass the spending plan into law in January and as a result, GDP growth slowed considerably.

The budget delay also caused liquidity problems as the depository account of the national government with the central bank simply accumulated with government spending curtailed. The so-called “Treasury Single Account” (TSA) of the government swelled to more than PHP 760 bn at one point, almost double that of the five-year average of PHP 414 bn as government funds were “trapped” with the BSP.

With the 2019 budget finally passed and expenditure growth picking up (latest print of 8.8%), we can expect funds parked in the TSA to slowly make their way back into the financial system to alleviate tightness further.

Philippine government spending growth and BSP Treasury Single Account
RRR cuts in 2018

Intuitively, reductions to the reserve requirement ratio (RRR) should help alleviate tight liquidity conditions with each cut releasing roughly PHP 100 bn in funds in the financial market.

The central bank rattled off two RRR reductions in 2018 which may have caught market players unaware given the manner in which the RRR was reduced and the timing in which they were carried out. At the time of their respective reductions, the peso was depreciating sharply (-4.5%) while inflation had breached the 2-4% target (4.3%). The infusion of PHP 200 bn at a time heightened risk-off sentiment may have prodded market players to seek safe haven with investors shifting to the Dollar (Peso depreciated another 5.6%).

In 2019, RRR reductions were carried out at a time of relative market calm with freed up liquidity finding a new home: the local bond market. The PHP 300 bn infusion may have helped push down Philippines local GS yields with market volume spiking (PHP 780.66 bn) in wake of the RRR cuts. The drop in yields working in tandem with the easing bias from the BSP (cut policy rates 75 bps so far) could, in turn, jump-start bank lending to fuel (latest print at 10.5%) investment activity.

With the central bank Governor Diokno pledging a sustained directive to lower RRR throughout his term, further RRR cuts may finally find their way to the real sector with borrowing activity recovering given the accommodative interest rate environment as liquidity tightness is further alleviated.

Philippine local bond market trading volume
2020: Turn on the tap

The three factors that caused the artificial tightness in domestic liquidity have reversed in 2019.

Going into 2020, with the central bank now building up its level of GIR (generating fresh peso liquidity), the government accelerating spending and RRR reductions carried out in an environment of accommodative interest rates, we can expect liquidity tightness to dissipate further with the accommodative monetary stance of the central bank forecasted to help foster investment momentum.

We expect the central bank to lower RRR further in 2020 by 200 bps while cutting policy rates by an additional 200 bps with the first cut seen as early as 1Q of next year.

Nicholas Mapa
Senior Economist, Philippines
+632 479 8855
nicholasantonio.mapa@asia.ing.com
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