External factors and Philippine monetary policy

Diwa C Guinigundo[1]

1. Introduction

The trilemma. The hypothesis known as the "impossible trinity" in international economics – that a country cannot enjoy free capital movements, independent monetary policy and a fixed exchange rate simultaneously but must choose two out of the three – has come to the fore as emerging market economies deal with the consequences of the recent global financial crisis. For a small, open economy such as the Philippines, which aims to expand economic development through increased financial openness, this policy trilemma makes the role of the central bank as the monetary authority even more crucial.

Integration risks. Financial openness can be a double-edged sword. It enables a more efficient allocation of capital, and encourages financial innovation. However, cross-border capital flows also increase the possibility of amplifying shocks to the economy. They may generate contagion, as crises in the source country can be propagated to the recipient country, and vice versa. The contagion process becomes more problematic when the damage in one country poses a threat to systemic stability in the other country. This was seen at the height of the recent global financial crisis, where cross-border bank lending was one of the key channels through which the crisis spread to emerging markets.

Therefore, while financial integration adds momentum to growth and development, it also makes the domestic financial landscape more vulnerable to a wide range of external shocks, thereby complicating the task of formulating appropriate monetary policy. Moreover, the increased integration of financial systems across the global economy has reshaped monetary policy frameworks and transmission channels.

The aftermath of the crisis. The recent global financial crisis has presented new challenges to central banking. Financial fragility, brought about by poor regulation and not by loose monetary policy (Svensson (2010)), played a defining role in the origin and magnitude of the global financial crisis. As a consequence, the crisis has provoked debate about the central bank's primary objective of price stability. It has also raised concerns that traditional central bank tools may no longer be as effective given the broader and more complex nature of financial systems.

Role of external shocks in formulating monetary policy. The increased integration of financial systems across the global economy implies that external influences can affect domestic policies. Kamin (2010) summarises these as follows. First, even with a flexible exchange rate, short-term rates set by central banks in many economies are responding to foreign financial conditions to a greater extent than before. Second, long-term interest rates in the domestic market likewise appear to be affected by international developments. Finally, liquidity and credit channels have become additional conduits of external shocks. This is not to say that increased financial integration has reduced the influence of central banks over the financial and economic conditions in their own countries. Rather, these findings indicate the growing importance of taking account of international conditions in the formulation of domestic monetary policy.

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[1] Deputy Governor, Bangko Sentral ng Pilipinas.

2. Monetary policy in a financially integrated environment

Macroeconomic management in a globalised economy. The concept of a globally integrated financial system is not new. However, as the recent global financial crisis has revealed, considering the speed and magnitude of the transmission of global factors across borders, as well as the diversity of channels for transmission, central banks need to revisit their understanding of the interplay between global factors and domestic variables and, more important, the role of these factors in financial stability.

Price and financial stability. Monetary policy is essential to financial stability. By achieving price stability, market distortions and uncertainties arising from inflation are eliminated, resulting in: (i) lower risk premia; (ii) reduced risk of misalignments between asset prices and economic fundamentals; (iii) lower potential for balance sheet problems that may lead to debt default; and (iv) reduced moral hazard and risk-taking.

However, price stability by itself is not enough to achieve financial stability. Specific policies and instruments are needed to ensure financial stability. Woodford (2010) observed that when the Federal Open Market Committee raised its rate during 2006–07, financial conditions did not tighten as much as would have been expected. Woodford provided explanations for this, as follows: (i) spending decisions depend more on the level of long-term interest rates than on the current level of short-term rates alone; and (ii) there has been a shift in investor appetite towards purportedly low-risk, short-term liabilities of very highly leveraged financial intermediaries. These findings have two important implications for monetary policy. One, decisions about interest rate policy should take account of changes in financial conditions, particularly changes in interest rate spreads. Woodford suggested that changes in credit spreads should be an important indicator in setting policy rates. Second, traditional interest rate policy alone will not, in general, provide a fully adequate response to a credit supply disturbance. Unconventional monetary policies are called for, such as central bank direct purchase of debt claims issued by private borrowers.

In the same manner, Svensson (2010) also proposed that financial conditions and asset prices should be used as indicators for monetary policy and their effects incorporated in inflation forecasts. However, Svensson also pointed out the need for more research on how to incorporate financial conditions and intermediation into the standard models of the transmission mechanisms of central banks.

Capital flows and monetary policy. Moving forward, as global market functions go back to normal, investor appetite has also been returning. The weak growth exhibited by the United States and other advanced economies has led to a general weakening of their currencies and resulted in a new round of loose monetary and fiscal policies. Meanwhile, the strong economic growth of emerging market economies has attracted greater foreign exchange flows. The sudden and prolonged surges in foreign exchange flows may threaten the conduct of monetary policy. If these capital flows are not managed actively and appropriately, they can have negative repercussions, such as real exchange rate misalignments, credit and asset price booms, inflationary pressures, overheating and financial imbalances that can culminate in a full-blown financial crisis.

Competitive depreciation and global efforts. The significant capital inflows to emerging market economies have led to a general appreciation of their currencies. In addition, the threat of protectionist sentiments, such as attempting to dampen currency movements to maintain export competitiveness, could have serious repercussions on global trade. The inability of the G20 to produce a clear strategy for dealing with currency tensions between key economies and the slow progress in global rebalancing efforts could result in a further strengthening of emerging market currencies, including the Philippine peso. If key currencies continue to be inflexible while their trading partners remain driven to defend the competitiveness of their currencies, the Philippines, and its neighbouring economies, will continue to be a magnet for investors seeking higher yields. This, in turn, could drive the peso even higher as major economies' currencies get weaker.

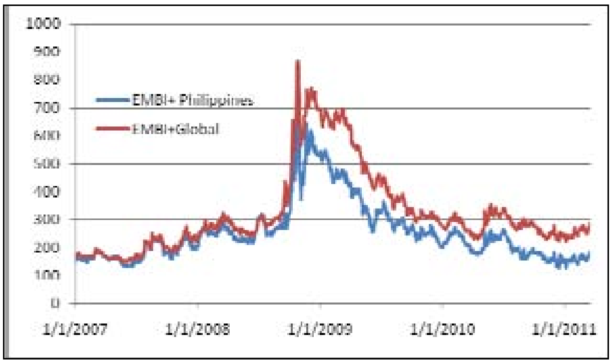
This situation is not sustainable in the long run and is bound to worsen the current global disequilibrium. Efforts by multilateral organisations to achieve a coordinated approach to global rebalancing should be continued at the international level, and key players in the global market should fulfil their roles in correcting global imbalances. For their part, emerging market economies, including the Philippines, have allowed their currencies to appreciate.

3. The global financial crisis and the Philippine financial system

Risk aversion and resiliency. In the case of the Philippines, the immediate effect of the global financial crisis was heightened risk aversion in the domestic financial system. The Emerging Markets Bond Index Plus (EMBI+) spreads for the Philippines widened considerably, peaking at 796 basis points on 24 October 2008. On that same day, the cost of ensuring Philippine debt went as high as 825 basis points. Amid widespread investor fears, the Philippine Stock Exchange Index declined sharply and remained subdued until the first quarter of the following year, reflecting a generally cautious stance.

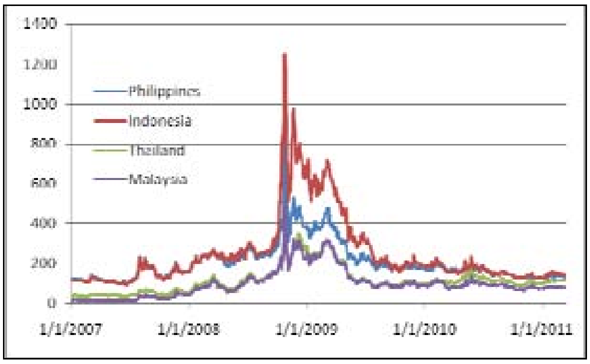
Graph 1

Emerging Markets Bond Index spreads



Graph 2

Five-year credit default swap



Source: Bloomberg.

Nevertheless, the impact remained relatively muted mainly because of the limited exposure of local banks to structured credit and related derivative products, which were behind the significant losses of large international banks. Moreover, Philippine banks rely more on traditional banking services, such as deposits, than on foreign financing. Corporate sector bond financing is also minimal, and private sector reliance on external loans is fairly limited.

Philippines in stronger position to weather volatilities. Another major contributing factor to the resilience of the Philippine financial system is that it was in a much better position to weather market volatilities than during previous episodes of financial turmoil (eg, the Asian financial crisis of 1997–98, when banks reacted to ballooning distressed assets by rationalising the granting of new loans, thereby curtailing deposit expansion). This time, with limited pressures on the balance sheet, domestic banks were able to keep their capital adequacy ratio largely above regulatory requirements while improving efficiency in terms of reducing the cost-to-income ratio.

Table 1

Philippine banking system: some indicators										
	2001	**2002**	**2003**	**2004**	**2005**	**2006**	**2007**	**2008**	**2009**	**2010**
Asset growth[1]	2.3	6.0	5.6	9.8	6.7	11.7	5.2	15.1	7.9	7.2[2]
Non-performing loans ratio	17.5	15.0	14.2	12.9	8.2	5.7	4.4	3.5	3.0	3.1[3]
Non-performing asset ratio	14.3	13.1	12.9	11.4	8.6	6.3	5.2	4.5	3.9	3.7[4]
Return on assets[1]	0.4	1.7	0.8	1.1	1.0	1.1	1.3	0.8	1.2	1.3[5]
Return on equity[1]	3.2	12.8	6.2	8.3	8.5	9.4	10.7	7.2	11.4	11.8[6]
Capital adequacy ratio	15.3	16.5	17.4	18.7	17.8	18.5	15.9	15.7	16.0	16.2[7]

[1] In per cent. [2] August 2010. [3] September 2010. [4] September 2010. [5] June 2010. [6] June 2010. [7] March 2010.

Reforms result in stronger banking system. The reforms implemented following the Asian financial crisis – cleaning up bank balance sheets, strengthening bank capitalisation through Basel II, improving governance structures, enhancing risk-management systems and adhering to international accounting standards – have come together to create a steadily growing, adequately capitalised, significantly stronger Philippine banking system.

Low interest rates, inflation allow liquidity support. The environment of low interest rates and manageable inflation, owing in part to a healthy and stable financial system, gave the Bangko Sentral ng Pilipinas (BSP) the flexibility to pursue liquidity support measures that have maintained the smooth functioning of the financial system and helped fund the growth requirements of the economy despite the global credit crunch. Table 2 enumerates the liquidity-enhancing measures rolled out by the BSP during the recent crisis.

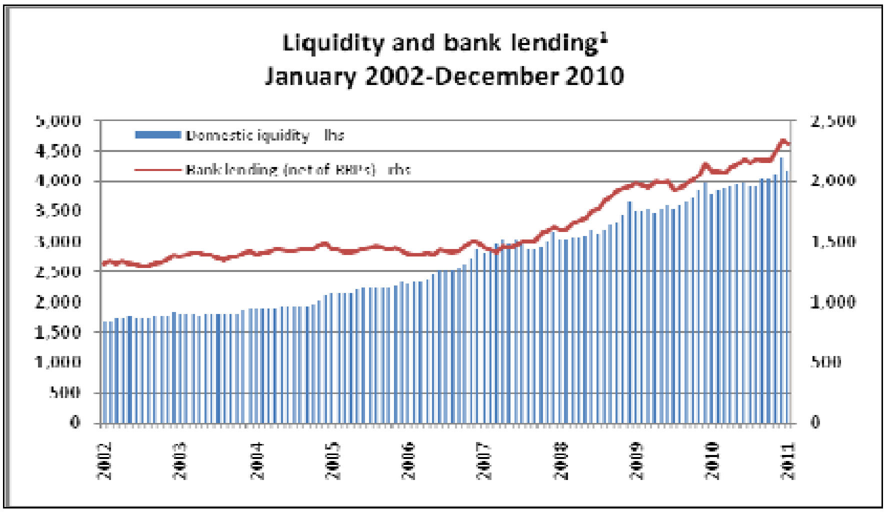
Table 2

Liquidity support measures implemented by the BSP during the global financial crisis

17 October 2008	Opening of US dollar repo facility Enhancement of the existing peso repo facility through relaxed valuation and broader acceptable collateral
7 November 2008	Increase in rediscounting budget (from PHP 20 billion to PHP 40 billion)
14 November 2008	Reserve requirement decreased by two percentage points
2 March 2009	Further increase in rediscounting budget (from PHP 40 billion to PHP 60 billion) Alignment of the rediscounting rate with the overnight reverse repurchase rate Easing of the non-performing loans ratio requirement and increase in the loan value of all eligible rediscounting paper

Complementary policy measures. In addition to the liquidity-enhancing measures, policy rate reductions were implemented, to the extent that the inflation outlook allowed, to bring down the cost of borrowing, reduce the financial burdens on firms and households and shore up business and consumer confidence for economic expansion. Complementary to the BSP's measures, in the first quarter of 2009 the national government put in place an Economic Resiliency Plan, which amounted to PHP 330 billion, to mitigate the impact of the global economic slowdown by stimulating economic activity. The main goals of the fiscal plan are to upgrade infrastructure and capital stock and to expand social protection.

Graph 3



[1] In billions of Philippine pesos.

Source: BSP

The accommodative environment ensured that funds were available and accessible to the market. Domestic liquidity and bank lending to productive sectors continued to grow – albeit at a slightly slower rate at the peak of the crisis – indicating the ability of the financial sector to continue supporting economic activities. Moreover, based on the Senior Bank Loan Officers' Survey conducted by the BSP during the third quarter of 2010,[2] lending standards to enterprises has been improving, indicating the absence of any credit tightening.

Table 3

Diffusion index/net demand

Senior Bank Loan Officers' Survey on standards for lending to enterprises

	2009				**2010**		
	Q1	**Q2**	**Q3**	**Q4**	**Q1**	**Q2**	**Q3**
Banks' margin on loans	34.8	11.1	–5.9	0.0	–5.3	–13.0	4.8
Size of credit lines	26.1	0.0	0.0	0.0	10.5	–13.6	–14.3
Collateral requirements	43.5	26.3	18.8	23.8	5.6	4.8	5.3
Loan covenants	56.5	26.3	29.4	23.8	5.3	5.0	5.0
Maturity	18.2	10.5	5.9	4.8	5.6	13.6	5.0

Positive diffusion index indicates that more banks tightened than eased credit standards, and vice versa for negative diffusion index.

[2] The Senior Bank Loan Officers' Survey was started in the first quarter of 2009 with the aim of enhancing the BSP's understanding of banks' lending behaviour, which is an important indicator of the strength of economic activity. The survey also helps the BSP assess the effectiveness of bank lending as a transmission channel of monetary policy.

4. Multi-speed global recovery: resurgence of capital flows

Foreign exchange (FX) flows complicate liquidity management; BSP employs conventional tools. The current resurgence of FX flows can complicate liquidity management, create pressures for currencies to appreciate and trigger systemic stress. Recognising the nature and magnitude of these capital flows, the BSP employs a wide variety of macroprudential instruments to help prevent overheating in the property sector and contain excessive risk-taking. These tools, which include limits on exposure to real estate loans, loan loss provisions, bank capital requirements, capital preservation requirements, standards for derivatives activities and limits to foreign exchange exposures, have helped reduce the likelihood of potential asset price bubbles and offset the effects of heavy capital inflows.

BSP further liberalises FX outflows. In 2007, the BSP rolled out a two-phase programme for liberalising the foreign exchange regulatory framework to encourage more stable flows and minimise volatility in the capital markets over a long-term horizon. The reforms are aimed at facilitating freer and more stable capital flows in the long run, promoting risk diversification that is supportive of a globalised economy and streamlining the documentary and reporting requirements on the sale of foreign exchange. On 28 October 2010, the BSP further amended the FX regulatory framework to keep FX transactions attuned to current economic conditions. The policy amendments consist of increasing FX transaction ceilings as follows: (i) over-the-counter FX purchases by residents for non-trade current account purposes, from US$ 30,000 to US$ 50,000; (ii) FX purchases by residents to cover advance payment requirements, from a maximum of US$ 100,000 to a maximum of US$ 1 million; (iii) FX purchases by residents for outward investments and/or investments in Philippine debt paper issued offshore, from US$ 30 million to US$ 60 million; and (iv) currency reconversion by non-resident tourists at ports of exit, from US$ 200 to US$ 5,000. Moreover, the BSP has introduced greater flexibility in managing FX exposures and facilitated foreign investment payments by allowing: (i) the private sector to prepay foreign currency loans without prior BSP approval; and (ii) banks to act on foreign investor requests for FX conversion and outward remittance of peso funds.

Philippine exchange rate objectives and capital flow surges. The exchange rate in the Philippines is market-determined. The BSP neither targets nor supports a given level or band for the exchange rate; rather, the exchange rate of the Philippine peso is determined by the forces of supply and demand. Under the inflation targeting framework of the BSP, no specific level of exchange rate in the short or long term is targeted or maintained.

Flexible inflation targeting. Nonetheless, this does not mean that the BSP is indifferent to developments in the FX market, to which it still pays careful attention. Consistent with its inflation targeting objectives, the BSP allows for greater flexibility with respect to exchange rate movements. At the same time, the BSP exercises greater self-discipline, entering the FX market only under well-specified circumstances, ie to smooth destabilising volatilities in the foreign exchange rate in order to maintain orderly market conditions and if inflation becomes a threat.

Real effective exchange rate (REER). Exchange rate movements in small, open economies, such as the Philippines, can affect balance sheets. More important, exchange rate movements can have adverse effects on inflation and inflation expectations. Given these considerations, the BSP monitors possible misalignments of the exchange rate, closely watching movements in the peso's REER to determine whether there is a high and persistent deviation from the REER's long-term average trend and whether such movements are supported by economic fundamentals.

Table 4

Year-to-date changes in selected dollar rates Appreciation/depreciation, in per cent[1]											
	2001	2002	2003	2004	2005	2006	2007	2008[2]	2009[3]	2010[4]	Cumulative 2001-10
Thai baht (onshore)	-1.9	2.6	8.8	1.8	-5.1	15.7	5.2	-2.9	4.1	11.0	39.2
Japanese yen	-13.1	10.8	10.8	4.5	-12.9	-1.0	5.2	23.9	-2.6	12.0	37.7
Singapore dollar	-6.0	6.4	2.1	4.2	-2.0	8.7	5.9	1.1	1.8	7.4	29.5
Chinese renminbi	0.0	0.0	0.0	0.0	2.6	3.4	6.9	7.0	0.0	2.7	22.5
Malaysian ringgit	0.0	0.0	0.0	0.0	0.6	7.3	6.2	-4.3	1.2	9.5	20.5
Korean won	-3.7	10.8	-0.5	15.2	2.3	8.8	-0.7	-25.7	8.2	2.1	16.8
Philippine peso	-3.2	-3.1	-4.0	-1.4	6.0	8.3	18.8	-13.1	2.9	5.1	16.2
Indonesian rupiah	-7.0	16.2	6.3	-9.2	-5.7	9.5	-4.5	-15.4	18.2	5.1	13.6
New Taiwan dollar	-5.3	0.91	2.0	7.0	-3.4	0.9	0.2	-0.9	2.5	5.1	9.0
Indian rupee	-3.3	0.6	5.2	5.0	-3.5	1.8	12.3	-19.2	4.9	2.0	5.6

[1] Negative value represents depreciation of the currency against the US dollar. [2] Closing prices as of 31 December 2008 except for Philippine peso (24 December 2008). [3] Closing prices as of 31 December 2009 except for Philippine peso (closing level on 29 December 2009). [4] Closing prices as of 31 December 2010 except for Philippine peso (closing level on 29 December 2010).

Source: Bloomberg

BSP measures. In view of the peso's fluctuations, the BSP initiated and supported measures to cushion the impact of currency appreciation on affected sectors – namely, the export sector – and on Filipinos working overseas and their beneficiaries in the home country. For the export sector, these measures include: (i) providing additional financing sources; (ii) contributing to the Export Promotion Fund; and (iii) promoting the use of hedging products. Meanwhile, for the overseas Filipinos, these initiatives include: (i) strengthening the use of formal channels for remittances; (ii) conducting dialogues with banks to persuade them to reduce remittance charges; and (iii) promoting financial learning among the expatriates and their beneficiaries to encourage them to channel their savings into productive investment activities.

The BSP has also taken a proactive stance in ensuring an informed public through greater transparency in the conduct of monetary policy and vigorous financial literacy campaigns. The BSP's advocacy programmes in economic and financial education, consumer protection and microfinance aim to promote financial awareness, protection and inclusion.

5. Lessons learned

Rethinking the conduct of monetary policy. The Philippine experience with the recent global financial crisis underlines the nexus between monetary and financial stability – inappropriate monetary policy is a threat to financial stability, while a stable financial environment is a requisite for the maintenance of price stability. The magnitude of the crisis and the speed with which it was transmitted to other economies demonstrated the interconnectedness of financial systems. Thus, central banks must enhance their understanding of financial linkages in the transmission of shocks and monetary policy. As financial markets become more integrated globally, and as financial products become more innovative and complex, central banks will have to pay closer attention to vulnerabilities in the financial systems of other countries and monitor the impact of other countries' policies on domestic markets.

Apart from the international considerations it must take into account in the conduct of monetary policy, the central bank, as the de facto financial regulator, must have at its disposal effective surveillance tools over the entire financial system. This means identifying, monitoring and addressing procyclicality and systemic risks generated by the collective behaviour of firms.

The first line of defence against financial imbalances is prudential regulation and supervision, instruments that are likely to be less blunt than monetary policy. Macroprudential measures, because they can be narrowly targeted at specific sectors, can lessen the collateral damage to non-bubble sectors. At the same time, microprudential regulation must also be strengthened. The development of the Basel III proposals, particularly higher capital and liquidity requirements, is a concrete step in this direction. But care must be taken to strike the right balance between the stability of financial systems and their efficiency. Well-designed regulatory reforms should make financial systems more resilient and stable without stifling growth.

On global rebalancing. The united front that the global economy presented at the peak of the crisis was a significant mitigating factor that facilitated the resolution of the liquidity and credit glut in the international markets. As weaknesses remain, a similar coordinated effort is needed to correct the underlying imbalances that were at the root of the global crisis. A global rebalancing is, therefore, crucial to the sustained and healthy recovery of the global economy. Two rebalancing acts are necessary: *internal rebalancing*, where private demand becomes strong enough to sustain growth and allow for fiscal consolidation; and *external rebalancing*, where countries with trade imbalances take measures to balance the current account.

The Philippines has a role to play in global rebalancing efforts as it works towards the following goals:

1. Increasing domestic demand

   Domestic demand has, historically, accounted for a large component of total GDP. In the current environment of low interest and inflation rates, domestic demand is expected to remain a driver of the country's growth.

2. Pursuing fiscal consolidation

   Fiscal consolidation should not put growth at risk. Having credible fiscal consolidation plans for the medium term would reassure markets and ward off pressures on interest rates as well as give the country room for maneuver if fiscal stimulus becomes necessary.

3. Managing capital flows

   The orderly management of large capital flows will ensure the sustainability of growth. The Philippines has the following options: (i) adherence to a flexible exchange rate; (ii) accumulation of foreign exchange reserves; and (iii) implementation of macroprudential measures to safeguard the stability of the financial system.

4. Strengthening and deepening the domestic capital market

   Important banking reforms have been undertaken since the 1997 Asian financial crisis with the aim of enhancing the stability of banks. These reforms have contributed to the current health of bank balance sheets. Nevertheless, there is still work to be done to deepen capital markets.

The role of the BSP in regional arrangements. One of the important lessons to come out of the global financial crisis is that regional cooperation plays a significant role in guarding against crises and establishing mechanisms to manage risks and vulnerabilities. Although there is no substitute for good national policies and solid macroeconomic fundamentals, international cooperation is a first-best solution to crises on a global scale. Moreover, cooperative efforts towards achieving regional stability pave the way for standby agreements and pooling facilities that provide safety nets against crises, thereby reducing the pressure at the national level to accumulate reserves as a cushion against external fluctuations.

For its part, the BSP has been determined in pursuing regional monetary and financial cooperation and integration. With respect to regional surveillance, the BSP has been actively involved in the establishment of the following: (i) the ASEAN Macroeconomic and Finance Surveillance Office, a high-level unit aimed at improving economic surveillance capacity in the ASEAN region; and (ii) the ASEAN+3 Macroeconomic Research Office, which is designed to perform key regional surveillance functions as part of the Chiang Mai Initiative Multilateralisation (CMIM) currency swap facility. Moreover, as chair of the EMEAP Monetary and Financial Stability Committee, the BSP oversees the close monitoring of financial and economic developments in the EMEAP region. Meanwhile, in line with its commitment to help address threats to the international monetary system, the BSP has contributed US$ 4.6 billion to the US$ 120 billion CMIM regional pooling scheme.

The BSP also supports efforts to establish an ASEAN Economic Community. Consistent with this, the BSP co-chairs, with Bank Negara Malaysia, the Task Force on Milestones toward ASEAN Monetary and Financial Integration (TF Milestones). The task force is expected to produce a critical assessment of the current state of financial services liberalisation, capital market development and capital account liberalisation in the ASEAN region.

Conclusion. The conduct of monetary policy is at another critical juncture, and the role of central banks has become more challenging. Nevertheless, more likely than not, central banks will continue to stand firm and remain judicious in the face of the ever-changing monetary and financial landscape. In the same vein, the BSP stands ready to face new challenges. Monetary policy in the Philippines has always been guided by the central bank's mandated commitment to price stability, while retaining the flexibility to respond to the evolving demands of the economy.

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