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Managing capital flows in the Philippines

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In the aftermath of the 2008 global financial and economic crisis, capital flows to emerging countries surged again. There have been similar episodes in the past three decades, including one that culminated in the 1997–98 East Asian financial crisis. The problems that have emerged in the various episodes are like a refrain in a song: appreciating currencies that could lead to exchange rate overshooting, pressure on asset prices, which can result in bubbles that amplify financial fragility and crisis risk, and possibility of overheating, resulting in inflation.

Policy responses are also well established, divided into macroeconomic measures and prudential regulations. Each policy measure involves trade-offs. In order to avoid these trade-offs, capital controls can instead be imposed. The issue then becomes whether capital controls are effective or not. There has also been discussion and debate on the conditions under which capital controls will be effective.

What differs in each episode of surges in capital flows are the circumstances facing a particular economy. What would be similar is that policymakers in each country would consider capital controls. This is a normal reaction given that macroeconomic measures and prudential regulations have limitations or involve trade-offs. Another common thread in the past is the opposition of the International Monetary Fund (IMF) to capital controls.

During the most recent surge, however, the IMF has for the first time openly supported the use of capital controls, albeit under strict conditions.[1] More surprisingly, emerging market economies disagreed with the IMF advice, arguing that the proposed framework reduces their flexibility. This was expressed in a joint

[1] Ostry et al. (2010), Ostry et al. (2011), IMF Strategy, Policy and Review Department.

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communiqué of the Ministers of the Intergovernmental Group of Twenty-Four addressed to the Development Committee of the IMF, viz:[2]

> "Ministers did not agree with the proposed framework for staff advice to member countries on managing capital flows and its inclusion in Fund surveillance. Policymakers of countries facing large and volatile capital flows must have the flexibility and discretion to adopt policies that they consider appropriate and effective to mitigate risks through macroeconomic policies, prudential measures and capital controls, as stipulated in the Articles of Agreement."

Moreover, the G24 also disagreed with the IMF assessment that "the onus of policy adjustment from inflow surges rests solely on the recipient countries." The G24 stated that the IMF must "take into account policies in capital-originating countries, especially systemically important financial centers, as well as specific circumstances of capital-receiving countries."

In this *Policy Notes*, the risks that emanate from the recent surge in capital flows are outlined and discussed in some detail. This is followed by a presentation of the IMF proposed framework on how to respond to surges in capital inflows. The various responses and the trade-offs and limitations are presented in summary form. The Philippine case is described with reference to possible reasons for the reaction of the G24. Policy recommendations are discussed in the last section.

Capital flows: theoretical considerations

Capital flows into emerging market economies are driven by both "push" and "pull" factors. The latter consist of favorable developments in the emerging market economies that attract capital. Meanwhile, "push" factors refer to elements outside the control of emerging markets such as the decline in international interest rates and economic recessions in industrialized countries. The recent surge in capital flows has obviously been driven by "push" factors.

Large capital flows, if not managed properly, can expose the emerging markets to at least three types of risks. The first is macroeconomic risk. Capital inflows could accelerate the growth of domestic credit, create economic overheating including inflation, and cause the real exchange rate to appreciate, thus affecting macroeconomic performance in a way not consistent or compatible with domestic policy objectives such as sustainable economic growth with price stability. The second is risk of financial instability. Capital flows could create maturity and currency mismatches in the balance sheets of private sector debtors (particularly banks and corporations), push up equity and asset prices, and potentially reduce the quality of assets, thereby contributing to greater financial fragility. The third is risk of capital flow reversal. Capital inflows could stop suddenly or even reverse themselves within a short period, resulting in depleted reserves or sharp currency depreciation.[3]

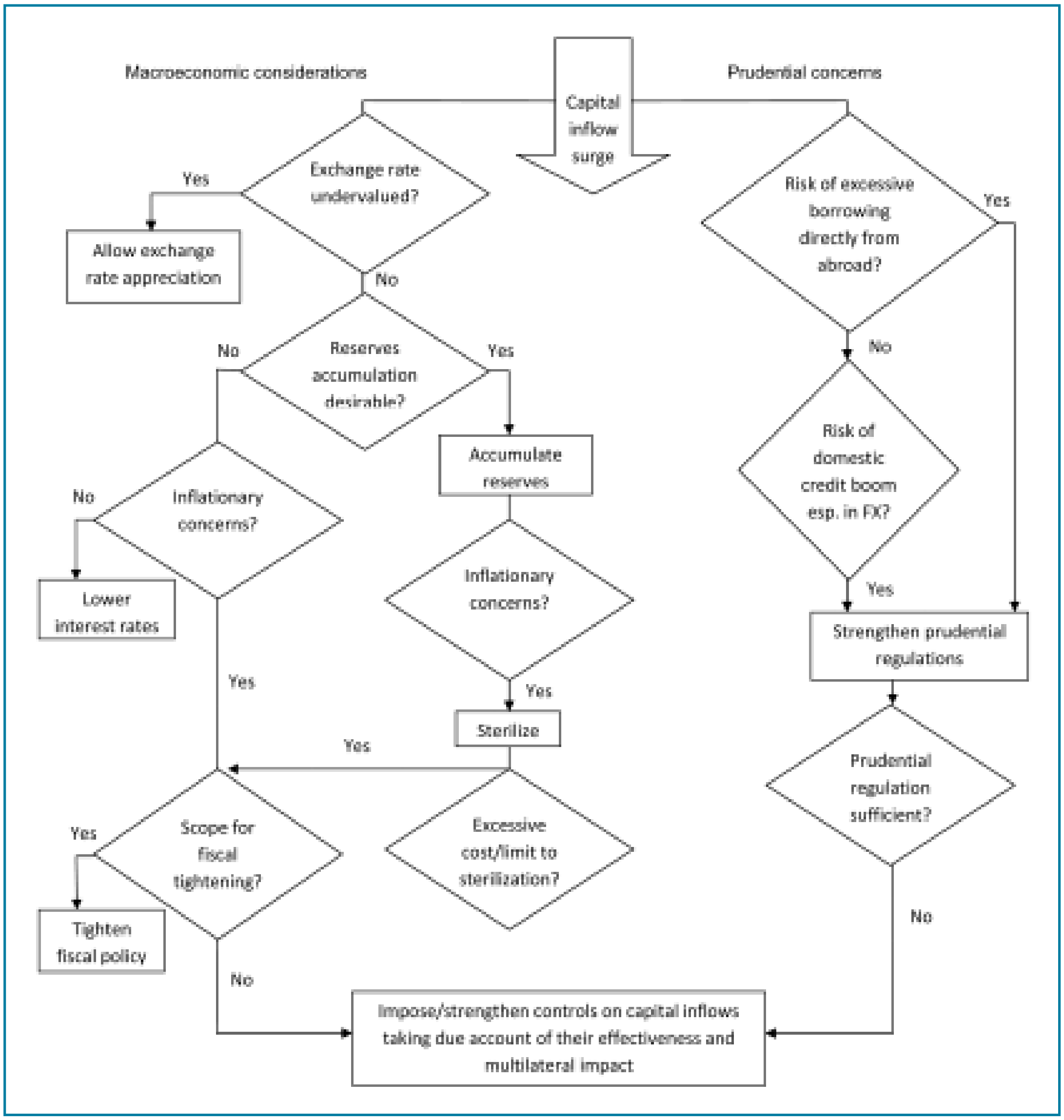
[2] Downloaded from http://www.imf.org/external/np/cm/2011/041411.htm.
[3] This paragraph is lifted from Kawai and Lamberte (2010), page 9.

Because of these risks, policymakers in emerging market economies are advised to respond to surges in capital flows. The proposed IMF framework is shown in Figure 1. A useful summary of these measures, including the possible trade-offs, is shown in Table 1. More details can be found in Kawai and Lamberte (2010).

The Philippine case

Capital has also flowed into the Philippine economy as shown in Table 2. The 'Capital and Financial Account' shows the net aggregate capital flows to the country. Surges are usually monitored through portfolio investment which is what is considered as 'hot money'. Based on this

Figure 1. Coping with surges in capital inflows: macroeconomic and prudential considerations[1]



[1] From the perspective of an individual country without taking account of multilateral considerations; on the effectiveness of controls.

Table 1. Summary of policy measures

	Policy Tools	Intended Outcome	Possible Limitations	Evidence on Effectiveness	Recommended Policy Responses
Macroeconomic Measures	Sterilized intervention	Prevent nominal and real appreciation while neutralizing the growth of base money	Rising quasi-fiscal cost; higher interest rates that attract additional inflows; unable to prevent real appreciation over the medium term due to eventual inflation	Some evidence of effectiveness in the short term, but not in the medium to long term	Limit the use of sterilized intervention as a short-run measure; reduce international reserves through a reserve-sharing arrangement (like a multilateralized Chiang Mai Initiative)
	Greater exchange rate flexibility	Direct monetary policy for macroeconomic management; discourage speculative capital inflows by creating two-way risks	Loss of international price competitiveness	Limited evidence on the response of speculative flows	Allow greater flexibility through regional cooperation (see the discussion of regional collective action)
	Fiscal policy tightening	Contain inflationary pressure; discourage capital inflows by reducing interest rate pressure; prevent real appreciation	Lack of flexibility and timeliness; a natural limit to the degree of tightening; reduction of the provision of some basic services and infrastructure investment; possibility of a positive signaling effect to attract additional inflows	Some evidence of effectiveness in preventing real appreciation and keeping better growth performance following capital flow reversals	Exploit the automatic stabilizer function of the budget; that is, the government may implement planned infrastructure investment and basic services delivery without increasing spending out of higher tax revenues or reducing tax rates
Structural Measures	Financial sector reform	Minimize the negative impact of capital flow reversals by promoting risk management	Not achievable in the short run	n.a.	Strengthen financial sector supervision and regulation; develop and deepen capital markets
	Controls on capital inflows	Limit capital inflows	High administrative capacity required, which is lacking in many emerging market economies	Some evidence of effectiveness in lengthening the maturity of inflows without much impact on the volume; effectiveness tends to weaken over time	For financially open economies, carefully design selective, temporary, market-based controls and avoid a system of extensive administrative controls. For financially closed economies, pursue capital account liberalization in a well-sequenced way together with institutional development
	Easing restrictions on capital outflows	Reduce net inflows by encouraging outflows; allow residents to diversify risks	Insufficient pent-up demand for foreign assets; possibility of a positive signaling effect to attract additional inflows	Some evidence of promoting additional capital inflows	Ease outflow controls together with complementary measures such as strengthening financial sector supervision
	Rebalancing growth	Reduce current account surpluses by refocusing sources of growth from external to domestic demand; contain upward pressure on the real exchange rate	Policymakers' reluctance to abandon existing policies	n.a.	For former-crisis economies, stimulate infrastructure investment. For PRC, reduce corporate and household savings and redirect investment toward social sector protection

Table 1 (cont'd.)

		Policy Tools	Intended Outcome	Possible Limitations	Evidence on Effectiveness	Recommended Policy Responses
		Further trade liberalization	Reduce current account surpluses by encouraging imports; contain upward pressure on the real exchange rate	Failure of net imports to rise when the tradables sector becomes more competitive as a result; possibility of a positive signaling effect to attract additional inflows	n.a.	Sustain ongoing efforts to liberalize trade
Collective Action	Global Solutions	Greater transparency	Minimize the volatility of capital flows by strengthening the role of fundamentals	Lack of sufficient attention to fundamentals by market participants	Occurrence of crises despite the rise in transparency	Support ongoing international transparency initiatives
Collective Action	Global Solutions	Countercyclicality in financial regulation	Minimize herd behavior resulting from imperfect and asymmetric information	Unlikely to receive wide support	n.a.	Consider this measure as part of the agenda for future research
Collective Action	Regional Solutions	Regional exchange rate coordination	Maintain macroeconomic and financial sector stability without much affecting international price competitiveness	Not viable without a mechanism for conducting intensive policy dialogue and cooperation	n.a.	Utilize existing policy dialogue processes such as ASEAN+3 ERPD and EMEAP to achieve collective currency appreciation
Collective Action	Regional Solutions	Regional financial market surveillance/ integration	Monitor regional financial markets and capital flows; mitigate the impact of investor herd behavior and financial contagion	Not viable without an effective institution	n.a.	Establish a new, high-level "Asian Financial Stability Dialogue" on regional financial sector issues
Collective Action	Regional Solutions	Regional cooperation on capacity building	Enhance capacity of financial regulators and supervisors to manage increasing financial risks in the markets	Not viable without an effective institution	n.a.	Include this measure among important functions of the "Asian Financial Stability Dialogue"

Source: Kawai and Lamberte (2010), Table 1.9, pp. 35–38

Table 2. Current transfers and net capital flows in the Philippines (in million USD)

	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010p
Current transfers	5,748	5,643	6,860	7,680	8,386	9,160	11,391	13,197	14,153	15,247	16,279	16,595
Current acccount balance	-2,875	-2,228	-1,750	-282	285	1,625	1,980	5,341	7,112	3,627	8,788	7,811*
Capital and financial account	4,185	3,363	911	1,056	726	-1,630	2,229	20	3,527	-1,649	-1,627	7,948
Financial account	4,022	3,225	849	1,029	672	-1,647	2,189	-118	3,503	-1,702	-1,731	7,850
Direct investment	1,114	2,115	335	1,477	188	109	1,665	2,818	-620	1,285	1,604	1,226
Portfolio investments	3,315	-553	1,027	746	562	-1,713	3,475	3,043	4,623	-3,627	-625	4,018
Financial derivatives	8	44	-15	-21	-64	-27	-43	-138	-288	-113	32	-191
Other investments	-415	1,619	-498	-1,173	-14	-16	-2,908	-5,841	-212	753	-2,742	2,797

Source: Bangko Sentral ng Pilipinas (BSP), International Monetary Fund (IMF)
Notes: p – preliminary; * – IMF staff estimate

concept, the Philippines experienced a surge in capital flows in 1999 after the 1997 East Asian financial crisis; the period 2005–2007, which was the lead up to the 2008 global financial crisis; and 2010, which is the most recent episode.

What has complicated matters is the heavy reliance of the economy on remittances from overseas workers. These are recorded as part of current transfers. While not strictly a capital inflow, it nevertheless would have similar effects. The large inflows of remittances has resulted in a current account surplus. This contributes to an increase in foreign exchange reserves which in turn exerts pressure on the currency to appreciate.

The impact of capital flows can be seen from the behavior of stock prices and the exchange rate (Figure 2). The peso appreciated sharply during the period 2005–2007. At the same time, there was a sharp increase in stock prices. Portfolio inflows were one of the main drivers in both cases.

Sterilized intervention has been the most common form of response among emerging markets and the Philippines is no exception. Narrowly defined, sterilization involves the exchange of domestic bonds for foreign assets, often through open market operations, designed to neutralize the increase in base money arising from the purchases of foreign currency. Through sterilized intervention, countries experiencing surges in capital inflows can maintain the nominal exchange rate while also preventing the capital inflow from increasing the balance of base money.

Sterilized intervention generally involves the tightening of monetary policy. It can be self-defeating by raising the level of interest rates and encouraging further capital inflows. Moreover, the interest cost of this measure has to be closely monitored, as sterilization typically

Figure 2. Stock prices and exchange rate in the Philippines (1998–2010)

carries quasi-fiscal costs that arise from the exchange of high-yielding domestic debt for low-yielding foreign assets.[4] It should be noted that unsterilized intervention is also an option, i.e., the increase in base money is not neutralized. However, this will likely lead to higher inflation.

Data indicate that intervention was heavier in the Philippines during the period 1998–2007 compared with1987–1997. Sterilization was also more pronounced in the post-crisis period (Yap 2010). Overall, intervention—usually measured as the percentage change in the level of international reserves—has been mildly successful in reducing the volatility of exchange rate movements. This is precisely the principle behind the Bangko Sentral ng Pilipinas (BSP) intervention policy: reducing volatilities rather than swaying the exchange rate in one direction or changing the path of the exchange rate.

An issue of great interest would be the consistency of sterilized intervention and inflation targeting. The objective of sterilized intervention is to maintain the monetary base at a certain level. Hence, the target is a monetary aggregate. Meanwhile, the main instrument in inflation targeting is the interest rate which is definitely affected by the process of sterilization. A conflict may arise in the objectives of maintaining a monetary aggregate and achieving an inflation target.

These types of situations make the use of capital controls more attractive. Capital controls have proven be effective in several economies (see for example Epstein et al. 2004). However, with the advent of greater financial integration, capital controls, particularly on inflows, have to be endorsed at the international level in order to be effective (Grenville 2007). This is one reason why the recent endorsement by the IMF—albeit done grudgingly—is a significant development.

Policy recommendations

There are at least two areas in the Philippines where policy measures can help stem currency appreciation or reduce overheating caused by capital inflows without having to resort to sterilized intervention. The first is through fiscal restraint and the second is through an increase in the investment rate.

The fiscal situation in the Philippines showed marked improvement during the period 2006–2008. Moreover, the proposal for fiscal restraint to stem currency appreciation is normally made in the context of a current account deficit. Hence, fiscal restraint was not a policy alternative during the surge in capital flows between 2005 and 2007. However, because of the deterioration in the fiscal situation in 2009 and 2010, better fiscal management—particularly in increasing the tax effort—has become an important tool in responding to the surge in capital inflows in 2010.

The investment rate in the Philippines—defined as the ratio of fixed investment to GDP—has been historically low in the Philippines. It is also low compared with the more developed Southeast Asian economies, i.e., Indonesia, Malaysia, Singapore, Thailand, and even Viet Nam. A higher investment rate will lead to more

[4] Definition of sterilized intervention and discussion of drawbacks lifted from Kawai and Lamberte (2010), pages 59–60.

imports which will reduce the current account surplus. Supply side constraints and institutional factors can explain the low investment rate. The government has to address these issues and the private sector has to display more 'animal spirits' in order to raise the investment rate in the Philippines.

As for capital controls, the IMF has raised concerns that widespread use of capital controls by emerging markets will have negative effects on the efficient allocation of investment across countries. Widespread use of controls could also constrain necessary steps to address global imbalances.

The arguments of the IMF, however, do not take into account the scenario wherein private investors can readily punish countries for imposing capital controls by taking their money elsewhere. Unilateral action will therefore be less effective. Capital controls will be a more effective policy tool if implemented in the context of regional cooperation.

The issue of capital flows should be analyzed in a broader context, with policies in industrialized economies being taken into consideration. In particular, the role of the US dollar as an international reserve currency has been questioned. The major contention is that an international reserve system that is based on a national currency is inherently unstable. The shift to a fiduciary dollar system—wherein there is no anchor to the dollar unlike during the gold standard—has only exacerbated the situation. It has been argued that the "exorbitant privilege" granted to the US is the major source of the global macroeconomic imbalances. Policy recommendations emanating from this analysis relate to the reform of the international financial architecture.

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