



The Relationship of Monetary Policy to National Security

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Background

There is no one single definition of national security. There are as many definitions of national security as those defining it. The country adopts the definition of national security in a holistic and comprehensive manner. Thus national security, as defined in the Philippines, is the state of condition wherein the people's way of life and institutions, their territorial integrity and sovereignty, as well as their welfare are protected and/or advanced. This definition of national security has evolved from the traditional state-centric concept to a more comprehensive concept that highlights human security as well. On the one hand, as indicated in the 2005 World Summit Outcome², human security emphasizes the right of all people to live in freedom and dignity, free from poverty and despair, and recognizes that all individuals, in particular vulnerable people, are entitled to freedom from fear and freedom from want, with an equal opportunity to enjoy all their rights and fully develop their human potential.³ State security, on the other hand, focuses primarily on the safety of states from military aggression.

In this light, the country's definition of national security is multidisciplinary, covering dimensions of politics, economics, socio-culture, technology, environment and military/defense (collectively known as PESTEM). While the critical dimensions of national security are clearly identified, there is no discussion whether the said dimensions are assigned with equal weights.

Economic security is one of the most important dimensions of national security, both when viewed under the lens of state centrism or human security, covering a vast expanse of subjects from the provision of basic necessities required for survival (individual welfare) to the national economic development agenda of the country (state advancement). Buzan (2008) argued that military security is dependent on economic security given that the latter determines the resource capacity of the country. In a broader perspective, economic security can be used as a barometer to gauge the general security of the state, i.e., comparing developed and developing countries may indicate that with economic security, other levels of security have become easier to establish.

Economic security is one of the most important aspects of national security as clearly demonstrated by the extensive studies undertaken for this subject. Karl Marx concluded that the economy formed the foundation upon which all other elements of society are based. He focused his sights on class struggles, pitting the exploited proletariat against the manipulations of bourgeoisie under capitalism (for its predecessor of feudalism, it was the serf against the feudal and landed lords). Eventually, the working class will prevail and establish a dictatorship of the proletariat.

Schumpeter, on the hand, argued that capitalism will eventually lead to creative destruction, which to some is a prophecy that capitalism will eventually crash on its own successes and excesses. However, some interpreted Schumpeter's creative destruction as the innovation that fuels the engine of capitalism, which enable the system to reinvent itself. For example, the evolution of technology has rendered some devices extinct, or near extinction (e.g., polaroid-

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²Based on the follow up summit to the United Nations' 2000 Millennium Summit, which led to the Millennium Declaration of the Millennium Development Goals.

³<http://unocha.org/humansecurity/about-human-security/human-security-all>

based cameras gave way to digital cameras, pagers were rendered obsolete by mass production of cellular phones, and black and white television sets were replaced by color, then smart TVs). Importantly, Adam Smith's "invisible hand" has ushered in the novel idea that the market can regulate itself and practice division of labor for selfish endeavors but positively impact on the society. Thus, the government should only intervene in case of market failure and when public goods are at stake.

The study of economic security is one comprehensive study in itself. In a nutshell, it deals with the allocation of scarce resources of the country to their most productive usage to provide security for the state and its citizens. Economic disciplines encompass a wide array of topics including human capital development, industrial policies, good governance to prevent rent-seeking activities, trade and international economics, as well as fiscal and monetary policies.

In the Philippines, the Bangko Sentral ng Pilipinas (BSP) is mandated to implement monetary policy to attain its fundamental mandate of maintaining price stability and a healthy banking system conducive to a balanced economic growth.⁴ This paper will cover the relationship of monetary and financial policies to national security.

Two Important Aspects of Monetary Policy's Relationship to National Security

Monetary policy is a compendium of measures or actions by a central bank to manage the supply and cost of money and credit to attain stable prices and ultimately promote economic growth. This operationalizes the fundamental mandate of the BSP as stipulated under Section 3 of the New Central Bank Act (Republic Act No. 7653), which states that "the primary objective of the Bangko Sentral is to maintain price stability conducive to a balanced and sustainable growth of the economy." Essentially, managing the supply and cost of

money is as synonymous as managing the liquidity of the financial system. Meanwhile, financial sector regulations are implemented to promote a healthy financial system. The financial system is the artery that ensures the mobilization of funds for productive usage. A systemic stress could threaten not only the stability of the financial system but this could also spill over to the entire economy, given that financial intermediation is very vital in spurring economic activity. Thus, potential pressures on price and financial stability may need to be pre-emptively addressed as they could adversely impact both human welfare and state affairs.

Price Stability

The BSP employs a menu of instruments tucked in its monetary policy toolkit. The primary monetary policy instrument of the BSP is effected through open market operations, wherein the BSP sets interest rates for its borrowing and lending operations. When the BSP wants to decrease the supply of money, it will raise interest rates, prompting banks to lend their funds to the BSP. In contrast, when the BSP wants to increase the money supply, the BSP will lower interest rates to encourage banks to borrow money from the BSP.

There are other monetary policy instruments at the BSP's disposal. Banks need to set aside a portion of their funds as reserves to readily service liquidity needs (e.g., client withdrawal). For example, if CB's reserve requirement is set at 20 percent, the bank can lend only 80 cents for every peso deposit. If the CB raises this to 40 percent, the amount the bank can lend will be reduced, thereby reducing money supply. In addition, lending facilities in the BSP that banks can tap directly could also be used as monetary policy instrument. For example, the BSP's rediscounting facility offers loans to banks with eligible papers of their borrowers as collaterals.

The rationale for liquidity management is to promote and maintain stable prices. Note that an oversupply of money in the system generates price pressures, typical in the case of too much money chasing too few goods. A good example of this is during the Japanese

⁴Other major functions of the BSP include being the lender of last resort, issuer of a currency, facilitator clearing and settlement of financial transactions, and the banker or fiscal agent of the government.

occupation when the proliferation of money-making printing presses rendered the Japanese-backed domestic currency almost worthless and they came to be known as “Mickey Mouse money.”

Financial liberalization reforms adopted over the years as well as continuing financial innovation have weakened the link between liquidity growth and inflation. Thus, the management of liquidity is a necessary but not a sufficient condition in promoting price stability. Given this, the BSP has been monitoring a larger set of economic variables in making decisions regarding the appropriate monetary policy stance including movements in key interest rates, the exchange rate, domestic credit and equity prices, indicators of demand and supply, and external economic conditions. Consistent with this policy stance, the BSP shifted to inflation targeting as a framework for conducting monetary policy. Inflation targeting focuses mainly on achieving price stability as the ultimate objective of monetary policy.⁵

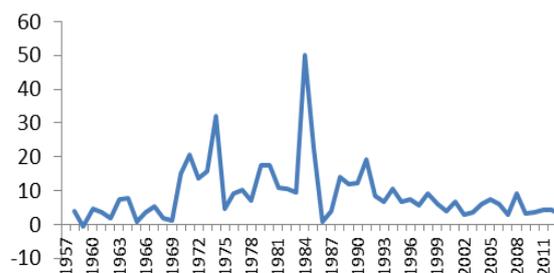
Price stability may therefore be considered a function of national security. Episodes of unstable and high prices are often associated with political instability as well. The 1923 hyperinflation experienced by Germany helped Adolf Hitler and the Nazi Party rise to prominence.⁶ More recently, the skyrocketing inflation rate in Zimbabwe, which peaked at 79.6 billion percent in mid-November 2008⁷ forced Zimbabwe President Robert Mugabe to concede on a power-sharing agreement with opposition leader Morgan Tsvangirai. The Philippines also experienced bouts of hyperinflation during the 1983-84 balance of payments crisis that coincided with the growing political unrest following the assassination of Senator Benigno Aquino on 21 August 1983. The dynamics of these two events eventually led to the 1986 EDSA peaceful revolution that unseated the 20-year reign of the late President Ferdinand Marcos.

⁵ For a more detailed discussion on inflation targeting, see <http://www.bsp.gov.ph/downloads/Publications/FAQs/targeting.pdf>

⁶ http://www.historylearningsite.co.uk/hyperinflation_weimar_germany.htm

⁷ Hanke, S. H. (2008) Zimbabwe: Hyperinflation to Growth. Harare, Zimbabwe: New Zanjab Publishing House.

Philippine Inflation Rate



It may be noted that monetary authorities could only manage inflation pressures emanating from aggregate demand. The effectiveness of their policy instruments may not reach pressures emanating from the supply side, such as price pressures arising from natural calamities, volatilities in international prices of oil and food, and changes in tax policy of the government.

The BSP remains committed to its fundamental mandate as the monetary policy stance remained consistent with the inflation objective conducive to a balanced economic growth. The full-year 2013 average inflation rate of 3.0 percent was at the low end of the Government’s inflation target range of 3-5 percent for 2013. This is the fifth consecutive year that the inflation has been kept within the Government’s target range.

Financial Stability

Although financial stability is not expressly stated as a mandate of the BSP, Section 3 of the New Central Bank Act also requires the BSP to “have supervision over the operations of banks and exercise such regulatory powers.”

The firmness, orderliness, effectiveness and sustainable functioning of the financial system stand vital to guarantee national economic security and the broader aspect/form of national security.⁸

Financial sector stability could be viewed through the system-wide health of the banking sector. Financial stability could be defined in terms of identifying the factors that create

⁸ <http://www.business-finance.org/financial-crisis/systemic-financial-risk-and-prevention-of-it-in-the-open-economic-environment.html>

financial instability. By focusing on instability, economic and financial variables could be used to gauge impending threats to financial stability. Ferguson (2002) noted that financial instability could be characterized using three main criteria, namely: (1) divergence of financial asset prices from fundamentals; (2) distortions in the credit market; and (3) deviation of aggregate spending from the economy's level of production.

Schinasi (2004) defines financial stability as a situation in which the financial system performs three functions, namely: efficiently allocating resources; assessing and pricing of financial risks; and absorbing financial and economic surprises and shocks. These functions imply that financial stability should not be seen in the narrow perspective of crisis avoidance but should also take into consideration the system's ability to optimally perform its functions under normal conditions. As such, financial system stability requires that the principal components of the financial system – i.e. financial institutions, markets and infrastructures – are jointly capable of absorbing adverse disturbances.⁹

Schinasi's definition of financial stability is consistent with the BSP's, which defines financial stability as a situation when the governance framework of the market and its financial infrastructure enable and ensure smooth functioning of the financial system conducive to sustainable and equitable economic growth.

When the financial system becomes unstable, it could severely disrupt the proper functioning of the economy, possibly leading to reduced national income, output loss, massive unemployment and higher poverty incidence. The resulting fragility in the economic environment could undermine national security.

The world experienced two major financial crises in the last two decades, namely: (1) the 1997-98 Asian financial crisis (AFC); and (2) the global financial crisis (GFC) of 2008. In a nutshell, the 1997 crisis originated in Thailand and spread globally as overvalued

currencies of crisis-hit emerging economies were proven to be unsustainable and economically unviable in the long-run. Meanwhile, the 2008 global financial crisis originated in advanced economies, particularly when the bubble in the US subprime market burst, causing global liquidity and credit crunch as well as mounting losses of financial institutions stemming from heavy leveraged exposures which necessitated governments to bail them out to prevent a total collapse of the global financial architecture (Hernandez, 2013).

Financial crises also have adverse political repercussions. Ongsingco (1999) observed that the Asian financial crisis resulted in the ouster of Indonesian President Suharto. More recently, the lingering Eurozone financial and debt turmoil has already caused the collapse of several governments in crisis-hit Eurozone countries. Greece's Prime Minister Georgios A. Papandreou, Portugal's Prime Minister José Sócrates and Italy's Prime Minister Silvio Berlusconi resigned amid a deepening and spreading debt crisis and the impending austerity measures that these countries are forced to undertake to prevent further deterioration in economic activity. More recently, Cypriot Central Bank governor Panicos Demetriades resigned in March 2014 on reports of disagreements with President Nicos Anastasiades, as Cyprus is mired in an economic crisis wrought by the collapse of the domestic banking system that necessitated an international bailout.

The BSP has been at the forefront of promoting a healthy banking system. The AFC was a learning experience that paved the way to implement and fast-track regulatory and supervisory measures. Tetangco (2014) noted that through the years, the BSP has pursued reforms toward strengthening corporate governance, enhancing transparency, expanding financial products and markets, helping develop the necessary market infrastructure, and strengthening banking regulations and guidelines. For example, Goldman Sachs (2010) noted that the appropriate policy frameworks and macroeconomic fundamentals provided emerging market economies the opportunity to accumulate reserves that enabled them to withstand the negative repercussions of the

⁹ European Central Bank. Financial Stability Review, December 2004.

global financial crunch. Guinigundo (2010) argued that the ill-effects of the global financial crisis were limited by the adoption of conservatism among Philippine banks that resulted in marginal exposure to derivatives/structured products. In addition, adequate information disclosure practices and the implementation of banking reforms translated to better risk management and consolidated supervision.

The BSP has been developing risk measurement tools to better capture and provide accurate and timely policy prescription on current and emerging risks. The BSP has developed a financial stress index using various financial sector indicators to gauge the health of the banking sector amid threats from both domestic and external shocks. The BSP also employs stress testing to assess the vulnerability of the financial system on macroeconomic shocks while the Distance-to-Default Model measures bank's default risk. Forward-looking models such as early warning indicators are also being continuously updated.

The BSP has also adopted macroprudential measures to complement the monetary policy toolkit to better respond to challenges of maintaining financial stability. Macroprudential policies are banking measures that use primarily prudential tools to limit systemic or system-wide financial risk by: (1) pursuing countercyclical policies to effectively nip financial imbalances in the bud; and (2) limiting build-up of system-wide financial risks by adopting the necessary safety valves.¹⁰

A. Pursuing Countercyclical Policies

Pursuing countercyclical policies could be construed as operationalizing Hyman Minsky's dictum that "stability brings instability," bringing about the inevitable Minsky moment. Thus, the BSP has imposed prudential limits on credit exposures. Since 1997, the BSP has issued regulations to limit banks' exposure to real estate loans to 20 percent of its total loan portfolio, exclusive

of interbank loans. In February 2008, the BSP revised the limit to exclude housing loans to individuals and loans for public infrastructure projects. For loans secured by real estate collaterals, the loan-to-value ratio is set at a maximum of 60 percent to mitigate the adverse impact of sudden and sharp decline in real estate prices, which usually spiral during periods of economic downturns. Loans to real estate have never exceeded the 20 percent threshold level.

**Real Estate, Renting & Business Services
(% to total loans)**



Source: BSP

In 2004, to prevent concentration risk, the single borrower's limit of twenty-five percent was imposed on banks. The single exposure limit is a more general version of the restriction on real estate loans.

B. Limiting Buildup of System-Wide Financial Risk

The passage of the General Banking Law of 2000 also paved the way for the BSP to adopt risk-based capital adequacy measurement of banks in conformity with international standards (Espenilla, 2005). For instance, the BSP has set the minimum capital adequacy ratio (CAR) of 10 percent, which is higher than the international standard of 8 percent. Philippine banks' CAR has consistently outperformed this benchmark. As of end-September 2013, universal and commercial banks posted a CAR of 17.5 percent on solo basis and 18.6 percent when consolidated with their subsidiary financial institutions.

Aside from reforms toward risk-based capital framework, measures toward enhancing corporate governance are continuously being updated to meet current and future challenges. For example, in December 2004, the BSP issued new regulations to strengthen

¹⁰ Hernandez (2013), "The Linkage between the Banking Sector and Political and Financial Turmoil," National Defense College of the Philippines, Camp Aguinaldo, Quezon City.

further the responsibilities of the Board of Directors of banks in ensuring that their institutions have controls in place to determine the allowance for probable losses on loans, other credit accommodations, advances and other assets consistent with the institutions' stated policies and procedures, generally accepted accounting principles (GAAP), the BSP rules and regulations and the safe and sound banking practices. In 2008, the BSP directed banks with resources above PhP500 million to appoint an independent full-time compliance officer, who shall have the rank of at least a vice president or its equivalent.

On a broader perspective, there is also a need to insulate the financial system from regulatory arbitrage. It may be noted that the financial system of the Philippines has multiple regulators: (1) the BSP for banks and quasi-banks, their financial allied subsidiaries and affiliates; non stock savings and loan associations, and pawnshops; (2) the Securities and Exchange Commission (SEC) for investment houses, financing companies, securities dealers/brokers, investment companies, and pre-need companies; and (3) the Insurance Commission (IC) for insurance and reinsurance companies, insurance brokers, and mutual benefit associations (Tetangco, 2012).

Lamberte (1989) noted that in 1972, financial intermediaries without quasi-banking functions (non-NBQBs) under the supervision of the SEC were allowed to issue commercial papers. However, these intermediaries were exempted from the then Central Bank of the Philippines' (CBP) regulations such as interest rate ceiling, reserve requirement and taxation on money market transactions. Having unregulated yields on its various instruments, they were able to attract more funds away from traditional deposits.

More recently, some have argued that shadow banking institutions deepened the severity of the GFC. Shadow banks refer to financial institutions that perform banking functions but are not regulated like banks. Roubini and Mihm (2010) noted that "shadow banks came in all shapes and sizes: nonbank mortgage lenders structured investment vehicles (SIVs), investment banks and broker dealers, money market funds, hedge funds

and private equity funds." Thus, to prevent regulatory arbitrage, financial sector regulators are now in close coordination to ensure system-wide stability of the financial sector. This is concretized in the BSP's decision to establish a Financial Stability Committee composed of various BSP departments that are directly involved in maintaining a healthy banking sector. On the macro level, the creation in 2011 of the Financial Stability Coordinating Council (FSCC) composed of the Department of Finance (DOF), IC, SEC, PDIC and the BSP signaled the domestic financial regulators' commitment to collectively identify financial risks and undertake prompt measures before these risks spillover. This is a right step that should be further enhanced to prevent such scenarios where financial regulators are held hostage by arbitrageurs whose only concern is to make profits in the short-run without regard to long-term consequences.

The BSP's major advocacy – Financial Inclusion

Kahn (2011) noted that financial stability is a function of financial inclusion. For its part, the BSP has been an ardent advocate to mainstream financial inclusion to foster greater financial security by reaching out to the marginalized and unbanked sector of the society. It formulated a financial inclusion framework that is built on three areas, namely: (1) broad access to credit at reasonable rates through responsible and proportionate regulation that encourages market innovation; (2) timely and relevant economic and financial learning activities; and (3) well-founded financial consumer protection programs.

The BSP has been proactively promoting the development of microfinance since 2000, as a flagship program for poverty alleviation. The BSP has also received international recognition for the significant strides it has made in microfinance. The Economist Intelligence Unit's global survey on microfinance has consistently ranked the Philippines as number one in the world in terms of policy and regulatory framework for microfinance. Meanwhile, the Credit Surety Fund (CSF) Program is a credit enhancement scheme developed by the BSP that provides a surety cover in lieu of acceptable collaterals

for loans of micro, small and medium enterprises (MSMEs) from banking institutions. The BSP's Economic and Financial Learning Program (EFLP) aims to promote greater awareness and understanding of essential economic and financial issues to help the public acquire knowledge and develop the skills needed to make well-informed economic and financial decisions and choices. Finally, the BSP has been fortifying its financial consumer protection efforts by creating a consumer redress mechanism within the BSP.

Conclusion

The concept of national security has evolved from a traditionalist and narrow perspective of protecting the state against external and internal threats to encompass both state and human security. It is now viewed through the lens of various dimensions that are inter-connected and whose dynamics national security is now measured. One of the important dimensions of national security is economic security. Monetary and financial policies are necessary to promote economic security. In recent years, prudent and appropriate use of monetary and financial policies has contributed to the strong macroeconomic fundamentals of the country that paved the way for higher economic growth which help fortify economic and political stability.

Furthermore, the higher economic growth translates to increasing nominal resource allotment for defense spending and the other dimensions of national security. It is therefore imperative that the stakeholders involved in promoting or protecting the country's national security be committed to excellence in performing their respective tasks.

For the part of the BSP, it should remain vigilant and guard against complacency by remaining committed to its mandate of price and financial stability while being supportive of productive activities.

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