

Tenets of Effective Monetary Policy in the Philippines



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Introduction

Tenets are defined as principles, beliefs, or doctrines generally held to be true by members of an organization or profession. Both theory and practice of modern central banking point towards some basic guiding principles for effective monetary policy formulation. This study aims to encapsulate the principles critical in the development and review of monetary policy in the Philippines. It then discusses how each of the tenets is applied in practice by the Bangko Sentral ng Pilipinas (BSP).

Price stability is a universal goal shared by monetary authorities all over the world. If inflation is low and stable, it is said that there is price stability. Since January 2002, the BSP has used inflation targeting (IT) as its framework for monetary policy formulation, joining a long list of countries—both industrialized and developing—which were able to move successfully from a regime of high inflation to low inflation following the implementation of IT in their countries.

Tenet 1: Price stability is the primary objective of monetary policy

Good monetary policy assigns to price stability the highest weight in the central bank's objective function, making clear that price stability outweighs other goals (e.g., exchange rate stability and promotion of high employment) when there is perceived or actual conflict among various policy objectives. McCauley (2006) stresses that multiple policy objectives can overburden monetary policy at the risk of incoherence and loss of credibility. A central bank, after all, cannot consistently pursue and achieve multiple goals with only one policy instrument (i.e., the short-term interest rate). Faced with rapidly rising prices, a central bank would have to reduce the money supply or raise interest rates to maintain internal stability. While such policy action can increase unemployment and fuel financial market volatility in the short run, the trade-off between price stability and the other potential monetary policy goals also diminishes over time. This is because price stability provides economic agents with some degree of confidence when making consumption and investment plans, contributing to the efficient allocation of economic resources and promoting long-term economic growth. At the same time, the cost of disinflation decreases as the central bank builds its credibility for fulfilling its pronouncements.

The “impossible trinity” also implies that price and exchange rate stability cannot be jointly targeted under an open capital account. The active use of monetary policy in pursuit of domestic price stability implies that the exchange rate must be allowed to float freely or run the risk of undermining the central bank’s commitment to low inflation. While the main idea of the “impossible trinity” continues to hold a powerful sway over the standard analysis of policy trade-offs between monetary policy independence and exchange rate movements amid capital flows, evidence from capital flow-recipient emerging economies shows that a careful balance among the three policy variables is achievable.

At the core of the “impossible trinity”, according to Grenville (2011), is the notion that monetary policy is implemented largely through base money changes. Official foreign exchange intervention is seen to be fully reflected in the base money which, in turn, limits the central bank’s ability to set interest rates. However, modern monetary policy is implemented by setting the policy interest rate directly via announcement. The announcement is supported by liquidity management in the financial system through open-market operations, which also underpin the capacity to sterilize foreign exchange intervention. Thus, a central bank’s ability to set interest rates need not be thwarted by official foreign exchange intervention if it has the instruments to sterilize its foreign exchange operations.

More importantly, the complete disregard of exchange rate movements could prove costlier in economies with severe currency misalignments.¹ Strong capital inflows for instance could lead to a large and abrupt appreciation of the local currency above its equilibrium level, resulting in economic dislocations and financial market imbalances, particularly in situations of limited inter-sectoral factor mobility and underdeveloped financial markets. Thus, there appears to be some scope for foreign exchange intervention to help ensure that the exchange rate does not move too far away from its equilibrium level even under an inflation targeting regime. Ostry, Ghosh and Chamon (2012) note that as long as monetary authorities have an additional policy instrument (i.e., sterilized intervention), a central bank need not undermine its inflation commitment when smoothing out foreign exchange movements. However, Ostry et al. also stress that central banks pursuing foreign exchange operations should emphasize clearly that interest rate adjustments are used to achieve the inflation target, while sterilized intervention are aimed at limiting exchange rate movements away from the equilibrium level.

In most of emerging Asia over the recent years, most countries, including the Philippines, have been able to maintain open capital markets, monetary policy autonomy, and a fair degree of control over their exchange rates.² In particular, the BSP was able to build its reputation as a credible inflation fighter despite occasional intervention in the foreign exchange market to ensure that the nominal exchange rate remains fairly in line with its long-term equilibrium. The BSP has adhered to a policy of limiting sharp fluctuations in the exchange rate to the extent that persistent exchange rate movements are seen to potentially compromise the inflation objective as well as result in damaging economic dislocations. This has resulted in the continued build-up of the BSP’s international reserves along with large carrying costs associated

¹ Ostry et al. (2012)

² See Grenville (2011)

with holding foreign-denominated assets amid rising sterilization costs. This has exposed the BSP to financial losses³ which if sustained could compromise the BSP's ability to use its policy instruments to pursue its policy objectives.

The passing of the New Central Bank Act in 1993 established the BSP as an independent monetary authority with the primary objective of promoting and preserving price stability conducive to sustainable economic growth. The BSP, like many independent central banks, does not have goal independence as the inflation objective is determined jointly with the national government. However, the Act also conferred on the BSP both fiscal and instrument independence. Fiscal independence effectively insulates the BSP from short-sighted political considerations, including the need to finance government deficits to support a chosen growth path. In addition, the BSP was prohibited by law from engaging in development financing while also setting a limit on the advances that can be provided by the BSP to the national government. The BSP was also divested of its fiscal agency functions which were transferred to the Department of Finance. Meanwhile, instrument independence implies that the BSP can calibrate its various policy instruments to maintain overall macroeconomic stability (price and financial stability) without outside interference.

Tenet 2: Effective monetary policy requires a credible nominal anchor

A nominal anchor for monetary policy is a variable or device which the central bank uses to stabilize expectations of economic agents about the nominal price level or its path. It can also reveal the central bank's policy intention to bring and maintain price levels towards the central bank's definition of price stability, thus improving the predictability of monetary policy. Khan (2003), however, notes that the credibility of an anchor depends largely on the central bank renouncing all other anchors.

Traditional nominal anchors for monetary policy have included monetary aggregates and exchange rates. However, more and more countries have abandoned these traditional nominal anchors in the 1990s in favor of inflation targets as financial liberalization resulted in the weakening relationship between money and prices, while exchange rate misalignments led to the problem of exchange rate crises. By contrast, inflation targets convey to the public a precise and easily-understood goal for monetary policy that the public can use to anchor their expectations. For example, a publicly-announced inflation target of 3.0-5.0 percent for a particular year sends a clearer policy signal than a pronouncement that states that monetary authorities are committed to maintaining price stability over the long run.

The BSP's annual inflation target is defined in terms of the average year-on-year change in the consumer price index (CPI) over the calendar year. The BSP has announced a fixed medium-term target of 4.0 percent \pm 1.0 percentage point for 2012-2014 to help promote a long-term view on inflation and increase the predictability of monetary policy. For 2015-2016, the BSP set the inflation target to 3.0 percent \pm 1.0 percentage point consistent with

³ The BSP has reported continued financial losses since 2010.

the desired disinflation path over the medium term, favorable trends in the structure of Philippine inflation, and the expected higher growth capacity of the economy under a low inflation environment.

By specifying a numerical definition of price stability and a time frame for achieving it, the public can readily monitor whether the BSP has achieved its inflation target or not, and adjust their inflation expectations accordingly. Whenever the target is not met, the public can also judge whether this was due to justifiable reasons (e.g., supply shocks, higher taxes, etc.) or to policy mismanagement. A commitment to a particular inflation target implies that the BSP is ready to utilize its policy toolkit to keep inflation in line with the announced target.

Tenet 3: Transparency in the conduct of monetary policy and careful communication of central bank intentions help anchor inflation expectations and enhance central bank accountability

The thinking among central banks has shifted over the past decade towards greater transparency and the need to carefully communicate central bank objectives, strategy, and decisions. Transparency can be defined as an environment in which the central bank provides in an open, clear, and timely manner all relevant information on its mandate, strategy, assessments, and policy decisions.⁴ It allows the central bank to build credibility in pursuing its mandate and, in the process, helping ensure that inflation expectations are firmly anchored. It also enhances discipline and accountability in policy formulation as well as predictability of central bank policy actions. Central bank communication has to be clear and well targeted, i.e., devoid of unnecessary “noise” or signals that could be misinterpreted to mean differently, to help shape inflation expectations of economic agents effectively.

By adopting IT and announcing the inflation target, the BSP submitted itself to the judgment of the general public, and faces loss of credibility whenever it fails to meet the inflation target. The BSP’s disclosure and transparency mechanisms allow the public to monitor the BSP’s performance in achieving its inflation target and to assess whether deviations from the target are due to an oversight by the BSP or to factors outside the purview of monetary policy. Documents released regularly by the BSP include the statement on monetary policy decisions (after the policy meeting), highlights of the Monetary Board policy meeting (one month after the meeting), and the quarterly Inflation Report (a month after last month of review quarter), which provides the details and analyses behind the policy actions of the BSP. Key BSP officials appear in budget hearings to provide testimonies on the state of the economy as well as various forums and public conference to speak about the BSP’s policy actions and directions. More importantly, the BSP Governor issues an Open Letter to the President and to the public in cases where the BSP fails to achieve the inflation target, outlining the reasons why actual inflation did not fall within the target, along with the steps that will be taken to bring inflation towards the target.

⁴ Definition by Oesterreichische Nationalbank (OeNB), retrieved from <http://www.oenb.at>.

Tenet 4: Monetary policy should be forward-looking and preemptive

Monetary policy takes effect after a long and varying time lag. Because of these lags, monetary authorities need to be preemptive and set their policy in response to deviations of projected inflation or output levels from their respective targets. In the Philippines, the monetary policy lag has been estimated at 12-15 months based on the interest rate channel of monetary policy. A transmission lag of one to two years typically corresponds to a central bank's policy horizon (Geraats, 2006).

Fry (2000) notes that it is impossible to achieve desired results by implementing discretionary monetary policy because of monetary policy lags. This argument favors the adoption of rules-based monetary policy frameworks such as inflation targeting and money growth rule (for economies that still have a stable relationship between money and prices). This also addresses the time-inconsistency problem where authorities can attempt to deviate from a long-run target outcome (e.g., an inflation target) to achieve a higher growth path in the short run.

Forward-looking policy formulation also necessitates the use of as much information as is available to get a comprehensive picture of where the economy is heading pending actual data releases. State-of-the-art statistical models, meanwhile, provide authorities with reliable forecasts on the future path of variables of interest, such as inflation and output. Using a suite of econometric models, the BSP projects the inflation path over a three-year forecast horizon. The lengthening of the forecast horizon beyond the usual two years is expected to enable the BSP to take into consideration the longer-run consequences of large movements in asset prices and levels of indebtedness on inflation and output that have been built up over long periods of time (Ingves, 2007). This practice is consistent with the flexible IT approach, and various IT central banks, including the Bank of England, Norges Bank (Norway), and the Riksbank (Sweden) have already done the same.

Tenet 5: Good forecasting tools are critical in the conduct of a forward-looking monetary policy

The inflation forecast is a key element of any monetary policy framework that endeavors to be forward-looking. Policymakers usually employ a suite of models, ranging from large-scale micro-founded macroeconomic models to reduced-form equations, to produce inflation forecasts and policy simulations. They can also look at private forecasts and high-frequency financial markets data (e.g., term structures of interest rates) to get an alternative reading of the inflation expectations of economic agents. In addition, policymakers can use business cycle models and other economic leading indicators to get an idea of where the economy is heading.

In forecasting, central banks can fall into the trap of what Haldane (2009) calls disaster myopia.⁵ He argues that in the context of risk management, models rely too heavily on recent data samples, potentially underestimating tail risks. Thus, forecasters must use a sufficiently long time series to help them better understand how risks might evolve in the future. However, they

⁵ Haldane (2009) likened this myopia to a driver slowing down after seeing a crash but soon speeding up again.

should also keep a close watch over potential structural breaks that could affect their analysis. The challenge is to learn from the past and “see beyond risk.” Good forecasts are not merely based on sophisticated econometric methods, but are also honed by expert judgment based on a thorough understanding of economic institutions and the transmission mechanisms. The BSP adheres to the “thick” economic modeling philosophy by maintaining a suite of models for forecasting and policy simulation. This approach recognizes that there is no single superior model that can accurately forecast the path of inflation over the policy horizon nor address all policy issues confronting policymakers. The BSP also periodically reviews its existing suite of econometric models to further improve its forecasting performance as well as develop new tools to keep up with new developments in modern monetary economics. A dynamic stochastic general equilibrium (DSGE) model was developed to complement the Bank’s existing workhorse models (i.e., BSP Single Equation Model and Multiple Equation Model). At the same time, conversion of the BSP Long-Term Macroeconomic Model (LTMM) to a quarterly medium-term macroeconomic model is ongoing. The IMF technical consultation on the development of a semi-structural forecasting and policy analysis system (FPAS) for the Philippines has also been completed in 2012.

Tenet 6: Gradualism is crucial in the conduct of prudent monetary policy

Gradualism in the conduct of monetary policy implies that a central bank should adjust policy rate settings in a calibrated manner given various uncertainties in its policy environment. Due to structural changes in the economy, the central bank could face a lack of information concerning the monetary transmission mechanism and the parameters linking the macroeconomic aggregates of importance to monetary authorities. It also faces uncertainty in the accuracy of the economic data utilized in policy formulation. Thus, Castelnovo (2003) notes that prudent, i.e., gradualist, monetary actions can help mitigate the “uncertainty cost” or the volatility induced in the economy by a misinterpretation by monetary authorities of economic trends or of the monetary transmission mechanism itself. Gradualism is particularly important given the tendency to put a larger premium on recent observations in policy assessment and formulation. At the same time, gradualism can help minimize interest rate volatility. Substantial jumps in the central bank’s policy interest rate can precipitate large and sudden changes in the market interest rates which could be damaging to the macroeconomy. By contrast, a smoother interest rate path can enhance financial market stability.

On a related point, monetary policy should be based on the principle of dynamic programming. Each policy move must be viewed as part of a sequence of actions over time aimed at achieving a desired level of future inflation or monetary aggregate. To minimize disruptions in the financial markets, the central bank does not implement drastic policy rate changes to meet its inflation target. Instead, monetary authorities normally implement a series of small rate cuts or hikes (e.g., 25 basis points each) with a given cumulative policy rate change in mind. Thus, policy rate changes could be viewed as part of a packet of measures towards a particular goal. To illustrate, the series of policy rate reductions, along with the various liquidity-enhancing measures introduced by the BSP during the 2008 financial crisis, were

implemented with a view of providing sufficient liquidity to keep the financial markets functioning smoothly and to fund the growth requirements of the economy amid the global credit crunch.

Tenet 7: The central bank should be flexible in the conduct of inflation targeting

The concept of flexible inflation targeting (FIT) implies that monetary policy aims to stabilize inflation around the inflation target and the long-term growth path of the economy, whereas strict inflation targeting seeks to stabilize inflation without regard to output volatility and other considerations (Svensson, 2009). FIT implies that monetary authorities must accept some inflation variability in order to dampen excessive volatility in growth or unemployment, while also ensuring that inflation is brought back on track over the medium term.⁶ Flexible inflation targeting can also be described as “forecast targeting.”⁷ The central bank chooses an interest rate path over the policy horizon that corresponds to a “reasonable” forecast path of both inflation and resource utilization, characterized by inflation approaching the inflation target at an appropriate pace as resource utilization approaches its long-term level.

As with many IT central banks in developed and emerging economies, the practice of inflation targeting in the Philippines has been flexible. The BSP has not been focused on the inflation objective alone. Due attention was given to the short-term consequences of variability in output growth. For instance, the BSP opted to maintain its policy settings in 2004 in the face of supply-side shocks and, instead, actively supported the use of non-monetary intervention measures to address more directly the supply-side inflation risks, particularly in the case of food prices. The BSP chose not to respond to the supply-side shocks because the inflation pressures were outside the purview of monetary action and an increase in policy rates would have had a limited impact in containing price pressures while adversely affecting the overall strength of economic activity during a time of considerable economic uncertainty.

The BSP's policy of limiting its participation in the foreign exchange market to tempering sharp fluctuations in the exchange rate is likewise consistent with the flexible approach to inflation targeting. The BSP's mandate is clearly to pursue price stability. However, amid the strong foreign exchange inflows to the country in recent years, the BSP has conducted foreign exchange operations along with the corresponding sterilization measures to help limit the excessive fluctuations in the exchange rate that could create large disruptions in economic activity. The said foreign exchange operations have led to the rapid build-up of the country's international reserves as well as financial losses for the BSP. The Philippines' gross international reserves have increased by 254 percent from US\$23.7 billion as of end-January 2007 to US\$83.8 billion as of end-December 2012. The end-2012 GIR was sufficient to cover about a year's worth of imports of goods and payments of services and income while the corresponding reserve adequacy ratios were 10.5 times the country's short-term external debt based on original maturity and 6.6 times based on residual maturity. At said levels, the import cover and reserve adequacy ratios of the Philippines are much higher compared to levels dictated by standard rules of thumb on international reserves. Meanwhile, based on preliminary

⁶ Roger & Stone (2005)

⁷ Svensson (2009)

and unaudited data, the net losses of the BSP rose further to P86.3 billion for January-November 2012, as compared to the P32.3 billion net loss incurred during the same period in 2011.

It is also worth emphasizing that while the BSP uses a Taylor rule as one of its guide posts in policy formulation, it does not blindly adhere to this policy rule but takes a more comprehensive look at all data available, providing authorities more discretion in its policy decisions. The BSP is well aware of unobservable quantities that are subject to considerable measurement errors in the Taylor rule.⁸ In view of this limitation, prescriptions from the Taylor rule are taken to be a rough guide to policy. It is not construed as a rigid, mechanical rule to govern monetary decision-making, nor as a substitute for well-informed economic analysis.

Tenet 8: Price stability is linked to financial stability

The 2008 global financial crisis has taught policymakers that price stability is a necessary but not sufficient condition to achieve financial stability. The global inflation environment had been favorable prior to 2007, with both inflation and output gaps generally stable, yet significant financial imbalances developed which triggered major macroeconomic adjustments later on.

It should be reiterated that the BSP has not been dogmatic in its practice of IT and does not slavishly adhere to a policy rule. It is cognizant that keeping inflation low and stable is not the only way to secure optimal economic performance.

The BSP is also mindful of the risk-taking channel of monetary policy. This channel is linked to the notion that financial institutions tend to take on more risks in a low interest rate regime. Asset prices are important in the BSP's pursuit of price stability for a variety of reasons. The information content of asset prices is vital to the monetary policymaking process because the build-up of asset market imbalances contributes to financial stability risks that can harm economic activity and therefore affect the outlook for inflation. The global financial debacle had a significant adverse wealth effect in advanced economies which impaired the propensity of firms and households to spend, save, and invest with potential negative effects on resource allocation at longer horizons. At the same time, vulnerabilities in the financial sector can have adverse effects on the traditional transmission channels of monetary policy, complicating and potentially reducing the effectiveness of monetary policy.⁹

The BSP monitors closely developments in the various asset markets in the Philippines and guards against the formation of destabilizing asset price bubbles (APB). Monetary authorities are attentive and alert to excessive credit growth, severe asset price misalignments relative to their long-term averages, and other indicators of financial instability as embodied in the FIT framework. The BSP is cognizant of the very high information requirements in establishing the presence of asset price bubbles. This difficulty, along with the potential broad-based impact of policy rate changes, has led to the

⁸ These include the long-run equilibrium rate of interest (the "neutral real rate"), the output gap (since the latter is based on the concept of potential output), and the expected inflation rate.

⁹ Opening Remarks by Dominique Strauss-Kahn, Managing Director, International Monetary Fund, given at the 10th Jacques Polak Annual Research Conference, 5-6 November 2009

view that other instruments such as supervisory and regulatory measures are more appropriate and more effective in preventing the build-up of asset market imbalances. The best approach to preventing destabilizing asset price bubbles in the Philippines is likely to involve a portfolio of instruments with macroprudential regulations as the first line of defense against damaging financial excesses. It is also important to emphasize that macroprudential measures, because they can be narrowly targeted at specific sectors, can lessen the collateral damage to non-bubble sectors of the economy.

The relative absence of significant APB episodes implies that the BSP's prudent stance in responding to asset price movements remains sensible. The BSP's flexible approach to IT allows it to "lean against the wind" by using financial indicators and various asset prices. If asset prices are rising too rapidly along with bank lending growth while consumer price inflation remains manageable, the BSP can try to prevent the formation of asset price bubbles by raising interest rates earlier than expected. While macroprudential regulation serves as the first line of defense against APBs, the BSP will not hesitate to adjust its policy interest rates if conditions indicating a potential overheating emerge. Monetary policy action will likely be too slow as a tool to address the imbalance once asset bubbles have clearly emerged. Increasing policy interest rates too late in the cycle runs the risk of causing damage to the financial sector and the economy as a whole by dealing with the bubble too late.

Going forward, the rapid rise in cross-border capital flows to emerging market economies, including the Philippines, presents additional challenges to macroeconomic management. The BSP is mindful of the risks of strong and sudden surges in capital inflows. Large capital inflows can complicate monetary policy formulation through increased pressures for real exchange rate appreciation or for money supply to expand significantly, generating potential inflation pressures going forward. At the same time, the rapid build-up in the country's international reserves, resulting from the BSP's foreign exchange operations, and the corresponding sterilization measures have resulted in financial losses for the BSP. Sustained financial losses could compromise the BSP's ability to pursue its policy objectives as well as result in a loss of credibility. The influx of hot money can also push up asset prices, thereby creating asset price inflation. There is also a risk that the flow of capital could reverse abruptly, leading to sudden stops that would be costly in terms of economic efficiency and the BSP's financial and price stability objectives.

In determining the appropriate policy responses, it is important to first determine the nature of the foreign exchange flows. In the case of the Philippines, a large portion of FX inflows are being driven by current account receipts (remittances, export receipts and BPO proceeds), which are structurally driven. Some appreciation of the peso therefore may be warranted. However, a careful balance must be achieved against the potential economic dislocations that could be produced should the peso be allowed to appreciate too strongly.

The BSP's pragmatic approach to dealing with capital flow surges involves a combination of policies grounded in the principle of flexible IT. This menu of instruments ensures that the BSP is not dependent on a single instrument, minimizing the policy dilemma that would have resulted if interest rate

action were the only tool available to stem the capital inflows. Specifically, the BSP's policy toolkit includes: greater exchange rate flexibility; reserve accumulation and associated liquidity management operations; foreign exchange liberalization; macroprudential tools; and calibrations in monetary policy, when necessary. At the same time, the BSP has undertaken some fine-tuning of its policy instruments to improve the effectiveness of its policy toolkit in promoting price and financial stability. In July 2012, the BSP sought to discourage funds from foreign sources from being placed in its Special Deposit Account (SDA) facility. This avoids the situation where BSP instruments for open market operations (OMO) become the magnet for additional capital inflows. The spread of the SDA rates over the RRP rate was also reduced to fine-tune the pricing of the instrument consistent with the decline in global interest rates. In Q1 2013, the BSP likewise decided to rationalize the BSP's SDA facility and set the interest rates on the SDA facility to 2.50 percent across all tenors. Benign inflation forecasts amid manageable liquidity growth and improving growth prospects provided the present flexibility to fine-tune the SDA facility.

While capital controls in principle may be included in the array of instruments available to the BSP to mitigate the impact of strong capital inflows, the BSP is of the view that the imposition of said controls may entail more costs than benefits for the economy. The imposition of strict capital controls hampers the efficient allocation of capital across countries. At the same time, the imposition of controls would send negative signals to investors and adversely affect the country's access to international capital markets and ability to attract foreign investments. It is also worth noting that the empirical evidence on the effectiveness of capital flow measures has been mixed. Where these measures had some success in addressing the risks associated with inflow surges, their effect is usually not long-lasting.¹⁰ At the same time, administrative difficulties and enforceability of said restrictions are crucial to their effectiveness. A tax on cross-border transactions, if it is to be implemented, should be universally applied to prevent tax arbitrage opportunities. Some difficulties in implementing the tax could also arise over time due to advances in technology and the growing sophistication of financial instruments, which allow investors to eventually circumvent controls and/or taxation. Finally, the imposition of capital controls in one jurisdiction may lead to adverse multilateral effects. The capital inflows that a country may be able to successfully turn away may be merely diverted to its "peer" countries, prompting the introduction of capital controls in these economies as well.

Tenet 9: Sufficient focus should be placed on monetary aggregates

The observed weakening in many countries of the relationship between money and prices (and output on the other hand) due to continued financial liberalization and innovation has also led a large number of central banks to switch to inflation targeting as an alternative monetary policy framework from the traditional monetary aggregate targeting approach. At present, the European Central Bank (ECB) is the only institution, among major central

¹⁰ Habermeier (2011)

banks, to assign a prominent role to money under its two-pillar strategy.

The importance of money in monetary policy formulation has been rediscovered of late. The 2008 global financial crisis has reminded central banks that inflation is and always will be a monetary phenomenon. The ECB's second pillar under its two-pillar strategy provides a longer-term perspective to the analysis of inflation risks. This is because the relationship between money growth and inflation is viewed as a long-run phenomenon. Leading indicator properties of monetary and credit developments for potential financial market imbalances likewise underscore the importance of monitoring closely liquidity conditions.

The BSP employed the monetary aggregate targeting approach to monetary policy prior to 2002. However, financial liberalization and financial innovation over the years had weakened this relationship, compelling the BSP to adopt the inflation targeting approach. Consistent with the flexible approach to inflation targeting, the BSP still gives due attention to monetary and credit aggregates in its regular assessment of the monetary policy stance. The BSP ensures that liquidity conditions are consistent with the funding requirements of the economy in line with its price and financial stability objectives. At the same time, the BSP looks at various asset and financial market indicators and compares these with domestic liquidity and credit conditions in determining the possibility of an asset bubble.

Tenet 10: Monetary policy should be complemented by other macroeconomic stabilization tools

Monetary policy alone cannot achieve the broad goals of economic stabilization. To achieve a cohesive program that will promote economic stability, monetary policy must be complemented by prudent fiscal policy (management of government spending and taxation) and an effective financial regulatory mechanism. Moreover, policy coordination has to be supported by institutional and operational arrangements.

The economic downturn resulting from the recent global financial crisis has brought to light the importance of policy coordination in promoting macroeconomic stability. The close coordination of monetary, regulatory, and fiscal policies in many jurisdictions paved the way for business confidence to improve and, ultimately, for economic recovery to take root.

At present, the BSP is responsible for both monetary policy and regulation over the banking sector. This ensures coordination in addressing misalignments in the banking sector that will adversely impact the overall economy. Meanwhile, the representation of the BSP in the Development Budget Coordination Committee (DBCC) helps guarantee the coordination of monetary and fiscal policies.¹¹ Another possible venue for promoting overall coordination of macroeconomic and financial sector policies in the Philippines is the inclusion in the Financial Stability Forum (FSF) of a representative from the

¹¹ The DBCC is an inter-agency body responsible for setting the annual government targets for macroeconomic variables, particularly the Gross National Income (GNI) and Gross Domestic Product (GDP) growth rates and inflation, which are important inputs in the formulation of the revenue, expenditure and financing programs of the NG. The NG, through the DBCC, sets the inflation target two years ahead in consultation with the BSP. The setting of the inflation target through the DBCC ensures that the inflation target is consistent with targets for GDP growth and budget deficit over the medium term.

BSP's monetary stability sector.¹² Given the importance of the country's fiscal balance on financial market conditions, the inclusion of a representative from the NG in the FSF could also be explored. It should be noted that closer monitoring of contingent liabilities, including those resulting from public-private partnership (PPP) guarantees, is key to enhancing the management of fiscal risks.¹³

Summary

The BSP has made significant gains in establishing the necessary regime for price stability in the 10 years that IT has been adopted in the Philippines. While this period is relatively short to assess the economic impact of IT, the BSP's experience to date is quite encouraging. Average inflation (2006-based) has declined from 6.9 percent in the seven years before IT was adopted (1995-2001) to 4.4 percent from 2002-2012. During the same period, the coefficient of variation, meanwhile, increased slightly to 0.4 from 0.2 due largely to supply-side shocks—related to food and oil prices—that are outside the control of monetary policy. Nonetheless, the BSP was able to build its reputation as a credible inflation fighter largely through its various disclosure and transparency practices. The BSP has been able to promote better public understanding of the monetary policy process under the IT framework, helping anchor the public's inflation expectations. In addition, increased public understanding has allowed the BSP to employ greater sophistication in communicating its policy stance, further increasing the effectiveness of its communication strategy. Going forward, the BSP will continue to exercise vigilance to maintain price and financial stability amid the challenges brought on by strong foreign exchange inflows and the present need to support sustained growth in the domestic economy.

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¹² The main purpose of the FSF is to harmonize policies across its four original member agencies (BSP, Securities and Exchange Commission, Philippine Deposit Insurance Corporation, and Insurance Commission) in promoting financial stability.

¹³ Hence, government-owned and -controlled corporations (GOCCs) will have to watch their bottomlines since GOCC financial positions are also included in the consolidated fiscal position of the government.

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