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# Coping with Surges in Capital Flows: The Philippine Case

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### *Introduction*

The Philippines saw a resurgence in capital flows in the latter part of 2010. Two things are behind this occurrence: (i) the Philippines' strength of recovery in 2010 and its upbeat growth prospects for 2011, owing to strong macroeconomic fundamentals, a sound banking system and favorable external payments dynamics; and (ii) the uneven pace of economic rebound between advanced countries and emerging market economies (EMEs), implying substantial differences in interest rates and currency strength. As the global recovery further gains traction, investors in search of higher yields turn to EMEs, including the Philippines, which have better growth prospects than advanced countries.

The resurgence of capital flows to EMEs underscores the still-relevant issue of the policy trilemma, which states that a country can only choose simultaneously two but not all three of the ideal economic features, namely, financial integration, independent monetary policy and a stable exchange rate. However, according to Aizenman (2011), countries rarely face the binary choices articulated in the trilemma (e.g., pure float vis-à-vis pure fixed exchange rate, or total financial integration or no integration at all). In practice, countries today adjust the degree of financial integration and the flexibility of exchange rate. Moreover, monetary authorities are usually de facto financial regulators as well. Their role in financial stability widens the choice of instruments that can be employed in response to capital surges.

### *Recent trends and implications*

Surges in foreign exchange inflows are no longer new to the country. Post-Asian crisis data show that, within the 2000-2010 period, FDIs and portfolio investments peaked in 2006 at US$2.9 billion and US$4.6 billion, respectively, before declining in 2008, at the height of the global financial crisis, when portfolio investment recorded a net outflow of US$4.4 billion. In 2010, portfolio investments swelled once more to US$7.5 billion. Providing stability to foreign exchange flows are exports (specifically, proceeds from business process outsourcing) and remittances, which have grown steadily over the years and have remained resilient despite the global slowdown following 2008. These inflows, which make up a large part of the current account, are structurally driven and are less susceptible to external shocks such as sudden stops and capital flow reversals.

Sources of Foreign Exchange Flows (In US$ Million)

| | 2000 | 2001 | 2002 | 2003 | 2004 | 2005 | 2006 | 2007 | 2008 | 2009 | 2010 |
|---|---|---|---|---|---|---|---|---|---|---|---|
| Foreign Direct Investment (net) | 2,240 | 195 | 1,542 | 491 | 688 | 1,854 | 2,921 | 2,916 | 1,544 | 1,963 | 1,713 |
| Foreign Porfolio Investment (net) | 259 | 1,084 | 1,374 | 1,380 | -803 | 3,621 | 4,610 | 3,789 | -4,416 | 2,090 | 7,460 |
| Exports of Goods & Services | 40,724 | 34,385 | 37,831 | 38,728 | 42,837 | 44,788 | 52,970 | 59,278 | 57,970 | 48,624 | 63,927 |
| Remittances | 6,050 | 6,031 | 6,886 | 7,579 | 8,551 | 10,689 | 12,761 | 14,450 | 16,428 | 17,348 | 18,764 |

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Nevertheless, sudden and prolonged surges in foreign exchange flows can threaten the conduct of monetary policy. Moreover, if these capital flows are not managed actively and appropriately, they can have negative implications such as real exchange rate misalignments, credit and asset price booms, inflationary pressures, overheating, and financial imbalances that can develop into a full-blown financial crisis.

***Coping with capital flow surges: BSP responses***

Capital flows can be classified as cyclical or structurally-driven. Capital flows that are cyclical in nature are generally reflective of global liquidity and investors' appetite for risk-taking. These flows are likely to be transitory and highly susceptible to reversals. Meanwhile, capital flows that are structurally-driven tend to be sustained over the long term, albeit with some periods of heightened volatility.

In dealing with surges in capital flows, a central bank needs to establish at the onset the sustainability, reversibility and volatility of these flows. The primary objective is to minimize the volatility in the domestic financial market and work towards managing the economy in a way that will encourage long-term capital flows.

To cope with capital flow surges, the BSP employs a menu of options that generally involves the combination of regulatory reforms and pragmatic approach to monetary policy.

- *Improved monitoring and understanding of foreign exchange (FX) inflows.* In determining appropriate responses, it is important to first determine the nature of FX flows, i.e., whether they are permanent or transitory. For a permanent increase in inflows, central banks would generally need to allow their currencies to appreciate to reflect the fundamental factors driving these inflows. At the same time, the greater exchange rate flexibility should be complemented by further reforms in the financial markets. For transitory flows, central banks can engage in reserve accumulation and sterilization to mop up any resulting excess liquidity in the financial system.

- *Exchange rate flexibility*: The BSP monitors possible misalignments in the peso by looking at the movement of the real effective exchange rate (REER) to determine if there is a high and persistent deviation from its long-term average trend and whether such movements are supported by economic fundamentals. Consistent with its market-determined exchange rate framework, the BSP allows the value of the peso to be determined by the supply and demand of foreign exchange. However, in cases of excessive movements in the exchange rate, the BSP participates in the market mainly to maintain order and stability.

- *Reserve accumulation*. The BSP takes advantage of strong foreign exchange inflows by building up its international reserves to create buffers against external shocks. As of March 2011, the gross international reserves of the BSP reached US$66.0 billion, which can cover 10.1 months' worth of imports of goods and payments of services and income. In terms of debt adequacy, this level is equivalent to 10.5 times the country's short-term external debt based on original maturity and 5.9 times based on residual maturity.

- *Macroprudential tools*. The BSP has put in place several macroprudential tools to limit banks' ability to fuel credit booms and engage in excessive leverage, such as, limits to real estate loans exposure, provisions for loan losses, requirements on banks' capital adequacy and regulations on derivatives activities. Most of these regulatory restrictions and requirements are in response to the Asian financial crisis in 1997. These prudent regulatory practices have helped curb the formation of potential bubbles in the equities and properties market during the 2007 episode of foreign exchange surges.

- *Enhanced monitoring and analysis of external borrowings*. In addition to evaluating foreign borrowing proposals from both the public and private sectors, the BSP also gathers annual borrowing plans which are used as inputs for policy setting, as well as for projecting and assessing FX flows. Starting this year, the BSP will also use a new debt monitoring system developed by the United Nations Conference on Trade and Development which is expected to further improve the BSP analytical capabilities.

- *Liquidity management*. The BSP implemented new measures on 10 May 2007 to help prevent potential inflationary pressures in the face of sustained foreign exchange inflows during that time. These liquidity management measures include: (i) encouraging the Government Service Insurance System, the Social Security System and other government-owned and controlled corporations to deposit funds with the BSP; (ii) allowing trust entities under BSP supervision to deposit funds with the BSP; and (iii) allowing special deposit account (SDA) placements of banks to be considered as alternative compliance with the liquidity floor requirements for government deposits.

  Growth in domestic liquidity has thus remained non-inflationary. After recording a 23-percent expansion in 2006, liquidity growth decelerated in 2007 to 11 percent, partly reflecting the impact of the measures implemented by the BSP to siphon off liquidity.

**Domestic Liquidity**

| | 2002 | 2003 | 2004 | 2005 | 2006 | 2007 | 2008 | 2009 | 2010 |
|---|---|---|---|---|---|---|---|---|---|
| Growth rate | 9.5 | 4.2 | 10.3 | 10.3 | 22.7 | 10.6 | 15.6 | 8.3 | 10.6 |
| Share to GDP | 46.6 | 44.6 | 43.5 | 43.0 | 47.6 | 47.8 | 49.4 | 51.8 | 51.6 |

- *Foreign exchange regulatory reforms.* The BSP approved a set of reforms in its foreign exchange regulatory framework to make the regulatory environment more responsive to the needs of an expanding and more dynamic economy that has become increasingly integrated with global markets.

| [illegible] | [illegible] | [illegible] | [illegible] |
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| 1. [illegible] | [illegible] | [illegible] | [illegible] |
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| 3. [illegible] | [illegible] | | |
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| 7. [illegible] | | [illegible] | [illegible] |
| 8. [illegible] | | | [illegible] |
| 9. [illegible] | | [illegible] | |
| 10. [illegible] | | [illegible] | |
| 11. [illegible] | | [illegible] | |
| 12. [illegible] | | | [illegible] |

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In liberalizing the outward flows of foreign exchange, the BSP believes that the burden of sterilizing net inflows will be reduced. Moreover, it is expected to facilitate greater portfolio diversification. The further liberalization of foreign exchange transactions is also expected to help alleviate upward pressures on the peso in the short term and allow freer and more efficient capital flows in the long term.

- *Capital market deepening*. The BSP supports initiatives related to the development of domestic and regional bond markets, particularly the creation of a wider array of financial products that would stir market activity and enhance greater market depth, breadth and liquidity. Furthermore, a developed capital market will help attract longer-term investments and not just short-term portfolio or hot money.

- *Prepayment of foreign borrowings*. Amid large inflows of foreign exchange, the BSP has, in the past, accelerated the servicing of some of its outstanding external debt obligations. The BSP has also encouraged the National Government and the private sector to take advantage of strong external liquidity to prepay their foreign debts, where feasible.

- *Monetary policy calibrations*. When inflation outlook is manageable and overheating is not a concern, the BSP can exercise its interest rate-setting authority to help temper surges in capital inflows. However, there could be complications in the use of the interest rate lever. For example, keeping low rates over an extended period can lead to a potential problem of credit build-up and excesses in asset markets. Furthermore, it may prove not to be very effective as factors other than interest rate differentials may be driving the capital flows.

- *Role of fiscal policy*. The balance between monetary and fiscal policy is also a critical factor in managing capital flows. One long-run option is to mobilize greater public savings. This approach reduces demand pressures on domestic resources and allows an easier monetary stance and lower interest rates, lessening the pull of high interest rates on short-term capital inflows. Nonetheless, few countries have relied on fiscal policy as it is usually too inflexible to be an effective tool for responding to fluctuations in capital movements.

***Way forward***

The best insurance against capital reversals is achieving sound macroeconomic fundamentals which translate into stable prices, a healthy financial sector and fiscal discipline. Such a condition is requisite to developing a deeper capital market and stimulating private investment, both of which are important in channeling foreign capital inflows to more productive sectors of the economy.

Nevertheless, the first line of defense against possible financial imbalances brought on by capital surges is prudential regulation and supervision, which is likely to be less blunt than monetary policy. Thus, micro-prudential regulation must be strengthened. The development of the Basel III proposal is a concrete step in this direction, particularly the inclusion of higher capital and liquidity requirements. However, care must be taken to strike a 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.

In addition, regional cooperation also provides buffers in times of crisis. Cooperative efforts toward regional stability give way to standby agreements and pooling facilities that a country can tap into to mitigate the impact of a crisis. These initiatives also reduce the pressure of accumulating reserves at the national level as a precaution against external fluctuations. For its part, the BSP has been involved actively in regional monetary and financial cooperation and integration such as the Chiang Mai Initiative Multilateralisation (CMIM) currency swap facility and several ASEAN surveillance efforts.

The International Monetary Fund (IMF) recently proposed a framework for dealing properly with capital flows. The framework is a tiered structure where the first line of defense is prudential measures, followed by capital flow management measures.[2] The IMF has also softened its views on the use of capital controls provided that these are within specific circumstances and not as a substitute for good macroeconomic policies.

The G-24, as a member of the International Monetary and Financial Committee (IMFC), acknowledges the IMF's proposal for a policy framework for the management of capital flows by the recipient economies but emphasizes the equal need to consider "push" factors or policies in the source countries.

Much work remains to be done toward achieving a globally-accepted framework for managing capital flows. In the absence of definitive prescriptions to address the risks brought on by capital flow surges, central banks should remain vigilant in monitoring closely external developments and should maintain sufficient policy flexibility to lean against threats of macroeconomic and financial imbalances.

[2] The IMF disaggregates capital flow management measures (CFMs) between: (i) residency-based CFMs, also called capital controls, which discriminate on the basis of residency; and (ii) other CFMs that do not discriminate on the basis of residency but are, nonetheless, designed to influence inflows such as broad limits on foreign currency borrowings, minimum holding periods and such. According to the IMF, the use of CFMs is possible if (i) the exchange rate is not undervalued, (ii) reserves are in excess of adequate prudential levels or sterilization costs are too high, and (iii) the economy is overheating, precluding monetary policy easing and there is no scope to tighten fiscal policy. The CFMs could also be used to complement fiscal tightening plans that are already in place, in light of the lags associated with the macroeconomic impact of fiscal consolidation. Moreover, the IMF suggests giving precedence to CFMs that do not discriminate on the basis of residency over residency-based CFMs.

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