Absorbing the Shock of Depreciation

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THE Bangko Sentral ng Pilipinas is the independent central monetary authority envisaged in the 1987 Philippine Constitution. Its job is to provide policy direction on money, banking and credit as well as supervise banks and similar financial institutions operating throughout the Philippines. The Bangko Sentral was legislated into existence on 10 June 1993 by Republic Act No. 7653, nearly a year after the Ramos Administration began. As the new central bank, the Bangko Sentral started its operations on 2 July 1993. Its primary objective is to maintain price stability that is conducive to the balanced and sustainable growth of the Philippine economy. The Bangko Sentral is also responsible for preserving the international value of the peso and maintaining its convertibility into other freely convertible currencies for both current account and capital account transactions in the balance of payments of the Philippines with the rest of the world.

The general policy of the Philippines on preserving the international value of the peso since 1970 is to float the exchange rate. This policy of floating the exchange rate is anchored on the idea that frequent and gradual adjustments in the exchange rate are less costly, less destabilizing and less disruptive to the national economy than a fixed exchange rate system. In addition, a floating exchange rate provides opportunities for adjusting the external competitiveness of Philippine production as its efficiency increases. This is because the floating exchange rate accommodates changes in the market supply and demand conditions. If more US dollars, for example, are demanded in the Philippines than are supplied, the peso price of the dollar tends to increase, implying that the Philippine peso depreciates relative to the dollar. On the other hand, if more dollars are supplied than are demanded, the peso price of dollars tends to decrease which means that the Philippine peso appreciates in relation to the US dollar.

This floating exchange rate was reinforced on 24 August 1992, some two months into the Ramos Administration,

when Circular No. 1353 was issued by the Central Bank liberalizing foreign exchange regulations throughout the Philippines. Under this circular, foreign exchange may be freely sold and purchased outside the banking system. It also allows foreign exchange receipts, acquisitions or earnings, to be deposited in foreign currency accounts, whether in the Philippines or abroad, or brought out of the Philippines. In the case of foreign loans and foreign investments which will eventually require servicing with foreign exchange purchased from the Philippine banking system, the proceeds of these foreign loans and foreign investments shall continue to be sold for pesos to the authorized agent banks of the Central Bank. The same requirement applies to payments for schemes or arrangements which take on the character of a loan.

This liberalization of foreign exchange transactions within the jurisdiction of the Philippines has encouraged significant capital inflows into the country, both foreign direct investments (FDI) and portfolio investment. By end-1993, for example, the Philippine Stock Exchange was rated by the World Bank's International Finance Corporation as yielding the highest returns in the Asia Pacific region, and the third highest returns throughout the world. The liberalization process has had the effect of linking the Philippine capital market with all the capital markets of the global economy. The Philippines has embarked on the globalization that is swiftly turning the entire world into a global village, with access to international capital on the best terms anywhere in the globe at anytime over the 24 time zones operating across the world. However, the same liberalization and globalization also imply that any changes in the financial and capital markets of the world would be communicated to the Philippines through fiber-optic and satellite communications in a matter of seconds.

This is exactly what happened on 2 July 1997 when the Bank of Thailand devalued its domestic currency, which for many years had been pegged to the US dollar at around 25 baht. In the following week, as the rest of the Southeast Asian financial markets reeled from the Thai baht devaluation, exchange rates in Indonesia, Malaysia, the Philippines and Singapore depreciated in rapid succession. By 31 October 1997, the Indonesian rupiah had depreciated by 47.8%, the Malaysian ringgit by 36.4%, the Philippine peso by 32.5% and the Singapore dollar by 10.6%. The Thai baht by this time had depreciated by 62.4%. The growing trade interdependence among the Asean countries, in which intra-Asean trade by end-1996 amounted to US$155.2 billion or 10 times its comparable value in 1987 of US$14.7 billion, tended to facilitate the communication throughout the Southeast Asian region of the contagion of depreciating Asean currencies.[1] The increasing crossborder migration of capital within the region did not help immunize any one Asean country from the virus of competitive depreciation as portfolio investment funds from overseas swiftly liquidated

their 1 or 2 percent country placements and fled for cover elsewhere in the global capital market.

In their initial efforts to keep their depreciating currencies within a moderate range of adjustments, the Asean central banks generally intervened in their respective foreign exchange markets as well as in their money markets, driving up domestic interest rates in the process. However, after using up a fair amount of their respective international reserves, they realized that such a policy of intervention turned out to be no match to the persistence and virulence of the speculation which had come to drive the volatilities in their respective foreign exchange markets. In the more recent weeks, as the Asean communities accommodated the reality of depreciating currencies, public policy has increasingly focused on bringing down interest rates so that incremental domestic investment continues while incremental exportation is being invigorated. Together, this twin growth in domestic investment and exports would keep overall economic growth on track.

In the case of the Philippines, central banking policy in the face of this currency turmoil is aimed at ensuring the stability and soundness of the country's financial system, the stabilization of the exchange rate around a market-determined level, and the moderation of interest rates conducive to new business development. To strengthen the financial system in the country, the Bangko Sentral ng Pilipinas adopted several measures in June 1997, well before the turbulence hit the currencies of the Asean region. On 5 June 1997, for example, the Bangko Sentral limited banks' exposure to real estate activity to 20% of their overall loan portfolio. This was meant to prevent riotous asset-price inflation or a financial bubble from destabilizing the banking system and eventually crippling the national economy towards a recession. On 6 June 1997, the Bangko Sentral also required the banks to keep in liquid assets 30% of the 100% cover for all foreign exchange liabilities of their respective foreign currency deposit units or FCDUs. On the same day, it issued guidelines to the banks for raising the quality of their bank management in their recruitment of officers and board directors. On 1 October 1997, it upgraded the ground rules for the determination of past due accounts as it reduced by 50% the number of installments in arrears. In addition to requiring on 1 October 1997 a general loan-loss provision on top of making provisions for probable losses linked to individually-identified bad accounts, the Bangko Sentral also raised the loan-loss provision by another 2% of banks' gross loan portfolio. It also endorsed to the Congress an amendment of the 1948 General Banking Act which would enable the Monetary Board to adopt internationally accepted standards for risk-based capital requirements.

As these measures intended to ensure the soundness and predictablility of the banking system were taken, the Bangko Sentral also adopted further measures to rationalize foreign exchange trading throughout the Philippines. On

22 July 1997, for example, it required the banks to have prior clearance of all their non-deliverable forward contracts before selling them to non-residents, including offshore banking units. Such instruments had been heavily used by speculators to drive up demand for US dollars thus artifically leading to further depreciation of the peso. In its efforts to keep banks from using their dollar resources for speculation, the Bangko Sentral on 1 July 1997 initially cut back by 50% their allowable overbought foreign exchange position to 10%. This was later brought down to 5% of their unimpaired capital or US$10 million, whichever is lower. In the meantime, the banks' oversold position was raised from 10% to 20% enabling them to sell more of their dollar holdings and increase the supply of foreign exchange in the market. On the same day, the Bangko Sentral also reduced from US$100,000 down to US$25,000 the maximum amount that banks can sell on over-the-counter (OTC) basis. Subsequently, on 17 September 1997 and 2 October 1997, as a measure to prevent banks from channeling dollar transactions through their subsidiaries and affiliates, the Bangko Sentral required banks to consolidate their accounts with such subsidiaries and affiliates in the computation of their net foreign exchange positions.

In the course of its management of overall liquidity in the money market, the Bangko Sentral in mid-July 1997 adjusted upwards its overnight borrowing rate all the way to 32% from its end-June level of 15%, as speculation on the peso/dollar rate became rampant. As a parallel action, it raised its overnight lending rate to 34% from its end-June level of 17%. By 20 August 1997, the Bangko Sentral found it necessary to temporarily suspend its overnight lending facility in order to keep overall liquidity at bay. However, as conditions in the money market improved, it eventually reduced its overnight lending rate. In addition to the statutory reserve requirement of 13% and in order to tame the inflationary tendencies implied by a depreciation of the peso, the Bangko Sentral on 31 July, 14 and 27 August 1997 and raised the level of the banks' liquidity reserves by four times from 2% to 8% and required them to keep these in the form of short-term market-yielding government securities bought directly from the Bangko Sentral. Since then, however, as the money market normalized, the liquidity reserves have been reduced by one percentage point on 15 October 1997, while another one percentage point reduction was effected on 15 November 1997.

But in the 10 November 1997 survey of 110 financial officers at the CFO Forum in Manila, conducted by the New York-based public relations outfit Burston-Marsteller, as many as 38% of the respondents identified foreign exchange risk to be among the risks they expected to affect their businesses over the next 12 months, while 32% of them also recognized interest rate risk as part of these risks (AWSJ 1997). Political risk was likewise listed by 10% of these respondents,

credit risk by 9%, liquidity risk by 7% and inflation risk by 4% of the same respondents. Moreover, the survey also disclosed that as many as 55% of these chief financial officers failed to hedge their foreign exchange risk.

To remedy this situation in the increasingly exposed and vulnerable private corporate sector of the Philippine economy, the Bangko Sentral ng Pilipinas installed on 22 December 1997 the non-deliverable forward (NDF) foreign exchange facility or the currency risk protection program (CRPP). As it operates, the non-deliverable forward market provides participants clues on how the currency is expected to trade in the forthcoming months. The obligations eligible for coverage under the NDF or CRPP facility must have been registered, unhedged and booked as of 19 December 1997 which still remain outstanding at the time an application is put forward for the NDF/CRPP facility. In this facility, all settlements are made in Philippine pesos because what bothers the unhedged market participant is the variability or volatility in the peso price of the foreign currency to which he or she is exposed.

Over and above these measures to strengthen the Philippine financial system, rationalize foreign exchange trading and manage overall liquidity in the system, it is also important to recognize that adjustments to a currency depreciation are either eased or aggravated by the economic fundamentals prevailing in a nation. In this regard, the Philippine economy managed to grow by 5.8% in GNP terms and by 5.1% in GDP terms in 1997 (Philippine Star 1998). By either measure, this pace of economic growth is 2.5 times more than the growth of the national population. It provides the cushion for absorbing the shocks of adjustments in response to the peso depreciation. Moreover, merchandise exports rose by 23.2% in the first 11 months of 1997, outpacing merchandise imports which increased by 10.6% (NSO1998). With exports growing 2.2 times faster than imports, the country's current account deficit has leveled at 4.5 % of its GNP, the same rate achieved for the whole year of 1996. Overall prices went up 5.1% on average (NSO 1998) in 1997 even as domestic liquidity (M3) was rising by 23.6% by end-September (Bangko Sentral 1998). Interest rates as indicated by the three-month Treasury Bill averaged 19.286% at the end of the auction last 26 January 1998. They will probably move moderately downwards as the national government turns up a surplus in its budget during the year. The basic balance in the Philippine balance of payments as of end-June 1997 remained positive as it had been in the last six years, which suggests that the international financial community is willing and ready to finance the current account deficit of the country with long-term money. All told, then, the Philippine economy seems robust enough to absorb the shocks of the adjustments arising out of the peso depreciation.

While the peso fell sharply within the week that it was depreciated, its rate of depreciation since 11 July 1997 on the basis of its five-day moving average has proceeded more gradually through 5

January 1998. It moved erratically since then, somewhat in tandem with the volatilities experienced by the Indonesian rupiah over the same period. As a matter of fact, although the peso depreciated half of the time, it also appreciated the other half of the time. Since 22 September 1997 the momentum for peso depreciation has been dissipating, with the 25-day momentum notably moving downwards and pulling in the same direction as the 40-day momentum of the peso-dollar rate. This is also corroborated in the generally narrowing volatility band around which the peso has depreciated or appreciated, as is suggested by the peso/dollar depreciation in actual pesos and centavos. When a logarithmic trend is fitted to the downward and upward swings of the peso/dollar rate since 15 July through 29 January 1998, it can be seen that there is a clear trend for the peso/dollar rate to stabilize towards an equilibrium.[2]

NOTES

This is an updated version of my Statement at the UP Mindanao Regional Conference on Planning, 15 November 1997, Davao City. The update includes measures taken by the Bangko Sentral ng Pilipinas since mid-November 1997 through 30 January 1998, as well as economic and financial developments in the Philippines since then.

1. A Granger Causality test on Thai baht/US$ and Philippine peso/US$ movements since 2 July 1997 through 4 September 1997 yielded an F-statistic of 5.3626 with probability of 0.00864, signifying the prevalence of contagion.

2. In the course of using the financial modelling technique known as Generalized AutoRegressive Conditional Heteroskedasticity (GARCH) on the peso/dollar rate volatility as observed between 2 July 1997 and 29 January 1998, an ARCH coefficient of 0.8612 was obtained signifying conditional heteroskedasticity implying that today's large or small volatilities echo yesterday's large or small volatilities as in a random walk; while a GARCHcoefficient of 0.1280 also emerged, which is less than unity implying that the volatilities will not persist. That is, they will dissipate as the peso/dollar rate stabilizes to an equilibrium value.

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