

Capital flows and financial assets in the Philippines: determinants, consequences and challenges for the central bank

Celia M Gonzalez¹

I. Introduction

Asian emerging market economies have recently been major beneficiaries of capital flows from the developed countries. The literature suggests that the major factors that encouraged this flow of capital to emerging market economies are the sustained decline in interest rates in the industrial world, and the depth of financial development in emerging markets (Reinhart (2005) and IMF (2007a)). However, the prolonged surge in capital flows to the region has renewed concerns among policymakers on issues related to global liquidity, financial stability and capital reversals. History has provided empirical evidence that massive capital inflows in the 1980s may have contributed to the stock market bubbles in Latin America, which led to an excessive expansion in domestic credit and undermined the stability of the financial system (Calvo et al (1994)). As such, policy responses to the surge in capital have included sterilisation measures and reforms to the regulatory and supervisory frameworks, which are generally aimed at addressing the mounting pressures on the exchange rate and growing liquidity in the financial system.

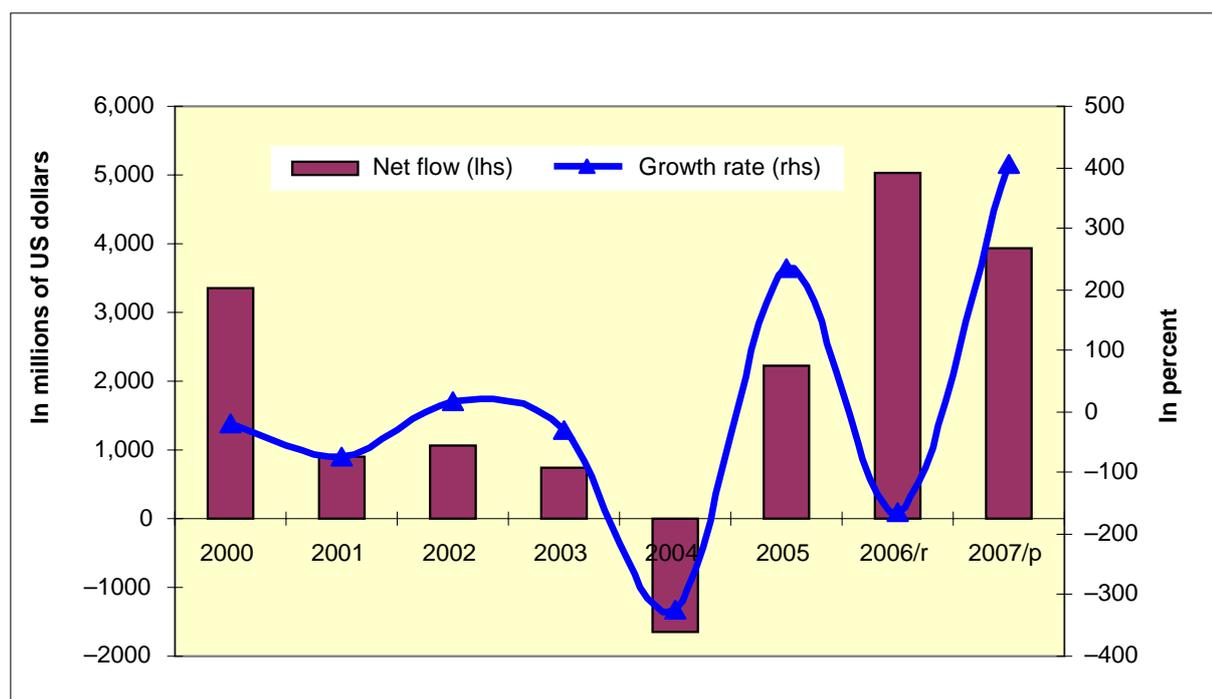
The interaction between capital flows and macroeconomic factors has been discussed in previous literature and addressed issues pertaining to the determinants, policy challenges and management of capital flows. This paper presents the trends of capital flows and financial assets in the Philippines for the period 2000–07, and outlines the policy responses of the central bank to the surge in foreign exchange inflows from both capital and current account transactions.

II. Trends and composition of capital flows

The Philippines generally posted net inflows in its capital and financial account during the period 2000–07, with exceptions in 2004 and 2006, in tandem with robust growth and positive prospects for the economy (Graph 1). After relatively stable flows for three years (2001–03), the pattern of net capital flows started to show an almost symmetrical upswing and downswing behaviour reflecting volatilities in the trend. Such behaviour can be traced primarily to the large net outflows posted under the portfolio investment account in 2004 (USD 1.7 billion) and the other investment account in 2006 (USD 5.8 billion). In 2007, the net capital and financial account registered a net inflow of USD 3.9 billion, an exceptional increase compared to only USD 20 million in 2006.

¹ Managing Director, International Department, Bangko Sentral ng Pilipinas (BSP). This paper was prepared for the Bank for International Settlements' Emerging Market Deputy Governors Meeting held on 31 January–1 February 2008 in Basel, Switzerland. The author acknowledges the research contribution of Mr Dennis Lapid and Ms Ma Teresa S Dueñas. The views expressed in this paper are solely the author's and do not necessarily reflect those of the BSP. The usual disclaimer applies.

Graph 1
Capital and financial account in the Philippines



r = revised; p = preliminary.

Source: BSP.

Net investment by non-residents in the Philippines, as reflected in the balance of payments (BOP), reached USD 10.3 billion in 2007, twice the year-ago level (Table 1). This was traced to the continued strength in portfolio investments concentrated in debt securities issued by the national government, a jump in other inward investments in the form of public sector programme loans, and increased currency and deposit placements by non-residents. In terms of other investments, non-residents' investments in the form of currency and deposits showed mixed movements, while bank loans posted net outflows in 2003, 2004 and 2006 and net inflows in 2005 and 2007. Net direct investments dropped markedly in 2001, partly due to the political situation, but started to pick up significantly in 2004. Several factors influenced the progressive rise in investor confidence, including strengthening macroeconomic fundamentals, political stability and reports of strong corporate earnings.

Residents' net investments abroad started to turn positive in 2002 and increased significantly in 2004. For the most part, this was accounted for by the surge in portfolio investments (debt securities) and other investments, which include bank loans² and currency and deposits. Moreover, investments in financial derivatives generally traced an uptrend starting in 2003, indicating growing appetite for more complex financial products, as well as expansion and greater integration with international capital markets. Residents' net investments abroad continued to grow in 2005–07, reaching USD 6.4 billion as of end-2007.

² Mainly by offshore banking units (which are considered residents for statistical purposes), particularly from 2005 onwards.

Table 1
Capital and financial account

In millions of US dollars

	2000	2001	2002	2003	2004	2005	2006/r	2007/p
Capital and financial, net	3,363	911	1,056	726	-1,630	2,229	20	3,928
Capital account	138	62	27	54	17	40	138	24
Financial account	3,225	849	1,029	672	-1,647	2,189	-118	3,904
Direct investment	2,115	335	1,477	188	109	1,665	2,818	-514
Portfolio investment	-553	1,027	746	562	-1,713	3,475	3,043	3,088
Financial derivatives	44	-15	-21	-64	-27	-43	-138	-288
Others	1,619	-498	-1,173	-14	-16	-2,908	-5,841	1,618
Non-residents' investment in the Philippines, net	1,709	8	1,943	1,078	689	7,275	5,086	10,284
Capital account	168	86	50	82	46	58	181	108
Financial account	1,541	-78	1,893	996	643	7,217	4,905	10,176
Direct investment	2,240	195	1,542	491	688	1,854	2,921	2,928
Portfolio investment	259	1,084	1,374	1,380	-803	3,621	4,610	3,569
Financial derivatives	-122	-98	-106	-118	-85	-141	-297	-458
Others	-836	-1,259	-917	-757	843	1,883	-2,329	4,137
Residents' investment abroad, net	-1,654	-903	887	352	2,319	5,046	5,066	6,356
Capital account	30	24	23	28	29	18	43	84
Financial account	-1,684	-927	864	324	2,290	5,028	5,023	6,272
Direct investment	125	-140	65	303	579	189	103	3,442
Portfolio investment	812	57	628	818	910	146	1,567	481
Financial derivatives	-166	-83	-85	-54	-58	-98	-159	-170
Others	-2,455	-761	256	-743	859	4,791	3,512	2,519

r = revised; p = preliminary.

Source: BSP.

However, it is worth noting that exports of goods and services and remittances from overseas Filipino workers have been the main sources of foreign exchange inflows. Further, these have, on average, been relatively more stable than investment flows, as indicated by their significantly lower coefficients of variation compared to investments (Table 2). This suggests that current account receipts are less susceptible to shocks. However, they have also contributed to recent currency appreciation pressures (2005–07).

Table 2
Relative magnitude and volatility of selected foreign exchange inflows
 2000–06

Sources of foreign exchange inflows	As a percentage of GDP	Coefficient of variation ¹
Overseas Filipino remittances ²	9.7	11.9
Exports of goods and services	48.0	6.3
Foreign direct investments	1.5	63.9
Foreign portfolio investments	1.7	97.0

¹ (Standard deviation/mean) *100%. ² Channelled through the banking system.

Source: BSP

III. Trends in financial assets

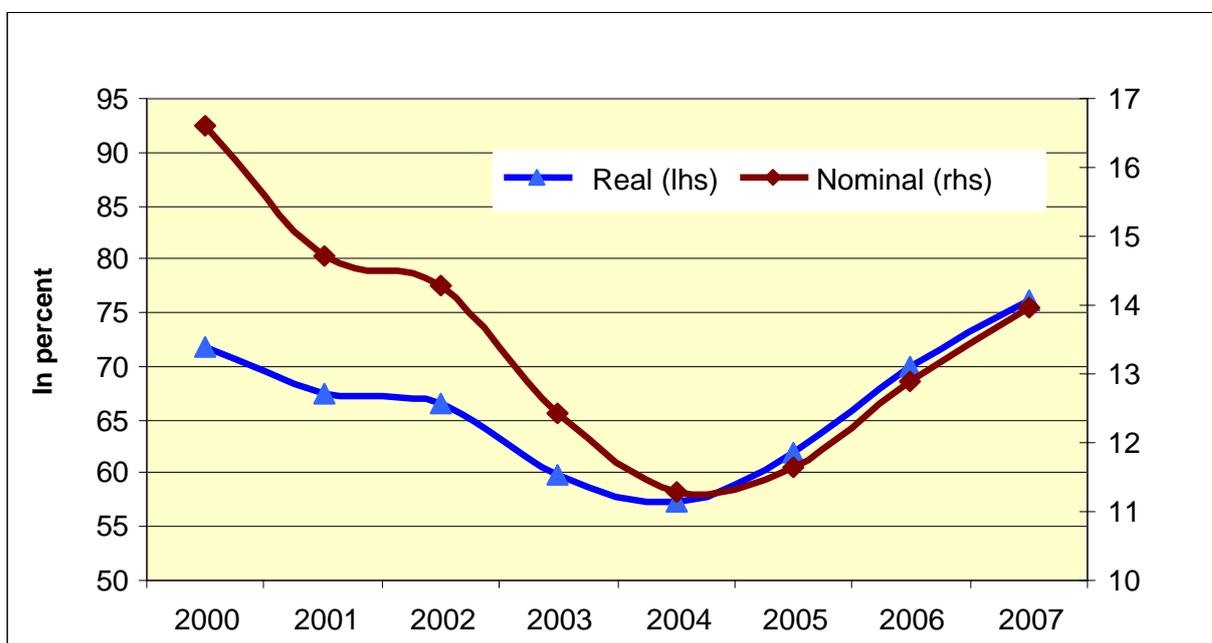
Prices of financial assets in the Philippines exhibited an uptrend during the period 2000–07, as shown in the appreciation of the peso relative to the US dollar (2005–07), the rise in the composite stock index (2004–07) and the fall in domestic interest rates (which correspondingly increased the price of peso-denominated bonds issued onshore).

Foreign exchange market

In terms of effective exchange rates, the Philippine peso posted a depreciating trend relative to the US dollar from 2000 to 2004 but began to appreciate from 2005 (Graph 2). For the period 2000–04, the peso, on average and in real terms, depreciated against its major trading partners' currencies by an annual average of 5.6%, while from 2005 to 2007, it appreciated by an annual average of 9.9%. In terms of nominal exchange rate, the peso strengthened from PHP 55.09/USD 1 in 2005 to PHP 46.15/USD 1 in 2007. This situation developed as the US dollar generally weakened against the peso and other regional currencies amid fears of a US recession following the subprime mortgage crisis and the weakness in employment conditions. In addition, the sustained increase in earnings remittances of overseas Filipino workers and enhanced investor confidence due to improving macroeconomic fundamentals also contributed to the appreciation of the peso.

Graph 2
Average effective exchange rate indices of the peso

December 1980 = 100%



Calculated against major trading partners (United States, Japan, European Monetary Union, United Kingdom).

Source: BSP.

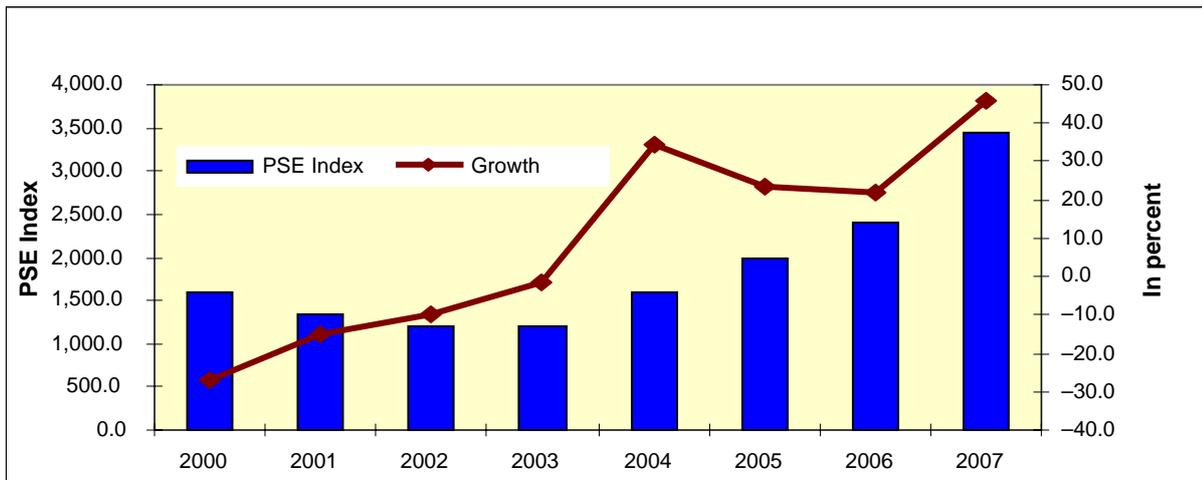
Stock market

The stock market experienced a boom in 1999 but this was not sustained the following year as the country underwent political and economic challenges (Graph 3). The market recovered gradually and in 2004 grew by 34.5% (measured by the percentage change of the composite stock index). The market sustained its bullish momentum thereafter, and posted record highs in the first six months of 2007. In early July, the stock market index reached 3,802.32 index points, a level close to the 1997 marker (3,313.11 index points). Trading was buoyed by strong economic fundamentals, easing US interest rates and net foreign investment inflows. However, the market closed lower in end-July at 3,501.2 index points, dragged down by concerns over the sell-off in US stocks and global equity markets due to the US subprime concerns, among other things.

Rising investor risk aversion due to the US subprime mortgage problem dominated developments in the equities market in the second semester of 2007. Market sentiment was also dragged down by the spike in crude oil prices, but the market's drop was softened by the US Federal Reserve's successive moves to cut policy rates, followed by the BSP's own policy rate cuts. As a result, the composite index averaged 3,616.85 index points in 2007.

Graph 3

Performance of the Philippine stock market



Source of basic data: Philippine Stock Exchange (PSE)

Bond market

Government issuances have continued to dominate the domestic bond market. As of end-September 2007, outstanding government securities (GS) amounted to PHP 2.25 trillion, 60.3% of which were regular issuances (eg T-bills and fixed rate treasury bonds, the latter accounting for 54% of total regular issuances). Prices of bonds, represented by T-bill rates, generally depicted a downtrend for the period 2000–07 (Graph 4). In 2000, the interest rate for 91-day T-bills averaged 9.9%, but this went down to an average of 3.4% in 2007, due to the sharp slowdown in inflation (to an average of 2.8%) as well as the significant progress in fiscal consolidation. The average 91-day T-bill rate for the sample period (2000–07) was 6.7%. The same downtrend was demonstrated by the longer tenors.

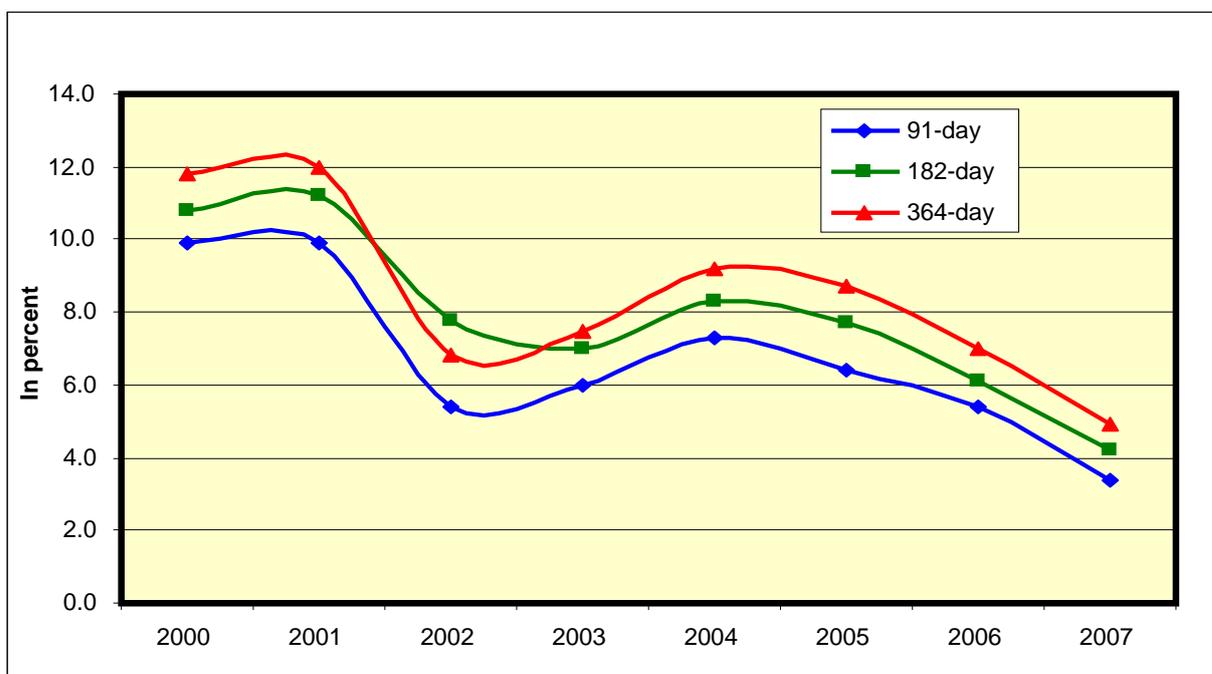
In the early 1990s, the Philippine debt securities market began to move from being a market dominated by short-term money market instruments to longer-term bond issues. Reforms complementing the liberalisation of the financial market in the 1980s were implemented by the government, leading to the emergence of the government bond market as a major venue for mobilising long-term funds. The major reforms include:

1. Making certain government securities eligible as reserves against deposits and trust products;
2. Broadening the investor base through the granting of more licences for primary dealers (mostly banks that represent the dominant players in the financial system) and introduction of small-denominated securities that appeal to retail investors;
3. Introducing government securities with longer maturities in 1991–96;³

³ In 1991, the government introduced three-year floating rate treasury notes (FRTNs). These were replaced in 1994 by fixed rate treasury notes (FXTNs) in the light of the volatile movement in interest rates, which adversely affected interest payments and hence the predictability of the fiscal position of the government. Medium- to long-term fixed rate treasury bonds (FXTBs) began to be issued in 1994 for two-year instruments, in 1995 for five-year tenors, in 1996 for seven- and 10-year instruments, in 1997 for 20-year issues and in 2000 for 25-year maturities.

4. Improving the infrastructure of the government securities market with the automation of the auction process and the establishment of the Registry of Scriptless Securities (RoSS); and
5. Introducing a government bond exchange programme to improve liquidity and lengthen the maturity structure of outstanding government securities.

Graph 4
Treasury bill rates



Source: Bureau of the Treasury

IV. Policy options for managing capital flows

In addressing surges in capital flows, central banks first need to examine the sustainability, reversibility and volatility of such flows. Typically, policymakers want to minimise large swings in capital flows and prevent undue volatility in domestic financial markets. At the same time, it is well recognised that capital inflows help relax the financing constraint of the domestic economy. Thus, rather than discourage inflows altogether, authorities generally undertake measures to attract direct investments and other long-term capital flows.

The typical immediate response to surges in inflows is to offset them through reserve accumulation, which can be implemented quickly and can provide some breathing space to policymakers, allowing them to assess whether inflows are transitory or permanent. This is often accompanied by sterilisation moves to prevent excessive liquidity expansion. Sterilisation can take a range of forms, eg sale of bonds, increases in reserve requirements on bank deposits and various types of central bank borrowing from commercial banks.

However, if inflows persist, authorities must reduce reliance on sterilisation to avoid potentially large costs, equivalent to the difference between the interest earned on foreign exchange reserves and the cost of absorbing additional liquidity. Indeed, aggressive sterilisation through open market operations can raise domestic interest rates and depress

aggregate demand. By fuelling high domestic interest rates, sterilisation may deprive the economy of the benefits of inflows in the form of higher domestic investment and growth (Schadler (1994)). When sterilisation proves to be infeasible, greater exchange rate flexibility can mitigate inflows by encouraging market participants to take cognisance of exchange rate risks in cross-border financial transactions. It also promotes and encourages the use of exchange risk management instruments.

Authorities may also consider increasing the demand for foreign exchange, which can be done by voluntarily accelerating prepayment of external debt and relaxing rules on capital outflows during periods of surplus. At the same time, the supply of foreign exchange can be reduced by encouraging the national government and market players to shift from foreign borrowing to domestic fund-raising activities (eg equity/bond issuances), helping develop the domestic capital market in the process.

Some countries (such as Chile in the 1990s and Thailand more recently) have opted to impose capital controls as a means of reducing the size of inflows, relieving exchange rate pressures, regaining monetary policy autonomy and encouraging more long-term types of inflows. However, the heterogeneity across countries in the capital control measures employed, the conditions under which they are introduced, and the degree of enforcement together imply that the apparent effectiveness of controls in one country may not necessarily translate into equal success in another setting. As such, the divergent experience and empirical evidence on the effectiveness of measures to restrict capital flows suggest grounds for caution. The most that can be said for controls on capital inflows is that they are able to expand monetary policy autonomy and change the composition of flows toward longer maturities, but are unable to reduce the volume of net flows (Magud and Reinhart (2006)). It is also uncertain whether controls can in fact relieve pressures on the exchange rate over an extended period of time. Even in country cases in which a narrow range of objectives were met, controls had only temporary effects as market participants eventually found ways to circumvent them.

For countries that choose to remain open and financially integrated, the best insurance against volatility and sudden stops in capital movements remains sound macroeconomic policy, characterised by low inflation, fiscal balance and prudent credit creation. Fiscal consolidation, in particular, can help moderate aggregate demand pressures in order to avoid any need for tight monetary policy and higher domestic interest rates.

V. BSP policy responses

The BSP has undertaken a variety of measures to temper appreciation pressures on the peso and maintain overall stability in the foreign exchange market. Among others, these include the build-up in international reserves (accompanied by measures to manage the resulting expansion in liquidity), prepayment of the BSP's debt, implementation of a series of reforms to further liberalise the existing foreign exchange regulatory framework, adoption of a risk-based approach to banking supervision, support for initiatives to develop the domestic capital market, and provision of various forms of assistance to sectors adversely affected by the peso appreciation.

Foreign exchange market and liquidity management

The BSP employs several types of discretionary open market operations to smooth short-term fluctuations in exchange rate movements as a result of changes in liquidity movements. Under an inflation targeting regime, the participation of the BSP in the foreign exchange market is aimed at dampening excessive volatility of the exchange rate, which may attract speculative demand and exacerbate further volatilities. Combined with other measures such

as adjustments in monetary policy stance and/or imposition of prudential regulations, these policy actions are taken to counter threats to inflation and inflation expectations which could deter the achievement of the inflation target.

With regard to liquidity management, the BSP has implemented new measures (effective 10 May 2007) to help prevent potential inflationary pressures that could build up over the medium term, mainly as a result of rapid money supply growth, including from sustained foreign exchange inflows. These liquidity management measures include: (a) encouraging the Government Service Insurance System, the Social Security System and other government-owned and controlled corporations to deposit funds with the BSP; (b) allowing trust entities under BSP supervision to deposit funds with the BSP; and (c) allowing special deposit account (SDA) placements of banks to be considered as alternative compliance with the liquidity floor requirements for government deposits. The SDA, a non-collateralised instrument priced at a premium over the reverse repurchase facility, has been used since November 1998 as an additional monetary policy tool in the absence of government securities that can be used for open market operations.

Foreign exchange regulatory reforms

The Philippine foreign exchange regulatory regime is characterised by an open current account, few restrictions on capital inflows and some controls on capital outflows. The liberalisation measures introduced in the early 1990s were directed at enhancing the supply of foreign exchange by reducing transaction and financing costs, broadening financing options and promoting opportunities for portfolio diversification. However, there remained a few restrictions on capital inflows and some controls on capital outflows. Hence, the BSP adopted a comprehensive yet measured approach for the roadmap toward further liberalisation of foreign exchange transactions.

On 22 February 2007, the Monetary Board (MB) approved the first phase of reforms to the foreign exchange regulatory framework to make the regulatory environment more responsive to the needs of an expanding, more dynamic economy that has become increasingly integrated with global markets. Improving macroeconomic fundamentals, as well as ongoing banking, capital market and institutional reforms, provided a favourable setting for the comprehensive review and gradual reform of the existing foreign exchange regulatory framework. The reforms, which became effective on 2 April 2007, involved changes in rules governing external current account and capital account transactions as well as prudential regulations.

First, with respect to current account transactions, the limit on allowable foreign exchange purchases by residents from banks to cover payments to foreign beneficiaries for non-trade current account purposes without supporting documents was increased from USD 5,000 to USD 10,000. Furthermore, the “no splitting” restriction and notarisation requirement for applications to purchase foreign exchange beyond a specified amount were also lifted. These measures are expected to accommodate the rising demand by residents for foreign exchange to service non-trade current transactions such as education of dependents abroad, medical care and payment of service fees, and to reduce transaction costs for bank clients, including retail customers.

Second, with regard to capital account transactions, the limit on allowable outward investments by residents without prior BSP approval and registration was increased from USD 6 million to USD 12 million per investor per year. Also, residents’ investments in foreign currency denominated bonds issued by the national government and other Philippine entities are now eligible to be funded with foreign exchange purchased from banks. The increase in the allowable limit on outward investments is expected to allow greater portfolio and risk diversification and facilitate integration with global markets.

Third, in the area of prudential regulations, a symmetrical limit of 20% of unimpaired capital with an absolute limit of USD 50 million was imposed on both the overbought (OB) and oversold (OS) positions of banks. The increase in the OB limit from 2.5% of unimpaired capital to 20% gives banks more flexibility to increase their foreign exchange holdings. This enhances banks' capability to service the increasing foreign exchange requirements of the corporate sector and contributes to further reducing exchange rate volatility. Restoring the OS limit at 20% of unimpaired capital, on the other hand, serves as a prudential measure to discourage excessive exposure of banks to foreign exchange risks. The adjustments in both the OB and OS limits complement the BSP's thrust towards risk-based supervision and are aligned with banks' improved capacity to manage foreign exchange exposures relative to their capitalisation levels.

On 20 December 2007, the MB approved the second phase of reforms⁴ to the foreign exchange regulatory framework. The second phase focused largely on two objectives: first, to promote greater integration with international capital markets and risk diversification; and second, to streamline the documentation and reporting requirements on the sale of foreign exchange by banks. Clarifications on certain existing regulations were also made.

Among other things, the policy reforms included further increases in (a) allowed foreign exchange purchases from banks by residents for non-trade current account transactions (without the need for supporting documentation) to USD 30,000; and (b) the limit on outward investments without the need for prior BSP approval to USD 30 million per investor per year or per fund in the case of qualified investors (QIs).⁵ QIs may also apply for a higher limit with the BSP. With the liberalisation of foreign exchange rules, banks are expected to continue to adopt safe and sound practices in undertaking their foreign exchange transactions. The BSP remains vigilant and stands ready to act to ensure that foreign exchange transactions are consistent with the stability of the financial system.

Structural reforms: bond market development

Complementing the reforms in the regulatory framework, the BSP supports initiatives related to the development of the domestic and regional bond markets. The lack of innovative and diversified financial products in the market leaves investors and intermediaries with very limited investment choices and narrow investment opportunities. Hence, the availability of a wider array of financial products would stir market activity by creating greater market depth, breadth and liquidity. It will also enable the market to better satisfy investors' diversified appetite for risk. The country's improving fiscal situation and economic fundamentals make its issuances an increasingly attractive investment option.

Domestic initiatives

With a view to mobilising domestic savings, introducing new financial instruments and revitalising the secondary market to help stimulate the domestic capital market, the BSP has:

1. Enhanced corporate governance in the banking system to improve investor confidence and increase availability of reliable information on which investment decisions are based;

⁴ These reforms took effect on 21 January 2008.

⁵ For the purposes of this regulation, QIs shall be limited to the following: insurance and pre-need companies; collective/pooled funds, whether in a corporate or contractual structure, such as mutual funds, unit investment trust funds and variable insurance; public or private pension or retirement or provident funds and such other entities and funds as the BSP may determine as qualified investors on the basis of such factors as financial sophistication, size and regularity of financial transactions, net worth and size of assets being managed.

2. Aligned local accounting standards with International Accounting Standards;
3. Launched the Philippine Payment System (PhilPASS), a real-time payment infrastructure system which is aligned with the systems operating in other countries. PhilPASS contributes to minimising systemic risk as real-time high-value payments between banks are made using their deposit accounts with the BSP;
4. Established the fixed income exchange (Philippine Dealing and Exchange System) that allows integrated and straight through processing of securities transactions from trading to custody;
5. Improved financial transparency by enhancing the existing benchmark for securities trading and enforcing more stringent mark to market regulations. Official calculation was assigned to a self-regulatory organisation (PDEX) to enhance the credibility of the benchmarks;
6. Provided for the recognition/derecognition of domestic credit rating agencies for bank supervisory purposes. The BSP issued these guidelines to meet a growing need for credit rating services by both the financial industry and regulators;
7. Expanded the menu of investment products to include unit investment trust funds (UITFs), long-term negotiable certificates of deposit, retail repurchase agreements, and securities borrowing and lending transactions. The creation of UITFs by authorised trust entities was aimed at aligning the operation of pooled funds under management by trust entities with international best practices and enhancing their credibility with retail investors. The UITF is an improved version of the existing common trust fund (CTF), with assets that will be marked to market daily so that investors will not be misled as to the real performance of their investments;
8. Defined the role of third-party custodians in the delivery of sold securities to avoid multiple sales and undocumented repurchase agreements;
9. Supported the passage of critical legislation to: (a) allow securitisation transactions; and (b) exempt the secondary trading of securities from documentary stamp tax; and
10. Reviewed the regulatory framework for corporate rehabilitation, individual retirement funds and collective investment schemes.

Regional initiatives

The Philippines is also actively involved in efforts to promote the development of the capital market and stability of the financial system in the region. Together with the other ASEAN member countries and Japan, China and Korea (collectively called ASEAN+3), the Philippines participates in the Asian Bond Market Initiative (ABMI) which aims to broaden and deepen the ASEAN+3 region's capital markets and reduce overdependence on the banking system for raising funds. The ABMI focuses on facilitating access to bond markets and enhancing market infrastructure for local and regional bond market development.

The BSP also participates in the Chiang Mai Initiative (CMI), a regional financing arrangement established in May 2000 that aims to provide short-term liquidity support for temporary balance of payment difficulties among ASEAN+3 member countries. The CMI presently involves two components: (a) the ASEAN Swap Arrangement (ASA); and (b) a network of bilateral swap and repurchase facilities among the ASEAN countries, in cooperation with China, Japan and Korea. To further enhance the current CMI setup, ASEAN+3 members are also currently working on multilateralising the CMI. Progress has been made on this front, as member countries have agreed in principle to adopt a self-managed reserve pooling arrangement (SRPA). Discussions are currently being held on the implementation details of the arrangement.

Other measures

While an appreciated peso relative to the US dollar yields some benefits, for example (a) helps dampen the inflationary pressures arising from price increases of imported commodities; (b) reduces the peso costs of serving foreign currency obligations; and (c) enables the BSP to further build up the country's gross international reserves, it also leads to a number of negative consequences, for example: (a) reduction in the price competitiveness of Philippine exports; (b) lowering of the peso equivalent of dollar remittances of overseas Filipino workers; and (c) lowering of the profits for domestic producers of import substitutes and the tourism sector. Thus, a number of measures have been implemented to assist the export sector as well as overseas Filipino workers.

Initiatives to support the export sector

In August 2005, the BSP gave a PHP 10.5 million grant to the Export Development Council (EDC) to help raise the performance of the export sector, increase its competitiveness and help increase foreign exchange earnings. A total of PHP 9.5 million or 90.5% of the grant was utilised for export promotion and development projects within the prescribed one-year utilisation period that ended on 2 April 2007.

In 2007, the BSP also contributed PHP 50 million to the PHP 280 million Export Promotion Fund. The Fund was established by the EDC as a public-private sector partnership to provide supplemental financing for the promotion and development of Philippine exports. The target beneficiaries are primarily the micro and small enterprises that have been adversely affected by the recent appreciation of the peso.

Aside from the direct grants to exporters, the BSP has set aside annual budgets for the peso and foreign exchange rediscounting facilities of PHP 20 billion and USD 500 million, respectively. The Peso Rediscount Facility and the Exporters Dollar and Yen Rediscount Facility allow banks to rediscount their existing loans to exporters, thus helping support the working capital needs of local exporters. Under Circular No 515 dated 6 March 2006, the coverage of these facilities was broadened and the avancement guidelines further simplified by reducing the eligibility requirements for applicant banks.

The BSP also promotes the use of hedging mechanisms and hedging products offered by banks to reduce foreign exchange risks. One such product is the foreign exchange insurance offered by the Development Bank of the Philippines (DBP), which gives exporters the ability to benefit from peso depreciation or protection from losses during peso appreciation. Under this product, the exporter has the right, but not the obligation, to sell their dollars against the peso to the DBP at a specified price on a specified date. The other hedging mechanism is forward foreign exchange rate protection, a forward foreign exchange contract where only the net difference between the agreed dollar/peso forward rate and the market rate shall be settled at maturity. Unlike the foreign exchange insurance scheme, forward foreign exchange rate protection entails no charges and offers a fixed exchange rate at a specified future date, therefore protecting the exporter at a certain rate if the peso appreciates.

Initiatives to support overseas Filipino workers

The BSP recognises the valuable contribution of overseas Filipino workers' remittances to the economy. As part of its efforts to improve the environment for the remittance flows, and in order to assist the workers in their remittance concerns, the BSP has created an interactive portal that links users to information on the different banks and non-bank remittance companies in the Philippines. This enables the remitters to scan the market for the lowest remittance rates. Further, the BSP encourages overseas Filipino workers to invest in financial products to optimise the use of their remittances for development and future integration of these workers into the Philippine economy. These initiatives include:

1. Issuance of retail treasury bonds to overseas Filipinos. The national government and the BSP have agreed in principle to offer retail treasury bonds starting 2008 as an alternative investment instrument for these workers. Discussions are ongoing on the size and mechanism of the bond issuance; and
2. Access to commercial bank investment products and services for overseas Filipino workers. Commercial banks offer specialised investment products and services such as insurance, pension and real estate loans through tie-up arrangements with pre-need and property firms.

VI. Conclusion

The paper presents the trends in capital flows and prices of financial assets in the Philippines for the period 2000–07. Surges of capital inflows, together with strong remittances from overseas Filipino workers, are associated with the rise in the prices of financial assets over the period, namely: (a) domestic currency; (b) bonds; and (c) stocks, which was due in turn to improving macroeconomic fundamentals, the sustained deployment of Filipino workers overseas, and global liquidity conditions. The BSP recognises that a major challenge related to this development is the need to put in place policies that will help maximise the benefits from the inflows while minimising the associated downside risks. Unfortunately, there is no single measure or approach to achieve this. What is required is a set of consistent policies geared to promoting investor confidence and sound risk management, providing high-quality, timely information and reducing risks associated with higher levels of investments. In this regard, the BSP has adopted a three-pronged approach to managing foreign exchange flows that: (a) promotes productive use of inflows; (b) facilitates private sector outward flows; and (c) sustains strong and stable macroeconomic conditions.

Productive use of inflows involves the prepayment of foreign currency debt and the building-up of the BSP's international reserves, accompanied by initiatives to mitigate the unfavourable impact of an appreciated currency on exporters and families/beneficiaries of Filipinos working overseas.

In facilitating private sector outward flows, the BSP takes the view that liberalising said outflows can help reduce the burden of sterilising net inflows and facilitate portfolio diversification by the private sector. In this regard, the BSP has already implemented the first and second waves of reform in its foreign exchange regulatory framework. These involve changes in regulations pertaining to external current account and capital account transactions as well as prudential measures. The liberalisation of foreign exchange transactions is also expected to help reduce upward pressures on the peso in the short term and allow freer and more efficient capital flows in the long term.

Sustaining a stable macroeconomic environment entails adherence to sound macroeconomic policy – such as fiscal discipline, low inflation and prudent credit creation – which remains the best insurance against capital reversals. At the same time, financial sector policy should be directed at reducing the vulnerability of the financial system by encouraging adequate risk management systems for supervised institutions.

References

Calvo, G, L Leiderman and C Reinhart (1994): “The Capital Inflows Problem: Concepts and Issues”, *Contemporary Economic Policy*, vol XII.

Dakila, F and R Claveria (2007): “Identifying the Determinants of Overseas Filipinos’ Remittances: Which Exchange Rate Measure is Most Relevant?”, *BSP Working Paper Series*, no 2007-02, Center for Monetary and Financial Policy.

Hannoun, H (2007): “Policy responses to the challenges posed by capital inflows in Asia”, speech delivered by the Deputy General Manager of the BIS to the 42nd SEACEN Governors’ Conference in Bangkok, Thailand on 28 July 2007.

International Monetary Fund (2000): *World Economic Outlook*.

——— (2007a): *Global Financial Stability Report*.

——— (2007b): *World Economic Outlook*.

López-Mejía, A (1999): “Large Capital Flows: Causes, Consequences, and Policy Responses”, *Finance and Development*, vol 36, no 2, September, <http://www.imf.org/external/pubs/ft/fandd/1999/09/lopez.htm>.

Magud, N and C Reinhart (2006): “Capital Controls: An Evaluation”, *NBER Working Papers*, no 11973.

Reinhart, C (2005): “Some Perspective on Capital Flows to Emerging Market Economies”, *NBER Reporter*, Summer, <http://www.nber.org/reporter/summer05/reinhart.html>.

Schadler, S (1994): “Capital Movements and Surveillance”, in T Baliño and C Cotterelli (eds), *Frameworks for Monetary Stability and Policy: Issues and Country Experiences*, International Monetary Fund, Washington, pp 357–72.