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**Currency Crisis and Policy Response:
The ASEAN and Philippine Case**

by

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ABSTRACT

This paper describes the start of the Asian currency crisis of 1997 and some of the more important responses by policy makers, using examples from the Philippines and other Asian countries. The ensuing developments are described and analyzed. Based on this latest episode of currency crisis, the study suggests responses that can be tried and those that must not be attempted. It ends with some lessons for the conduct of macroeconomic management.

Currency Crisis and Policy Response: The ASEAN and Philippine Case

by

Cayetano Paderanga, Jr.¹

The recent episode on ASEAN currency markets has given rise to the question as to whether this is based on fundamentals or whether this is due to region-wide reversal in market sentiment. How to respond to the immediate crisis and manage the macroeconomic environment afterwards is then discussed. Summary and tentative recommendations for policy are in the last section of the paper.

I. The roots of the problem

The underlying causes of this region-wide currency correction may be found in the concerns regarding the perceived loss of real competitiveness of ASEAN economies increasingly voiced in the year and one-half before July 1997 and in the substantial appreciation of the U.S. dollar in the first six months of the year. These currencies had appeared to have effectively been pegged to the dollar over the last few years. Physical bottlenecks were showing up in rapidly clogging transport networks and the resulting increase in the cost of doing business. There was perception that the communication facilities of these countries, while rapidly modernizing and deepening, were still inadequate. The lack of real competitiveness is reflected in the performance of the external accounts of the ASEAN economies. First, after experiencing rapid export growth, a drastic slowdown down occurred in 1996 (See Figure 1). These economies also exhibited deteriorating trade and current account balances in recent years (See Figures 2 and 3).

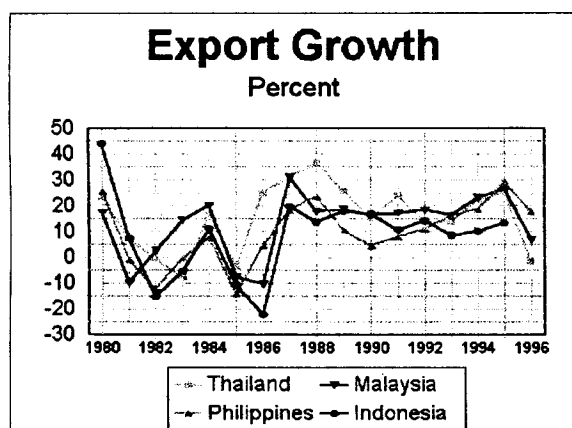


Figure 1

¹Member, Monetary Board, Bangko Sentral ng Pilipinas. The author would like to acknowledge the initial comments of Emil Antonio, Aarne Dimanlig, Jesus Estanislao, Vaughn Montes and the participants in "A Special Conference on Current Philippine and ASEAN Financial Issues," University of Asia and the Pacific. November 4, 1997, and participants of the Meeting on the Currency and Haze Crises in Southeast Asia.

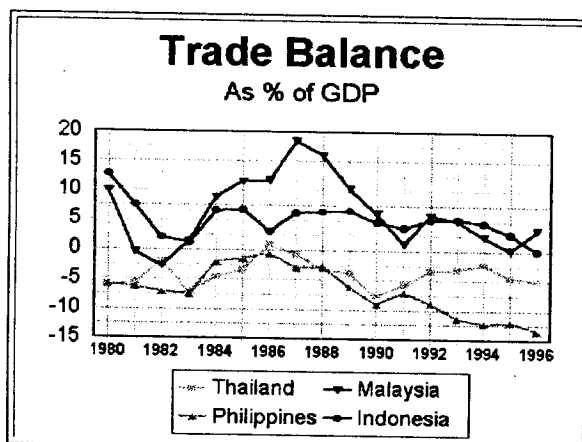


Figure 2

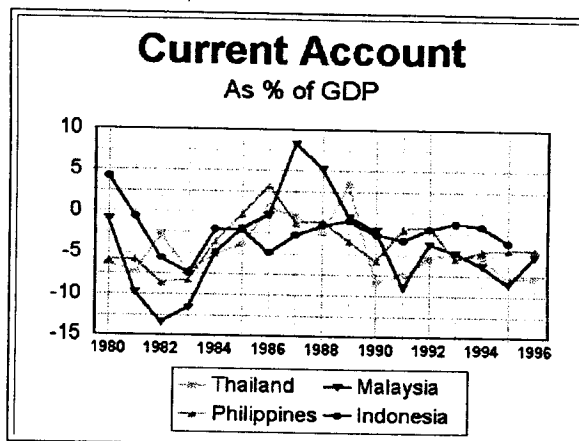


Figure 3

The concern over real competitiveness has arisen over emerging infrastructure bottlenecks in Southeast Asian economies in the last few years. Physical bottlenecks have been manifested in rapidly clogging transport networks and the resulting increase in the cost of doing business. There was also perception that the communication facilities of these countries, while rapidly modernizing and deepening, were still inadequate. Bureaucratic procedures in some countries also increased the cost of doing business. These red tape and elaborate procedures clouded prospects of immediate catch up by investments in infrastructure. This, for example, was one of the questions being raised about the expected higher growth prospects of the Philippines.

Real competitiveness in countries where physical infrastructures' limits were not yet pressing was threatened by looming deficiencies in skilled manpower. Thus, while nobody doubted (at that time) Malaysia's ability to provide the physical infrastructure for its super corridor for information technology, experts were openly wondering where the skilled manpower to fill the positions created would come from. This was particularly important in the face of a few other big projects that the country had announced, for example, its mega-airport, among others. Thus, while the prognoses about Southeast Asian economies were generally still rosy, concerns were increasingly being aired and predictions about medium-term growth were being qualified in the international financial market.

Price competitiveness

In 1994, China unified its internal and external exchange rates, effectively devaluing its currency by more than one-fourth. The Southeast Asian countries were expected to match this depreciation, at least in the medium term, in order to maintain their competitiveness. However, these countries which were undergoing substantial capital inflows at that time were unable to achieve matching currency corrections. Some motivations have been ascribed to the ASEAN countries for this failure to adjust, including the use of the exchange rate as a nominal anchor against inflation.²

²Indonesia was the notable exception as it implemented a policy of gradual depreciation of around 5 percent, roughly equal to the difference between Indonesian and U.S. inflation rates.

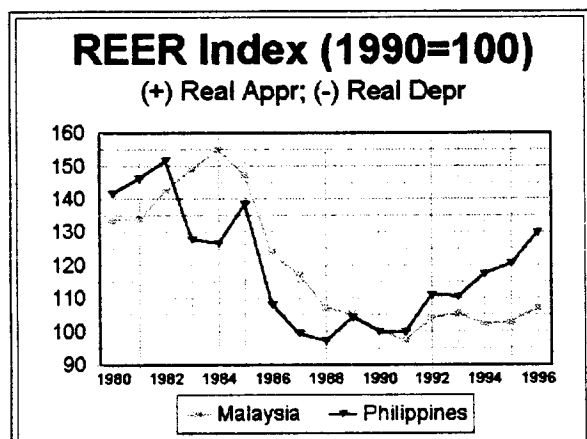


Figure 4

✓ In the first six months of 1997, the Japanese yen and the German Deutschmark depreciated by about twenty and 10 percent, respectively. Since the ASEAN currencies were effectively pegged to the U.S. dollar, this meant that the competitiveness of their currencies which were already misaligned with respect to their biggest perceived competitor, China, had been further eroded. Prior to 1997, there were already indications of the erosion of price competitiveness. Figure 4 shows that a trend appreciation in real exchange rate of the Philippines and Malaysia starting 1991.

Asset bubbles and nontradable growth

The strength of the currencies and the steadiness of the exchange rates in relation to the U.S. dollar gave the impression of macroeconomic stability which fed the stock markets in the region. As a result, there was a boom in the stock markets, the real property industries and other non-tradable activities around Southeast Asia. The consumption of imported articles like cars, perfumes and other luxuries also soared. An accompanying explosion of credit for both consumer and what is suspected to be real estate loans did nothing for investor confidence.

Deteriorating financial sector indicators

Reflective to what was happening in the nontradable sector, domestic credits boomed. Figure 5 shows the rapid expansion in real bank credit. However, this development does not appear to have been accompanied by an increase in industrial production (See Figure 6).

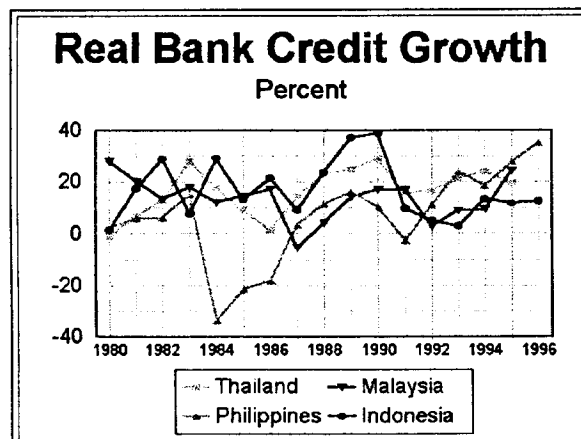


Figure 5

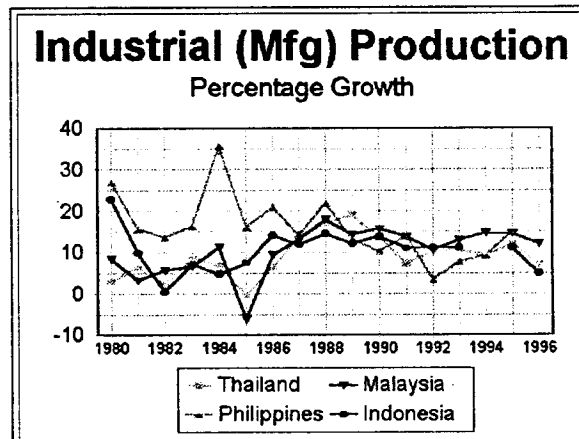


Figure 6

Emblematic of this was the Philippines where domestic credits increased by more than 50 percent in 1994 and by more than 40 percent in 1995. While the monetary authorities were trying to contain base money, the exuberance of the period resulted in a rapidly increasing money multiplier. The increase in money multiplier was not unique to the Philippines (See Figure 7). Increased confidence in the economy and the inflow of capital into the region made credit cheap. The apparent stability in the exchange rates also induced firms and individuals, including banks, to use their newly-recovered access to capital markets abroad.

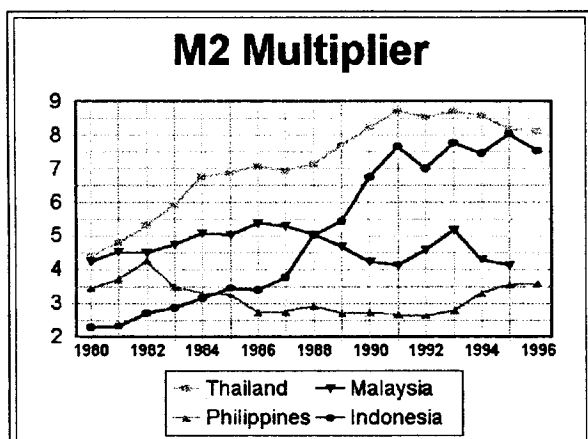


Figure 7

There were also other indicators of a fragile financial system. The rising ratio of bank credit to deposits indicate that the banking systems were becoming overstretched (Figure 8). Likewise, the net foreign exposure of the banking systems dramatically increased in the nineties, making them susceptible to external shocks (See Figure 9).

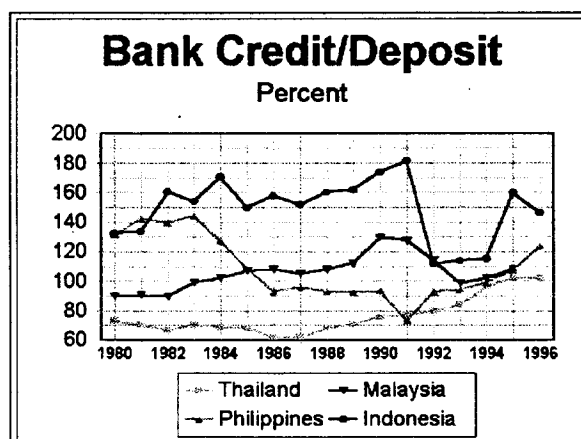


Figure 8

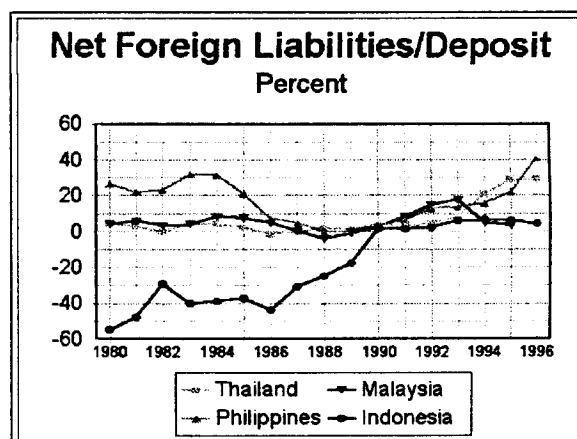


Figure 9

The apparent stability in the exchange rates also induced firms and individuals, including banks, to use their newly-recovered access to capital markets abroad. It started with a wave of initial public offerings (IPO's) both domestic and foreign and was soon followed by convertible bonds floated abroad. The ultimate statement was made by the issuance of a few Philippine banks of floating rate certificates of deposits (FRCD's).

During the first part this year, increasing concerns expressed by analysts caused the private sector and monetary authorities to caution against the rapid increase in foreign obligations. The banking sector also slowed down the growth of domestic credits. During the first part of this year, this had decelerated to

just more than 30 percent. However, from hindsight, this was already too late. Doubts about the fundamental stability of the financial markets had already been planted. Starting with the devaluation of the Thai baht on July 2, 1997, the rest of the ASEAN currencies have been rocked by successive shocks (with the possible exception of the Singaporean dollar).

Could it have been avoided

Could have the crisis been avoided? That question is probably foremost in the minds of several ASEAN policy makers since, at least, some of them have tried to implement macroeconomic policies to prevent the "overvaluation" of exchange rates identified with "Dutch diseases" and the Southern Cone problem. Indonesia had followed the gradual depreciation of the rupiah at a rate equal to the difference between U.S. and domestic inflation. Thailand had used fiscal surpluses to allow itself the leeway to purchase capital inflows without triggering inflation.³ Malaysia, on the other hand, had tried to reduce its inflation to a rate equal to that of developed countries (thereby negating the need for corrective devaluation). In the Philippines, the issue of currency "overvaluation" was a constant fuel for heated debates among several sectors even as policy makers tried to lower inflation to the rates of its neighbors and trading partners. Looking back, ASEAN policy makers with the possible exception of the Philippines which was under an IMF program seem to have been aware of the dangers of currency misalignment and were using available macroeconomic instruments to avoid its dangers. The main weakness in most of the ASEAN economies seems to have proceeded from microeconomic aspects of the "overborrowing syndrome" (McKinnon and Pil, 1995; Krugman, 1998).

On the other hand, it must be borne in mind that the inflow of foreign funds facilitated by the ease of foreign borrowing had resulted in widening trade and current account deficits and other macroeconomic imbalances identified with the "Dutch disease" and "Southern Cone" problems, as mentioned earlier. To what extent stronger macroeconomic efforts at preventing the manifestations of misaligned currencies should have been attempted will now be discussed among researchers and practitioners.

II. Policy responses

The most pressing question confronting us now is how to respond to the continuing currency shocks to their economies. Several actions in various combinations have been suggested including the following: maintenance of macroeconomic discipline, presentation of a credible package, "rescue packages" from the IMF and some partners, more market orientation in exchange rate management. Other, more radical, suggestions include regulation of currency trading and regulation of market players.⁴

What not to do

It could be confusing to choose from the various combinations of policies available for responding to the shocks. More obvious is what should not be done. Nothing could be worse than policy actions which introduce more uncertainty into the economic system. Among these are interventions designed to bring about policy-desired instead of market-determined outcomes. An example of this would be interventions in the currency market, which are patently ineffective and unsustainable, epitomized by the unsuccessful attempt by Malaysian authorities to use pension funds to hold up stock market prices. Included would be incessant rule changes devised to restrict the activities of market players. While both of these actions may have their functions in normal times, they only manage to cloud the environment and increase uncertainty during turbulent periods.

³Moreno and Spiegel (1997).

⁴While not receiving much support at the moment, these suggestions, nevertheless, could be included in an alternative set of more radical responses.

Incredible market interventions add incorrect information because the market realizes that such activities cannot be sustained. Instead, market players end up wondering where the rate will end up when the interventions are finally over. During the process the authorities become weaker as market players unearth more information about how meager their resources really are.⁵ The danger is that when the turmoil finally starts to subside the authorities will no longer have the resources to "guide the market."

Constant changes in the rules under which market players operate have effects which are just as perverse. The rule changes places unanticipated restrictions on market players actions. While these temporarily bring about curtailments in market fluctuations, the results are ephemeral because what is really achieved are unintentional rigidities in the market's ability to stabilize shocks. What is more, market actors will now apply premiums for their activities. Authorities actually end up with market players continuously trying to second-guess their actions. The market very soon ends up being more volatile than before. Besides, the required premium required by market players will be registered in exchange and international interest rates, among others, being higher. These premiums represent economic costs which are totally unnecessary and which do not really help in the recovery from the turmoil.

Indeed, several other admonitions may be given. Most of these hover around the central theme that trying to alter to the market and tinkering with the rules are better left alone during periods of turmoil. The first objective is to remove uncertainty from the system as soon as possible. While uncertainty lingers, no plans are being made, no investments being done, and no significant economic activity is being carried out. Any action which prolongs this state of affairs merely worsens the economic malaise coming from the initial shocks. Instead, authorities need to immediately show the markets that no extraordinary effort is being made to embroider what is admittedly a negative picture. Transparency as to the true state of affairs and the immediate intentions of the authorities are the minimum ingredients for returning the economy back on track.

~~What~~ to do (the bare elements)

One of the palpable effects of the prevailing currency turmoil is the paralysis that it has induced in almost all sectors of the Philippine economy. There are several manifestations, most of them interrelated.

One dimension often mentioned is the pervasive uncertainty in the economy. This has been manifested, for example, by the drastic underachievement of most sales targets in the last Christmas season despite the continuing income growth and low inflation. Because of the continuing depreciation of the peso and the popular talk of expected inflation and labor dislocation, households preferred to hold on their cash.

The uncertainty induced by the currency turmoil may also have increased the cash and liquidity preference of households, increasing the deposit rate levels these households required. The resulting absence of liquidity, coupled by the opening up of the government fiscal deficit, put upward pressure on interest rates. These interest rates in turn led to a noticeable reticence on the part of businessmen to implement investment programs, start production cycles, or engage in new economic activities.

These developments indicate the need for a comprehensive approach focused on the currency problem. The public is in dire need of a credible assessment of the situation and coherent, feasible plan to respond to the economic developments. At the moment, responses by the various sectors have been disjointed, ad-hoc and uncoordinated. This results in a pervasive feeling of helplessness in the face of seemingly uncontrollable events. Concerted action, whether fully or partially successful, would remove the most immediate effects of uncertainty.

What has really happened?

⁵Besides, in very recent days market wisdom is increasingly shifting towards the view that governments even acting in tandem do not have the resources to counterbalance what is now a multi-trillion dollar market.

One way to start thinking of the prevailing currency problems is to ask the question what would happen if all prices (and incomes) within the economy were to be multiplied by two. The simple answer would be "no" except for a renumbering of all nominal values. The real situation, of course, is different from this conveniently reassuring, simple model. The significant differences are discussed in the succeeding paragraphs. This simplified picture is introduced in order to calm the most common cause of panic about the current situation: that prices of most goods, especially basic commodities, will rise beyond the reach of the working masses. After the initial panic, the following feeling of helplessness and frustration follows almost naturally.

In reality, the current situation is more than just a renumbering. There are at least three differences from the simplified model. First, there may be firms and financial institutions with unhedged foreign currency obligations. Second, there is a change in the ratio between the price of importable or exportable (i.e. "tradeable") goods and the price of non-tradeable commodities (e.g. haircuts and real estate). Another way of describing this is to say that there has been a change in the price ratio between the imported component of Philippine output and the local content. Finally, there is an inflationary injection resulting from the depreciation. This injection is dependent on the import component of the economy.

Asset redistribution

The presence of unhedged foreign obligations is the most immediate aspect of the currency depreciation. Firms, taking advantage of low foreign interest rates and the seeming stability of the peso-to-dollar exchange rate, face the possibility of financial failure due to the peso's depreciation. In the immediate future, these firms will probably try to stave off failure by cutting down on its expenditures, including the slow down in its employment and production activities⁶. (In the long-run, firms with competitive advantage under the new environment will probably be bought by third parties and will continue to function at normal rates as long as its activities are viable under the new environment.) The foreseeable effect is a rearrangement of firm and industry ownership among those most exposed to unhedged foreign obligations. While this could lead to a transfer of resources from less to more efficient⁷ managers of the economy's assets, one can expect a heightened lobbying for protection from the groups under threat. As a matter of fact, the mingling of political and economic power has been blamed for the inability of governments to act decisively during the Asian currency crisis.

On the other hand, certain actions have to be done during periods of turmoil. Authorities need to make an honest and transparent assessment of the situation.⁸ A well-executed, sober study — by, say, a credible body of high government officials or a respected commission — will significantly reassure markets that there will be no surprises in the future. At the same time, allow the prices to settle at market-oriented even if, perhaps, initial levels.⁹ Authorities should trust in the high-level assessment to guide the market fundamentals and attempt to influence outcomes only after markets have substantially stabilized.

This often leads to a dilemma on what to do about vulnerable entities in the economy. Sectors of the economy are either (a) overexposed to foreign obligations and, therefore, vulnerable to currency depreciation or (b) unable or slow to make the adaptations to rapid price movements. Some of the former institutions may even involve foreign investors, leading to the fear of a loss in international credibility.

⁶In the long-run, the firm will probably be bought by third parties and will continue to function at normal rates as long as its activities are viable under the new environment.

⁷At the very least, less to more prudent and effective managers.

⁸Here any analysis of the economy which is too rosy is probably going to be discounted by the markets and will only add to the uncertainty as to the true picture.

⁹Trying to influence the outcomes at this point will only confuse the markets.

The prescription in both cases is to allow the price shocks to go through the domestic economy as fast as possible in order to avoid the prolonged uncertainty mentioned above. The best avenue, it seems would be to allow the currency and financial sectors to absorb the external shocks and to let the real side of the economy to continue on its activities as soon as possible.

Overexposed firms, including their foreign investors, made business decisions dependent on the strong domestic currency and must take the losses as part of the cost of doing business. A favorable turn of events would have given them large profits, to which they would have felt perfectly entitled to. Allowing them to reap the fruits of their decisions can be expected to increase credibility of our commitment to market processes. There is also the signal that authorities may be sending to economic actors. These firms made business decisions to speculate on inflation hedges. Rescuing them now would encourage others to overinvest in these activities in the future, to the detriment of more productive and developmental projects.

The downside to this "cold-turkey" approach to the financial shock is the danger of systemic disturbance to the banking sector. As firms feel the pressure, the stress will show up in the balance sheets of banks in the form of non-performing loans and bank ratios start to deteriorate. The issue of forbearance versus decisive action and their attendant side effects become apropos at this point.

Two points may be made at this time. It may be helpful to distinguish the impact of the currency shock on the balance sheet from that on the profit and loss statement. As policy makers try to prevent the shock to the balance sheet by defending the exchange rate, they may use high interest rates and other instruments which may, in their own way, be detrimental to the profit and loss statements of firms and banks. The latter may actually have longer-lasting and more debilitating effects when all the costs are calculated.

As a second consideration, policy makers could look at the total system as consisting of three important sectors: the currency market, the financial sector, and the real economy. Policy intervention can be applied at any point in the chain, depending on the economic and social policy of the country. A vigorous defense of the currency, depending on the instruments use, could imply that authorities have decided to let the currency shock go through the currency and financial sectors straight to the real economy. Allowing the exchange rate to adjust implies that some of the shocks will be contained in the currency and financial markets. In the financial sector, policy intervention can take the form of liquidity relaxation and third-party capital infusions into firms and banks. Numerous combinations of several instruments can be packaged. It is important to note that not doing one instrument cannot be equated with doing nothing.

Vulnerable sectors include wage workers whose pay respond slowly to price changes. Drastic price movements such as that caused by substantial currency depreciation can be traumatic to these sectors. Following the general principle of letting price shocks go through the system, we can allow wage adjustments for these sectors based on the impact on their cost of living rather on panicky reactions to the exchange rate.¹⁰ This will assuage these sectors that they will again pay the price of currency shocks and policy mistakes. As long as these guidelines are followed, there can be an orderly adjustment to the initial shock and a net benefit from the real exchange rate adjustment.

Banking and credit difficulties, higher interest rates

Some of the organizations with unhedged foreign obligations are banks which issued floating rate certificates of deposit (FRCs) and are now severely under pressure from the increase in the peso value of their obligations. The servicing costs of these obligations have also increased dramatically in peso terms. There are two immediate effects: first, with the increased need for servicing these banks require immediate liquidity and will therefore be willing to pay higher interests just to acquire the needed liquidity; second,

¹⁰ A concrete application of this is to allow wage adjustments to the extent of actual or estimate inflationary impact of the currency shock (rather than to the full rate of the currency adjustment which would be based on the exaggerated assumption that their whole market basket is imported).

the ability of these banks to service the liquidity needs of their clients will be severely impaired. This leads to the initial impetus for a credit crunch under the Mishkin(1996) scenario.

In desperation, these banks bid up the marginal deposit rates and put pressure on the other banks to also increase their deposit rates. This increases the marginal costs of funds for all banks. In the atmosphere of uncertainty described above, this triggers the second step of the credit crunch. Banks throughout the system now increase the lending rates (and the required rates of return on approved projects), make rollovers of current bank loans difficult, cut down on credit lines, and even unilaterally reduce approved loan values. There is an increase in the excess reserves of banks as they try to be as liquid as possible. Together with the reduction in asset prices which reduces the value of collateral, these developments induce the onset of a full-blown credit crunch.

The foregoing developments are aggravated by the policy actions of authorities. For example, the *Bangko Sentral ng Pilipinas* belatedly¹¹ tried to limit the exposure of Philippine banks to foreign obligations and to sensitive sectors of the economy and introduced policy changes as the crisis was unfolding. Since July 11, 1997, for example, the monetary authorities have imposed a requirement that 30% of the foreign currency deposit units must be invested in the form of cash and near-cash assets, lowered the loan values for real estate purposes from 70 to 60%, raised (but subsequently lowered) the liquidity ratio by 2% then an additional 2 %. They also imposed a minimum loan-loss reserve ratio (i.e. aside from the usual set-aside for expected uncollectible loans estimated through various techniques) of 2% on all banks, to be phased in over two years. Table 3 enumerates some of the more prominent changes in regulations enacted by the Monetary Board since July 11.

The problem is that reactive and frequent policy changes during a period of turmoil is that it worsens the situation by adding policy uncertainty. The end result has been a reduction in the available credit. Banks have had to reduce loan amounts, ask for additional collateral, or reduce credit lines. The resulting credit crunch increased interest rates.

Table 3
Measure Taken By BSP Since July 11, 1997

1.	Regulations pertaining to FX positions	<p>10% overbought, 20% oversold</p> <p>5% overbought or \$10 million, 20% oversold</p> <p>required all banks to submit a report on the daily consolidated FX position of banks (including branches/offices, subsidiaries and affiliates, in the Philippines and abroad)</p> <p>advised all AABs to require the submission of an applicant's income tax return to support an application to purchase foreign exchange not exceeding US\$ 6 million for outward investment which does not require prior BSP approval</p>
	BSP Circ. 134 (7-22-97):	
	BSP Circ. 137 (7-31-97):	
	Circular Letter (9-5-97):	
	Circular Letter (9-11-97):	
2.	Non-deliverable forwards	<p>Prior BSP clearance for NDFs</p> <p>Submission of inventory of NDFs with non-residents required all commercial banks to report to the BSP all cancellations or nondelivery of outstanding forwards sales contracts not later than 2 banking days after cancellation/non-delivery</p> <p>provided rules and regulations governing the NDF foreign exchange facility of the BSP</p>
	BSP Circ. 135 (7-22-97):	
	Circular Letter (7-22-97):	
	Circular Letter (10-24-97):	
	BSP Circ. 149 (12-22-97):	

¹¹That is, after the currency turmoil had affected the Philippines on July 11, 1997.

3. Changes in allowed OTC transactions
BSP Circ. 138 (7-31-97) adjusted the maximum amount of dollars that banks can sell OTC, without need for documents, to US\$25,000 from US\$100,000
4. Increases in liquidity reserves
BSP Circ. 136 (7-31-97): 4% liquidity floor
BSP Circ. 139 (8-14-97): 5% liquidity floor
BSP Circ. 140 (8-27-97): 8% liquidity floor
BSP Circ. 141 (9-4-97): Scheduled lowering of liquidity floor
For EKB/KB/NBQBF
8% to 7% by 9-5-97
7% to 6% by 9-12-97
For Thrift Banks
8% to 7% by 9-5-97
7% to 6% by 9-12-97
6% to 5% by 9-19-97
For Rural Banks
5% to 0 by 9-5-97
BSP Circ. 144 (10-1-97): Scheduled lowering of liquidity floor
For EKB/KB/NBQBF
6% to 5% by 10-15-97
5% to 4% by 11-15-97
For Thrift Banks
5% to 4% by 10-15-97
4% to 3% by 11-15-97
5. OTC sale of foreign exchange to residents for non-trade purposes
BSP Circ. 138 (7-31-97): lowered to \$25,000
6. Adjustments in loan loss provisions
BSP Circ. 143 (10-1-97): 2% general loan loss provisioning
transitory provision - 1% first year; 2% second year;

BSP Circ. 148 (11-10-97): also amending the guidelines for post-due loans reducing the number of installments in arrears from six and two to three and one in cases of loans payable on monthly and quarterly installments respectively
Amending policy on general loan loss provisioning exclude interbank loans from coverage
transitory period - 1% first year; 1.5% second year, 2% third year
7. Ceilings on Real estate loans (prior July 11)
Circular Letter (6-5-97): 20% limit excluding loans for residential units not exceeding P3.5 million
Loan value not more than 60% of appraised value except housing loans and loans not exceeding P3.5 million to finance residential units

Circular Letter (9-25-97): Prescribing schedules for housing loans under government programs, real estate loans considered non-risk assets, and real estate loans with original amounts of P3.5 million and below
8. Regulations pertaining to FCDUs
Circular Letter (6-6-97): 30% liquidity cover on FX liabilities of FCDUs

- | | |
|---|---|
| BSP Circ. 142 (9-16-97): | provided that an investment funded by foreign exchange deposited in the investor's FCD account for investment purposes shall be issued a BSP registration document (BSRD) only after the amount deposited has been converted to pesos |
| Circular Letter (10-30-97): | provided that the encumbered foreign currency cover for foreign exchange liabilities in the FCDUs of commercial banks shall be: (1) minimum of 15% effective 12-15-97; and (2) minimum of 30% of 30% effective 6-15-98 |
| 9. Disclosure of FX positions
Circular Letter (7-17-97): | FX position submitted within 24 hours |
| 10. Publication of interest rates
Circular Letter (9-5-97): | EKBs required to submit to BSP interest rates for the BSP to publish |
| 11. Forex subsidiaries/affiliates of banks
Circular Letter (9-5-97): | Forex subsidiaries/affiliates of banks are considered as part of the banking system and are subject to the FX rules and regulations; submission of consolidated FX position |
| Circular Letter (9-17-97): | Forex subsidiaries/affiliates shall not sell FX to: non-residents and resident financial institutions other than Authorized Agent Banks of the BSP and bank-affiliated forex corporations |
| Circular Letter (10-2-97): | Clarification to Circular Letter (9-17-97) - Forex subsidiaries/affiliates may sell FX to residents but not to resident financial institutions other than Authorized Agent Banks of the BSP and bank-affiliated forex corporations |
| 12. Reporting of forward sales contracts
Circular Letter (10-9-97): | Submit a report on all forward sales contracts starting January 1997 to September 1997; regular submission of monthly report |
| Circular Letter (10-24-97): | Reporting of all cancellations and non-delivery of outstanding forward sales contract
Commercial banks with expanded derivatives licenses which transact NDF are exempt from such requirements |
| 13. Report on auto loan and credit card exposure
Circular Letter (11-10-97): | Quarterly report on auto loans and credit card receivables by commercial/thrift banks and NBQBs |

In addition to the foregoing developments, the public responds to the uncertainty by shifting their portfolio towards more liquid assets (cash and near-cash). This leads to a general increase in the cash-to-deposit ratio. Together with the increase in cash reserves of banks, this development reduces the money multiplier. With roughly the same amount of base money (following the normal monetary program), liquidity in the economy contracts and interest rates rise.

Economic slowdown

The second dimension of the exchange rate correction is the change in the price ratio of tradeable relative to non-tradeable goods. This means that economic activities and industries which were viable under the old exchange rate (say P26.40:\$1) such as some real estate and consumer-durable projects will no longer be viable. On the other hand, some industries may become more attractive under the new exchange rate (say P40.00:\$1) but will start producing only after a time lag.

There are two short-term results of this industrial restructuring: First, economic output (gross domestic output, GDP) will contract in the immediate future as sunset industries stagnate and sunrise industries take time to tool up for full production¹². The immediate expectation for the Philippines, even under the best circumstances, therefore, is for a reduction in the rate of GDP growth.

Rise in unemployment

The second short-term impact, corollary to the first, is an increase in unemployment as firms in the sunset industries retrench while there is a lag in the employment increase in sunrise industries. While the restructuring would have been desirable in order to enhance Philippine competitiveness, the suddenness and radical extent of the change give rise to unwanted short-term difficulties. Even under the best of circumstances, that is, even when no reduction in general economic conditions are experienced, industrial restructuring will imply a temporary increase in unemployment because of the friction in moving worker from sunset to sunrise industries.

Increased inflation

Finally, the exchange rate correction can be expected to result in an increase in measured inflation.

III Suggested Responses

Full assessment of the situation and a credible program

One of the most immediate tasks of government in the currency turmoil is to restore economic equilibrium and remove uncertainty from the system as fast as possible. For this, it has to provide a candid and full assessment of the situation and present a coherent, decisive and credible response.

A set of respected officials, beefed up by civic leaders and experts, must be formed into a high-level commission. Fully supported by a secretariat coming from inside and outside government, this group can provide a candid, full and credible assessment of the economic situation and the short-term risks faced by the country. This will indicate to everybody where their particular risks lie, allowing them to make the necessary individual adjustments and preparations in order to minimize recognizable risks. This would be much preferred by individual actors to the hazy picture which most of them would have in a situation where guess work as to the extent of risk that each, individually, is under.

An important component of this assessment would be the expected impact on critical sectors such as banking where uncertainty could lead to indiscriminate withdrawals from the financial system. This lack of information reinforces the uncertainty already present in the economy.

The report on the current situation needs to be accompanied by a strong, consistent and credible program of what to do in the short-term in order to stabilize then rehabilitate the economy.

Financial sector policies

¹²Depending on the import and export elasticities, this may also result in an increase in the balance-of-trade deficit as

The assessment of the financial sector must be accompanied by a strong indication that the government will move strongly to resolve the situation. While the effect of forbearance on the incentives in that sector must be considered, it would be important stress that present institutional arrangements will be used to protect depositors. This is needed to reassure the public and prevent unwarranted panic.

At the same time, the commission must determine as speedily and accurately as possible the suspected reduction in the money multiplier in order to infuse the needed liquidity into the system. To preserve the correct public perception and maintain desired level of price expectations, the government must reiterate its adherence to disciplined monetary policies. This infusion of liquidity while holding on to the correct inflationary expectations is designed to reduce the level of interest rates as soon as possible.

Credit systems targeted toward low-income groups channeled through government agencies can also be facilitated to protect the most vulnerable sectors from higher interest rates.

Labor-facilitation, retraining and other safety nets

To reduce frictional unemployment as much as possible, labor matching and facilitation services through government and non-governmental channels must be speedily reinforced. Several features can be tentatively proposed to jump start the process: use of systematic national, regional, and local databases to match jobs with applicants; continuously updated inventories of job vacancies and applicant pools; state-of-the-art information networks to support the system and procedures; local committees for tripartite planning and labor facilitation administration.

Infusion of resources into a serious labor training and re-training program. The tripartite (with NGO participation, where useful) system must be used to a) determine which industries and firms are liable to be under stress, b) estimate the number of workers to be affected, c) determine where they can be absorbed, and d) design the retraining programs needed to make them ready for their next jobs.

For those workers, desirable to form their own small and medium enterprises or who may be difficult to place can be assisted with training, extension consultancy, credit and even joint venture capital assistance. These livelihood projects can be used to enhance the existing livelihood programs of the different government agencies.

Fiscal restraint

Even if the government has not been particularly profligate in the current turmoil, it still has to exercise fiscal restraint if just to show its determination to keep inflation in check. The abolition of the most obvious candidates of wasteful expenditure and their reallocation to the programs listed above is imperative. A target reduction of several billion pesos and where they will be taken from would strongly stress this resolve.

Timing is important here. This may be needed only for a few months if the government is able to carry it out effectively. Once the economy has been stabilized, it may need to increase expenditures in order to prime the economic recovery. In other words, this does not necessarily mean penury for government supported activities. Rather, it requires consummate timing and sequence of government actions.

Institutional framework

For the safety net programs to be most effective, it must be exercised as close to the ground as possible. For this reason, regional, provincial, and local multi-sectoral committees led by the local government units, chambers of commerce and unions must be mobilized to assess the local situation, estimate the actual impact on the ground, plan and monitor the retraining, facilitation and livelihood programs. As much as possible, national government must facilitate and support but mostly allow the local participants large say on the shape and design of these programs.

Program for Rehabilitation and reform

Once the current turmoil in financial markets has stabilized, a program of rehabilitation and structural reform needs to be put in place. The same high-level body can also prepare a program of rehabilitation and reform designed as a broad overall response to the new international environment.

The first component of this medium-term program would be actions to strengthen the banking system and the financial sector. It could start with a comprehensive review of bank policies with the view towards strengthening methods of supervision and examination. A systematic analysis of financial techniques and instruments can also be carried out in order to define the set of allowable market-oriented bank activities. This study would include new instruments such as derivatives and new policies such as exposure to the various sectors of the economy. It would be reviewed regularly for modifications but would remain fixed in the interim. The final output could be a comprehensive report on the banking and financial sectors, laying out its current status and the necessary reforms and medium-term guidelines needed to strengthen the financial sector.

The next step can be the implementation of a market-oriented exchange rate policy which, at the same time, pays attention to the underlying fundamentals of long-run competitiveness and the developmental trade-off between tradable and non-tradable activities. This would reassure market actors, including foreign investors, that policy makers will try to avoid drastic market corrections in the future.

To address the long-term competitiveness of ASEAN as a place to operate, there should be a systematic, consistent and persistent program to improve physical, financial and human resource infrastructure. The exact proportion among the three components will depend on the current endowments of each country but the thrust should be unmistakable. Those countries such as the Philippines that lag in industrialization also need to emphasize strong programs to steer their economies away from non-tradeable toward tradeable activities.

This high-level body may also inquire into each country's response to the calls for more international cooperation in preventing and responding to currency crises. A study of the current turmoil suggests some principles which may be useful for deciding which forms the cooperation will take. First, investor panic seems to feed on the paucity of information. The inability to distinguish between vulnerable and strong countries worsen the asymmetric information problem that leads to contagion.¹³ Second, when currency turmoil starts indecisiveness and hesitation on the part of authorities can quicken the panic and herd instinct of market players afraid to be caught leaving when the currency is permanently devalued. A strong and consistent response by the authorities will reassure investors that fluctuations will be temporary or minor adjustments. Third, market players will also be looking for medium and long-term plans or programs in addition to short-term actions. This would imply that temporary fixes to symptomatically calm markets will not work in the end.

There are several levels for possible cooperation. Countries can routinely exchange information on what is happening in their currency and financial markets. This will go beyond the price and volume of trading which are routinely published by formal markets. The short and medium-term flows of currency and other capital funds can also be regularly exchanged in order to spot emerging movements. Suitably alerted, authorities can decide to act in concert or independently fix what may be causing the large movements. Following the alert, governments can plan their responses and inform regional partners in order to apprise them of possible spill-over effects. Thus, surprises will be less and authorities can act in tandem when needed.

On the same considerations, a more elaborate consultation process among ASEAN macroeconomic managers can be instituted. This may not need new institutions. One of the Senior Officials Meetings or Ministerial meetings can be transformed into a G-7 type of meeting where

¹³Frankel and Shmukler (1996).

macroeconomic developments and plans for each country can be reported. Some discussions can be informally undertaken, with each government noting the comments of its partners but with the full freedom to do as it sees fit. At the very least, this will allow other countries to anticipate and allow for expected spill-overs. At best, some adjustments to allow for spill-overs to other countries can be made.

A review of the existing liquidity arrangements can be made in order to maintain and increase their effectiveness. One possible enhancement is the suggested institutions of the Asian currency fund. However, in order to minimize the possibility of incentive incompatibility problems (where governments will become more lax because of the availability of the bailout fund), some form of monitoring and consultation may be necessary. Some have suggested that this fund be attached to the IMF process. This has the advantage of avoiding administrative duplication. However, this will have to be discussed further in order to examine all the dimensions of the issue. At any rate, a strong effort to enhance the present regional cooperation arrangements needs to be undertaken.

Summary

This paper has examined the roots and responses to the ASEAN currency crisis. It asserts that while speculation may have helped magnify the impact of the disturbance, there were investor concerns which had been expressed long before the unfolding of events. Early response to these concerns would have mitigated a significant portion of the turmoil.

Once the turmoil had started, some forms of responses — from hindsight — would have minimized the turmoil. Lessons on how to respond to these events in the future may be gleaned by a thorough and systematic analysis of the present crisis.

Finally, ASEAN can perhaps look for ways to cooperate in order to avoid or mitigate the occurrence of currency turmoil in the future.

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