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(For discussion only)

**IMPLICATIONS OF FINANCIAL INSTRUMENT
INNOVATIONS ON MONETARY POLICY
AND MANAGEMENT**

Inception Report

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INTRODUCTION

The Bangko Sentral ng Pilipinas (BSP) has requested assistance from the USAID-Manila to examine the impacts of recent financial innovations taking place in the Philippine financial sector on the conduct of monetary policy. The ultimate objective of the requested assistance is to strengthen the capability of the BSP in monetary policy and management with respect to financial instrument innovations. The specific tasks of the contractor are the following:

1. Assess the existing potential use of new financial instruments in the Philippine financial market and analyze the underlying features of such instruments, including derivatives, bonds, securities and equity instruments, swaps, options and other off-balance sheet accounts, as well as those arising from foreign exchange transactions.
2. Assess and measure the potential impact of the new financial instruments on the behavior of leading monetary aggregates and key monetary indicators, including multiplier, velocity, interest rates and exchange rates. This shall include an in-depth assessment of the present definition of monetary aggregates.
3. Assess the impact of the electronic money payment system expected to be introduced in 1998.
4. Provide limited short-term training for immediate requirements necessary to improve BSP management capability to deal with perceived urgent stabilization problems. Justification should be provided for these training requirements.
5. Provide recommendations on policy and institutional measures to further strengthen monetary policy and instruments with respect to these financial innovations. Recommendations shall include policy advice, quantitative estimation activities, information monitoring systems and additional training requirements for BSP staff. Recommendations for the different measures and their assistance requirements should be supported by justification and should include a listing of priorities.

Barents has been selected as the contractor for this activity. This inception report outlines the approach the contractor is going to adopt to carry out the tasks indicated above.

DEVELOPMENT CONTEXT

The Philippine financial system was liberalized considerably beginning in the early 1990's. Rules on exporter sales of their foreign exchange proceeds were eliminated and a foreign exchange market developed. In the fixed income markets, the government began to issue medium and long-term securities, ranging from 2-year notes to long-term 20-year bonds. The private sector began to issue medium-term commercial papers. The liberalization of the entry and scope of operations of foreign banks increased competition in the banking system. The increased competitive environment motivated banks to introduce new financial instruments into the local financial system.

There also was some interest on the part of policy makers in allowing financial derivatives markets to develop. In late 1995, BSP issued circular 102, which spelled out the

conditions necessary for banks to obtain licenses for derivatives activities. These conditions include establishment of a risk management unit as well as software and expertise preconditions.

As of mid-1998, 11 banks have been authorized to conduct derivatives activities under "expanded" derivatives licenses. In addition, many banks have outstanding applications for such licenses.

As early as late 1996, shortly after the first institutions were authorized to do derivatives, there was some small amount of derivatives activity. When several Asian countries had crises in July 1997, the Philippine peso also was affected. The exchange rate, initially at P26 to the dollar, depreciated over a number of months to about P40 to the dollar. The BSP severely tightened the allowable banks' net long foreign exchange positions to the lesser of 5% of capital and P10 million, in reaction to the peso's sharp depreciation. The BSP has also sought to limit the use of non-deliverable forward contracts and dollar deposits associated with the peso forward contracts.

These developments have posed potential challenges to the stability and effectiveness of Philippine monetary policy and management.

ISSUES AND APPROACH

This section outlines the issues to be analyzed and discusses the approach to be used to examine financial innovations in the Philippines and the effect on the monetary aggregates and monetary policy. It proceeds from a simple framework in which the BSP uses an intermediate target to influence the ultimate target of monetary policy.

Through discussions with regulators and market participants and data analysis, the contractor will evaluate the importance of financial innovations, such as financial derivatives and other innovations, problems with the markets, and problems with the supervision of financial markets and institutions on the formulation and implementation of monetary policy. (The people to be interviewed, questions to be asked, and the issues to be evaluated follow as attachments.)

A Financial Derivatives

1 Investigate the Extent of Derivatives Use

- A Obtain and evaluate the BSP data on the volume of different types of financial derivatives
- B Investigate which types are commonly used and by which type of institutions

2 Problems Regarding the Use of Derivatives

- A Talk to market participants---foreign and domestic banks with derivatives licenses or who have applied for expanded derivatives licenses---about issues regarding

- Problems with hedging
- Problems with accounting
- Problems with BSP forms and regulations

B Talk to the BSP about financial derivatives, with emphasis on

- Types of derivative that concern BSP
- Perceived effect on monetary policy formulation of foreign currency deposits

C Talk to Department of Finance on tax issues, especially

- Relating to government securities and repurchase agreements
- Relating to derivatives

B Regulatory Issues

The contractor will consider a number of issues regarding bank regulation. These include

- The structure of bank regulation in the Philippines as it relates to monetary policy issues
- The regulation of derivatives and other financial innovations
- The role of regulation and the efficiency of financial markets

C Monetary Policy Issues

The contractor will analyze the current use of derivatives and other financial innovations. This analysis will consider

- Empirical problems in measuring the monetary aggregates
- The use and affect of money substitutes (e.g., ATMs, credit cards, smart cards, CTFs, FCDUs, etc.)
- Risk to the banking system
- Implementation and effectiveness of monetary policy

The contractor will analyze the BSP's general approach to monetary policy. This area of investigation will include

- The goals and objectives, both short-run and long-run, of policy
- The role of the exchange rate and interest rates in setting policy
- The use of reserve requirement changes

D Other Issues

The contractor will also consider the operation of the government securities markets. The emphasis in this section will be to determine how current regulations and tax system affect the

government securities markets, the efficiency of the capital markets in general, and the implementation of monetary policy

DELIVERABLES

The report submitted by the contractor will include the following items

Discussion of the role of financial markets in economic development, including government securities, markets, private debt markets, and the role of financial derivatives in allowing risk transfers

Analysis of the extent to which financial derivatives are being used currently in the Philippine economy and prognosis for future use

Evaluation of whether financial derivatives are impacting the implementation of monetary policy

Evaluation of whether financial derivatives are affecting the monetary aggregates

General assessment of the focus of monetary policy

How should policy be implemented? With base money, interest rates, exchange rates?

Assessment of the functioning of the government securities markets

How is the primary market working? How is secondary market working? (These are vital both to the implementation of monetary policy and to the development of the capital markets)

Evaluation of whether the BSP should look at the derivatives positions of the commercial banks in a way consistent with prudent risk management

Subject to data availability, analysis of the extent to which financial innovations, such as credit cards, ATMs, debit cards, and smart cards are currently being used and their potential effects on monetary policy

Evaluate the use of dollar deposits at Philippine banks (FCDUs) and dollar deposits accompanied by peso forwards (i.e., so-called engineered swaps) Evaluation of which monetary aggregate, if any, should include some or all of FCDUs

Conduct of short-term training program on monetary policy analysis

Tables, charts, and summary of econometric results will accompany the analysis as needed

TIME FRAME

Activities	1	2	3	4	5	6	7	8	9	10	11	12
1 Collection of existing literature and secondary data	■	■	■	■	■							
2 Interviews with various participants of the market including regulators			■	■	■	■						
3 Data analysis and write-up				■	■	■	■	■				
4 Submission of the first draft and discussion with BSP officials								■				
5 Conduct of the training							■					
6 Revision of the report									■	■	■	
7 Submission of the final draft												■