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Monetary policy and exchange market pressure: The case of the Philippines

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Abstract

This study examines how monetary authorities respond to exchange market pressure (EMP) and tests whether traditional monetary prescriptions of contracting money to lend strength to a currency are valid in the case of the Philippine peso. Monthly data for the period 1990.1–2000.4 and a VAR methodology in Tanner [Tanner, E.C., 1999. Exchange Market Pressure and Monetary Policy: Asia and Latin America in the 1990s. IMF Staff Papers 47 (2001). Originally IMF Working Paper 99/114 (August 1999); Tanner, E.C., 2002. Exchange Market Pressure, Currency Crises, and Monetary Policy: Additional Evidence from Emerging Markets. IMF Working Paper WP 02/14 (February 2002)] are used. In general, it is found that contracting domestic credit growth and raising the interest rate differential both reduce EMP. In crisis periods, however, authorities responded differently to EMP. They chose not to sterilize and instead contracted domestic credit growth. The possibility of a perverse effect from raising domestic interest rates cannot be ruled out.
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1. Introduction

The Asian Financial Crisis interrupted what had previously been a long period of relative exchange-rate stability in East Asia. Following the devaluation of the Thai baht in July 1997, other currencies of the region also depreciated with varying degrees of severity. In the case of the Philippine peso, monthly year-on-year depreciation jumped to 10.45% in July 1997, compared with only 0.69% in June and annual rates of change that were in the single digits prior to the crisis. [1] A standard IMF prescription to affected countries at the time was to use contractionary monetary policy to counter depreciation pressures but not to target any particular exchange rate level (see Boorman et al., 2000, p. 8).

This study examines whether traditional tight-money prescriptions indeed contributed to the strength of the Philippine peso during the period. In the traditional view, tighter monetary policy, as implemented through lower domestic credit growth or higher interest rates, should in principle help strengthen a currency whether this is reflected in the exchange rate, in additional foreign reserves, or both.

In light of the experience of affected Asian countries during the crisis, however, doubts have been raised regarding the validity of traditional theory. A revisionist view has been proposed in which raising interest rates could actually exacerbate the depreciation of the domestic currency and inflict harm on the real economy. A 'Laffer curve' could then be said to exist, following which contractionary monetary policy induces a panic among investors and a decline rather than a gain in a currency's value (see for example, Pakko, 2000; Corsetti et al., 1998; Furman and Stiglitz, 1998; Radelet and Sachs, 1998). High interest rates could then lead to actual or expected bankruptcies, or fears of default on debt, which weaken not only the economy but the banking system as well, resulting in a higher risk premium. The expected return on domestic assets declines as the risk premium rises, even though domestic interest rates rise. Still other studies put forward a fiscal-based theory in which higher interest rates mean a higher burden on the public sector (see for example, Flood and Jeanne, 2000; Lahiri and Vegh, 2000; Lahiri and Vegh, 2001). In this view, the currency would not strengthen without a corresponding adjustment of the primary surplus.

The appropriate policy response to pressures on the currency thus poses a dilemma: can currency pressures be reduced by contracting money supply and raising interest rates as traditional theory prescribes, or would such a policy response be ineffective and possibly counterproductive? Are the effects of contractionary monetary policy invariant with respect to the period when it is used, i.e., do the predictions of traditional theory hold equally under crisis and non-crisis periods?

This study uses exchange market pressure (EMP) rather than exchange rate movements alone to gauge the strength of the domestic currency. This is because there is evidence to suggest that monetary policy in the Philippines (as well as in some other Asian countries), was anchored on the exchange rate regime and managed to reflect

[1] The annual depreciation rate of the peso stood at 52.06% in 1997 compared with 0.28% in 1996.

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