

## **THE EXCHANGE RATE**

### **KEY DEFINITIONS AND CONCEPTS**

#### **1. *How is the exchange rate defined?***

The exchange rate is the price of a unit of foreign currency in terms of the domestic currency. In the Philippines, for instance, the exchange rate is conventionally expressed as the value of one US dollar in peso equivalent. For example, US\$1 = ₱44.00.

In every exchange rate quotation, therefore, there are always two currencies involved.

#### **2. *Why is the exchange rate important?***

The exchange rate is important for several reasons:

- It serves as the basic link between the local and the overseas market for various goods, services and financial assets. Using the exchange rate, we are able to compare prices of goods, services, and assets quoted in different currencies.
- Exchange rate movements can affect actual inflation as well as expectations about future price movements. Changes in the exchange rate tend to directly affect domestic prices of imported goods and services. A stronger peso lowers the peso prices of imported goods as well as import-intensive services such as transport, thereby lowering the rate of inflation. For instance, an increase in the value of the peso from US\$1:₱50 to US\$1:₱40 will lower the price of a \$1 per liter gasoline from ₱50.00 (₱50 X \$1) to ₱40.00 (₱40X \$1).
- Exchange rate movements can affect the country's external sector through its impact on foreign trade. An appreciation of the peso, for instance, could lower the price competitiveness of our exports versus the products of those competitor countries whose currencies have not changed in value.
- The exchange rate affects the cost of servicing (principal and interest payments) on the country's foreign debt. A peso appreciation reduces the amount of pesos needed to buy foreign exchange to pay interest and maturing obligations.

#### **3. *How is the exchange rate determined?***

Under the system of freely floating exchange rates, the value of the dollar in terms of the peso, like any commodity or service being sold in the market, is determined by the forces of supply and demand. Under a fixed exchange rate system, a par value rate is set between the peso and the dollar by the central bank. The par value may be adjusted from time to time.

**4. *How does the exchange rate change?***

Under a floating exchange rate system, if more dollars are demanded than are offered, the price of the dollar in terms of the peso will tend to increase; that is, it will cost more pesos to acquire one dollar. If, on the other hand, more dollars are offered than are demanded, the value of the dollar in terms of the peso will tend to decrease; that is, it will cost less pesos to acquire one dollar. In contrast, under a fixed rate system, a change in the exchange rate is effected through an official announcement by the central bank.

**5. *What is the country's foreign exchange policy?***

At present, the country's exchange rate policy supports a freely floating exchange rate system whereby the Bangko Sentral ng Pilipinas (BSP) leaves the determination of the exchange rate to market forces. Under a market-determined exchange rate framework, the BSP does not set the foreign exchange rate but instead allows the value of the peso to be determined by the supply and demand of foreign exchange.

Thus, the BSP's participation in the foreign exchange market is limited to temper sharp fluctuations in the exchange rate. On such occasions of excessive movements, the BSP enters the market mainly to maintain order and stability. When warranted, the BSP also stands ready to provide some liquidity and ensure that legitimate demands for foreign currency are satisfied.

**6. *How is foreign exchange traded in the market?***

In the Philippines, banks trade foreign exchange using an electronic trading platform called the Philippine Dealing and Exchange Corp. (PDEX) through any of the following ways: Reuters or Bloomberg dealing, over-the-counter, or via brokers. The PDEX captures all spot transactions (which involve the purchase or sale of a foreign currency for immediate delivery, i.e., within one day for US dollars and within two days for other convertible currencies), done through any of these transaction vehicles.

Banks trade for their clients, as well as for their own accounts. When they trade for their own accounts, banks follow the guidelines set by the BSP.

**7. *How does one judge whether the exchange rate is at an appropriate level or not?***

One way of judging the appropriate level of the exchange rate is by looking at the trend in the real effective exchange rate (REER) of the peso versus a basket of currencies. This measure takes into account not only the nominal exchange rate movements but also the relative inflation rates among trading and competing countries. As such, the REER is a more comprehensive measure of external price competitiveness.

The BSP looks at three currency baskets:

- major trading partners (MTPs) composed of the US dollar, Japanese yen, Euro and UK pound;
- broad basket of competitor currencies consisting of the Singapore dollar, South Korean won, New Taiwan dollar, the Malaysian ringgit, Thai baht, Indonesian rupiah, and Hong Kong dollar; and
- narrow basket of competitor currencies which include the Malaysian ringgit, Thai baht, and Indonesian rupiah.

An increase in the peso's REER index (i.e., from a base year where the index is equivalent to 100) denotes a real appreciation and consequent loss in external price competitiveness, while a decrease translates to a real depreciation and corresponding gain in external price competitiveness.

**8. *How does one measure the volatility of the peso?***

One way of measuring the volatility of the peso is through the coefficient of variation, which is the ratio of the standard deviation and the average exchange rate of the peso for a given period. A low coefficient of variation indicates a stable peso while a high coefficient of variation reflects a volatile peso.

**9. *What measures are undertaken by the BSP to maintain order and stability in the foreign exchange market?***

The BSP uses three general tools to operationalize the exchange rate policy, namely: 1) participation in the foreign exchange market; 2) monetary policy measures; and 3) foreign exchange regulations.

The BSP participates by buying and selling foreign exchange in the foreign exchange market to ensure order and temper destabilizing swings in the exchange rate. It does not set out to reverse the underlying trend of the peso, whether it is appreciating or depreciating; rather, its objective is to smooth out volatility in the exchange rates. Assume that there is an artificially strong demand for dollars which is causing the exchange rate to weaken. The BSP can quell speculation by selling dollars to moderate the depreciating trend. If there is an artificially strong supply of dollars relative to demand in the market, the BSP can soften the appreciation of the peso by buying dollars.

If the exchange rate movement threatens to move inflation rate outside its target range, the BSP also uses monetary policy measures, including adjusting the key policy rates or the interest rates it charges for its borrowing and lending activities. For example, in periods of weakening pressure on the peso, increases in interest rates tend to dampen the demand for dollars. As a result, the depreciation pressure on the peso eases. However, any such interest rate action needs to be consistent with the price stability objective of the BSP.

The BSP has also combined foreign exchange intervention and monetary measures with market-based foreign exchange regulations to prevent major exchange rate volatility. For example, during the recent episodes of strong foreign exchange inflows, the BSP pursued liberalization of the country's existing foreign exchange regulatory framework, particularly pertaining to outward investments, foreign exchange swaps, capital movements as well as banks' foreign exchange

positions. The reforms allowed individuals and businesses greater access to foreign exchange for outward investment and over-the-counter transactions. By making the FX environment more open, some of the pressure on the exchange rate could be alleviated.

## **RECENT DEVELOPMENTS IN THE EXCHANGE RATE**

### ***10. How has the exchange rate moved since 2009 and what were the factors behind the movement?***

The peso averaged ₱47.64/US\$1 in 2009, depreciating by 6.6 percent from the ₱44.47/US\$1 2008 average, as the full impact of the global financial turmoil and the continued risk aversion against emerging market economies was felt.<sup>1</sup> However, in terms of end-period levels, the peso appreciated by 2.4 percent to ₱46.36/US\$1 at end-December 2009, from ₱47.49/US\$1 at end-December 2008. The resiliency of the domestic economy along with the continued inflow of overseas Filipino (OF) remittances led to the peso's appreciation towards end-2009.

In the second quarter of 2010, the peso averaged ₱45.51/US\$1, appreciating by 1.2 percent compared with the ₱46.03/US\$1 average in the first quarter. On a year-on-year basis, the peso appreciated by 5.2 percent from the ₱47.88/US\$1 average in the second quarter of 2009. The strengthening of the peso in the early part of the quarter was supported by sustained OF remittances driven partly by seasonal flows for tuition fee expenses, and capital reflows to emerging market economies. The peso was also supported by the positive outlook on the Asian region's economy and China's announcement to allow some flexibility on the movement of the yuan – breaking 23 months of peg against the U.S. dollar.<sup>2</sup> The successful proclamation of President Benigno C. Aquino III in the May 2010 national election boosted further optimism on the Philippine economy's outlook.

However, the peso was weighed down starting in the middle of the second quarter by renewed risk aversion due to the Euro area's debt crisis. Despite the European Stabilization Mechanism (ESM) agreed on 8–9 May 2010 to address severe tension in the financial markets,<sup>3</sup> contagion fears rose amidst the uncertainty about the policy responses, and concerns that the sovereign debt crisis will spill over to the banking sectors in Europe. At the same time, questions about the sustainability of the strength of the global recovery surfaced. Fueling apprehensions was the slight easing of the global composite Purchasing Managers' Index (PMI) to 57.0 in May from 57.7 in the previous month as business activity in both the manufacturing and the services sectors lost some momentum.<sup>4</sup> In the U.S., total nonfarm payroll

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<sup>1</sup> Dollar rates or the reciprocal of the peso-dollar rates (based on reference time data) were used to compute for the percentage change.

<sup>2</sup> People's Bank of China (19 June 2010).

<sup>3</sup> At a special summit on May 8-9, EU leaders agreed on a new European Stabilization Mechanism (ESM). The proposal comprises two parts. First was the extension of the €50 billion balance-of-payments facility for non-EMU members to eurozone members. The fund will be enhanced by €60 billion for eurozone members and carry IMF conditionality. This facility is financed by the issuance of EU bonds backed by the €141 billion EU budget. The second part includes a new €440 billion special-purpose vehicle (SPV) guaranteed proportionally by participating eurozone member states. According to the two-thirds versus one-third formula, the IMF will provide up to €250 billion of the total €750 billion facility. (Roubini Global Economics)

<sup>4</sup> European Central Bank, Monthly Bulletin (June 2010).

employment declined by 125,000 in June due to the removal of around 225,000 temporary workers from Federal government payrolls.<sup>5</sup>

### ***11. How did the peso perform on a trade-weighted basis?***

On a real, trade-weighted basis, the peso gained some external price competitiveness in 2009 against the basket of currencies of MTPs. The REER index of the peso against the basket of currencies of the country's MTPs decreased by 3.0 percent as the nominal depreciation of the peso against these currencies more than offset the widening inflation differential. However, the peso's average REER index in 2009 increased by 1.2 percent and 0.3 percent against its competitor currencies in the broad and narrow series, respectively. This developed as the widening of the inflation differentials against these baskets of currencies negated the nominal depreciation of the peso against these currencies.

In the second quarter of 2010, the peso lost external price competitiveness relative to the previous quarter against the baskets of currencies of the Philippines' major trading partners (MTPs) and competitor countries in both the broad and narrow series. In particular, the real effective exchange rate (REER) index of the peso against the baskets of currencies of the country's MTPs and competitor countries in the broad and narrow series increased quarter-on-quarter by 5.3 percent, 0.9 percent and 4.0 percent, respectively. This developed due to the combined effects of the nominal appreciation of the peso and the widening inflation differential against these currency baskets.

Nevertheless, on a year-on-year basis, the peso gained external price competitiveness against the basket of competitor currencies in the broad and narrow series in the second quarter of 2010 as the REER index of the peso decreased by 4.1 percent and 7.0 percent, respectively. However, the peso lost external price competitiveness against the MTPs during the same period as the REER index of the peso against this basket of currencies increased by 10.1 percent.

### ***12. Has the peso been volatile?***

In 2009, the coefficient of variation (COV) was lower at 1.5 percent relative to the 6.5 percent COV during the same period in 2008. Despite the depreciation of the peso in the first eight months of 2009, the movement of the peso was relatively stable during the year compared with the fluctuations observed in 2008. Monthly COV were below 1.0 percent except in June and September 2009. Behind the peso's volatility in June 2009 was the risk aversion amid concerns on the country's slow growth and widening fiscal deficit. In September 2009, the peso's volatility could be traced to the strengthening of the peso against the U.S. dollar following increased risk appetite for emerging market assets on signs of a possible global recovery.

Furthermore, the peso's volatility was higher at 1.9 percent in the second quarter of 2010 compared with the 0.7 percent posted in the previous quarter due to renewed risk aversion in May and June 2010.

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<sup>5</sup> U.S. Bureau of Labor Statistics (June 2010).

**13. *What is the medium-term outlook on the peso?***

The exchange rate is expected to be generally stable in the medium term, supported by modest demand for foreign exchange as the global financial crisis has forced greater reliance on domestic sources of capital, and given prospects of lower import requirements, respectable levels of reserves, sustained OFs' remittances and a rebound in exports over the longer horizon.

However, the foreign exchange rate remains highly sensitive to changes in market sentiment, and the pace of the economic recovery in the Philippines and the Asian region.

Thus, the overall direction of the peso's movement will still be very much influenced by risk appetite towards emerging markets, which will depend on the speed of the global economic recovery.

**POLICY RESPONSES BY THE BSP**

**14. *What were the recent monetary policy and foreign exchange measures undertaken by the BSP?***

**Monetary Policy Measures**

On 15 July 2010, the Monetary Board decided to keep the BSP's key policy interest rates steady at 4 percent for the overnight borrowing or reverse repurchase (RRP) facility and 6 percent for the overnight lending or repurchase (RP) facility. The interest rates on term RRP, RP, and special deposit accounts (SDAs) were also left unchanged as the current monetary policy settings continue to be appropriate, given the favorable inflation outlook and on-target inflation expectations. At the same time, the Monetary Board observed that upward inflation pressures are present, including stronger-than-anticipated domestic economic activity and buoyant consumer and business sentiment. Other upside risks include rising liquidity and strengthening credit activity, recovering global commodity prices, power rate hikes, and declines in agricultural output due to adverse weather conditions.

Nonetheless, given ample liquidity and the continued stability of financial markets, the Monetary Board also decided to phase out liquidity-enhancing crisis response measures, effective 3 May 2010. In particular, the Board decided to reduce further the peso rediscounting budget from ₱40 billion to its pre-crisis level of ₱20 billion.

**Foreign Exchange Measures**

As a continuation of the foreign exchange liberalization program, the BSP approved on 15 January 2009 the third phase of reforms, which includes the liberalization/streamlining of rules on foreign borrowings of private banks for

relending purposes and the registration of inward foreign portfolio investments.<sup>6</sup> The third phase of foreign exchange regulatory reforms also includes all the provisions in the first and second phases of reforms initiated in 2007 as well as the provisions that are intended to improve monitoring of foreign exchange flows and to formalize/clarify existing practices.

Moreover, the MB approved on 23 April 2009 the streamlining of the documentation requirements and other reforms on the sale of foreign exchange by foreign exchange dealers/money changers (FXDs/MCs). The streamlining of the documentation requirements will make it possible for residents with foreign loans/foreign currency loans as well as foreign investors that chose not to seek BSP approval and/or registration of the loans/investments to source their foreign exchange requirements from FXDs/MCs without necessarily compromising compliance with anti-money laundering regulations.

## **ISSUES ON FOREIGN EXCHANGE**

### **15. *Why did the BSP adopt a floating rate system?***

The floating exchange rate system was adopted in 1970 because the government considered that occasional, large fluctuations—typical of the fixed exchange rate system—are more costly, destabilizing and disruptive to the economy than the more frequent but more gradual changes that may occur in a free float.

The floating rate system is consistent with the current regime's national strategy of achieving external competitiveness through efficiency, which is also a central theme of the recent bold liberalization efforts. In terms of exchange rate policy, such efficiency is injected into the economy by basically leaving exchange rate determination to the market forces of supply and demand.

### **16. *Why not fix the exchange rate? Or adopt a dual or multiple exchange rate system?***

Under a system of fixed exchange rate, the central bank commits to sell or buy any amount of foreign currency demanded in excess of what can be supplied by the market or offered for sale in excess of what is demanded, to keep the official exchange rate at a certain level.

For a small open economy such as the Philippines, large capital flows can occur at any time. In times of massive dollar inflows, the monetary authorities must buy the excess dollars to keep the foreign exchange at the desired level. In so doing, reserves are accumulated but pesos are released into the system from which inflationary pressures could result. Siphoning off excess pesos for example (through the sale of government securities in the BSP's portfolio) could entail substantial cost to the BSP in terms of the difference between the cost of

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<sup>6</sup> The first phase of reforms pertaining to the foreign exchange regulatory framework (22 February 2007) involved changes pertaining to capital and current account transactions, as well as to prudential regulations that were in place for almost 10 years. The second phase (20 December 2007) aimed to promote greater integration with international capital markets and risk diversification supportive of an expanding economy with global linkages; and to streamline documentation requirements on the sale of foreign exchange by banks.

borrowing to pay for the dollar purchases and the return to the BSP on the foreign exchange purchases. Apart from the fiscal costs of sterilization, the sale of government securities is likely to push up interest rates and attract additional foreign capital inflows into the economy.

On the other hand, in times of massive dollar outflows, monetary authorities must sell dollars to accommodate any excess demand. In so doing, reserves are drawn down. If the massive outflow is sustained, reserves will diminish. Before this happens, the central bank is forced to reset the official exchange rate, often opening itself to exchange losses. Thus, fixing the exchange rate places a heavy burden on monetary authorities in terms of reserve and liquidity management.

A dual or multiple exchange rate system is discriminatory and distorts resource allocation. If the government sets a high rate for exporters and OFs, it will have to subsidize the difference between market rates and the fixed higher rate. However, this is not feasible since government revenues are not yet sufficient to cover our annual budget. On the other hand, private banks will not be willing to do this as it will incur losses in the process of paying higher than prevailing market exchange rates.

**17. *Is the current exchange rate policy in line with the inflation targeting approach to monetary policy?***

The BSP's adherence to a freely floating exchange rate or a market-determined exchange rate system anchors its commitment to its Constitutional mandate to maintain price stability.

It is also consistent with the inflation targeting (IT) framework of our monetary policy which demands disciplined commitment to participate in the foreign exchange market only in well-defined circumstances, such as when there is a need to smooth out exchange rate volatility which can threaten our inflation target. The BSP's participation in the foreign exchange market during such a situation is compatible with price stabilization since fluctuations in the exchange rate tend to feed directly into domestic prices of imported goods and services, and indirectly, through the prices of goods and services that use imported inputs. The increase in prices of both the imported and import-intensive goods, in turn, leads to demands for wage hikes and transport fare adjustments, among other things. Through this channel, exchange rate movements affect both the actual inflation and inflation expectations.

**18. *Why can't the BSP intervene more heavily during periods of high peso volatility?***

Heavy intervention cannot be sustained for a long period of time because it could create problems for monetary policy.

To sterilize intervention and mop up excess liquidity, the central bank would have to either raise policy rates and/or undertake open market operations. These policy actions may not be sustainable because they are costly to central banks.

- High interest rates required to siphon off liquidity would give countries with

fiscal difficulties and/or weak macroeconomic conditions very little room to maneuver.

- Moreover, raising interest rates is likely to result in a further increase in foreign capital inflows which may necessitate more sterilization, resulting in a vicious cycle.

On the other hand, unsterilized interventions may lead to unwarranted monetary expansion and generate upward pressure on prices. This runs counter to a central bank's mandate to maintain price stability.

**19. *What is the view of the BSP regarding the imposition of capital controls?***

Imposing strict capital controls poses more costs than benefits.

- First, there are administrative difficulties that must be hurdled to implement effectively these restrictions. The tax on international transactions should be universally implemented to prevent the creation of tax arbitrage opportunities. Some difficulties in implementing the tax could also arise due to advances in technology and the growing sophistication of financial instruments, which allow investors to circumvent controls and/or taxation.
- Second, the imposition of controls hampers the efficient allocation of capital across countries.
- Finally, the re-imposition of controls would send negative signals to investors and adversely affect our access to international capital markets and our ability to attract foreign investments.

**20. *What are the advantages and disadvantages of a firm peso?***

On the one hand, a firm peso confers benefits to the economy—the consumers in general (by tempering the general rise in the prices of goods and services or inflation arising from increases in international prices of imported or import-based commodities), importers, Filipinos who travel or invest abroad, and those who pay for foreign loans (including the government). Overall, a firm peso:

- Helps dampen inflationary pressures;
- Translates to lower debt servicing;
- Enables the BSP to build up international reserves; and
- Allows prepayment of foreign exchange obligations.

On the other hand, a firm peso could have some negative impact on certain sectors, including some export-oriented companies, domestic producers of import substitutes, tourism sector, foreign investors, creditors who had lent money in foreign currency, and overseas Filipinos and their families.

**21. *What are the advantages and disadvantages of a peso depreciation?***

A weak peso can improve the external price competitiveness of Philippine products, thereby increasing the country's export earnings. The peso equivalent of OF remittances in foreign currencies will also increase as the peso depreciation

will mean more pesos in exchange of one foreign currency unit (e.g., US\$1). Moreover, tourism and investment activities will increase as it will be less costly and more desirable for foreigners to travel and invest in the Philippines.

However, a peso depreciation can also increase inflationary pressures as it would cost more pesos to buy imported products and raw materials such as oil and rice.

**22. *What is the impact of the recent global financial turmoil and economic slowdown on the peso?***

The effect of the troubles in the global financial markets should be felt mainly through increased risk aversion.<sup>7</sup> This growing risk aversion is a contributing factor to the weakening of the peso, which started in March 2008. As global investors shifted away from emerging market assets, which they perceived to be relatively riskier, the local stock market experienced sustained selling and returns on selected investment exposures declined, which eroded market confidence. This, in turn, led investors to divest their portfolio of regional currencies, including the Philippine peso. Thus, the peso depreciated, as determined by market forces of supply and demand of foreign exchange.

**23. *Is there a possibility for the establishment of a single Association of Southeast Asian Nations (ASEAN) currency?***

Integration within the Asian region has been progressing significantly in recent years. This may be observed from the rise in intra-regional trade and flows of investments within the region. There are also a number of initiatives which support the greater linkage between economies. These initiatives include the establishment of free trade agreements, the Chiang Mai initiative and various efforts to develop the regional bond market.

Amidst these initiatives, there is also a discussion on the possibility of the region adopting a single currency and eventually forming a monetary union with one central bank for the region. This issue has been examined by economic authorities in the region and it has been found that the ASEAN is not ready yet to adopt a common currency in the near future. This is due to lack of macroeconomic convergence, inadequate regional institutional framework, low intra-regional trade and concerns over the potential loss of sovereignty over national policymaking. Furthermore, more than the economic prerequisites, the formation of a common currency area requires political will and social consensus. At present, these factors need to be strengthened. The policymakers in the region are focusing instead on deepening integration through trade liberalization and financial market developments. While the adoption of a single currency may be difficult in the near to medium term, its eventual emergence cannot be discounted.

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<sup>7</sup> Governor Tetangco's remarks as cited in BusinessWorld issue dated 13 August 2007.