

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, $US\$1 = ₱50.00$.

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 $₱50.00$ ($₱50 \times \$1$) to $₱40.00$ ($₱40 \times \$1$).
- 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 of and demand for foreign exchange.

Thus, the BSP's participation in the foreign exchange market is limited to tempering 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.

When banks trade, either for their clients or for their own accounts, they follow a set of guidelines laid by the BSP (Manual of Regulations on Foreign Exchange Transactions, as amended; Circular 471 dated 24 January 2005; and other applicable BSP regulations) to ensure orderly trades in the foreign exchange markets.

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.

On 26 March 2013, the Bangko Sentral ng Pilipinas (BSP) released three new indices which measure the nominal and real effective exchange rates (EER) of the peso relative to the currencies of the following groups of countries: 1) all major trading partners (TPI) of the Philippines covering merchandise exports and imports;¹ 2) trading partners in advanced countries (TPI-A);² and 3) trading partners in developing countries (TPI-D).³ The methodology used for calculating the new indices was also revised as the BSP shifted from arithmetic to geometric formulation and from base year to chained indices.

Starting 2014, the new indices replaced the old EER indices as the official effective exchange rate indices of the BSP. The new peso EER indices would enable BSP to gauge more objectively the overall movements in the exchange rate of the peso across currencies. An increase in the indices means an overall appreciation of the peso and a consequent loss in external price competitiveness against the basket of currencies, while a decrease translates to a real depreciation and a 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 (COV), 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.

¹ The *Trading Partners Index (TPI)* measures the nominal and real effective exchange rates of the peso across the currencies of 14 major trading partners of the Philippines, which includes US, Euro Area, Japan, Australia, China, Singapore, South Korea, Hong Kong, Malaysia, Taiwan, Indonesia, Saudi Arabia, United Arab Emirates, and Thailand. The major trading partners of the Philippines are defined as trading partners which accounted for at least one percent share of the total merchandise exports and imports of the Philippines for the past five years (2007-2011).

² The *TPI-Advanced* measures the effective exchange rates of the peso across currencies of trading partners in advanced countries comprising of the US, Japan, Euro Area, and Australia.

³ The *TPI-Developing* measures the effective exchange rates of the peso across 10 currencies of partner developing countries which includes China, Singapore, South Korea, Hong Kong, Malaysia, Taiwan, Indonesia, Saudi Arabia, United Arab Emirates, and Thailand.

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 suppress 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 those 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 in the third quarter of 2017 and what were the factors behind the movement?*

On a quarter-on-quarter basis, the peso depreciated against the US dollar by 1.92 percent to average ₱50.84/US\$1 in Q3 2017 from the previous quarter's average of ₱49.86/US\$1. On a year-on-year basis, the peso likewise depreciated by 7.45 percent relative to the ₱47.05/US\$1 average in Q3 2016.⁴

In July, the peso averaged ₱50.64/US\$1 depreciating by 1.56 percent from the previous month's average of ₱49.85/US\$1. The weak performance of the peso was due mainly to: (i) the country's higher-than-expected trade deficit in May; (ii) the release of upbeat US economic data, specifically the producer price index (PPI) and jobless claims;^{5,6} and (iii) market players' cautiousness ahead of the US Fed's policy meeting on 25 to 26 July.⁷

The peso continued to depreciate in August, relative to its July level, by 0.46 percent to average at ₱50.87/US\$1. The peso depreciation during the month was due mainly to: (i) hawkish comments of New York Fed President William Dudley supporting another rate hike this year and the planned unwinding of Fed's bond holdings; (ii) heightened concerns following the terrorist attack in Spain; and (iii) rising doubts over the Trump administration's campaign period promise of economic stimulus plans.⁸

In September, the peso averaged ₱51.01/US\$1 depreciating further by 0.26 percent relative to the average in August as sentiment towards the US dollar recovered due partly to: (i) easing tension between North Korea and the US; (ii) weaker-than-expected impact of Hurricane Irma; (iii) hawkish remarks of US Fed chair Janet L. Yellen during her speech in the National Association for Business Economics meeting in Cleveland on 26 September; and (iv) the revival of talks on US President Trump's tax reform program.

11. How did the peso behave on a real trade-weighted basis?

⁴ Dollar rates (per peso) or the reciprocal of the peso-dollar rates were used to compute for the percentage change.

⁵ The Philippine trade deficit widened to US\$2.8 billion in May 2017 as the 17 percent increase in imports surpassed the 14 percent growth in exports. This was also higher than the median estimate of US\$1.5 billion in a Bloomberg survey of nine economists.

⁶ According to the US Labor Department, initial claims for state unemployment benefits dropped 3,000 to a seasonally adjusted 247,000 for the week ended July 8. It was the 123rd straight week that claims remained below 300,000, a threshold associated with a healthy labor market. The Labor Department also reported that price index for final demand edged up 0.1 percent in June amid sustained increases in the cost of services that offset declining energy prices. The year-on-year increase in the PPI, however, slowed to 2.0 percent from 2.4 percent in May as last year's energy-driven rise dropped out of the calculation.

⁷ BusinessWorld reported that while the US Fed might not raise interest rates again this month, it might continue to affirm its plan to adjust interest rates once more before the year ends following strong forecasts of key US economic data on existing home sales, durable goods orders, and second-quarter economic growth.

⁸ Reuters reported over 100 people were injured while 13 were killed after a suspected Islamic State militant drove a van into crowds in Barcelona, Spain on 17 August 2017. Meanwhile, US President Trump had decided to disband the American Manufacturing Council and the Strategic and Policy Forum, raising questions on the US leader's ability to organize the business community.

On a real trade-weighted basis, the peso gained external price competitiveness in Q3 2017, against the basket of currencies of all trading partners (TPI), trading partners in advanced (TPI-A) and developing countries (TPI-D). The real effective exchange rate (REER) index of the peso decreased, relative to Q2 2017, by 4.71 percent, 4.84 percent, and 4.62 percent against the TPI, TPI-A and TPI-D baskets, respectively, on account of nominal depreciation of the peso coupled by narrowing inflation differential against these currency baskets.^{9,10}

Likewise, the peso gained external price competitiveness against the TPI, TPI-A, and TPI-D baskets, relative to Q3 2016. This developed as the nominal depreciation of the peso offset the impact of widening inflation differential against these currency baskets, resulting to a decrease in the REER index of the peso by 5.26 percent, 3.79 percent, and 6.25 percent against the TPI, TPI-A, and TPI-D baskets, respectively.

12. Has the peso been volatile?

Volatility of the peso's daily closing rates (as measured by the coefficient of variation) stood at 0.61 percent during the review quarter, higher than the 0.55 percent registered in the previous quarter.¹¹ Relative to other currencies in the region, the volatility of the peso remained in the middle of the pack.¹²

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

Over the policy horizon, the peso is expected to be broadly stable. The expected growth in foreign exchange inflows from overseas Filipino remittances and BPO revenues in 2017 by 4.0 percent and 10.0 percent, respectively; and the recent Fitch Ratings' affirmation of the Philippines' investment grade score of "BBB-", are expected to support to the peso. Likewise, the sustained inflows from foreign direct investments, tourism receipts, as well as the ample level of the country's gross international reserves and the country's robust economic growth, could

⁹ The Trading Partners Index (TPI) measures the nominal and real effective exchange rates of the peso across the currencies of 14 major trading partners of the Philippines, which includes US, Euro Area, Japan, Australia, China, Singapore, South Korea, Hong Kong, Malaysia, Taiwan, Indonesia, Saudi Arabia, United Arab Emirates, and Thailand. The TPI-Advanced measures the effective exchange rates of the peso across currencies of trading partners in advanced countries comprising of the US, Japan, Euro Area, and Australia. The TPI-Developing measures the effective exchange rates of the peso across 10 currencies of partner developing countries which includes China, Singapore, South Korea, Hong Kong, Malaysia, Taiwan, Indonesia, Saudi Arabia, United Arab Emirates, and Thailand.

¹⁰ The REER index represents the Nominal Effective Exchange Rate (NEER) index of the peso, adjusted for inflation rate differentials with the countries whose currencies comprise the NEER index basket. A decrease in the REER index indicates some gain in the external price competitiveness of the peso, while a significant increase indicates the opposite. The NEER index, meanwhile, represents the weighted average exchange rate of the peso vis-à-vis a basket of foreign currencies.

¹¹ The coefficient of variation is computed as the standard deviation of the daily closing exchange rate divided by the average exchange rates for the period.

¹² The volatility of the peso was higher than that of Indonesian rupiah but lower than that of Singapore dollar, Malaysian ringgit, South Korean won, Thailand baht, Chinese yuan, and Japanese yen.

continue to provide stability to the peso.¹³ The credit rating upgrades that have been earned over the last few years are expected to sustain market confidence towards the Philippine financial markets.

Over the medium term, the peso, however, may continue to be affected by external developments that likewise affect local market sentiments. These include: 1) shift towards protectionism; 2) continued rise in US policy rates; 3) aggressive rollback in financial regulations in the US; 4) faster credit growth in China; 5) weak demand, low inflation, weak balance sheet in AEs; and 6) non-economic factors such as geopolitical tensions in the Korean peninsula, etc. Nonetheless, the peso is expected to remain broadly stable on account of the country's strong macroeconomic fundamentals- including robust GDP growth, stable inflation, strong and resilient banking system, and prudent fiscal position.

¹³ As of end-September 2017, country's gross international reserves (GIR) stood at US\$80.96 billion (revised). This can cover 8.5 months' worth of imports of goods and payments of services and primary income. It is also equivalent to 5.4 times the country's short-term external debt based on original maturity and 3.6 times based on residual maturity. Foreign direct investments (FDI) remained positive and registered a net inflow of US\$3.9 billion as of end-July 2017. Remittances from OF workers continue to flow in from various geographical locations globally. For the period January to August 2017, cash remittances from OFs amounted to US\$20.7 billion. Exports of goods grew y-o-y by 18 percent in the first half of 2017. As of end-June 2017, business process outsourcing (BPO) and tourism receipts reached US\$11.0 billion and US\$3.1 billion, respectively.

POLICY RESPONSES BY THE BSP

14. What were the recent foreign exchange measures undertaken by the BSP?

FX Rules Further Liberalized	Feb 2016	<ul style="list-style-type: none"> • To maintain a safe and sound financial system and a stable FX market, the Monetary Board approved further liberalization of the rules governing FX transactions in the Philippines. The amendments include: <ul style="list-style-type: none"> ○ Prior BSP approval is no longer required for the borrowings from offshore sources/FCDUs of banks of the following resident entities: <ul style="list-style-type: none"> ✓ Purely private sector loans (i.e., without guarantee from the public sector or banks) that are intended to finance energy-/power-related projects; and ✓ Private non-bank financial institutions engaged in microfinance activities where loan proceeds will be used for microfinance lending. ○ Allowing the conversion to FX of pesos arising from disapproved subscriptions of non-resident investors to stock rights offering of companies listed at the Philippine Stock Exchange. • Other procedural/clarificatory amendments to the Manual of Regulations on Foreign Exchange Transactions were also approved for better guidance of users.
FX Rules relaxed/liberalized anew	July 2016	<p>As part of continuing efforts to keep regulations appropriate for the changing needs of the Philippine economy and following the thrust towards greater openness in view of the country's increasing integration with global markets, the MB further liberalized existing regulations governing transactions in FX effective 15 September 2016:</p> <ul style="list-style-type: none"> ○ Increased the amount of FX that Philippine residents may purchase from the banking system without supporting documentation (other than an application to purchase FX) for legitimate

		<p>transactions from US\$120,000 to US\$500,000 (for individuals) and US\$1 million (for corporates). This is to enhance and further facilitate access to FX of both individuals and corporates for legitimate non-trade current account transactions.</p> <ul style="list-style-type: none"> ○ Allowed the deposit by Philippine residents of FX purchased from banks for certain underlying transactions (such as for travel abroad and payment of certain obligations to non-residents) into their Foreign Currency Deposit Unit (FCDU) accounts, prior to outward remittance to the intended non-resident beneficiaries. This is to provide residents with greater flexibility in managing their cash flows as well as provide greater ease in transacting in FX. ○ Lifted the prohibition on the sale of FX by banks and their forex corporations for resident-to-resident transactions. This is to facilitate payment by residents of obligations to their resident counterparties and allow further diversification of residents' investments. ○ Lifted prior BSP approval and registration requirements for private sector loans to be obtained from FCDUs/Expanded FCDUs of banks. This is in line with the BSP's thrust to facilitate access of the private sector to bank financing. ○ Increased the amount of Philippine currency that may be brought into/out of the country from ₱10,000 to ₱50,000. This is to provide greater convenience to travelers to and from the Philippines, and allow settlement of obligations in jurisdictions outside the Philippines where the Philippine Peso is accepted as a currency of settlement.
<p>Further Amendments to Foreign Exchange (FX) Regulations</p>	<p style="text-align: center;"><i>Dec 2016</i></p>	<ul style="list-style-type: none"> ● The BSP eased rules on foreign exchange flows anew to facilitate entry of significant amounts for foreign banks in the country as they move to meet capital requirements. This is intended to align regulations with the provisions of R.A. No. 10641, which allowed the full entry of foreign banks and BSP Circular No. 858 dated 21 November 2014. ● The approved policy changes mainly involve: (a) inclusion of an express provision that the FX funding

		<p>for permanently assigned capital of foreign bank branches must be inwardly remitted and converted to pesos at the exchange rate prevailing at the time of remittance, pursuant to the pertinent provisions of the Manual of Regulations for Banks (MORB); (b) use of a general reference to the MORB instead of citing R.A. Nos. 7721 and 10641 or the specific provisions of the MORB; and (c) revision of the definitions of “unimpaired capital of a local bank”, “unimpaired capital of foreign bank branches” and “unimpaired capital of foreign bank subsidiaries” as contained in the MORB.</p>
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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 foreign exchange 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

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 for 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, and creditors who had lent money in foreign currency, and overseas Filipinos and their families.

21. *What are the advantages and disadvantages of 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, 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 "currency wars" on global financial markets? What have been the policy responses?*

"Currency wars" refer to competitive currency devaluations among countries. An example of this is the situation in which substantial monetary policy easing in many of the major advanced countries to support their economies has fueled a downward slide in the value of their currencies, while emerging economies (including many Asian countries) attempt to arrest the appreciation of their own currencies (e.g., against the US dollar) through a variety of measures.

Policy responses by emerging economies to cope with the risks brought about by large and destabilizing capital inflows have included exchange rate appreciation, macroprudential measures and tighter fiscal policy. However, there are significant cross-country differences in the extent of exchange rate flexibility and the scope for policy responses in some countries receiving large inflows.

Competitive currency devaluations are a "beggar-thy-neighbor" policy that can ultimately destabilize the still weak global recovery. A sharp depreciation in the value of a major currency could result in the adoption of protectionist policies by other countries in response. This could destabilize global financial markets, pulling asset values away from fundamentals, and eventually hurt businesses and households worldwide.

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 Multilateralization 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.