

Q&A ON THE EXCHANGE RATE IMPACT: HOW MUCH, WHAT WE CAN DO, AND WHAT'S NEXT

In general, a firm currency is welcome news as it reflects positive developments in the country's economic fundamentals,

In 2007, as the Philippine economy grew at its fastest rate in 31 years, the Philippine peso emerged as one of the top performing currencies in Asia and hit a 7 ½-year high of ₱41/US\$1 in December 2007.

For Filipino consumers, a firmer peso meant lower prices in peso terms for imported goods and services. For instance, a stronger peso shielded the Philippines from the full impact of record high world oil prices. Based on our estimates, prices of oil products would have been higher by about P2.00 per liter if the peso had not appreciated against the US dollar. This would have raised transport fares and consequently food prices as well for Filipino consumers.

On the other hand, for sectors whose earnings are denominated in US dollars, a firmer peso is not a positive development. This includes exporters as well as overseas Filipinos and their dependents who now receive less pesos for every dollar they exchange.

Given this, discussions have been divided on whether a firm peso is ultimately a positive or a negative for our country.

It is in this context that we saw the need for this series of Questions & Answers. We hope that through this, we are able to promote better understanding of issues related to exchange rate developments and the government's policy responses to these issues.

I. Exchange Rate and the Foreign Exchange Market: Some Key Definitions

1. What is the exchange rate?

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 = ₱41.00.

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:

- a. 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.
- b. 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 \$1:P50 to \$1:P40 will lower the price of a \$1 per liter gasoline from ₱50.00 (₱50 X \$1) to ₱40.00 (₱40X \$1).

c. 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.

d. 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 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: through 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 Bangko Sentral ng Pilipinas (BSP).

4. 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, Malaysian ringgit, Thai baht, Indonesian rupiah, and Hong Kong dollar; and
- ✍ narrow basket of competitor currencies which include 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 price competitiveness, while a decrease translates to a real depreciation and corresponding gain in price competitiveness.

II. The Role and Responsibility of the BSP in the Foreign Exchange Market

5. *Who determines the level of the exchange rate or the value of the peso against the US dollar?*

Like most countries in today's globalized environment, the Philippines follows a market-determined foreign exchange policy.

In other words, our government does NOT fix the exchange rate at a given level but instead allows the interplay of supply and demand for the currency to determine the exchange rate. Meanwhile, BSP's participation in the foreign exchange market (by either buying or selling dollars) is limited only to ensuring orderly conditions and avoiding unnecessary swings in the exchange rate.

Thus, if the supply of US dollars is much more than the demand, the value of the dollar will drop in peso terms. This happens, for instance, when Overseas Filipinos (OF) send more dollars to their families before Christmas, who in turn exchange their dollars to pesos for their shopping.

On the other hand, if many corporations simultaneously buy dollars to pay for their imports when dollar supply is low, the value of the dollar will rise versus the pesos.

6. *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 promote 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. BSP's participation in the foreign exchange market during such 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, lead 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.

7. *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 forex intervention and monetary measures with market-based foreign exchange regulations to prevent major exchange rate volatility. For example, during 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 purchases for non-trade current account transactions, use of 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.

8. *Why can't the BSP 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.

Moreover, occasional, large fluctuations—typical of a 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 system.

On the other hand, 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.

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

The BSP is not inclined to use capital controls—such as administrative measures imposed to resist downward or upward pressure on the exchange rate or to discourage particular forms of capital inflows—because, among other reasons, data show that exports and remittances and not foreign investments make up the bulk of foreign exchange inflows. Hence, controls on capital flows, particularly portfolio inflows, may not effectively curb the peso appreciation. Furthermore, use of controls involves administrative costs and has been shown to be ineffective in the long run as ways to avoid them are found.

10. Why can't the BSP intervene more heavily to avoid a further peso appreciation?

Heavy intervention cannot be sustained for a long period of time because it could create problems for monetary policy. If the BSP continues to buy large amounts of dollars, it will have to siphon off the equivalent amount of pesos it has released in the market to keep inflation stable. This can not be done without incurring massive costs. On the other hand, not siphoning off the pesos used to buy the dollars may lead to excessive money in circulation and fuel inflation.

III. Recent Developments in the Foreign Exchange Market

11. How has the exchange rate moved in 2007 and what were the factors behind the movement?

The peso appreciated by 18.8 percent to close at ₱41.28/US\$1 at end-2007, the second-highest appreciation among the Southeast Asian currencies since the end-2006. As of 31 January 2008, the peso continued to appreciate, going up by 1.8 percent to close at ₱40.55/US\$1 (Table 1).¹

Table 1. Year-to-Date Movements of Selected Asian Currency

| Asian Currency | Percent Change | |
|--------------------|--------------------------------|--------------------------------|
| | 28 Dec 2007 vs. 29 Dec 2006 | 31 Jan 2008 vs. 28 Dec 2007 |
| Thailand Baht | 19.8 | -4.2 |
| Philippine Peso | 18.8 | 1.8 |
| Indian Rupee | 12.2 | 0.1 |
| Chinese Yuan | 6.9 | 1.7 |
| Malaysian Ringgit | 6.4 | 2.6 |
| Singaporean Dollar | 6.3 | 2.1 |
| Japanese Yen | 5.3 | 5.3 |
| New Taiwan Dollar | 0.3 | 1.1 |
| Korean Won | -0.6 | -0.8 |
| Indonesian Rupiah | -4.5 | 1.5 |

¹ Dollar rates or reciprocal of the peso-dollar exchange rates was used to compute for the percentage change. Figures used are based on the last done deal in the afternoon (4 p.m.).

The reasons behind the peso appreciation are:

- ✍ favorable investor sentiment, which, in turn, is due to the economy's strong macroeconomic performance:
 - ✍ strong real GDP growth of 7.3 percent for 2007;
 - ✍ low inflation throughout 2007, averaging 2.8 percent, the lowest annual average in 21 years;
 - ✍ fiscal overperformance for 2007 with the National Government posting a fiscal deficit of ₱9.4 billion pesos, substantially lower than the deficit of ₱64.8 billion posted in 2006.
- ✍ sustained overseas Filipino (OF) remittances which amounted to US\$13.1 billion during the period January-November 2007
- ✍ net inflows of foreign portfolio investments (investments in government securities, stocks and money market) which amounted to US\$3.5 billion in 2007
- ✍ net foreign direct investment inflows amounting to US\$1.9 billion in January-November 2007
- ✍ steady export earnings which grew by 6.0 percent year-on-year in January-December 2007
- ✍ weakening US dollar due to imbalances in the US economy.

12. How did the peso perform on a trade-weighted basis?

The nominal appreciation of the peso in 2007 also translated into a real appreciation.

In particular, the period January-December 2007 saw the peso's average REER index increasing by 9.0 percent against the currencies of its MTPs, and by 9.0 percent and 5.2 percent against its competitor currencies in the broad and narrow series, respectively. This development broadly suggests that the peso lost some price competitiveness in 2007.

However, during previous years, the peso generally maintained its competitiveness against its MTPs as well as against the broad and narrow currency baskets of competitor countries (Table 2).

Table 2. Effective Exchange Rates (Year-on-year change)

| Year | NEER | | | REER | | |
|------|-------|-------|--------|------|-------|--------|
| | MTP | Broad | Narrow | MTP | Broad | Narrow |
| 2002 | -3.0 | -8.9 | -13.3 | -1.3 | -7.2 | -11.3 |
| 2003 | -12.8 | -6.7 | -12.8 | -9.9 | -5.9 | -11.1 |
| 2004 | -9.3 | -3.1 | 4.9 | -4.1 | 0.9 | 2.4 |
| 2005 | 3.2 | -4.0 | -11.2 | 7.9 | 0.7 | 2.3 |
| 2006 | 10.9 | 5.0 | 14.2 | 12.9 | 7.5 | 2.9 |
| 2007 | 8.2 | 8.0 | 6.5 | 9.0 | 9.0 | 5.2 |

Notes: A negative sign implies a depreciation while a positive sign indicates an appreciation.

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

The peso is expected to remain firm in 2008 despite the risk posed by volatile oil prices, turbulence in the financial markets due partly to problems in the US housing market and global credit tightening.

The peso is expected to weather these external shocks as the country's sound macroeconomic fundamentals—particularly the country's resilient economic growth, benign inflation and comfortable external payments position—will continue to generate market confidence.

Sustained dollar inflows from overseas Filipino remittances, portfolio and foreign direct investments as well as exports receipts will further provide support to the peso.

IV. Firm peso: some consequences and implications on key economic sectors

What is preferable: a firm peso or a weak peso? There are advantages as well as disadvantages in both cases.

On the one hand, a firm peso confers benefits to the economy—the consumers in general (by tempering the general rise in 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 and the taxpayers in general).

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 (OFs) and their families.

Presently, the country benefits on a net basis from having a firm peso.

14. What are the advantages of a firm peso?

A firmer peso helps dampen inflationary pressures.

A firmer peso can temper inflation from increases in the price of imported commodities, including milk, wheat and oil. For instance, even if gasoline remains fixed at US\$1 per liter but the exchange rate moves from ₱ 50 to ₱ 40 to a dollar, its price in pesos will be lower by ₱10 per liter. In other words, imported goods and services are cheaper in peso terms whenever the dollar weakens and the peso gets firmer. This has the effect of lowering the rate of inflation or the rate of increase in the prices of basic commodities and services, a clear benefit to all Filipino consumers including OFs and exporters.

Based on oil price data from the Department of Energy (DOE), if the average exchange rate of the peso stayed in the ₱51.30/\$1-level (average exchange rate for 2006), prices of unleaded gasoline and diesel would have averaged higher by about ₱2.67 per liter during the January-November 2007 period.

Electricity tariffs would have been higher if the peso has not been appreciating. The appreciation of the peso has allowed power producers to save on the peso costs from

imported oil and coal. As a result, Meralco was able to cut its rates in October due to lower generation charges and the mandated rate reduction (MRR).

The foreign currency differential adjustments (FCDA) charges by Metro Manila water concessionaires were likewise lower in 2007 due to the appreciating peso as reflected in the foreign exchange assumptions used by the Metropolitan Waterworks and Sewerage System (MWSS).

A firmer peso translates to lower debt servicing.

The appreciation of the peso decreases the peso equivalent of foreign liabilities and the amount of pesos needed to buy foreign exchange for debt servicing. For instance, if the exchange rate moves from ₱50 to ₱40 to a dollar, we pay ₱10 less for every US\$1 of foreign debt. In this case, a strong peso generates savings that government can use to finance basic services including health, education, and infrastructure. Again, this benefits the public in general and helps sustain growth for the long-term.

The National Government, other government entities—including the BSP—and private corporations can realize savings from principal and interest payments of foreign debts when the peso strengthens. Based on the estimates by the Development Budget Coordinating Committee (DBCC), for every ₱1.00 appreciation, ₱2.2 billion savings on interest payments on foreign debt will be realized.

A firmer peso enables the BSP to build up international reserves.

Strong foreign exchange inflows provide the BSP opportunity to buy the dollars available in the market resulting in the build up of the country's gross international reserves (GIR) to more comfortable levels. Latest data as of end-January 2008 show the gross international reserves rising to a record level of US\$34.4 billion.

At this level, the GIR can cover 6.0 months of imports of goods and payments of services and income. This level is also equivalent to 5.0 times the country's short-term external debt based on original maturity and 3.1 times based on residual maturity (i.e., outstanding external debt with original maturity of one year or less, plus principal payments on medium- and long-term loans of the public and private sectors falling due within the next 12 months).

A firmer peso allows prepayment of foreign exchange obligations.

The build-up in international reserves has also allowed the early repayment or prepayment of the country's foreign exchange obligations.

| Summary of Prepayments (in million US dollars) | | |
|---|--------------|--------------|
| | 2006 | 2007 |
| BSP | 1,395 | 805 |
| NG | 679 | 126 |
| Other Public | 136 | 186 |
| Private | 1,586 | 1,629 |
| Total | 3,796 | 2,746 |

In view of these prepayments, savings on interest expense were realized. Moreover, these sent a signal to foreign creditors and investors about the economy's strong fundamentals.

As a result of these prepayments, the country's external debt-to-GDP ratio has gone down from 54.9 percent as of end-2005 to 40.4 percent as of end-September 2007. The decrease in the debt-to-GDP ratios indicates that the country's capacity to pay its foreign debt is improving. This, in turn, helps the economy to weather external shocks. This is also a major factor considered when the country's credit ratings are assessed. Recently, there has been an upgrade made by Moody's in the outlook on the Philippines' ratings from stable to positive. An improvement in the country's credit ratings lowers the borrowing costs of both the government and private corporations.

15. What is the impact of a firm peso on the export sector?

With a peso appreciation, Philippine exporters could find themselves less competitive in the global marketplace as exports become more expensive in dollar terms.

However, other currencies in the region have been strengthening against the US dollar, and this tends to reduce or even offset the loss in price competitiveness arising from the peso appreciation.

Exporters who use local products are heavily affected by the peso appreciation as the cost of their raw materials have not gone down. In contrast, exporters who rely heavily on imported raw material components may not be as heavily affected as import costs have also gone down.

16. Are there other determinants of export competitiveness apart from price competitiveness?

It is important to remember that the international competitiveness of Philippine exports is affected not only by movements in the exchange rates, but also by trade policies, incentive structures, and macroeconomic environment which affect productivity and the cost of doing business.

The efforts to develop the export sector could focus on improving key areas such as power, transportation, infrastructure, new technologies and skills development. Moreover, market intelligence and promotion activities and negotiations for market access could be further intensified so that Philippine firms could enlarge their market shares.

17. What is the impact of a firm peso on the beneficiaries of OF remittances?

Beneficiaries of OFW remittances may also be affected adversely by a firm peso. As the peso appreciates, beneficiaries of OFW remittances receive less pesos for every dollar that is sent by an OFW. However, their pesos can also buy more local products because of lower inflation resulting from lower import costs.

Many of our workers are deployed in countries whose currencies are appreciating against the dollar. These workers are paid in the currencies of the host countries. For those workers paid in currencies that have strengthened against the US dollar, the peso equivalent of their remittances may not necessarily be lower.

As an example, let us consider the appreciation of the Canadian dollar against the US dollar:

In January 2005, using the exchange rate US\$0.8182/C\$1, C\$100 is equivalent to US\$81.82. If we convert this to peso using the average exchange rate during that period (₱55.77/US\$1), then the peso equivalent is ₱4,563.06.

Given the appreciation of the Canadian dollar against the US dollar, the exchange rate increased to US\$0.9722/C\$1 in September 2007. Thus, when converted, C\$100 is equivalent to US\$97.22 while the peso equivalent is ₱ 4,584.76 using the exchange rate of ₱47.16/US\$1 in September 2007.

| | <u>First Stage</u> US\$/C\$ | <u>Second Stage</u> Peso/US\$ |
|---------------------------------------|--------------------------------|---|
| <u>Exchange Rate</u> | | |
| January 2005 | 0.818193 | 55.77 |
| September 2007 | 0.972171 | 47.16 |
| %appreciation (+)/ depreciation (-) | 18.82 | 18.26 |
| | | |
| | US\$ Equivalent | Peso Equivalent |
| <u>Given remittance of C\$100</u> | | |
| January 2005 | 81.8193 | 4,563.06 |
| September 2007 | 97.2171 | 4,584.76 |
| | | |
| <u>Difference Jan 2005 vs Sept 07</u> | | |
| In level: Current – Previous | | ₱21.70 |
| In ratio: Current/Previous | | 1.004755 (above 1 implies gain in peso equivalent) |

Note: The conversion into pesos goes through two stages: first stage, from Canadian dollars (C\$) to US dollars and second stage, from US dollars to Philippine peso.

18. What is the impact of a firm peso on other sectors?

Domestic producers of import substitutes may find themselves at a disadvantage as imports become cheaper.

The tourism sector may likewise be affected as foreign tourists find it less attractive to visit the Philippines while domestic tourists find it cheaper to visit places abroad. Similarly, the hotel industry will receive less pesos for the equivalent US dollar charge for hotel accommodation paid by foreign tourists.²

The income of business processing operations (BPOs) in dollar equivalent may be lower as operating costs are in peso terms (i.e., more dollars are needed to pay for their peso expenditures, e.g., wages and salaries). BPOs include call centers, back office operation, medical transcription, legal transcription, animation, software development, engineering design, digital content, and other data transcription.

19. Did a firm peso contribute to the 1997 currency crisis?

In the case of the Philippines, the relatively weak financial sector at that time was the main factor behind the financial crisis in the country. Another contributory factor was the large foreign currency indebtedness of the corporate sector. On a more general level, however, for many countries, the choice of exchange rate regime (which could have affected the movements of the local currency) contributed to the 1997 Asian financial crisis. The

² Data show that although visitor arrivals in the Philippines have continued to grow, the growth rate has gone down from 20.1 percent in 2004 to 8.7 percent in 2007

experience of East Asia revealed that those countries under a fixed exchange rate system when faced with massive capital outflows were forced to support their currencies, leading to the depletion of reserves. This led to the adoption of a flexible exchange rate system (as was the case of Thailand) or the imposition of capital controls (as was the case of Malaysia).

20. *Has the firm peso contributed to the decline in manufacturing?*

The observed decline in manufacturing growth cannot be solely ascribed to the appreciation of the peso. In fact, manufacturing was already experiencing difficulties even when the peso was depreciating in 2004-2005. Such difficulties are brought about by a number of factors such as high power costs, weak infrastructure (e.g., road and bridges, mass transport system, telecommunication and IT facilities), financial and corporate restructuring and competition from China. Moreover, the Philippines still ranks as one of the lowest in the Global Competitiveness Index (GCI) among Asian economies included in the survey. The survey cites inadequate supply of infrastructure as the second most problematic factor in doing business in the Philippines.³

As a result, the manufacturing sector has suffered from import competition via squeezed margins and reduced market share. There are also well known structural shifts in the economy with consequent re-allocation of resources. For instance, the services sector has grown substantially, accounting for nearly half of GDP growth in recent years. This trend may indicate a diminishing comparative advantage of the Philippine manufacturing sector.

V. BSP measures: mitigating the impact of a firm peso

21. *What measures have the BSP undertaken to temper the peso appreciation?*

Mindful of the potential impact of a strong peso on some sectors of the economy, the BSP has implemented measures to temper the appreciation pressure and maintain orderly conditions in the foreign exchange market. These include:

- ✍ building-up in international reserves of the BSP
- ✍ encouraging the National Government to borrow more in pesos
- ✍ prepaying of the foreign currency debt. The National Government and other government corporations have also been prepaying some of their foreign currency obligations.
- ✍ liberalizing the foreign exchange regulatory framework particularly pertaining to outward investments, foreign exchange purchases for non-trade current account transactions, use of 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.

22. *What are the additional measures to assist exporters?*

³ The Global Competitiveness Report, 2007-2008. World Economic Forum.

The BSP has taken other steps to help mitigate the possible negative impact of the peso's appreciation on the export sector.

- ✍ Continuing to make available the Peso Rediscount Facility (PRF) and the Exporters Dollar and Yen Rediscount Facility (EDYRF), which has a budget of US\$500 million. These facilities allow banks to rediscount their loans, thus freeing up funds which banks can use to expand lending;
- ✍ Contributing ₱50 million to the Export Promotion Fund (EPF), an initiative of the Export Development Council (EDC), which aims to raise export competitiveness and performance;
- ✍ Working towards increased access to financing by supporting administrative and legislative moves that facilitate identification of good borrowers and reduction of borrowing costs (such as the Credit Information Systems Act); and
- ✍ Promoting the use of hedging products that are being offered by banks to reduce foreign exchange risks. On 28 June 2007, the Development Bank of the Philippines (DBP), together with the Department of Trade and Industry (DTI) and the Department of Finance (DOF), conceptualized a hedging program for exporters.
- ✍ The hedging program aims to shield exporters from further exchange rate losses through the foreign exchange insurance and forward foreign exchange rate protection products. DBP's first transaction on hedging under the DBP's Hedging Facility amounted to US\$113,000 as of end-September 2007. This has subsequently grown to US\$2.4 million as of end-October 2007.

23. What are the measures to address the concerns of OFWs

- ✍ To address the concerns of OFWs, the BSP's efforts have been focused on improving the remittance environment for OFW remittance flows through
 - ✍ facilitating the flow of remittances through formal channels; and
 - ✍ encouraging banks to reduce remittance charges
- ✍ The National Government (NG) and the BSP have agreed in principle to offer retail Treasury bonds (RTBs) starting 2008 as an alternative investment instrument available to OFs. The initial offer size could be as much as US\$1 billion, depending on market reception to the bond offering. The issuance of OFW bonds could help prepare OFs for future reintegration in the Philippine economy and raise additional funding for government requirements, including infrastructure development. This will also neutralize the impact of the remittance inflows on the foreign exchange rate as these would be utilized for productive investments.
- ✍ The BSP continues to undertake its advocacy through financial literacy campaigns (or FLCs) that aim to promote a culture of savings among OFs and their families. The FLCs also encourage the channeling of these savings into investments such as placements in financial instruments and business ventures. The BSP also discusses safe practices in investing in financial products. Priority has been given to areas with heavy concentration of OFs and dependents.
- ✍ The BSP also created an interactive portal that will link users to information on the different banks and non-bank remittance companies in the Philippines, including

locations of their branches abroad, remittance center, foreign bank/correspondents, products and services, and charges/fees for remittance services to any part of the Philippines.

- ✍ The BSP likewise continues to improve the country's payments and settlement system to facilitate faster, safer and more efficient transfer of funds to beneficiaries of OFs.

VI. Next Steps

24. What are the next steps to be taken in light of the continued appreciation of the peso?

The continued appreciation of the peso prompted concerned government agencies, bankers and exporters to suggest further measures that can help cushion the negative effect of a peso appreciation on certain sectors.

On 3 October 2007, the BSP hosted a conference on hedging facilities for exporters to familiarize merchandise and service exporters with various hedging products available in the market as well as the BSP's regulations on hedging transactions and relevant foreign exchange policies.

The BSP will roll out this hedging conference to the regions during the first quarter of 2008 to provide knowledge on hedging and other foreign exchange measures to individuals and businesses based in the region.

The BSP likewise continues to review the foreign exchange regulatory framework with a view to allowing individuals and businesses with legitimate transactions to have greater access to foreign exchange.

25. What can exporters do?

To ease the impact of the appreciation of the peso against the dollar on its operations, exporters may implement the following measures:

- ✍ Avail themselves of hedging facilities offered by banks;
- ✍ Diversify markets such as shifting from US market to the European and Asian markets whose currencies are also appreciating;
- ✍ Pool purchases of raw materials for similar export products in order to increase the volume of purchases and thereby negotiate higher discounts from domestic and foreign suppliers of raw materials;
- ✍ Streamline operations including by implementing just-on-time delivery and reducing inventory costs; and
- ✍ Negotiate with buyers for higher prices or shift transactions by quoting in terms of stronger currencies such as the euro to be able to mitigate the impact of the weakening in the US dollar.

26. On the part of the government, what else needs to be done?

The government can further assist the affected sectors by addressing power and infrastructure issues that could have a long-lasting impact on raising the competitiveness of Philippine industries. In this regard, the following initiatives are being pursued:

- ✍ The government continues to press ahead with the power sector reform program to ensure the viability of the National Power Corporation (NPC). This will facilitate adequate power supply to meet the requirements of the growing economy in the medium term.
- ✍ The government has also formulated the Comprehensive and Integrated Infrastructure Program which aims to address key bottlenecks in the Philippines to spur inter-island farm trade, improve distribution of food and agricultural products in the countryside, reduce travel time and transportation cost through an efficient network of transport infrastructure that will link the entire country. The government is prioritizing infrastructure projects that are strategic and critical to stimulate trade and investments, such as the construction of ports, roads and highways, rail systems and airports.