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 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 is determined in the interbank foreign exchange market (by the forces of supply and demand just like any commodity or sevice being sold in the market). 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 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 the 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.

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

[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.

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 ensure stability in the foreign exchange market. For example, the BSP has been keeping FX regulations responsive through the liberalization of FX rules (with appropriate safeguards).

The BSP likewise continues to have recourse to measures that can cushion the impact of sharp peso movements. These include maintaining a healthy level of foreign exchange reserves as buffer; reviewing and adjusting macroprudential measures (such as risk weight for non-deliverable forwards); and liquidity enhancing and management tools such as the US dollar repo facility, exporters' dollar and yen rediscounting facilities (EDYRF) and the enhanced guidelines on Currency Risk Protection Program (CRPP).

RECENT DEVELOPMENTS IN THE EXCHANGE RATE

10. How has the exchange rate moved in the first quarter of 2020 and what were the factors behind the movement?

The peso appreciated against the US dollar in Q1 2020. The peso averaged ₱50.83/US$1 in Q1 2020, appreciating by 0.39 percent from the Q4 2019 average of ₱51.03/US$1. On a y-o-y basis, the peso likewise appreciated by 3.02 percent relative to the ₱52.37/US$1 average in Q1 2019. [4]

The peso appreciated in Q1 2020 due partly to the continued decline in oil prices in the world market and positive market sentiment amid the Fitch Ratings' credit rating outlook upgrade for the Philippines in February 2020. Policy measures implemented by authorities to counter the impact of the COVID-19 on the economy also supported the peso.

In January 2020, the peso depreciated by 0.14 percent to an average of ₱50.84/US$1 from the ₱50.77/US$1 average in December 2019. The peso's depreciation was due partly to global market risk aversion and safe-haven buying driven by (i) the geopolitical tension between the US and Iran; and (ii) heightened fears of the potential economic impact of the spread of novel coronavirus from Wuhan, China.

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

Meanwhile, in February, the peso appreciated slightly by 0.18 percent to an average of ₱50.74/US$1 from the average a month ago. The peso appreciated amid market expectation of a rate cut by the BSP during its 6 February 2020 monetary policy meeting; optimism over China's actions towards containing the coronavirus outbreak; and reduced market uncertainty after the conclusion of the impeachment proceedings in the US Congress. In addition, positive market sentiment over the credit rating outlook upgrade for the Philippines by Fitch Ratings, as well as the release of trade deficit data for 2019, which narrowed to $37.05 billion from $43.53 billion in 2018, likewise provided support to the peso.

In March, the peso depreciated by 0.31 percent to an average of ₱50.90/US$1 from the average in the previous month. The peso's depreciation reflected continued concerns over the global impact of the coronavirus disease, which has then spread outside China and over hints of a possible rate cut by the US Federal Reserve to cushion the impact of the outbreak in the US economy. The imposition of a community quarantine in the National Capital Region (NCR) and, afterwards, the enhanced community quarantine covering the entire island of Luzon amid concerns over the spread of COVID-19 in the country have likewise added pressure to the peso.

On a year-to-date basis, the peso depreciated slightly against the US dollar by 0.09 percent to close at ₱50.68/US$1 on 31 March 2020 from the end-December 2019 closing rate of ₱50.64/US$1.[5]

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

On a real trade-weighted basis, the peso lost external price competitiveness in Q1 2020 against the basket of currencies of all trading partners (TPI); trading partners in advanced (TPI-A) countries; and trading partners in developing (TPI-D) countries relative to Q4 2019. This was indicated by the increase in the real effective exchange rate (REER) index of the peso by 3.55 percent 5.67 percent, and 2.41 percent, against the TPI, TPI-A and TPI-D baskets, respectively.[6,7]

Relative to Q1 2019, the peso likewise lost external price competitiveness across currency baskets during the review period. This developed following the nominal appreciation of the peso and the widening inflation differential, resulting in the increase in the REER index of

[5] Based on the last done deal transaction in the afternoon.

[6] The TPI measures the nominal and real effective exchange rates of the peso across the currencies of 14 major trading partners (MTP:s) 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-A 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-D 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.

[7] 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.

the peso by 5.15 percent, 5.14 percent and 5.17 percent against the TPI, TPI-A and TPI-D baskets, respectively.

12. Has the peso been volatile?

The volatility of the peso's daily closing rates (as measured by the coefficient of variation) stood at 0.43 percent in Q1 2020. This was lower than the 0.80 percent registered in the previous quarter.[8] The volatility of the peso in the review quarter was lower than the volatility of most currencies in the region.

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

Over the policy horizon, the peso should continue to reflect emerging demand and supply conditions in the foreign exchange market. Once normal economic conditions resume after the country recovers from the current pandemic, the following factors should support liquidity and supply conditions in the foreign exchange market: inflows from overseas Filipino (OF) remittances and Business Process Outsourcing (BPO) revenues; and foreign direct investments. Meanwhile, the ample level of the country's gross international reserves; the country's firm macroeconomic fundamentals; the credit rating upgrades that the country earned in recent years are expected to sustain market confidence towards the Philippine financial markets and provide stability to the local currency over the medium term.

Moving forward, the movement of the peso will remain market-driven. Allowing market forces to determine the level of the peso has the following benefits: (i) a flexible peso is consistent with the BSP's inflation targeting (IT) framework; and (ii) a flexible peso acts as an automatic stabilizer to restore macroeconomic balance for a small open economy like the Philippines.

POLICY RESPONSES BY THE BSP

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

FX Rules Further Liberalized	Feb 2016	• To maintain a safe and sound financial system and a stable FX market, the Monetary Board (MB) approved further liberalization of the rules governing FX transactions in the Philippines. The amendments include: o Prior BSP approval is no longer required for the borrowings from offshore sources/FCDUs of banks of the following resident entities:

[8] 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.

		✓ 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. o 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	Jul 2016	• 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: o 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 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. o 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.

		o 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. o 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. o Increased the amount of Philippine currency that may be brought into/out of the country from P10,000 to P50,000. 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.
Further Amendments to FX Regulations	*Sep 2016*	• 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 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.
	Dec 2017	• Lifted prior BSP approval requirement for private sector foreign loans as well as foreign currency-

		denominated loans/borrowings from onshore banks (including those in the form of bonds/notes/other debt instruments issued offshore) that are not guaranteed by the public sector. These borrowings will be subject to registration only if these will be serviced with FX to be purchased from the banking system. • Streamlined and simplified documentary requirements for applications for: (i) approval of public sector foreign/foreign currency loans; and (ii) approval/registration of private sector foreign/foreign currency loans. • Replaced the positive list of costs/projects that may be funded with foreign/foreign currency loans with a general policy statement (i.e., the purpose must be legitimate, and not contrary to laws, regulations, public order, public health, public safety, or public policy). o Lifted BSP registration for private sector, provided these are duly reported to the BSP: ▪ loans that are not guaranteed by foreign governments/official export credit agencies covering importation of freely importable commodities under deferred L/Cs or D/A-O/A arrangements with a term of more than one (1) year; and ▪ short-term loans in the form of export advances from buyers abroad. • Lifted the $60,000.00 daily limit on FX sale by depository banks (AABs) for the balance of peso deposit accounts of non-residents. • Opened temporary window for registration of private sector foreign/foreign currency loans. The temporary window was opened for six months to allow BSP registration of the accounts and servicing of the outstanding balances on scheduled due dates using FX resources of the banking system. Previously, these loans can only be settled with the borrower's own FX or with funds sourced outside the banking system.
	May 2018	• Lifted prior BSP approval on: (a) conversion of foreign currency loans granted by banks to peso loans; and (b) transfer of such loans, as well as Real and Other Properties Acquired from banks' foreign currency deposit unit books to the Regular Banking Unit books.

		Prior BSP approval under certain conditions on the aforementioned transactions was originally put in place to ensure that banks fully understand the nature and extent of the risks involved. The conditions also ensure that banks have put in place appropriate business policies and risk management systems to manage these transactions.
Currency Rate Risk Protection Program (CRPP)	*Oct 2018*	• The BSP, on 5 October 2018, issued Circular No. 1015, which outlines the enhanced guidelines of the "Currency Rate Risk Protection Program (CRPP) Facility," which was first implemented at the wake of the 1997 Asian Financial Crisis. • The CRPP is a non-deliverable forward (NDF) contract between the BSP and a universal/commercial bank (UKB) in response to the request of bank clients who are seeking to hedge their borrowings denominated in foreign currency to protect them from exchange rate volatility. Under this facility, parties agree that, on maturity of the forward contract, only the net difference between the contracted forward rate and the prevailing spot rate shall be settled in pesos. • Under this facility, the eligible obligations are unhedged foreign currency obligations in amounts of not less than US$50,000.00 that are current and outstanding as of the date of application, including: o BSP-reported/registered short-term (ST) trade-related loans from eligible banks; o BSP-reported medium/long-term trade-related FCDU/RBU loans with payments maturing within 90 days as of date of application; o BSP-reported/registered short-term trade-related borrowings of oil companies from offshore banking units (OBUs); and o US dollar trust receipts, among others. Maximum tenor is 90 days with option to re-avail. The following are some of the regulatory relief encompassed in the CRRP facility: o Exposures under the CRPP facility shall not be subject to NDF position limits;

		○ Reduced market risk capital charges shall be applied for net open positions for NDFs under this facility; and ○ UKBs will not need additional derivatives authority since transactions under the CRPP are considered generally authorized derivatives activities.
Further Amendments to FX Regulations	*Jan 2019*	• Further liberalized rules on inward investment and associated derivatives transactions by broadening the coverage of inward investment transactions, allowing registration of investments filed beyond the prescriptive period, expanding the definition of eligible banks that can register investments on behalf of BSP, streamlining processes and simplifying documentary requirements, and facilitating sale of FX relating to investments; • Further relaxed the rules on outward investments and associated derivatives transactions by expanding the coverage of outward investment transactions and lifting the prior BSP approval requirement for purchase of FX beyond the threshold amount, subject only to prior notification to the BSP; • Allowed the submission of supporting documents through electronic means for: (a) registration of private sector foreign loans/borrowings without public sector guarantee; (b) registration of inward investments; and (c) sale of FX by banks covering various FX transactions; and • Provided a grace period of one (1) year from effectivity of the implementing Circular to file applications for registration of investments regardless of the date of funding.
Operational relief measures for FX transactions in response to COVID-19 Pandemic	*Mar 2020*	• On 27 March 2020, the Monetary Board approved operational relief measures for FX transactions in line with the declaration of "community quarantine" by the Office of the President (OP) amidst the spread of coronavirus disease 2019 (COVID-19).[9] The following measures are expected to facilitate the public's access to the FX resources of the banking system to finance legitimate transactions:

[9] BSP media releases: BSP Issues Operational Relief Measures for Foreign Exchange (FX) Transactions http://www.bsp.gov.ph/publications/media.asp?id=5338

		○ Relaxation of submissions of reports or applications (i.e., allowing for electronic submission and digital signature) of foreign currency loans/borrowings/investments; ○ Non-imposition of monetary penalties for delayed submission of reports; ○ Waiver of applicable processing fees for applications covering private sector foreign/foreign currency loans/borrowings with FX obligations due within the period covered by the Circular; and ○ Issuance of BSP documents [e.g., Bangko Sentral Registration Document (BSRD), implementing letter] by the International Operations Department in electronic form. • These measures are effective for the duration of the declaration of "community quarantine" by the Office of the President, or as may be extended by the BSP.

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 in excess of what is supplied by the market or offered for sale 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 flexible 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.