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THIRD QUARTER ECONOMIC REPORT

THE PERKS AND PERILS OF A STRONG PESO

A currency appreciation is often associated with a more robust and stable economy. However, a closer look at the strong peso shows that it has its perks and perils. Because its impact vary among the different sectors of the society, one would be hard put to evaluate whether on the whole, a strong peso is really advantageous or not.

The Philippine economy grew by 6.6 percent in the third quarter of 2007, slowing from the previous two quarters' over 7 percent growth, but considerably higher than the 5.1 percent recorded in the third quarter last year. With just one more quarter to reckon with, the government will likely meet its GDP growth target for 2007 which has recently been upgraded from 6.1 to 6.7 percent to 6.9 to 7.3 percent.

Meanwhile, the gross national product (GNP) registered a big jump to 8.2 percent this quarter, from 5.6 percent in the same period last year as net factor income from abroad more than doubled its growth, from 11.2 percent to 25.2 percent mainly on account of the US$9.11 billion OFW remittance inflow during the period. Furthermore, the economy's third quarter growth was at par with its Asian neighbors, trailing only behind China (11.5%), Singapore (8.9%), and Taiwan (6.9%).

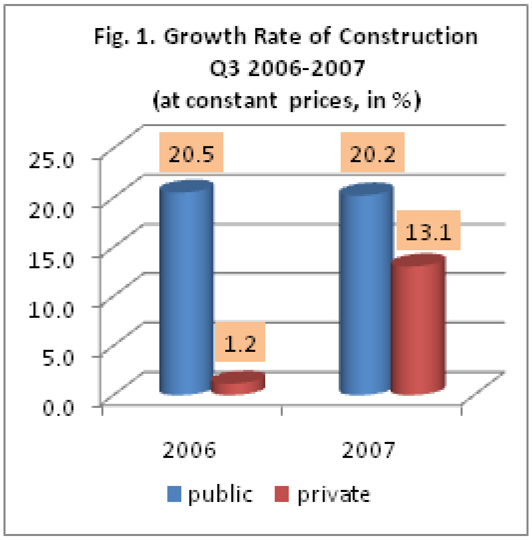
On the production side, the economy expanded on the back of the solid performance of agriculture, which grew by 5.6 percent from 3.6 percent in the third quarter of 2006, benefiting from the increased production of corn and the impressive performance of the fisheries sector. Overall agriculture's growth in the first nine months already averaged 4.6 percent, an indication that the 4 percent to 5 percent sectoral growth target for the year will likely be achieved.

Meanwhile, industry's growth in the third quarter accelerated to 6.1 percent from 4.9 percent as the construction and mining and quarrying sectors continued to post double-digit growth rates. Manufacturing remained a big contributor of growth to industry although its growth has slackened even more from 4.4 percent in the third quarter of 2006 to 3.3 percent this year. Services, in contrast, expanded at a faster pace, with trade and private services contributing the most to its growth.

The SEPO Economic Report is a quarterly publication of the Senate Economic Planning Office. Its purpose is to provide useful information on the current state of the economy to the Senators and Senate Officials. The SEPO Economic Report is also available at www.senate.gov.ph.

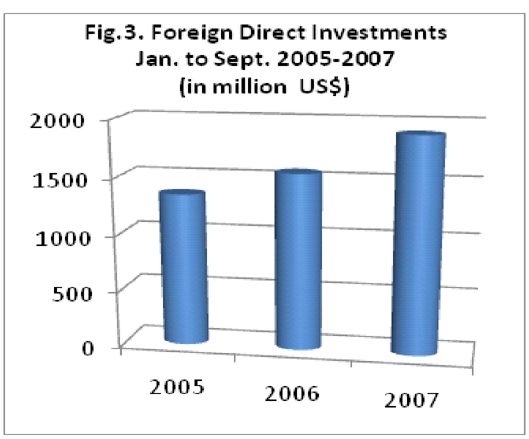
Table 1. Gross Domestic Product, Third Quarter 2006-2007 (percent, at 1985 constant prices)			
Particulars	**Q3 2006**	**Q3 2007**	**Q1-Q3 2007**
GROSS DOMESTIC PRODUCT	5.1	6.6	7.1
Net factor income from abroad	11.2	25.2	18.9
GROSS NATIONAL PRODUCT	5.6	8.2	8.1
Production side			
Agriculture, fishery & forestry	3.6	5.6	4.6
Agriculture & fishery	3.7	7.7	5.7
Forestry	-0.8	-3.3	-2.1
Industry	4.9	6.1	5.5
Mining & Quarrying	-5.1	21.8	8.4
Manufacturing	4.4	3.3	3.8
Construction	8.3	16.7	12.5
Electricity, Gas and Water	9.2	8.5	8.8
Services	5.8	7.2	6.5
Transport, Communication & Storage	6.1	6.4	6.3
Trade	5.5	8.2	6.9
Finance	5.5	7.9	6.7
Ownership of Dwellings & Real Estate	7.6	6.9	7.2
Private Services	6.1	8.5	7.3
Government Services	4.2	2.0	3.1
Expenditure side			
Personal Consumption Expenditure	5.2	5.6	5.4
Government Consumption Expenditure	4.5	8.3	6.4
Capital Formation	8.0	7.5	7.7
Fixed Capital	2.1	8.9	5.5
Construction	6.7	15.4	11.0
Durable Equipment	-1.9	3.4	0.8
Breeding Stocks	1.1	3.6	2.3
Exports	9.2	-4.9	3.1
Imports	1.2	-6.3	-6.5

Source: National Statistical Coordination Board



Source: National Statistical Coordination Board

Source: Bangko Sentral ng Pilipinas



Source: Bangko Sentral ng Pilipinas

On the expenditure side, higher consumer spending spurred by remittance inflows and the still benign inflation rate continued to drive growth. Another bright spot is the considerable increase in fixed capital spending to 8.9 percent from 2.1 percent in the third quarter of 2006. Private construction, in particular, rose to 13.1 percent from 1.2 percent even as public construction's growth has noticeably decelerated. Investment in durable equipment also turned around, from -1.9 percent in 2006 to 3.4 percent for the period in review.

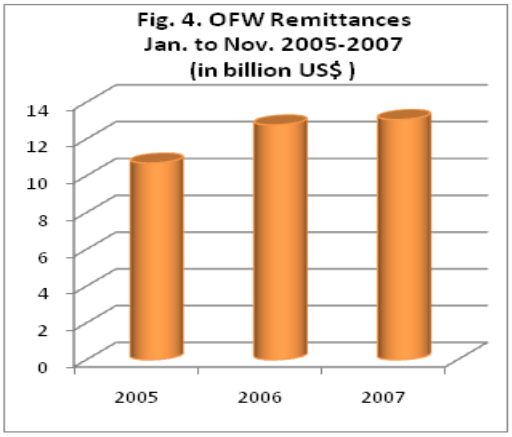
The third quarter growth, however, would have been much higher had it not been pulled down by the weak performance of the export sector. Total exports registered a -4.9 percent growth, from a high of 9.2 percent in the same period last year whereas total imports also contracted, from 1.2 percent to -6.3 percent. The weak export growth was in part due to the anemic demand for electronics in the US, and to the strengthening of the peso, Asia's best performing currency in 2007.

Given the peso's remarkable performance last year, this paper focuses its discussion on the appreciation of the said currency, and summarizes its impact on the various sectors of the economy. It also presents the different policies currently undertaken and/or being proposed and offers supplementary measures to address the situation.

Recent trends in the exchange rate

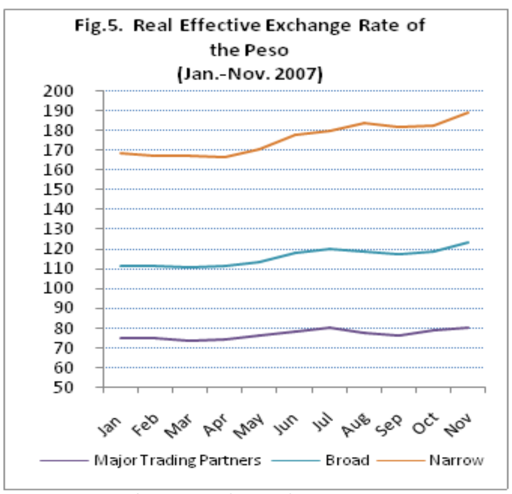
The nominal peso-dollar exchange rate has been increasing since 2005. Its rise, however, has been much sharper in the last two years. Finishing P49.13 to the dollar in December 2006, the peso continued its rally in the first semester of 2007, benefiting from the generally peaceful election and strong GDP growth figures. However, at the height of the US subprime crisis in August 2007, it slightly depreciated to P46.1:$1 from P45.6:$1 in July, or by 1 percent month-on-month. It again gained ground in September and continued to strengthen from then on. By December, the peso has already advanced by 19.5 percent from its January 2007 level. It will likely continue its ascent in 2008, as it has already entered the P40-to-the dollar territory last January 9. Analysts are forecasting that it will likely hit P38, or as high as P35 this year, even as the government assumption still puts it at a more conservative P40-P46 to a dollar.

Strong dollar inflows from portfolio and foreign direct investment (FDI), and dollar remittances of OFWs have been propelling the peso



Source: Bangko Sentral ng Pilipinas

The real effective exchange rate or REER, is usually preferred over the nominal effective exchange rate as it also accounts for the relative inflation rates among trading countries.



Source: Bangko Sentral ng Pilipinas

to appreciate. According to the Philippine Stock Exchange (PSE), the amount of capital raised from Initial and secondary public offerings in 2007 totaled to PhP97.25 billion, higher by 156.6 percent compared to the P17.43 billion raised in 2006. FDI posted a surplus of US$1.9 billion from January to October despite the contraction of 4.3 percent in FDI compared to the same period last year. Meanwhile, OFW remittances for the first 11 months of 2007 reached US$13.1 billion, higher by 14.1 percent compared to the year-ago level of US$11.4 billion as more highly-skilled, and thus highly compensated overseas workers, were deployed. Remittances coursed through banks are projected to reach US$14.3 billion in 2007.

In addition, uncertainties in the US economic outlook brought by its subprime problems have driven down the demand for dollars, which consequently added pressure for the peso to appreciate. The subprime problem, with its far-reaching consequences across the US economy is considered as one of the major challenges Asian economies will have to hurdle this year.

The real effective exchange rate

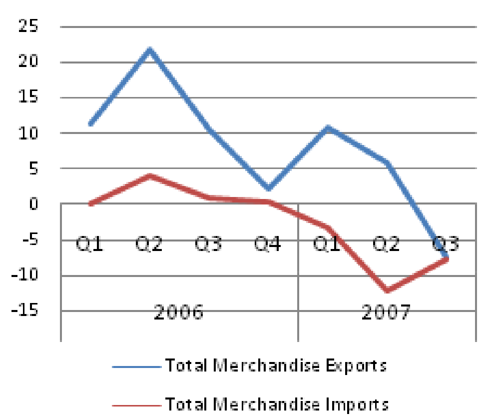
Standard economic theory postulates that a currency appreciation can erode the price competitiveness of a country's exports in the world market. This, however, rests on the assumption that only one currency remained unchanged. In the real world, though, the values of currencies change simultaneously. Because of the general weakness of the dollar, for instance, other Asian currencies also strengthened last year. The Indian rupee gained more than 12 percent in 2007 while the Thai baht trod a similar path, appreciating by an average of almost 15 percent against the US dollar.

An indicator that can measure the external price competitiveness of the currencies vis-a-vis the other currencies is its effective exchange rate. The real effective exchange rate or REER, is usually preferred over the nominal effective exchange rate as it also accounts for the relative inflation rates among trading countries.

The Bangko Sentral ng Pilipinas (BSP) constructs exchange rates of the peso against three currency baskets namely: *basket of major trading partners* (US dollar, yen, euro and UK pound); *broad basket of competitor currencies* (Singaporean dollar, South Korean won, New Taiwan dollar, Malaysian ringgit, Thai baht, Indonesian rupiah, and Hong Kong dollar); and *narrow basket of competitor currencies* (Malaysian ringgit, Thai baht, and Indonesian rupiah).

... the appreciation of the peso has varying impacts on the different sectors of the economy, and as such, one would be hard put to evaluate whether on the whole, a strong peso is really advantageous or not.

Fig. 6. Merchandise Trade Growth Rates, Q1 2006-Q3 2007



Source: National Statistical Coordination Board

As shown in Fig. 5, the peso's REER remained fairly stable against all currency baskets in the first quarter of 2007. According to the BSP, while there has been a nominal appreciation of the peso against these baskets of currencies in the first quarter, it was tempered by the inflation differential, which narrowed during the period. Inflation rate in the Philippines went down considerably to an average of 2.9 percent in the first quarter of 2007 from 4.9 percent in the preceding quarter.

However, from April to July 2007, the peso appreciated in real terms across all baskets of currencies, indicating that the peso lost some international competitiveness during the period. The trend was reversed in August and September, at the height of the US subprime crisis. In September, the peso depreciated against the baskets of currencies of its major trading partners by 1.85 and against its competitor countries, both broad and narrow by 1.33 and 1.36, respectively. It again recovered in October and rose steeply in November with the increased OFW remittance flows that came with the holiday season.

The rising peso: boon or bane?

The exchange rate is often pointed to as an indication of how well the economy is doing. An upward movement in the exchange rate or a currency appreciation is often associated with a more robust economy whereas currency depreciation denotes the opposite. For instance, during the election period in May 2007, the strong peso was often trumpeted by administration candidates as one of the proofs that the economy is indeed getting better.

The exchange rate, however, is a weak barometer of the country's overall economic performance. For one, it is influenced by many factors, and whether these factors are signs of an improving economy could be subject to much debate. On the one hand, the peso appreciation has been credited to strong dollar inflows from export earnings and from portfolio and foreign direct investments, all of which are indicative of positive investor sentiment. On the other hand, it is also attributed to the weakening of the US dollar and the continued inflows of OFW remittances, which do not really confirm the strength of the domestic economy, the latter even reflecting its inadequacy in terms of providing employment opportunities in the country. Moreover, the appreciation of the peso has varying impacts on the different sectors of the economy, and as such, one would be hard put to evaluate whether on the whole, a strong peso is really advantageous or not.

Impact of peso appreciation

...two of the most important factors that affect the vulnerability of export-oriented industries to a rising currency are: the pricing strength, which captures the size of profit margin an industry/business works with; and the degree to which the industry is protected or hedged.

On export. The rise in the Philippine peso has been an important factor behind the significant drop in total export earnings over the first three quarters of 2007 to 3 percent from a double-digit growth of 14.5 percent for the same three-quarter period in 2006. Of the registered 9,601 individual exporters in the Philippines, some appear to have been hit harder than the others. According to a study,[1] two of the most important factors that affect the vulnerability of export-oriented industries to a rising currency are: (1) the pricing strength which captures the size of profit margin an industry/business works with; and (2) the degree to which the industry is protected or hedged. Exporters with weaker pricing power or relatively lower profit margins and whose products have relatively lower import content are the most vulnerable to a currency appreciation whereas industries that export goods and services which are highly in demand overseas, have relatively high import content, and have big profit margins are the least affected.

Agri-based and traditional manufacturing export industries such as garments and handicrafts which employ very little or no imported inputs, and have weak pricing power are the most vulnerable industries during a peso appreciation. This is apparent in the 2006 and 2007 export data. Exports of bananas and plantains drastically dropped to -4.6 percent in the same period in 2006. Exports of centrifugal sugar declined further and while the export growth of shrimps and prawns improved a bit, it remained negative. Agricultural exports account for more or less 5 percent of the country's total export earnings.

Table 2. Growth Rate of Selected Merchandise Exports, Q1 to Q3 2006-2007

Source: NSCB
Total merchandised export and import growth rates are based on peso term at constant 1985 price.

Similarly, the garments industry showed signs of susceptibility to the stronger peso. Exports of garments recorded a negative 11.8 percent growth from January to September 2007, a far cry from the robust 13.17 percent growth over the same period in 2006. Exports of baskets and basketwares also plummeted to negative 40.4 percent in the first three quarters of 2007, from 1.4 percent in the same period in 2006.

According to Export Development Council (EDC), 34 firms have already shut down, citing peso appreciation as the reason. The Philippine Exporters Confederation (PhilExport) has a higher estimate – as of June 2007, 75 firms have already closed shop. PhilExport further reports that handicrafts and furniture exporters, which are mostly micro and small and medium enterprises (MSMEs) and employ about 30,000 people, had incurred an average of P1.5 billion in exchange rate losses in the first half of 2007.

[1] a study on Currenct Impacts on Exports conducted by Infometrics Ltd for the New Zealand Trade and Enterprises

Exports of semiconductors and electronic microcircuits, which account for about a third of total exports weakened as well, but not as adversely affected as the others. Exports of semiconductors and electronic microcircuits posted a 4.23-percent growth over the first three quarters of 2007, down from 11.8 percent in 2006, while exports of finished electrical machinery managed to post a 25.13 percent growth, albeit lower than the 31-percent growth posted in 2006.

These types of exports are naturally hedged as they have high import content, and as such, a peso appreciation reduces their production costs. The decline in their growth rates can actually be attributed more to the weak demand for electronics overseas, rather than to the strong peso.

On imports. With the strengthening of the peso, imports become relatively cheaper so it is expected that importation would increase. However, imports have not been rising. This, in part, reflects the weak demand for exports, but it also shows that domestic investors are not importing, upgrading or buying new machines.

Other sectors which also find themselves at a disadvantage include the domestic producers of import substitutes, as they now have to compete with cheaper imports, and the tourism sector as the Philippines effectively becomes a more expensive tourist destination vis-a-vis other countries whose currencies did not appreciate as much as the peso did.

On export of services. According to the Business Processing Association of the Philippines(BPAP),[2] the strong peso poses a real challenge to the outsourcing industry as it increases the cost of labor and consequently reduces the industry's revenue margins. PeopleSupport, for example, highlights in their quarterly report their operating margins' decrease by 5.5 percent in the third quarter of 2007 as compared to the third quarter of 2006 due to the appreciation of the peso. BPAP is quick to add though that the labor costs of investing in the Philippines remain competitive vis-à-vis other competitor countries (e.g. India) because their currencies have also appreciated. Moreover, with the demand for Filipino services currently surpassing the supply of services, the industry can still tolerate the rising peso, as long as a high level of cost efficiency is maintained, BPAP explains. For how long this competitive edge will be kept, though, remains a question.

[2] BPAP is the umbrella organization of call centers and other IT-enabled service providers in the country.

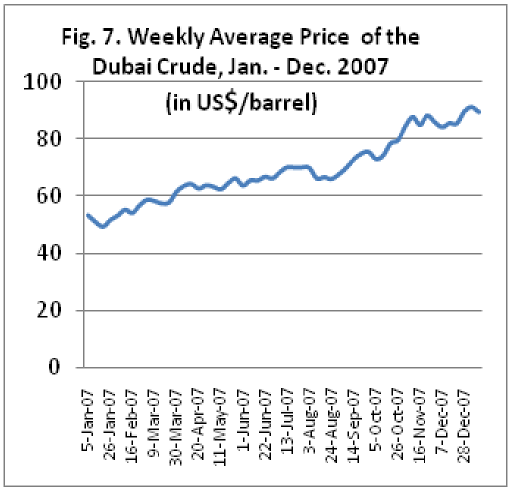


Fig. 7. Weekly Average Price of the Dubai Crude, Jan. - Dec. 2007 (in US$/barrel)

Source: www.medz.gov.th

Table 3. Impact of Peso Appreciation on Local Pump Prices

Type of Fuel	Estimated at P44/$ (P/li,P/kg)	Estimated at P49/$ (P/li,P/kg)	Savings (P/li, P/kg)
Gasoline	51.47	55.20	3.73
Diesel	47.13	51.22	4.09
Kerosene	49.57	53.75	4.18
LPG	60.96	65.39	4.43

Source: Department of Energy

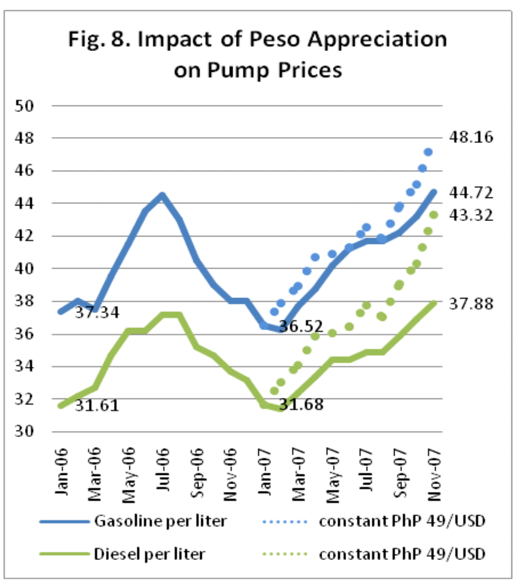


Fig. 8. Impact of Peso Appreciation on Pump Prices

On OFWs. Perhaps the most adversely affected by the strong currency are the families of OFWs, as they are now receiving 20 percent less pesos in exchange for dollars than what they were getting a year ago. However, even with the decrease in buying power, many skilled workers are still opting to look for jobs overseas because the exchange rate still provides leverage to their salaries as compared to working in the Philippines. Others just find comfort from their augmented salaries, which have somewhat dampened the effect of the strong peso. Engr. Nelson P. Ramirez, director of United Filipino Seafarers, shares that the shortage of maritime academicians in Europe and in other Western countries has prompted the maritime labor market to increase its wages in order to attract and capture qualified sea personnel.[3] As an example, the monthly wage of $5,000 for captains of oil tankers has increased to $7,000 per month.

However, for the OFWs, whose salaries remained the same, the strong peso means reducing personal expenses abroad and employing further belt-tightening measures to cope with the lower exchange rate.

On prices. All other things constant, the general public stands to gain from a currency appreciation as it puts a downward pressure on the prices of oil imports, and consequently, the prices of basic goods and services. Unfortunately, ordinary citizens have not felt this, as world oil prices have increased dramatically since the beginning of 2007.

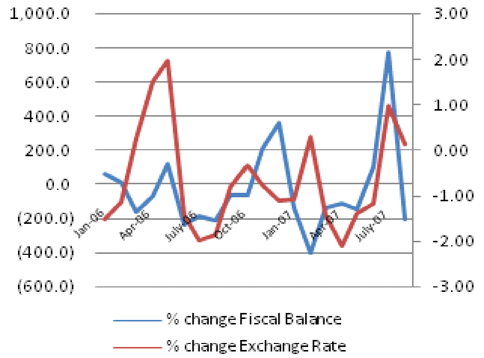
From as low as US$48.88 per barrel in January 2007, the price has increased steadily throughout the year with the record high price being breached practically daily from September to November before finishing at US$89.32 per barrel in December. The price peaked at US$92.6 per barrel on January 4, 2008, representing a 67.4-percent increase from its price a year ago.

Oil prices have risen worldwide due mainly to the increased demand from the US, China and India as well as fears over political instability in Nigeria and the nationalization of oil reserves in Russia and Venezuela. This was further exacerbated by speculative activities on the part of investors, hedge fund managers and investment banks who have been pouring funds into oil futures and energy derivatives as they use oil as a hedge against the weak US dollar.

The strength of the local currency has helped reduce the impact of this rise on domestic pump prices of petroleum products such as gasoline and diesel. The Department of Energy estimates that if the peso stayed at the PhP49/$1 level, the price of gasoline would be

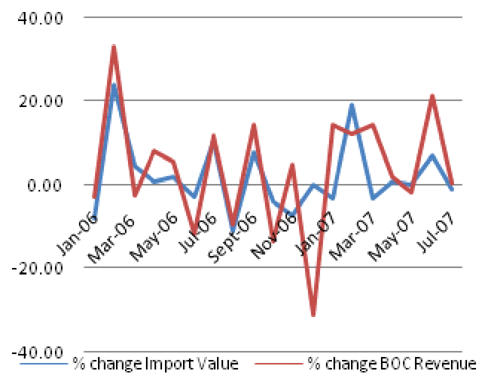
[3] Per correspondence with Engr. Ramirez of the United Filipino Seafarers, dated November 28, 2007

Fig.9. Philippine Fiscal Balance and Exchange Rate (in % change), Jan. 2006-Sept. 2007



Sources: DOF and BSP

Fig. 10. Import Value and Customs Revenue (in % change), Jan. 2006 - Aug .2007



Source: Bureau of Customs

Table 4. External Debt Ratios 2003-2007, (in percent)

				Jan. - Sep.	
	2003	**2004**	**2005**	***2006***	***2007***
Debt (in US$ bn)	57.4	54.8	54.2	*54.1*	*54.4*
External Debt/GNP	67.2	58.6	50.7	*44.4*	*36.8*
External Debt/GDP	72.1	63.1	54.9	*48.3*	*40.4*
Service Ratio	16.9	13.8	13.5	*11.1*	*9.8*

Source: Bangko Sentral ng Pilipinas

PhP3.73 per liter more than it would be compared to the price at the PhP44/$ level. Likewise, the price of diesel would have been PhP4.09 per liter higher had the exchange rate stood at PhP49/$1. Data from Petron, for instance, shows a PhP3.44 per liter difference for the price of gasoline and a PhP5.44 per liter difference for diesel had the exchange rate remained constant at PhP49/$1. Looking at it another way, gasoline and diesel prices today are almost at par with pump prices in August 2006 even if crude today is US$17 higher.

The appreciation of the peso also redounded to lower utility charges. Savings from imported oil and coal reduced electricity costs while the lower foreign currency differential adjustments (FCDA) charges of water concessionaires tempered the increase in water rates.[4]

On the fiscal position. The fiscal position has a direct impact on exchange rate movements – a higher fiscal surplus induces capital inflow, which in turn puts downward pressure on the exchange rate.

However, the impact of exchange rate movements on the fiscal position may appear to be ambiguous. This ambiguity arises from the offsetting effects of a currency appreciation on revenues and expenditure. For instance, the peso appreciation has a negative effect on revenues through lower peso value of imports, other things constant.

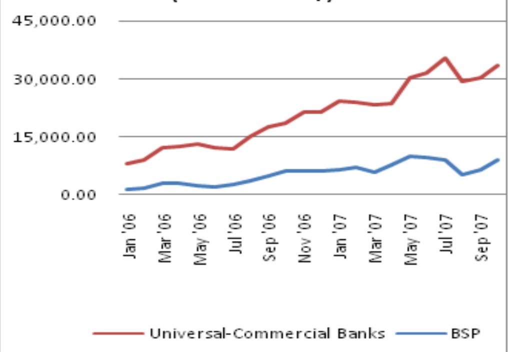
Sensitivity indicators provided by the Department of Finance (DOF) show that for every one unit (peso) appreciation of the peso, the government loses an estimated PhP2.7 billion in import revenue. Figure 10 shows changes in import value and the corresponding changes in revenue collection of the Bureau of Customs (BOC). Notice, however, that the exchange rate movement is more stable relative to import revenue movement, particularly in the period covering June 2006 to January 2007. This implies that tariff revenue is not solely influenced by the movements in the exchange rate and that other factors such as tax collection efficiency may be at play.

On the expenditure side, the peso appreciation has a positive effect on debt servicing since about half of the national government debt are from foreign sources. The sensitivity analysis released by the Development Budget Coordinating Committee (DBCC) estimates that the government saves P2.2 billion on interest payments on

[4]The BSP reports that on a cumulative basis, water rates in Metro Manila for 2007 posted a net increase of P0.70/m3 for Manila Water Company (MWCI) and P0.44/m3 for Maynilad Water Services (MWSI) customers. However, the appreciation of the peso tempered the net increase of water rates in 2007 by P0.48/m3 and P0.36/m3 for MWCI and MWSI, respectively, due to the negative foreign currency differential adjustment (FCDA)

foreign debt for every P1 appreciation. As of September 2007, the country's external debt service ratio stood at 9.8 percent, lower than the 11.1 percent posted during the same period last year and well below the 20-25 percent international benchmark.[5] Prepayments during the 12-month period ending September 2007 reached US$2.0 billion, of which US$1.8 billion pertained to future years' maturities.[6]

Fig. 11. Outstanding Foreign Currency Swaps (in million US$)



Source: BSP

The sharp decline of BSP's foreign loans payable is also due to the strong peso, which increased the ability of the BSP to prepay foreign loans and obligations. During the first quarter of 2007, the BSP prepaid its term loan facility amounting to US$675 million originally maturing in September 2007. It again made pre-payments for its term loan obligations originally maturing in October 2007 and April 2008 worth US$130 million (BSP, 2007).

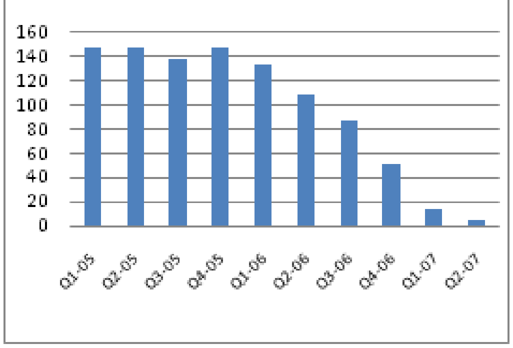
Policy responses

To mitigate the adverse effect of the rapid rise of the peso, the Philippine Exporters Confederation has asked the government to peg the peso's exchange rate to the dollar. While this policy may sound appealing for some sectors of the society in the short term, it is actually a dangerous strategy, one that will likely have debilitating effects to the whole economy in the long run. The most damaging effect of exchange rate pegging is that it can increase financial fragility and may result in a potential financial crisis as what had happened during the East Asian crisis (Mishkin, 1998).

What then is the government doing to address the situation?

Monetary and foreign exchange measures. To temper the rapid peso appreciation, the BSP engaged in the sterilization of capital inflows and mopped up excess liquidity through the use of open market operations.[7] As shown in Fig. 11, it also engaged heavily in foreign exchange purchasing through *currency swaps*. Foreign currency swaps, another form of sterilization, require the central bank to agree to sell foreign exchange against the domestic currency and then buy it back at a future date, preventing the equivalent amount of domestic currency from pouring into the financial system. This, however, cannot be applied indefinitely because it comes with heavy fiscal (and/or

Fig. 12. BSP Foreign Loans Payable, 1st qtr 2005-2nd qtr 2007 (in billion pesos)



Source: BSP

[5]This implies that the country has sufficient foreign exchange earnings to service loans maturing during the period.

[6]Loans and other obligations may come with provisions for pre-payments where the borrower could save money by either pre-terminating or pre-paying without penalties.

[7] would be the immediate policy response to surges in capital inflows. Sterilization is typically done through open market operations although it can also be done by engaging in foreign exchange swaps, increasing reserve requirements, encouraging private investment offshore, and allowing foreigners to borrow from the domestic market. (Fischer, 1993).

quasi-fiscal) costs, can ultimately result in higher domestic interest rates and stimulate even greater capital inflow; and increase exposure to credit risks, thereby increasing the system's vulnerability to a sudden reversal of capital flows (Park and Song, 1997).

Aside from an aggressive pre-payment of foreign loans as earlier mentioned, the BSP also increased its gross international reserves(GIR) to further lessen the supply of foreign exchange. By the end of 2007, the GIR amounted to US$33.7 billion or 5.90 months import cover, up by 46.5 percent from its end-2006 level of US$23.0 billion or 4.26 months import cover.[8]

To ease the surge in capital inflows, the BSP also reduced its policy rates four times in 2007. The first cut was on July 12, 2007, when the Monetary Board decided to adjust downwards its key overnight rates to 6.0 percent for the reverse repurchasing (RRP) rate and 8.0 percent for the repurchasing (RP) rate. They were reduced further by 25 basis points each on October 4, November 15 and December 20. The RRP and the RP rates now stand at 5.25 percent and 7.25 percent, respectively (BSP, 2007).

Moreover, the BSP began to relax some of the restrictions it imposed on capital outflows. For instance, the amount that local firms can invest offshore without central bank approval was increased from US$6 million to US$12 million in April 2007, and to US$30 million in December 2007. Also, the amount of foreign exchange that residents may now purchase without documentation was increased from US$5,000 to US$10,000 in April 2007 and to US$30,000 in December 2007. The BSP also simultaneously increased US dollar overbought positions from 2.5 percent to 20 percent (or US$50 million, whichever is lower) of unimpaired capital and introduced a cap on US dollar oversold positions (previously without limits).[9]

Intervention in forward exchange market (e.g. hedging facilities). The government, through the Department of Trade and Industry (DTI), has also called on the Development Bank of the Philippines (DBP) and other banks to help exporters manage their foreign exchange risks through the forward exchange markets. Two hedging instruments were introduced. The first one is the foreign exchange insurance, under which, exporters pay a certain amount of insurance fee[10] in exchange for what is termed as "protection rate." Should

[8] Prior to the financial crises in the 1990s, the traditional rule of thumb is that reserves equivalent to three months of imports are sufficient to accommodate current account transactions.

[9] Overbought positions refer to the amount of foreign exchange domestic banks are allowed to hold overnight, while oversold positions refer to amount of foreign exchange domestic banks are allowed to sell against the domestic currency.

[10] The Insurance fee is based on the market rates, movement of the dollar/peso and protection rate as computed in the Reuters or Bloomberg pricer.

Table 5. NG Financing Program, 2007
(in billion pesos)

Particulars	2007 Program	Jan.-Oct. 2007 Program	Jan.-Oct. 2007 Actual
Net Financing	82.5	66.7	89.5
External (Net)	54.6	41.1	55.8
External (Gross)	120.8	98.6	110.8
Less:	66.2	57.5	55.0
Domestic (Net)	27.9	25.6	33.7
Domestic	260.1	239.2	299.6
Less:	232.2	213.6	265.9
Gross Financing	100%	100%	100%
Foreign	32%	30%	27%
Domestic	68%	70%	73%

Source: DOF

the peso appreciate upon maturity, the exporters are able to sell at their protection rate instead of the prevailing market rate. If the reverse happens and the peso depreciates, they are able to sell at the prevailing market rate, thus even gaining from the currency depreciation. The second instrument is called the forward exchange rate protection, a forward contract between the exporter and DBP where only the net difference between the dollar/peso forward rate and the market rate are settled at maturity.

However, according to the EDC, relatively few exporters have availed of these instruments since its launching in June 2007. A massive information campaign is therefore warranted so that more exporters can take advantage of these facilities.[11]

In addition, documentation criteria may be relaxed and ceilings on forward transactions can be raised increasingly in conjunction with the increase in the volume of international transactions.

Changing the borrowing mix. Changing the borrowing mix, from foreign to domestic sources, is another way of addressing the strong peso. Some of the measures proposed by noted economist Dr. Raul Fabella are: (1) borrowing foreign exchange from the BSP rather than accessing foreign financing; (2) borrowing in peso and pre-paying these loans in dollars; and (3) using excess dollars to pre-pay foreign debt. These measures induce greater demand for foreign exchange and conversely, decrease the supply of foreign exchange.

A look at the financing program of the national government shows that the share of foreign borrowings to total borrowings has actually been declining in recent years. Conversely, the share of borrowings from domestic sources has been increasing. As of September 2007, 73 percent of the NG borrowings came from domestic creditors, though the target for the said period is only 70 percent. In 2008, the NG is set to borrow 30 percent from foreign sources and 70 percent from domestic creditors, a slight decline from 32 percent and 68 percent, respectively in 2007. If the share of foreign borrowings will be further reduced, the appreciation of the peso would be further tempered.

Conclusion

The appreciation of the peso has been largely attributed to the sustained influx of capital flows. While this is widely viewed as an

[11]The government has also provided some relief to the exporters by giving exemptions from paying the US$50 container security as mandated by Executive Order 592; reducing wharfage fees by less than ten percent; eliminating the fees for export inspections, clearances, permits, certificates, and other documentation requirements; and holding off labor 's campaign for a legislated wage increase.

impetus for rising investment levels and economic growth, it can also be a double-edged sword that may inflict destabilizing side effects, primarily, the overvaluation of the domestic currency. Given this, it is important to carefully manage the foreign resources entering the country. Foreign loans, for instance, should be thoroughly scrutinized to make sure that they will be used optimally whereas remittances should be directed toward income-earning, job-creating investment activities.

Moreover, there is a need to stimulate domestic investments. Despite their cheaper cost, imports have not been rising, an indication that domestic investors are not importing new machines, upgrading or buying investment inputs from abroad, which would have increased the demand for the dollars, and consequently, dampened the rise of the peso. Why domestic investments growth is still sluggish when foreign direct investments have already been increasing is somewhat mystifying. Are domestic investors being discriminated against, or are they simply more pessimistic compared to the foreigners? It is also possible that it is a simple indication of how domestic investors have lost their competitiveness.

The BSP seems to be exhausting all possible monetary and foreign exchange policies at its disposal to stem the rapid rise of the peso. But since global forces are also at play, it can only do so much.

Hedging facilities may provide temporary relief to the export sector, which is adversely affected by the appreciating peso. This, however, may not be sustainable over the long term. An alternative is to address non-price competitiveness issues.

Lowering the cost of doing business by trimming down the bureaucratic costs and reduction of export fees, power costs, wharfage fees and shipping costs will help improve the price competitiveness of Philippine exports. Worker retraining in the export industries lagging behind will also help mitigate the immediate adverse impact of the peso appreciation on the real sectors in the medium term. A more positive solution is to diversify exports and to widen the market of export products to reduce dependency on the booming sector and make them less vulnerable to external shocks, such as a sudden drop in commodity prices or an unexpected downturn in the economy of a major trading partner such as the US. Tapping new markets (midrange to high end markets), such as Japan and Europe, will expand the market of export products while the upgrading of product design and quality by investing in research and development will strengthen existing export markets and ensure the creation of niche markets.

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