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Gerardo P. Sicat¹

I. Introduction

As one of the key prices in macroeconomics, the peso exchange rate helps to balance domestic production with international needs. In a market-driven economy, such a balancing is not merely with respect to what appears to be current market adjustments but in relation to major economic policy objectives. The Philippine Development Plan, 2011-2016, according to the government document,

“...seeks to enable the industry and services sectors to contribute significantly to economic growth and development....”[p. 79]

The main problem of the Philippine economy is that it has many pockets of underdeveloped areas. Though it is at the low end of middle income developing countries, a large segment of the population is still mired in poverty. Unemployment and underemployment rate is high. There is much underutilized labor. Even if the employment rate is mentioned in the range of 8 to 10 percent of the labor force, one-fourth of the labor force can be considered underemployed. The informal sector which serves as the sponge of activity among the underemployed is large. This is where many of those with insecure and impermanent jobs make it possible to have a living.

The recent continuous *appreciation* of the peso threatens to make this problem even worse. It will create problems for the export industry where a lot of factory workers find employment. Every day the peso appreciates in value, the export sector is hurt by losing revenues since their dollar earnings when converted into pesos become less.

The continuous appreciation needs to be addressed by economic policy. In 2005, the exchange rate was 55 pesos to the US dollar. In 2010, it was 44.3 to one dollar. When I began writing this piece a month ago, it was 42.42 pesos to a dollar. Today (October 17, 2012), as I complete this paper after laying in wait for some time, the exchange rate is 41.33 pesos to a dollar.

This paper analyzes the issue of whether this currency appreciation is inevitable. There are situations in which a currency appreciation could be premature in relation to the nature of the country's structural problems that have to be solved.

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After this introduction, the paper has three more sections.

In Section II, the Philippine peso exchange rate performance is compared with that of four fast growing East Asian economies. This is done by tracking the daily exchange rates of these currencies during the recent period of close to two years running. These countries are high growth economies. Our country's policy makers also aspire for high economic growth. Though each country is unique, they are subject to a common set of world-wide stimuli.

In Section III, the factors that have caused recent peso appreciation are examined and related with domestic economic growth issues.

In Section IV, various options of discretionary policy concerning the exchange rate are discussed. These are mostly in the realm of monetary policy and, to a large extent, to the coordination of monetary and fiscal policy.

“Context in terms of world economic adjustment.” The period under study is one in which the world's economies are undergoing structural adjustments. Such adjustments have enormous implications on currency exchange rates. The contemporary historical scenario of the period shows these developments in terms of exchange rate trends, which in effect follows the policy objectives of the major world economic players.

In 2007, the US plunged into a major recession which has led to efforts to provide fiscal and monetary measures to stimulate economic recovery. A consequence of this recession and the measures taken was the depreciation of the US dollar.

US economic recovery – and the world's overall – has been delayed by the crisis that hit the euro zone. Two major economic blocks (the US and Europe) in trouble became a problem for world economic recovery. In the past, one major economic grouping would help prop up the other but this time both are weak.

China is the country that holds a steady but slow forward appreciation of its currency, the yuan. It looks almost like a gentle downhill trend line, implying less and less amount of yuans is able to buy a US dollar. China has a special position in the world economy's adjustment. Through its aggressive growth policies based on an undervalued exchange rate, it succeeded in recent decades to accumulate the largest amount of international reserves at a time when most of the developed countries were incurring serious balance of payments deficits. The United States adjustment, humbled by the collapse of the economy during the 2007 financial crisis and recession, has been adjusting through the depreciation of its currency. This is one of the tools for US economic recovery.

In the publicly contentious economic dialogue between China and the US, the required adjustments would be for China to appreciate its currency so that it could reform its outward orientation toward a greater reliance on domestic growth. This in turn would create opportunities for the US to strengthen its exports as well as reduce its dependence on low priced Chinese imports.

II. Four Asian currencies compared with the Philippine peso

As a way of instructing ourselves with how the peso exchange rate has moved compared with other currencies, the evolution of four East Asian neighbors is tracked with that of the peso. These countries are China, Indonesia, South Korea and Thailand.

They are high growth economies in the region. They are also export-oriented. In fact, their impressive performance has been fueled by their strategy to rely on exports as the engine of their economic growth.

These countries are also economic dynamos that have been improving their balance of payments position over the years propelled by their continued economic growth and essentially outward market orientation of their productive economies. The Philippine balance of payments has turned relatively favorable toward surpluses based on three main factors: a base of steady export growth or maintenance, the success of its BPO outsourcing industries and the increasing inward flows of remittances from OFWs.

Table 1 tells us more about the result of these development circumstances. The international reserve asset positions of East Asian countries have been dominant. While all these countries have been making their economic successes on the basis of domestic growth due to strong export industries, the Philippines alone is achieving its success because a dominant segment of its labor force is sending dollar remittances home to feed their dependents.

Table 1. Gross International Reserve Position (Official Reserve Assets)	
	In Billion US Dollars
China	2,467.5
China, HK	295.6
China, Taiwan	360.2
Japan	1,295.8
Indonesia	116.4
PHILIPPINES	78.5
South Korea	316.8
Thailand	175.1

Source: International Monetary Fund (April, 2012 data); For

China and Taiwan, Global Finance, 25th Anniversary Edition, 2012

Note: China data was from the World Bank, March 2011, according to Global Finance.

China has the highest reserve position. It is at a juncture of its history where economic correction would involve appreciation of its currency. Japan has for years been trying to appreciate the yen in response to market demands, but it has maintained its economic position as a trader because it has sent its major manufacturing firms to developing countries to export their products, hence, giving Japan sufficient capital incomes from such investments. South Korea is copying Japan's strategy but has devised an exchange rate policy that appears consistent with its old posture. And Thailand and Indonesia, as the charts below will show, have been maintaining their export competitiveness because they continue to pursue their growth objectives.

As the diagrams below will illustrate, it is the Philippines that appears to be maintaining a policy of appreciation, which is likely to kill its competitiveness at a time when it is most needed to spur industrial growth.² Such an outcome will make it into an importing economy and mainly a domestic producer for its major needs.

"China." The Asian economic growth power house today is China. For four decades, China experienced high economic growth using essentially an exchange rate policy³ that was tied to the US dollar. The US dollar floats according to market conditions. An undervaluation of the currency enabled China to create a huge industrial base that was designed to take advantage of world markets hungry for inexpensive industrial goods, using its large reserve of labor manpower to produce for export. This was the traditional East Asian model, following Japan's early rise in industry (even though that happened under a different exchange rate system (the gold standard and later, the Bretton Woods system of fixed exchange rates after the Second World War).

This exchange rate policy, accompanied by aggressive economic reforms, made double-digit growth rates possible. The Chinese economy was transformed from a low income economy to one of the most outstanding successes in one of the shortest "economic miracles" of history and enabled the

² The exercise that reviewed the daily exchange rates of several East Asian countries and the Philippines induced me to write the two successive essays on the peso exchange rate in my *Philippine Star* column, *Crossroads* (Sicat, 2012). This piece invited a response from the Bangko Sentral Deputy BSP Governor Diwa Gunigundo (2012). He pointed out that the BSP does not target a particular nominal exchange rate but that it does pay more attention to the "real effective exchange rate (REER)." Nominal exchange rates are the exchange rates that the markets report on a daily basis. The REER is a derivative measure based on the trade-weighted exchange rate movements of market competitors in relation to the peso. The BSP calculates the REER and, to my knowledge, no one really undertakes an independent calculation, although any economist with sufficient theoretical background and understanding of international trade can undertake such, even making altered assumptions about the weights and competitor countries used. Interestingly, the BSP's version of REER says that, for the same relevant period.

³ China's currency is the renminbi, which literally means "people's money." Its unit of account is the yuan, the old name for the traditional Chinese currency. Since it is the yuan as the unit of account which is tracked in the IMF's currency, what is often termed as "renminbi" currency exchange rate is equivalently called "yuan exchange rate." Hence, I use here the term, "yuan appreciation" to depict the rising value of the Chinese currency.

accumulation of immense balance of payments surpluses. High export growth induced high saving rates that permitted huge domestic investment expenditure.

In terms of the emerging economic adjustments moving forward, the depreciation of the US dollar would be matched or complemented by corresponding appreciation of the Chinese yuan. In the US, such a development would improve the competitiveness of the US economy and correct its balance of payments deficits through rising exports and a corresponding fall of imports.

In China's case, reorienting its growth toward satisfying domestic needs rather than foreign demand would be facilitated by appreciating the yuan. This would allow imports to become cheaper and give its citizens more purchasing power. This was even necessitated by the world economic recession which makes this development even more imperative. Thus, exchange rate appreciation would enable China to buy more from other countries which accommodates its own need to shift its growth drivers toward internal rather than export growth.

China's economic status in terms of past foreign exchange reserve accumulation plus its outstanding economic growth record, makes its case the upper limit for a defensible currency appreciation under current circumstances.

"South Korea." Next to China and Japan, South Korea is another East Asian economic powerhouse. Like China, Korea has had an export-oriented economic growth. High growth enabled it to be transformed into an integrated industrial economy with an extensive export framework. Korea's growth has essentially been patterned after Japan and has succeeded hugely in that effort.

"Indonesia." The largest country of ASEAN is Indonesia. Its economic growth has been steady over a long period of its history since the mid-1960s, broken only by the Asian financial crisis of 1997 when the Thai baht suffered a major collapse. Initially fueled by a highly protectionist industrial policy, it undertook major outward economic reforms in 1987. The structural reforms enabled it to reorient its domestic economy at a time of great internal economic distress.

"Thailand." The steady economic achiever in ASEAN is Thailand. Over time, it achieved a balanced growth that favored agriculture as well as industry. Such progress enabled it to survive the financial crisis of 1997 when the baht collapsed from excessive buildup of debt. Certainly, its exchange rate policy is being carried out with lessons well learned from that experience.

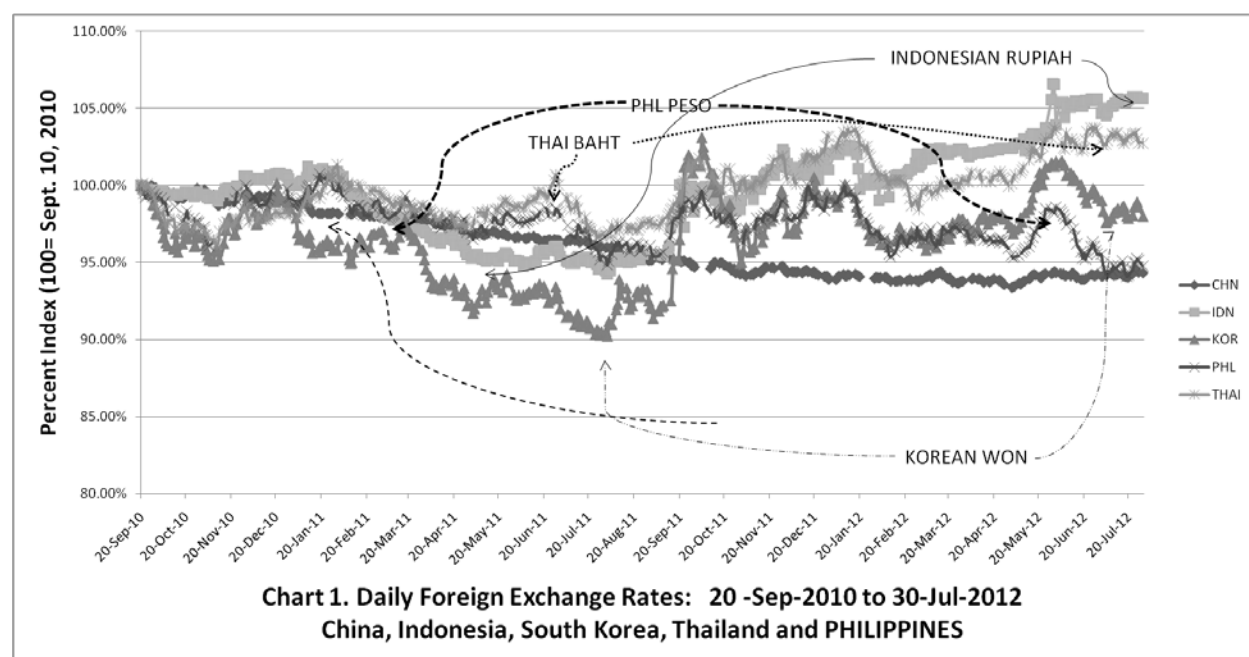
As to the shadow of the financial crisis of the past, both Thailand and Indonesia survived after a rescue from IMF which also enabled them to pursue major financial reforms. South Korea, another country that suffered badly from the contagion of that crisis, used that crisis to submit to deeper financial reforms that allowed it to open its highly protected financial system to foreign investment.

"Data source." Daily exchange rate statistics were downloaded from the IMF data base. We establish the beginning date as September 20, 2012. (Strangely, the Philippine peso daily series in the IMF database begins only on this date while the other currencies are available for longer and earlier

periods. The daily exchange rates are published separately in the data set maintained by the BSP, for instance, the *Monthly Statistical Bulletin*.⁴ The period provides an adequate time span though a longer one would have been desirable. The terminal date chosen was July 31, 2012.

To make all the exchange rate data comparable, they are converted into individual indexes using the beginning date as the base. These calculated index numbers are then charted together to determine how they have tracked relative to one another. All these countries would have individual foreign exchange rate movements in response to their own unique country situations and economic policies. However, in general, they are all responding to the same general world economic conditions that affect their respective foreign trade regimes and capital movements.

Chart 1 shows the evolution of the foreign exchange rates of these countries.



At the beginning of the period, the Korean won appreciated more than the Chinese yuan. But one year later, Korea decided to depreciate the won abruptly. The won became even cheaper than the rate at the beginning, a low of 92 to a peak of 103 all within the period of September to October, 2011, a depreciation that was equivalent to 12 percent. From that point in time, the won has essentially been kept close to the value that it had at the beginning of the period. Needless to say, this won rate had its volatility, but never has it appreciated to the level of the yuan appreciation.

Indonesia's rupiah has not appreciated except for a brief period of about three months during March to July 2011. This, however, was only slightly off the Chinese yuan appreciation rate. After that

⁴ When I mentioned this fact to Governor Tetangco whom I met accidentally during a recent public occasion, he was surprised since the BSP has been sending IMF the data. He promised to look into this point. I suppose that the Department of Economic Research has been apprised of this.

period, the rupiah has been on some maintenance of its depreciated value. Over time, the gap between the rupiah has widened from the appreciating yuan.

The case of the Thai baht tracks the path of the Indonesian rupiah, although more gently. At the end of the period, the baht maintained its current exchange rate more depreciated relative to the base date.

The Philippine peso is the currency that has behaved most akinly to the appreciation of the Chinese yuan. The peso's movement is much more volatile compared to the trend-like appreciation of the yuan. In fact, the peso depreciated more than the yuan from October, 2011 but this gap closed toward the end of July, 2012. Of the five currencies under comparison, it is the Philippine peso that has followed the appreciation of the Chinese yuan when it has relatively the weakest strength in terms of export performance.

On September 20, 2010, the base date for the comparison, the per dollar exchange rate of each currency was as follows: China, 6.711 yuan; Indonesia, 8,070 rupiah; South Korea, 1,163.1 won; Philippines, 44.254 peso; and Thailand, 30.73 baht.

On July 31, 2012 (the end of the period), the per dollar exchange rates of the same countries were: China, 6.33 yuan; Indonesia, 9,485 rupiah; South Korea, 1,139.9 won; Philippines, 41.93 peso; and Thailand, 30.623 baht.

Looking at these exchange rates in terms of the indexes and relative to the start of the period, we find that on July 31, 2012, the following currency rates have these index numbers all measured in percent: China, 94.33; Indonesia, 105.64; South Korea, 98.01; Philippines, 94.76; and Thailand, 102.75.

(If the index number is below 100, it means that the currency has appreciated. If they have risen above 100, the currency has depreciated. Judging from the viewpoint of export encouragement, the currencies that have depreciated have gained an advantage over those that have appreciated.)

These numbers are telling to any economist and businessman. The peso has behaved like the Chinese yuan, although the peso's day to day value has changed unsteadily compared to the yuan. The two currencies have both appreciated, with the Chinese yuan only slightly so.

“Comparing directly with the Philippine peso.” Chart 2 shows the movements of each of the four currencies in relation to the Philippine peso. This information can be imputed from Chart 1, but a straightforward calculation of the index ratio of one currency to the same index value of the peso on the given day provides more direct information.

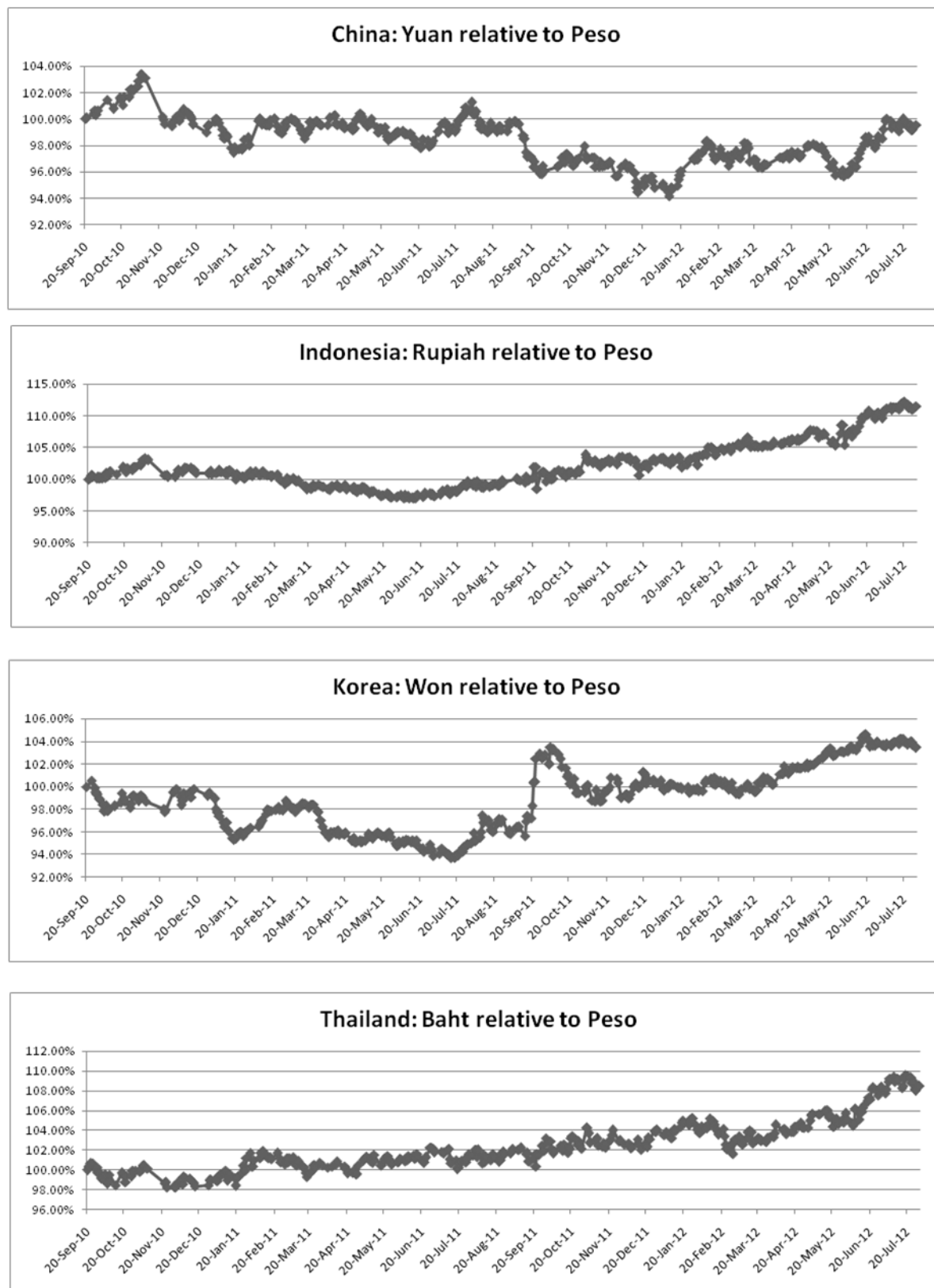


Chart 2. Index of Daily Exchange Rate Movements, Sept. 20, 2010 to July 31, 2012
China, Indonesia, Korea, Thailand relative to Philippines

The yuan to peso movement (top panel) shows such a ratio. This simply reads as follows. When the ratio is above 100, then the yuan has a higher index value than the peso. This means the yuan depreciates *more* (or, appreciates less), relative to the peso. Readings below 100 means the opposite: the peso depreciates *less* relative to the yuan.

As shown in Chart 1, the yuan appreciation was steady and somewhat slowly progressing. In contrast, the peso exchange rate was a much more volatile index. Thus, the ratio which is quite volatile and full of dips and rises shows the more turbulent movement of the peso exchange rate. It is to be noted that for one year from the base period, the peso exchange rate moved almost erratically around the Chinese yuan appreciation rate. During the second period, after a short time in which the peso depreciated more relative to the appreciating yuan, the peso relatively appreciated so that by the end of the period, the peso exchange rate was almost equivalent to the appreciation level of the yuan.

Indonesia shows no such trend. The Indonesian authorities had maintained a depreciation of the rupiah in relation to the peso (second top panel). The exception was for a brief period of two months when the peso appreciated slightly more than the rupiah. Thereafter, the rupiah had undergone a consistent higher depreciation relative to the peso.

Pretty much the same picture is depicted in the Thai baht case (lowest panel). After January 2011, the baht depreciated more in relation to the peso.

The interesting picture of the Korean won relative to the peso is shown too (third panel). The won had appreciated more than the peso prior to September, 2011. But after the Korean depreciation in that month, the won essentially was at parity with the peso until late during that period when the won depreciation relative to the peso became marked.

By July 31, 2012, a rough calculation of the export edge of other countries relative to the Philippines is clear. Indonesia's advantage in relative depreciation to the peso is 10.57 percent; South Korea's, 3.25 percent; and Thailand's 8 percent. The Philippines is not yet in the league of China's commanding reserve and development position. Yet of all the four countries with which it is compared, the Philippines tracks China's yuan more, even though this is somewhat more in volatile fashion.

The stark conclusion from this simple exercise is that the Philippine peso has appreciated the most compared to the three currencies of Indonesia, Thailand and South Korea, three high growth East Asian economies.

III. The Philippine economy's structural problems and the appreciating peso

In this section, the factors that create an appreciating peso and its implications on the economy are discussed.

The main impact of exchange rate policy is on a country's international trade in goods and services and evidently on the balance of payments. The appreciation described in the previous section is not inevitable. There are steps that could be taken that could stabilize the currency, even maintain it at a level that makes Philippine industry more competitive in trade. The other countries referred to, especially the obvious comparators, Thailand and Indonesia have been following such a track. They have, in recent periods, been displaying a more successful domestic economic policy, maintaining a given exchange rate thereby obviating an adverse deterioration of its trading position.

In the Philippine case, continued appreciation of the peso has been creating a false sense of security. This is because the appreciation enables the country to buy imports with less pesos. At the same time, this makes the country's exports more expensive to foreigners because it takes more of their money to buy what we sell to them. Thus, foreign made consumption and intermediate goods are made cheaper to us while what we produce at home and sell to them become relatively more costly to foreigners. (This condition of peso appreciation is, of course, the opposite of peso depreciation, which means the peso loses value in terms of foreign money. As a result, foreign goods become more expensive and exports become cheaper to foreigners. The balance of payments impact of depreciation is the opposite of appreciation)

With the steady increase in OFW remittances and the expansion of the export of BPO (business process outsourcing) industries, the Philippine external balance has improved steadily. This has in addition encouraged short-term capital inflows. The result is a rising balance of payments surplus. This happens in the following manner.

First, the improvement in perceptions of future Philippine economic growth attracts short-term capital inflows, mainly portfolio investments in domestic assets that could be purchased by foreigners. Target assets are short-term deposits in Philippine financial institutions and investments in equities and domestic bond issues (both private and public). This explains the recent boom in the Philippine stock market. It also explains the expansive mood of some Philippine enterprises that cater to the high needs of the economy – telecommunications, expansions of some major conglomerates with a major stake in growing parts of the economy, and of course, the equities market itself. Another factor is the attractiveness of Philippine bond issues by government institutions as well as by well-known companies.

Second, the weakness of the world economy and the unprecedented fall in world interest rates that have followed the monetary moves made by leading world central banks – first, the US Federal Reserve System and now by those of the European Central Bank – created a demand by foreign funds for financial returns elsewhere. Philippine interest rates are high relative to world interest rates and this

differential provides added incentives for capital inflows into the country. In part, the various moves of the foreign central banks to reduce the borrowing rates in their home countries had also led the Philippine monetary authorities to reduce domestic interest rates (mainly to narrow the interest rate differentials prevent a rush of more capital inflows.)

“Exchange rate appreciation favors a consumption-driven development process.” Exchange rate appreciation encourages domestic consumption. Foreign made goods become cheaper. Domestic incomes inordinately rise at home (as a result of an income and wealth effect) but home-produced goods become more expensive to foreign countries. If the country enjoys full employment at high income position arising from past developments (as demonstrated by China’s achievements), this development would be a welcome one. It would constitute a rise of living standards involving the ability to command imported goods. It would be otherwise if, with cheaper imports, domestic industries, especially those already with markets abroad, were to lose their competitive edge. This could mean loss of jobs and possible contraction of output. It could further discourage domestic investments that are designed to raise domestic output, especially, those marked for foreign trade.

Such a strategy biases investments in favor of home goods production mainly. This might not be totally undesirable. For instance, rising domestic incomes will certainly continue the need to highlight improvements of domestic infrastructure. Such needs are manifest whether or not the economy is trade oriented or mainly oriented toward satisfying domestic consumption needs. But such a development does not contribute to the direct strengthening of the internal competitive capacity of the economy as it will not likely contribute to the expansion of its internationally trade-oriented sector.

“Domestic investment expenditure needed.” There is much need for domestic investment spending so that the supply of productivity enhancing activities and labor employment in the economy could expand. The need for public infrastructure is self-evident in the Philippines. The poor state thereof has been decried by domestic as well as foreign observers as deterrents for future investments. During the rise of East Asian economies in their high growth years, their investment rates have also risen. In the Philippine case, an investment to GDP rate of 20 percent or thereabouts is rather low.

At a time when foreign exchange resources are rising, the country’s investment deficiencies should be filled. This requires even a higher inflow of foreign exchange resources because investment expenditure is to raise demand for capital goods that are produced in foreign countries. This is why the boon in balance of payments surpluses could be illusory at this point if it does not bring in a rising demand for domestic investment activity. As other countries experienced high growth rates, their incremental investment rates have also risen. Among ASEAN economies, at least a 25 percent to GDP investment rate has not been uncommon in recent decades. China’s rate had gone beyond 35 percent of GDP during its high growth period.

In addition to infrastructure, attraction of new investments from all sectors, including new foreign direct investments, are needed to expand the private economy’s competitive capacity. Recent

improvements of Philippine prospects have been one of the good news happening in the country. But such investments could be undermined by currency appreciation.

Whatever might be the impact on exports, a high level of investments would still be needed to improve the economy's non-tradable sector – the public utilities, transport and communications infrastructure, and all things that simply help to raise domestic economic productivity.

Although domestic economic conditions appear to be improving, the country still suffers from major structural changes that can only be solved by development policies that reduce the country's high unemployment rate. This means growth within the formal economy, not simply rising employment in the informal sector that sucks the high unemployment rate.

The peso appreciation has given a false sense of optimism about the country's economic condition. The peso appreciation makes domestic shoppers find that foreign goods are cheaper in the shopping malls. A side effect of this development is that domestic goods become relatively more expensive compared to imports.

“Impact on export industries.” An unfavorable impact of currency appreciation is on export industries. This point was made in the prologue to this paper and it is time to discuss this further.

The appreciation simply makes domestic resources that enter international trade more costly than they should be. Some countries fix their exchange rates precisely to make sure that their export competitiveness does not suffer even as market forces tend to fluctuate in their influences on the whole economy. Unless there is a rise in domestic productivity for Philippine resources – labor, capital, and land especially – the country's export industries will lose their markets. The hurt will be most felt by those industries that are at the margin of competitiveness because they could be wiped out of the market. All export industries are hurt however because loss of competitive advantage simply translates as loss of market share, loss of profitability if there is any, and of course, decline in employment.

The recent complaint of a car battery exporter⁵ is just an example of what the appreciation of the peso is doing to a range of industries. This exporter states that a two peso appreciation against the dollar erodes 5 percent of its export revenues. The company translates this leads into a 33 percent cut of its profitability which is already quite low.

Exchange rate appreciation has hurt the country's garments industry badly in the course of years. This happened in the 1990s and whatever remains of it is getting hurt further. Many of the import substituting industries that were adjusting toward a more competitive position during the same period were not helped by the appreciation of the peso. As the country embraces more open trade policies, the exchange rate level needs to be reasonably helpful to the export sector. A continuous appreciation

⁵ See Louella D. Desiderio, “Peso rise may force battery manufacturer out of business,” (The Philippine Star) August 18, 2012.

would help to wipe off that competitive potential. The country's natural structural position would be to make use of its abundant labor resource and allow the exchange rate to play a role so that it induces dramatic domestic economic growth that employs this labor. Only the export sector – where Philippine industries and economic resources can be competitive – can create that rapid growth of employment

The peso appreciation has weakened the position of many of the country's marginal exporters and has taken away the competitive edge of steady export earners. A sound market-based exchange rate policy should do the opposite: to support the country's exporters and defend their competitive margin rather than swipe it. Such a policy reinforces the production base and enlarges the set of competitive producers rather than weaken it.

The peso's strength has helped to reduce the ability of labor intensive industries to compete. The semiconductor assembly, for example, is threatened by rising cost from appreciation. Even the business process outsourcing (BPO) industry which relies on high skilled workers could be affected by rising peso appreciation.⁶ Such industries today – especially the last two groups of exports – provide the mainline sources of export revenues. They have sizable employment impact on the economy.

Compare this with what is happening elsewhere in ASEAN. Recently, in the news was that Foxconn (the company that has been producing many of the Apple Computer products) has committed to make major investments in Indonesia. It is rumored that the investment could reach around \$10 billion dollars in the next few years. Could we be in the running for highly wanted companies that export to the world if our currency is appreciating? (See further discussion on impact on export industries.)

The Philippine economy's need for more investments is made manifest by the relative inability of domestic manufacturing to rise in line with the competitiveness of other ASEAN partners. Rising investments in manufacturing is necessitated by improved domestic price incentives for local manufacturers which a depreciating or stable exchange rate provides. Certainly, it would not come from an appreciating exchange rate.

Sourcing of supply by foreign buyers could shift to those countries that offer more competitive terms. Reduced competitiveness means reduced employment at a time when unemployment and underemployment are big problems for the country.

The time for the country to experience currency appreciation is when the country's labor force is near full employment within a highly productive domestic economy. Today, the economy is suffering from a lot of inefficiencies including low productivity. It implies that there is need for large investments to make the economy move from its sad state of inadequate public and private infrastructure to one in

⁶ My colleague at the UP School of Economics, Raul Fabella has pointed out the danger that the country could lose its BPO competitiveness with India as a result of the depreciation of the Indian rupee. In fact, Fabella (2011) has been warning, for sometime the need to maintain a realistic exchange rate policy so as to energize the country's productive sectors and enhance Philippine competitiveness.

which such facilities could be taken for granted. That gap has to be filled by continuous investment demand so that the country could move toward that more highly productive and technological state. This, in turn, will re-attract a lot of Filipinos who have gone abroad in search of good jobs that they cannot find in their homeland, to come back. (In fact, the appreciation of the peso also reduces the effective income that OFW remittances get when exchanged at home to support their families, thus making them relatively poorer.)

“Destabilizing aspects of short-term capital inflows.” Short term capital inflows have further contributed to the appreciation of the peso. The improvement of the economy, matched by facilitative freedom in capital movements – a desirable if somewhat edgy policy under poor hands – has led to the country’s attractiveness to foreign investors. These are short-term investors – those who manage large funds to make cutting edge profits on the slightest of financial advantages due to exchange rate policies and differentials in international interest rate policies.

The opening of the economy in the form of capital movements has made inflows and outflows more free since economic liberalization was adopted. The capital movements are facilitated by the country’s advances in its financial institutions, which have been the beneficiaries of past financial and banking reforms.

Short-term capital movements have no significant impact on the country’s productive capacity yet they provide some useful signals about the country’s relative attractiveness as an investment site. There is a lot of speculative component, however, in the form of these capital flows which could cause volatile movements in the exchange rate. Short-term placements on existing investible assets in the economy provide some measure of confidence about the future. Yet, in general, they are influenced by many other short-term factors that affect the investment horizon. A strongly performing domestic economy, however, will induce long term commitments of many fund investors and could provide supportive force to the short-term positive picture.

This, incidentally, is the strong point about the changing perception of the Philippine economy that it is due to the improvement of economic and political governance. The “comeback” or “breakout” about the Philippine economy is the ace that the Aquino administration holds. And it is receiving good marks from the market for this reason with recent sovereign credit upgrades. The improvement of the investment climate, of course, is a thing still to be realized.

“Long term capital inflows sorely needed.” The irony of the present setup is that while the country has a fairly free movement of foreign capital in the short term, the economy suffers from a rigid long term capital market. The country for decades has been held hostage by restrictive provisions affecting the role of foreign capital in the political constitution. Although these restrictive provisions apply only to a limited set of strategic industries and resources, those provisions have had a large infectious role in creating a broader set of nationalistic rules that had stymied economic policy and filled investment procedures with many bureaucratic caveats, impediments and regulations.

The Aquino administration that improving governance – and there are good signs that this is happening – would be sufficient. It is my opinion that it is inadequate – that in the end, getting the restrictive economic provisions would be a major element in getting assuring permanence of the improvement of the foreign investment climate. More optimistically, however, such provisions are under potential policy change in the future, although the opportunity to do so in this Congressional term has been lost due to lack of time.

IV. Monetary and Fiscal Coordination

The exchange rate policies of most countries today are likely to be more market determined. No country currency has been on a fixed exchange rate since the Plaza Accord when all major currencies went on a free-float and the Bretton Woods system of fixed international exchange rates abandoned. But even under the present setup, it is possible for a currency to be linked more tightly with one major currency.

Under this setup, a country's exchange rate could be anchored on a particularly strong currency – or basket of currencies – in order to attain a stable exchange rate. Thus, the exchange rate policy allows much leg room for the exercise of discretion. The exchange rate outcome would still respond to supply and demand changes that are unique to the country. There would still be volatility, but it is in relation to that of the stronger currency. The volatility of exchange rates is mainly an outcome of short run developments. The resulting short run exchange rate should not deviate far too much from a desired long run exchange rate.

1. Most East Asian models of development have been market-based, yet their exchange rates are set or maintained at rates that they defend. They do not conform to the truly market-based flexible exchange rates that are allowed to move according to supply and demand. Instead, they target essentially an exchange rate with respect to a major currency. Most likely, that anchor currency is the US dollar. (China and Hong Kong have done this for decades.) If at any given time, there develops an unsustainable exchange rate position, then an adjustment to a new level is undertaken. The rate at which it settles then is essentially defended. *From what we observe of Thai and Indonesian exchange rates in the first section, it would seem that the respective countries are tracking a defense of a targeted exchange rate. China's exchange rate policy is definitely a guided rate, with undervaluation of the yuan as an apparent outcome.*
2. Since the floating exchange rate era arrived after the Plaza Accord, peso exchange rate policy has been subject to a flexible float. During the time when the country's main problem was foreign exchange deficits and fiscal deficits, the exchange rate became a free float primary variable, adjusting prices and leaving the rest of the market determine the required adjustments.

The country's exchange rate is an indirect outcome of many domestic policies that affect the demand for and supply of foreign exchange. As important as the impact of the various aspects of

domestic economic policies might be, the critical aspect of determining a sound exchange rate policy is effective coordination of monetary and fiscal policy which is undertaken at the level of a desired exchange rate which the monetary authorities try to fix.

“Monetary policy: range of central bank actions.” The central bank’s turf is the control or regulation of money supply. It is thus sensitive to all the tools essential for the control of the level of the money supply. That supply has to meet the economy’s needs, or inflation could result. The excess flow of foreign money into the system (due to a favorable trade balance and net capital inflows – mostly short-term) injects new money into the domestic economy.

The main weapon of the central bank is tied up with the interest rate. The interest rate in an open economy is affected by world interest rates. To reflect the scarcity value of capital, the domestic rate of interest has to be higher than the cheapest interest rates available in the world economy. The benchmark for international interest rates is the US Federal rate of interest. It is linked to the interest paid to the safest of all long term debt instruments – US bonds and Treasury bills. Countries, depending on their specific situations, adjust their interest differentials.

The classic problem facing the Bangko Sentral at this time is not scarcity but relative plenty: how to absorb the buildup of foreign money entering the domestic economy, given the level of demand that the economy can absorb and the tolerance that it has for inflationary pressure. The inflow of short term foreign money can be further abetted by the monetary instruments themselves, a kind of unexpected side effect. For instance, if the rate of interest used to attract SDA deposits (discussed later below) is high and therefore attractive enough, it could induce additional flows of short term money into the country. (The central bank has wised up to the suspicion that foreign short-term inflows have been parked into SDA deposits. They recently introduced regulations to stop the practice.)

The higher is the interest rate differential between the local interest rate and the foreign interest rates, the greater is the inducement for short term capital flows into the country. Given a perceived good investment climate and a reliably sound currency exchange rate, the inducement for such capital flows become stronger. Recent glowing investment reviews about Philippine prospects, the flow of short term capital is likely to strengthen this even further.

Under the stress of excess foreign money inflows, the monetary authority has the obligation to sterilize what the domestic economy cannot absorb. Yet, what cannot be absorbed by the economy depends to some extent on what the fiscal authorities are doing. Sterilization is an operation in which excess liquidity is removed from the money supply. It is the central bank’s judgment to determine how much this effort requires. Sterilizing particular levels of monetary inflows require that the money does not enter the domestic economy directly.

There are many channels for sterilization. One way is to spend invest/ lend the money for tenors beyond short term – abroad or locally. The options for long term conversion in the local market could be constrained by the volume of actual investment activities happening at home. One way is to utilize

excess dollar resources through a domestic investment fund. If the buildup of domestic investment projects is slow – as it is being demonstrated in the slow uptake of the PPP projects – the resulting absorption rate would be low. The continuous boom in private construction of office buildings and housing condominiums is partly being financed by demand arising from remittances, but here, the danger is one of over-building: the domestic demand for building could get filled up with the new capacities and no further demand could be generated. It may be easy to build new buildings but if there is no market demand for the built units, a real estate bubble could result.

In that case, the excess money needs to be moved off-shore. The purchase of foreign investment instruments – such as US Treasuries – or deposit in other foreign banking institutions also helps address this problem. Another way is to use new money to retire existing debt, especially short and medium term debts and other debts with high interest costs. This is only possible for central bank debt, or those debts that involve the country's banks with foreign debts, in which case the use of foreign exchange swaps would be involved. If government instrumentalities owe such foreign debts, then the problem requires coordination with the fiscal authorities. (In fact, there are many areas of coordination that could make exchange rate management easier.)

Another method of using the excess dollars is to set up a vehicle for investments. This transforms the short term cash assets into longer term investment claims. Some cash rich countries have used excess dollar assets into a country investment fund designed to build further wealth. Most of the rich emirate states in the Middle East have sovereign wealth funds. Singapore's sovereign wealth has invested in a lot of Philippine projects. The Philippine dollar holdings are still relatively small and do not yet merit this strategy because there are many development backlogs at home. If the government's infrastructure investment program were to take place at the scale that is warranted at the moment – even with the help of foreign direct investments – then the likelihood is that the needed demand for dollars would take up current supplies of dollars adequately. (In due time, the sovereign wealth route could provide a useful channel for sterilizing the foreign exchange bounty of the country.)

Traditional methods for reducing the money supply at home through adjustments of reserve requirements on banks could work only up to a limit. The reserve requirement has been traditionally close to 20 percent of deposits. The recent rate is 21 percent of deposits. The higher the requirement for reserves, the more costly it becomes for the banks because that reduces their potential to lend or raise more deposits. The central bank had offered incentives to lessen the cost to them by permitting holdings of government bonds for some part of the reserves, which earn interest.

A direct method of sterilization within the domestic economy is simply by borrowing from the public the excess liquidity that arises. One of the consequences of the central bank reform law that created the BSP, however, was to remove the authority to issue freely negotiable instruments of borrowing from the public.⁷ Not having this authority, the central bank introduced an alternative that substituted directly for

⁷This was a reaction to the Jobo bills of the 1980s, which were central bank debt instruments issued to mop up domestic liquidity when the country faced its worst financial crisis and the government wanted to cut down inflation.

the introduction of central bank bills of indebtedness. This is the Special Deposit Account (SDA), which is designed to suck money out of the domestic money supply. The SDA deposits are like time deposits placed with the central bank. The SDA effectively removes the excess money from circulation, but the central bank pays interest to entice these deposits. SDA deposits are not negotiable instruments, which makes them more powerful in sterilizing excess liquidity. SDA deposits have ballooned enormously over time.

The interest costs involved in keeping these moneys simply under lock and key (with no investments to match them) represent the operational cost of the sterilization process. Since they earn nothing for the central bank, they represent the main losses incurred in support exchange rate operations. One of the policy questions faced by the monetary authorities is how far the interest differential can be kept to keep attracting SDA deposits. Is the current rate too high? In short, is the subsidy excessive?

The central bank has relied mainly on its tools to manage the exchange rate and it is still unable to hold back the appreciation by itself. The SDA which is the main tool used to remove money from circulation has been costing the central bank a pretty subsidy. SDA deposits of 1.63 trillion pesos at recent count at the current 4.18 percent annual interest rates paid to them would cost the central bank 68.3 billion pesos in interest cost. At this rate, the operation is likely to be unsustainable. Other channels of sterilizing the dollar inflows would keep these operational costs much less.

“Fiscal policy and the exchange rate.” In the first two years of the Aquino administration, the fiscal branch of the government has taken a tight stance over spending. In general, the outcome of this conservative fiscal stance has been well-applauded. Tight spending created fiscal stability. It won plaudits from international observers, leading to sovereign credit upgrades from the credit rating agencies.

The objectives of the fiscal branch have been to continue a conservative fiscal stance in order to create further improvement in credit ratings. The finance secretary has avowed as an objective to secure “investment grade” sovereign credit rating. This has many beneficial upshots: improved credit terms for the government and for the country’s principal enterprises when they approach the international capital market.

It is great advertisement as well for the country’s improving investment climate. This factor has to some extent helped to encourage more short term capital inflows seeking improved returns. Thus, this success adds to the problems faced by the central bank in regulating money supply.

The operations of the fiscal branch have enormous impact on the exchange rate outcome. The Treasury has a large debt service requirement from year to year. This requires the purchase of dollars as well as a continuing borrowing program for foreign currency. There are enormous opportunities for the

One aspect of the Jobo bills was that they succeeded in mopping up excess liquidity but they made possible the contraction of income and spending as well as contain the inflation of that period.

fiscal branch to avail of the growing foreign exchange resources that are available at home. This will increase the demand for dollars held by the central bank. Use of this channel can increase the demand for Philippine dollar holdings and thereby release the pressure for currency appreciation.

Foreign debt reduction is another route. Yet, it seems that the Treasury seeks foreign borrowing for its requirements. The benefits of debt reduction is that it reduces the debt service ratio, and this has enormous impact on the macro-fundamentals, even if the impact might be on some reduction of the country's accumulating international reserves.

The other area of coordination concerns the management of the domestic public debt. In times past, the problem was one of fear that government borrowing from the central bank would mean printing money. Today, that is not likely to happen, with the central bank awash with money. The SDA accounts have amassed quite a sum of money that could be used to finance government debt. Of course, this could create a problem of displacing private sector financing of the government's fiscal deficits through its purchase of treasury bills. There are many possibilities for coordinating fiscal action with monetary policy.

An objective of the BSP reform in 1994 was to make the monetary authorities independent. The idea behind the reform was to insulate the central bank from the demands of the government (the fiscal branch) from its perennial problems of financing the budget deficit. The reform was reacting to the problems that the country faced as it battled the era of foreign exchange scarcity. The problem then was to create safeguards so that the monetary authorities could be made distant from the demands of the fiscal branch of the government.

The reform probably did not foresee a situation when the reverse of exchange scarcity could happen. When foreign exchange surpluses create excessive domestic monetary expansion, imagine what would result if the fiscal branch and the monetary branch acted like two independent republics? To obviate this situation, in fact, the monetary board as reconstituted includes two members appointed by the president to represent the fiscal branch (the government) and all other independent members representing the general economic community. (Complete independence is of course a fiction, because, in the end, the President appoints all members of the monetary board.) Also, the governor of the BSP was made chairman of the monetary board, replacing the secretary of finance (who may or may not be a member of the board). In fact, the president has always made the secretary of finance as one of the two government representatives of the board to assure monetary-fiscal coordination.

In the current circumstances, it is appropriate to raise whether a failure of coordination has happened in the actions of the two "republics"—the monetary branch and the fiscal branch. To put it in graphic terms, the two policies have to dance to the same music.

"Desirable areas for fiscal and monetary coordination." Monetary policy cannot do all the adjustments under the present situation. Fiscal policy has to help the monetary authorities by inducing demand for domestic money so that the exchange rate could be kept. Sterilization by the central bank

might be helpful but the scale that is needed to be done under the present circumstances needs support from the fiscal authorities. Demand for money and a rise in government spending will raise the capacity to absorb the balance of payments surpluses.

Both monetary and fiscal policy working together will relieve the pressure on the peso exchange rate to appreciate. Possible areas of actions present themselves in the area of managing the budget: (1) domestic public debt management; (2) external debt management; and (3) higher room for government spending, especially in public investment.

Domestic public debt management. Treasury bill and the government bonds have much more room to absorb the domestic liquidity if there is sufficient coordination between the central bank and the Treasury so that interest rate competition between the two instruments is less acute. The floats of government debt are designed to absorb private savings just at the SDA accounts are designed to sterilize excess cash in the system which are also savings. SDA deposits can be reduced with an increase in Treasury absorption of these savings.

An improvement of Treasury coordination on relying on domestic saving mobilization could help reduce SDA deposit accumulation. The interest paid on SDA deposits is an interest cost and represents losses for the central bank. These losses are, in the final analysis, the Treasury's contingent liability, for in the end, it would have to finance BSP losses (when the time comes). Through this coordination, there would be less SDA accounts to hold. Moreover, the SDA operations of the central bank are not sustainable and eventually, it would be forced to cap such losses if only to maintain a viable net capital position.

External public debt management. The Treasury needs to buy dollars to service the external public debt. Often, this is also done to refinance existing debts in addition to just servicing them. It does not seem logical to borrow abroad when domestic dollars at home are a-plenty and can absorb the government's need for dollars.

In fact, there is a case for external debt reduction. Pre-paying some of the external debt to relieve the government of foreign exchange demand enables the government to reduce the debt service burden. Pre-paying and termination of some debts would also be attractive during this regime of record low world interest rates. This will enhance a strengthening of the buildup of international reserves or shield the country much more from other emergencies.

An implication of the rising foreign exchange reserves is the question of whether the level to which the foreign exchange reserves have risen has been excessive. Reserves are useful in relation to the management of existing foreign exchange liabilities and the import needs of the nation.

Room for higher fiscal spending. There is in fact much greater room for more government spending, especially if that spending is for highly productive investment projects. The fear of the fiscal branch that the country's fiscal fundamentals still need to be more tightened is wrong. The country now has a high

rate of saving but there is a large excess saving that is not going to investments. The excess dollar inflows from remittances and other export revenues have continuously created new large flow of saving that is causing the generating the pressure for the peso to appreciate.

The true metric for determining the country's economic conditions has shifted without any one suspecting that it has been happening for years. The country's measure of capacity is no longer the GDP – the gross domestic product – which is the measure of domestic production. Most of the institutions that review Philippine economic performance using economic ratios to the GDP, which is the normal measure applied to all developing countries.

The World Bank, the IMF, the ADB and all others including the investment analysts are using Philippine fiscal ratios – fiscal deficits to GDP, revenues to GDP and others – as a means of comparison with other countries in monitoring macroeconomic performance. For its part, the government has taken this analysis seriously to demonstrate its adherence to the straight and narrow path. It is good management practice to raise the sources of tax revenues because the country has been underperforming on this front for decades. The government has to raise tax revenues to catch up with what other growth oriented developing countries do – for there is a huge gap between government expenditure and tax receipts.

However, the country has moved beyond the excessive constraints of the economic ratios to GDP. The relevant ratio for the Philippines *now* is the gross national product – the GNP. The GNP is what the Philippine national income accounts call the gross national income – GNI – as recommended by recent statistical usage. Over the years, remittances and exports have raised the country's economic capacity through the rise of incomes.

The GNI has been outstripping GDP for years. Net factor incomes – or incomes from Philippine factors earned by working abroad – have surged to produce the dollars that keep pouring in to make an income difference within the country. The difference between GDP and GNI is “net primary income.” Much of that net primary income is received through worker remittances sent home to the country.

From 1998 to 1999, GNI outstripped GDP by an average annual difference of 14.1 percent. From 2000 to 2004, the annual difference of GNI from GDP was 19.9 percent; but from 2005 to 2010, this has grown to 28.2 percent. In fact, in 2010, this was 33.2 percent. Judging from these ratios, a fiscal deficit ratio of two percent of GDP would turn that deficit into a fiscal surplus in relation to the GNI, thus providing a huge additional fiscal space.

The most important implication of these recent developments is that the government has a large fiscal space to undertake public investments if it wants to aim for high growth in the next few years while at the same time reducing the pressure of balance of payments surpluses. Constraining government spending for investment spending especially is creating huge problems for the economy – for it would create more problems for currency appreciation. This is the time to be bold in undertaking investment programs of larger dimensions so as to remove the country infrastructure bottlenecks that

have strangled the country's ability to grow faster. The buildup of projects under the PPP (Private-Public Partnership) program is too slow and the pace of investment participation of qualified parties is too narrow. The slowness of the government to undertake reforms in relation to the restrictive provisions that inhibit foreign direct investments to participate in large scale infrastructure construction is limiting the country's future prospects.

Conclusion. There are many avenues for fiscal coordination with the monetary authorities so as to achieve common goals of stabilizing the peso, in maintaining an exchange rate that does not disrupt the country's competitive position in its current export industries, and, finally, in safeguarding the conservative fiscal stance even in this new age of rising foreign exchange riches. But also, the ultraconservative fiscal stance is no longer called for in view of the enlargement of the fiscal space due to the expansion of the GNI (in contrast to the GDP base).

The monetary-fiscal policy coordination encompasses the implementation of the development project needs of the country. Such coordination requires accepting the need to raise the current low level of domestic investment to eliminate the bottlenecks that hinder higher economic productivity. The backlog in investments for development is high. The country has deficits in public utility deficits especially in the electricity sector. This is as true in transport – land, seaports and airports – where daily gridlocks are felt in many areas. There is need to forestall environmental degradation, improve flood control projects, and raise irrigation services in agriculture to keep agriculture moving forward.

All these, of course, are in the hands of the development planning institutions and the infrastructure operational departments and agencies. Until this aspect of absorbing the demand for dollars get their act going to meet the country's continuing investment needs, the problem of exchange rate appreciation will continue to hound the monetary and fiscal authorities.

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