



Policy Advisory

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WEIGHING THE IMPACT OF THE PESO APPRECIATION

**Congressional Planning and Budget Department
House of Representatives**

EXECUTIVE SUMMARY

The rapid appreciation of the peso against the US dollar particularly in the fourth quarter of 2007 has led to the peso's overall gain of almost 15% last year. The strengthening of the peso was mainly attributed to the robust inflow of overseas Filipino workers' (OFWs) remittances, supported by the improvement in foreign portfolio and direct investments.

Mixed reactions on the peso appreciation were expressed by different sectors of the economy. The government welcomed the appreciation because of reduced debt servicing while importers enjoyed lower prices of imported products. On the other hand, OFWs whose spending power weakened and exporters whose competitiveness declined have called on the government to mitigate the impact of the peso appreciation.

The peso is expected to further appreciate against the US dollar this year and could range between P39:§ and P41:§. Inflow of remittances will continue to be strong and the outlook for foreign investments remains positive.

While the government is committed to support an exchange rate that is market-determined, the Bangko Sentral ng Pilipinas is compelled to intervene to maintain market stability which can, however, result in huge losses. Several programs have also been introduced to mitigate the losses of affected sectors such as the extension of credit facility to exporters and investment opportunities for OFWs. While there are losing sectors, the peso appreciation presents opportunities to some. The government should prepay some of its dollar-denominated obligations. Local manufacturers should also import the much-needed capital equipment to improve their productivity.

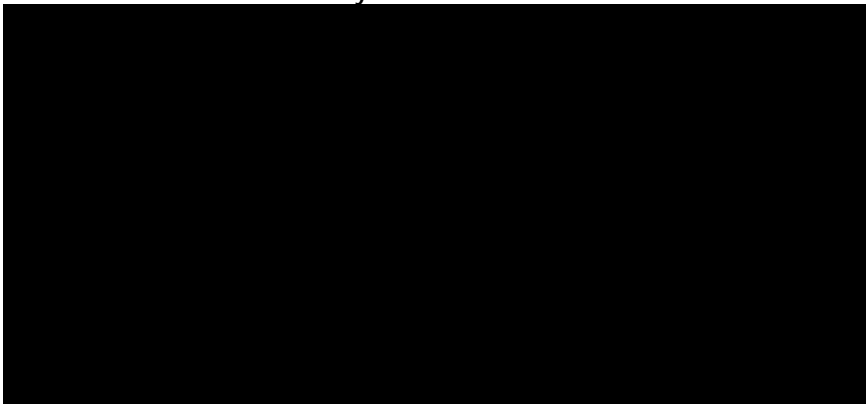
WEIGHING THE IMPACT OF THE PESO APPRECIATION

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Background

The appreciation of the peso against the US dollar started in the second half of 2005. From a monthly average of P56.1562:\$ in September 2005, the peso steadily gained strength against the dollar (with only six months of weakening) to reach P41.7429:\$ in December 2007. The highest climb of the peso occurred in October 2007 when it gained P1.75 against the US dollar. As of 16 January 2008, the exchange rate reached P40.524:\$, the strongest since February 2000.

Table 1
Peso:Dollar Exchange Rate
January 2004 – December 2007



Source: Bangko Sentral ng Pilipinas

This paper benefited from the discussions with Director General Rodolfo V. Vicerra and Director Manuel P. Aquino.

The strengthening of the peso can be mainly attributed to the huge inflow of OFW remittances, supported by the improvement in foreign portfolio and direct investments. For the period January-November 2007, remittances have amounted to \$13.1 billion and expected to reach \$14.3 billion for the whole year. A number of huge initial and follow-on offerings at the stock market have also attracted foreign investors last year. Foreign portfolio investments registered at the Bangko Sentral ng Pilipinas (BSP) posted a net inflow of over US\$3.5 billion last year, 35% higher than the US\$2.6 billion investments in 2006. On the other hand, foreign direct investment net inflow for the period January to October recorded a surplus of US\$1.9 billion.

Privatization proceeds amounting to P90 billion in local currency for the period January-November 2007 also helped strengthen the peso. Moreover, the general weakening of the dollar against other currencies contributed in the peso appreciation. Among Asian currencies, the peso was the best performer, gaining almost 15% against the US dollar in 2007.

Effects of the Peso Appreciation

Advantages

- i) **Lower debt servicing.** Accounting for 42.4% of the total national government outstanding debt, the foreign debt of the country has reached P1.63 trillion or \$36.1 billion (P45:\$1) as of September 2007. With the peso appreciation, the amount needed to service the country's foreign debt in local currency declines. For 2007, the Congressional Planning and Budget Department (CPBD)

estimates that the government paid P4.51 billion less in its foreign debt servicing. For 2008, government savings from foreign debt servicing could reach as high as P20.4 billion if the peso further appreciates to P39:\$ based on the high-end of the updated CPBD forecast range of P39-P41:\$. At P41:\$, expected savings from interest payments would amount to P15.9 billion. In fact, it has been reported in the papers that a similar amount of reduction in interest payments for foreign loans resulting from a recomputation of the exchange rate assumption from P48:\$ to P41:\$ was ratified by the bicameral conference committee. These savings will be realigned to the budget for social services.

Table 2
Interest Payment Savings from Peso Appreciation
(In Billion Pesos)

Particulars	2007	2008
Interest Payment		
Program (P48:\$)	117.06	108.81
Using 2007 Actual & 2008 Forecast Rates	112.55	88.41
Savings from Peso Appreciation	4.51	20.40

Notes: BESF Assumed Exchange Rate, 2007&2008 P48:\$
Average Exchange Rate, 2007 P46.15:\$
2008 Updated CPBD Forecast, high-end P39:\$
Interest payment for foreign debt in 2008 was estimated using the
percent share of the programmed 2007 payment which is 37%.

- ii) **Cheaper imports.** The appreciation of the peso makes the country's imports cheaper. In particular, it cushions the impact of the surging price of oil in the world market which accounts for about 10% of the total import bill of the country. Without the peso appreciation, the CPBD estimates that the increase in the pump

price of fuel in the local market could have reached as high as P11.83, 43% higher compared to the actual average price increase of P8.27 in 2007. The tempered oil price increase has contributed in restraining the increase in inflation rate.

To some extent, cheaper imports softened the blow on exports through the imported raw materials used in manufacturing export products which particularly benefited the electronics sector. However, as cheap imports become generally more attractive, these could be used as substitutes for goods that are produced domestically. The resulting decline in the demand for local goods could cost some local jobs.

Disadvantages

- i) **Lower purchasing power of beneficiaries of overseas Filipino workers (OFWs).** The number of OFWs has reached 8,233,172 as of December 2006. At an average family size of five, the total number of Filipinos benefiting from remittances would total about 40 million or nearly half of the total population. The strong peso, however, has reduced the peso value of remittances. From P48.9143:\$ in January 2007 to P41.7429:\$ in December 2007, OFW beneficiaries have lost P717.14 for every \$100 sent to them. This amount could have been used for the payment of a utility bill particularly for those living in the provinces. Furthermore, at an average of \$1.2 billion monthly remittance, OFW beneficiaries got P8.6 billion less in December compared to what they would have received using January 2007 rates.

In the last five years, OFW remittances recorded significant contributions to the economy - accounting for about 8.4% of the

gross national product. This has been supporting the robust growth in private consumption spending which accounted for more than three-fourths of the gross domestic product.

- ii) **Decline in export competitiveness.** Prices of exports become more expensive with the appreciation of the peso which makes them less competitive in the global market. Exports account for nearly 50% of the domestic economy. Last year, several sectors have already scaled down their operations due to sluggish demand for their products. Food exporters have reduced their operations by 30%. A number of companies in the seaweeds industry, which recorded drastic decline in their earnings, have also discontinued their operations and caused the displacement of 100,000 workers and farmers.

The volume of production index (VoPI) of the manufacturing sector was mainly on the downtrend since January 2006. Significant reductions in factory output were observed in textiles and footwear and wearing apparel, among others. The Philippine Exports Federation estimates that the export sector loses one percent of its annual revenues for every one peso appreciation against the US dollar. For the period January to November 2007, total merchandise exports have reached \$45.8 billion, 4.8% growth over the same period in 2006 and 1.2 percentage points short of the 2007 downscaled target of 6%.

The softening of the global growth outlook particularly in the United States contributes to a weaker prospect of the sector this year. Local firms project exports growth to be flat up to a maximum of 5% growth. While the share of the exports to the United States has been declining in recent years, it still accounts

a significant 18% of the total exports. Stiff competition in the global market for electronics may also continue and could lead to lower prices and thus, lower revenues for exporters.

- iii) **Decrease in government revenues.** The appreciation of the peso also reduces government revenues through lower proceeds from import taxes. Revenue collections by the Bureau of Customs (BOC) in dollar terms are converted to peso value when it is recorded by the Bureau of the Treasury. Thus, the peso value of the revenues declines when the peso appreciates. The Department of Finance estimates that a one peso appreciation will reduce revenues by P2.7 billion.

Outlook

Without major government intervention to mitigate the strengthening of the peso, the CPBD's updated forecast of the average P:\$ exchange rate this year could range between P39 and P41. The inflow of remittances will remain strong as deployment of Filipino workers abroad will continue with more job openings in many countries such as Canada, Australia and Saudi Arabia, among others. Outlook for foreign investments also remain positive as macroeconomic fundamentals continue to be strong. Several companies such as Pepsi-Cola Products Philippines Inc. are expected to come up with their initial public offerings to raise more capital this year.

Moreover, proceeds from privatization will also beef up the dollar supply. For this year, the government is targeting privatization proceeds at P48.525 billion. Among the assets to be put on sale are

the 100-hectare Food Terminals Inc. property and government's stakes in San Miguel Corporation and Manila Electric Company.

The home mortgage problems in the US coupled with its declining interest rates are also expected to make foreign investors turn to emerging markets such as the Philippines to get better returns from their investments.

Conclusion/Recommendations

The appreciation of the peso could be considered as a double-edged sword. Those that benefit from the appreciation are the government through lower debt servicing and consumers, including businesses, which consume imported products. On the other hand, those adversely affected are OFWs and their families, exporters, and also the government through the reduction in revenues from imports.

The government is committed to support an exchange rate that is determined by the market. Intervention of the BSP in the market is undertaken to maintain stability and to avoid unexpected market volatility. For the period January-November 2007, the BSP has incurred a huge loss amounting to P84 billion in trying to reduce fluctuations in the foreign exchange rate which when left unchecked could be damaging to the economy. The BSP remains operationally viable despite the huge loss. However, the BSP may claim its unsubscribed capital amounting to P40 billion from the government should the losses go out of control.

It is important that the government tries to take advantage of the peso appreciation and at the same time mitigate the losses of affected sectors. The government should prepay some of its dollar-

denominated loans. Several programs have also been initiated to help exporters such as the establishment of the P280 million Export Promotion Fund and the creation of measures to extend credit facility to the sector. At the same time, exporters must continue to look for other export markets. While the share of the country's exports to the US has been declining in recent years, it still accounts for a significant 18% of the total exports.

The strengthening of the peso should also be taken as a good opportunity by local businesses to import the much-needed capital equipment to improve efficiency and productivity and consequently, make them better prepared to compete in the global market in the long term. The United Nations Economic and Social Commission for Asia and the Pacific (UNESCAP) cited in its report that improving productivity which increases the value-added components of products will enable exporters to move away from low value-added products that are most susceptible to purely price-based international competition.

A number of programs have also been introduced to ease the loss of OFWs. Among these are the reduction of remittance costs, skills improvement program for lower-paid OFWs, and the issuance of open investment instruments such as the \$1 billion retail treasury bonds. While OFWs have significant contributions to the economy, the government should not become over-dependent on their remittances to boost the economy. The surge in the number of Filipinos who aspire to work abroad is a reflection of the inability of the government to provide decent opportunities for them. Thus, in the long-term, a priority for the government should be to look for ways to foster local employment opportunities which can ensure a good future for its citizens.

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