Philequity Corner (April 28, 2008)
By Valentino Sy

Using currency appreciation to combat inflation

In recent years, Asian central banks spent countless billions of dollars so as not to lose export competitiveness. That may be changing. Now, Asian nations like Singapore, Malaysia and China are allowing currency gains in a bid to stem inflation.

Singapore, which uses its currency to guide monetary policy, unexpectedly set a stronger trading band on April 10 for the Singapore dollar (+5.5 percent ytd), pushing it to a record high against the US dollar. Malaysia - which for a long-time has maintained a peg against the US dollar - has allowed its currency to appreciate a bit faster than the Chinese yuan (+4.2 percent ytd). The Malaysian ringgit (+4.6 percent ytd) climbed to its highest level since October 1997.

Currency Performance

			%Chg
Major Currencies	**end-2007**	**25-Apr**	**year-to-date**
Swiss Franc	1.1325	1.0342	8.7%
Euro	1.4585	1.563	7.2%
Australian Dollar	0.8753	0.9334	6.6%
Japanese Yen	111.66	104.43	6.5%
British Pound	1.9861	1.9858	0.0%
Canadian Dollar	0.982	1.0140	-3.3%
Asian Currencies			
Taiwanese Dollar	32.422	30.34	6.4%
Singapore Dollar	1.4409	1.3616	5.5%
Malaysian Ringgit	3.3075	3.1542	4.6%
Chinese Yuan	7.3141	7.01	4.2%
Indonesian Rupiah	9390	9230	1.7%
Philippine Peso	41.28	41.875	-1.4%
Indian Rupee	39.38	40.145	-1.9%
Thailand Baht	29.9	31.667	-5.9%
Korean Won	935.9	995.275	-6.3%

Source: Bloomberg

Peso no longer a cushion

Last week, crude oil prices skimmed $120 per barrel, up 87 percent compared to prices a year ago. Despite the Philippines' decreased dependence on oil for its power needs (see our article "*Oil on the way to $100*" in the Oct. 29, 2007 issue of **The Philippine Star**), the higher prices of its substitutes such as coal and natural gas have contributed to higher energy costs.

The bad news is that the peso is no longer acting as a cushion against high energy prices. In 2007, the peso was the best performing currency in Asia, strengthening by 15.6 percent against the US dollar. This year, that cushion is no longer there. Year-to-date, the peso has weakened by 1.4 percent against the US dollar (see table above).

Inflation more widespread

That cushion is all the more needed now that inflation has spread to agricultural commodities like rice which the Philippines imports and a staple among Filipinos. Last week, rough rice for July delivery soared to as much as $25.7 per hundred pounds, up more than 80 percent in 2008 alone. Prices of agricultural commodities are rising to record levels not only because high fuel prices have driven costs, but also because stocks have hit their lowest levels in decades due to erratic weather and stagnant yields.

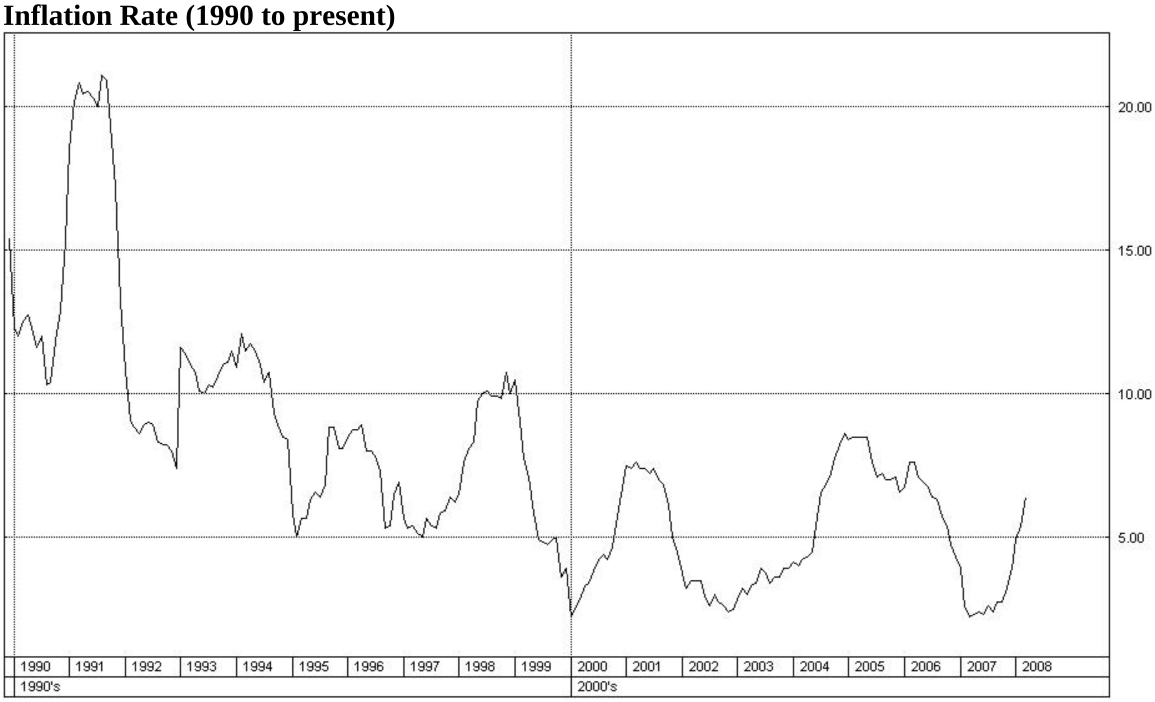
In addition, some Asian governments have overreacted to surging rice prices by curbing rice exports, which is like hoarding at a national level. Thus, with energy and rice making up a big chunk of the consumer basket, it was not surprising to see Philippine inflation hit a 21-month high of 6.4 percent in March. In fact, we expect inflation to trend higher and even surpass previously set government targets.

Second round effects

Even more worrisome than the fuel and food price hikes are the so-called "second round" inflation effects. This refers to wider price pressures due to increased inflationary expectations as businesses demand higher prices and labor demand higher wages. Already, there are wage and transport fare adjustments that are pending, and therefore, inflation is unlikely to come down anytime soon. Big labor groups are seeking a hike in the minimum wage by 80 to 125 pesos. Meanwhile, transport groups are seeking between 1.00 to 1.50 pesos hike in the first 4 kilometers and between 25 to 50 centavos increase in the succeeding kilometers.

Given all these adjustments, it is very likely that inflation will continue to trend higher and peak around the early months of 2009 after bottoming out in the 1st quarter of 2007. Historically, inflation (from peak to trough and vice versa) runs within a two-year cycle as pointed out in our previous article (see "*Inflation Ri(ce)sing*" in the April 14, 2008 issue of **The Philippine Star**).

Inflation Rate (1990 to present)



Source: Technistock

Choosing the lesser of two evils

In the past two years, the Bangko Sentral ng Pilipinas (BSP) bought dollars in the open market to prevent a rapid appreciation of the peso and to protect exporters, especially near the 40 peso to the dollar level. This is evident in the rapid accumulation of gross international reserves (GIR) which stood at $35 billion as of end-2007 (up 47 percent) and the massive foreign exchange losses which the BSP incurred amounting to Php113 billion in 2007.

Unfortunately, at this point, policymakers may have to choose between protecting the exporters and controlling a runaway inflation that may reverse all the gains the government has made the past few years.

By letting inflation go out of hand, policymakers risk a wage spiral, a rise in business uncertainty which discourages investment and saving, a rise in unemployment, and eventually a drop in the country's output.

For the protection and benefit of the majority of Filipinos, letting exporters hurt for the time being, while controlling inflation through exchange rate appreciation may be the lesser of two evils.

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