Philequity Corner (July 28, 2008)
By Valentino Sy

BSP at the Helm

The proactive stance by the Bangko Sentral ng Pilipinas (BSP) in addressing the threat of sustained high inflation clearly shows that our monetary authorities are on top of the situation. The market clearly agrees. After the surprise 50 basis points hike in policy rates, the peso stabilized and strengthened by 4.2 percent.

Prior to this decisive move by the BSP, the peso was among the 3 worst currencies in Asia especially after the Philippines hugged the limelight a few months ago as the world's top rice importer. Earlier this month, the peso fell as to as low as 45.88 against the US dollar (-11.1% year-to-date) before rallying to close at 43.95 last Friday.

Asian Currencies vs. US Dollar	Price	%Chg Year-to-Date
Chinese Yuan	6.8186	7.02
Taiwanese Dollar	30.43	6.57
Singapore Dollar	1.3591	5.95
Indonesian Rupiah	9,119.00	3.08
Malaysian Ringgit	3.2500	1.74
Vietnamese Dong	16,795.00	-4.64
Philippine Peso	43.95	-6.18
Indian Rupee	423,025.00	-6.83
Korean Won	1,008.30	-7.17
Thai Baht	33.44	-10.88
Pakistani Rupee	70.93	-13.12

Source: Bloomberg

More rate hikes possible

In a recent statement, the BSP said that it is prepared to take all necessary actions to address the threat of high inflation and promote price stability. This means more rate hikes down the road especially to control inflation expectations that could permanently undermine long-term economic growth.

"It's really important that a lower inflation environment is reestablished. If not, then the cost to the economy of prolonged high inflation would be even higher, so we have to act now," BSP Gov. Amando Tetengco, Jr. told the Foreign Correspondents Association of the Philippines last Thursday.

Already second round effects have set in, as evident in the rise of core inflation. Minimum wages were increased by 7 percent while transport fares were increased by 12 percent. Nevertheless, the BSP has clearly shown that it is willing to act promptly and decisively before these secondary shocks exacerbate inflation concerns and spark more generalized inflation.

Business sector & capital markets welcome higher rates

We believe that the BSP is doing the right thing in signaling that policy rates could be raised anew. In a normal environment, hiking interest rates is negative for business because it raises costs. But now, with the threat of runaway inflation, a tighter monetary policy is acceptable to the business sector and, in fact, is necessary.

The International Monetary Fund (IMF) and ratings agency Fitch agree. *Inflation should be the top concern of policy makers confronted by higher food and fuel prices*. This was the main message from Dominique-Strauss Kahn, Managing Director of the IMF, during the recent Group of Eight (G8) summit in Hokkaido, Japan.

Meanwhile, in a forum sponsored by the Philippine Stock Exchange (PSE) and Union Bank, Fitch Ratings head of Asia Sovereigns James McCormack said that "depending on where inflation is, that tells you where the policy rates needs to be … if inflation goes higher then clearly interest rates will move higher as well."

Most of the time, the business sector and the capital markets are against higher interest rates. It is ironic that higher rates are welcomed this time around.

Investors reassured

While we commend the decisive action and sound money policies of the BSP & its Monetary Board, we also applaud President Arroyo, Finance Secretary Gary Teves and our economic managers for standing pat on the EVAT on oil. Likewise, we congratulate the Philippine Stock Exchange and its president Francis Lim for coming out with a very firm and timely statement against the lifting of EVAT on oil.

Again, it is ironic that the business sector and the capital markets would welcome taxes. But in this current environment where market confidence remains fragile, strong-minded economic managers with firm policies actually provide the badly-needed reassurance to investors and businessmen.

Peso at 42 by year-end

In the past, the BSP has shown that it was capable of stabilizing the exchange rate during wild swings. It supported the peso/dollar rate at 40 by buying US dollars aggressively at that level to cushion the blow to exporters, money remittance businesses and OFWs. If not for the aggressive buying of the BSP, the peso would have gone down easily to 38.

Right now most major houses have reversed their very optimistic forecast of 34 to 36 for the peso and are currently predicting 47 to 48. However, we believe that with the BSP firmly at the helm, they can afford to raise rates, steer the peso to an optimal level and address the inflation threat (see *Using Currency Appreciation to Combat Inflation* in the April 28, 2008 issue of **The Philippine Star**). Thus we are sticking to BSP's target of 42 to 45 for 2008.

Still, the main determinant that will drive the world economy and the capital markets will be the price of crude oil. But if oil prices and agricultural commodities sustain their downward trek (see table below), inflation would likely subside over the near-term. If so, the peso at year-end could actually hit the low-end of the BSP's target which is 42.

Commodity	Price High	Date	Current Price	%Decline
Wheat (USD/bu)	12.45	3/12/2008	8.11	-34.86%
Rough Rice (USD/cwt)	24.82	4/23/2008	16.72	-32.63%
Sugar #11 (USD/lb)	15.18	3/3/2008	12.44	-18.05%
Soybean (USD/bu)	16.37	7/3/2008	13.86	-15.33%
Corn (USD/bu)	6.3	5/8/2008	5.96	-5.40%
Crude Oil (USD/barrel)	147.27	7/11/2008	123.26	-16.30%

Source: CBOE, Bloomberg

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