**Philequity Corner (June 26, 2006)**
**By Ignacio B. Gimenez**

# Flight to the dollar

Global currencies are falling quite significantly versus the US dollar as investors are speculating on higher interest rates in the US. The Federal Reserve is widely expected to further raise rates not only during the forthcoming Fed meeting this week but also in August. This, after the Fed policymakers have raised the rates 16 times since June 2004 to 5%. A *Bloomberg* report over the weekend stated that interest-rate futures traders see a 100% chance of an increase by 25 basis points this June 29 and an 88% chance of another 25 bps rise in August.

Against this backdrop, most currencies tumbled from their month-long highs (between the second and third week of last month). The following table summarizes the movement in selected currencies vis-à-vis the US dollar. It shows the Euro and the Japanese Yen to have weakened versus the dollar after continually posting gains earlier in the year. Our own peso was not spared as it lost 4% of its value to P53.26 from a high last month of P51.33. Among the Asian currencies, the Thailand baht and Singaporean dollar fell the least by 2% from their peak last month.

**Selected currency spot rates vs. the US dollar**

| | **Rate as of 6/22/06** | Highest level in May | % chge |
|---|---|---|---|
| Major Currencies | | | |
| Australian Dollar (USD/AUD) | 0.7329 | 0.7800 | -6% |
| Swiss Franc | 1.243 | 1.190 | -4% |
| Euro (USD/Euro) | 1.2576 | 1.300 | -3% |
| Japanese yen | 116.09 | 109.59 | -6% |
| | | | |
| Asian currencies | | | |
| Indonesian Rupiah | 9,318.20 | 8,670.81 | -7% |
| Taiwan Dollar | 32.675 | 31.010 | -5% |
| Philippine Peso | 53.26 | 51.33 | -4% |
| Korean Won | 944.23 | 913.96 | -3% |
| Indian Rupee | 45.907 | 44.640 | -3% |
| Malaysian Ringgit | 3.6564 | 3.5600 | -3% |
| Singapore Dollar | 1.5971 | 1.5600 | -2% |
| Thai Baht | 38.349 | 37.400 | -2% |

*Source: Technistock*

## More than 50 bps rate hike?

The financial market jitters may not ease soon. Some analysts are speculating that the US Fed may raise interest rates by up to 50 bps on its June 28-29 meeting alone. The speculation was fuelled by the recent durable goods orders reports in the US which show the May figure growing by 0.7% after falling 1% in April. This could provide comfort to the US Fed as the data indicate that the US economy could tolerate a higher interest rate. With this as a backdrop, the interest rate differentials between the various economies and that in the US could widen and thus encourage further flight to the dollar.

Only those who have raised their own interest rates to narrow the differential with US interest rates seem to have weakened the least like in the case of Thailand and Korea. The Euro and Yen could follow suit soon. The European Central Bank has reportedly been mulling an interest rate higher than what the US Fed would implement. Meanwhile, the Bank of Japan is also largely expected to raise rates next month for the first time in five years (the BoJ has been maintaining a near-zero interest rate).

**What's in it for us?**

Unfortunately, our good economic fundamentals no longer provide assurance that the peso could remain stable for long. For one, our three-month T-bill rates have remained at 5% which offers no significant differential from the 5.22% yield on the ten-year US treasuries. In other words, this does not provide any attraction or incentive to risk-averse investors especially amid the volatility in the financial markets. To further complicate things, a 20% withholding tax is imposed on Philippine government securities thereby limiting returns to investors.

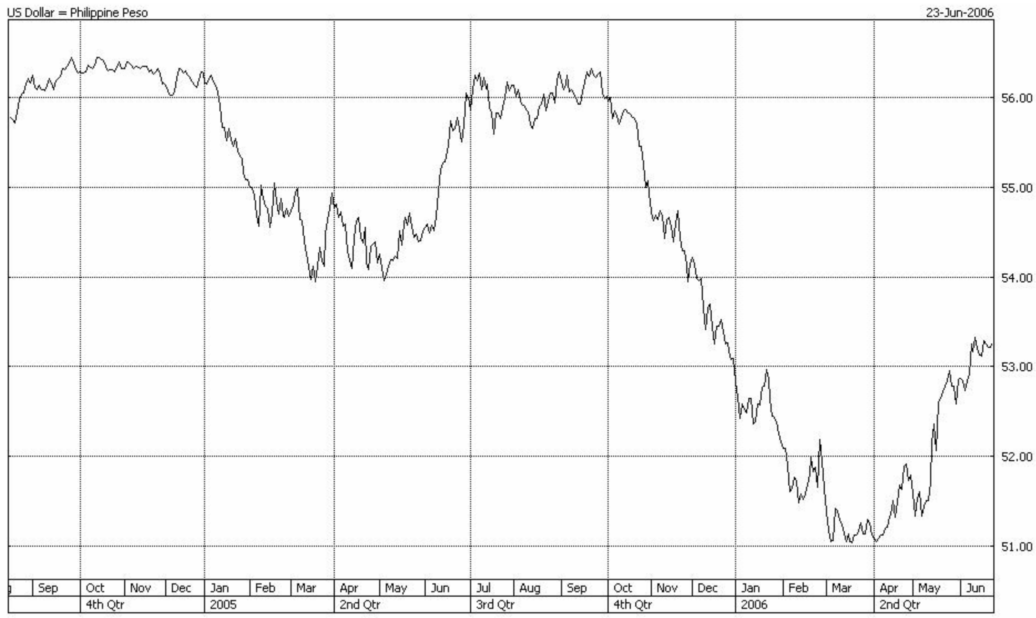
Our monetary policymakers have repeatedly discounted the need for raising domestic interest rates as inflation have remained tempered so far. They argue that inflation could ease further in the second half of the year, bringing the year's average within their comfortable expectations. While we agree with our monetary authorities as far as inflation is involved, we nonetheless argue that inflation may no longer be the sole consideration in setting interest rates. There is the need to continue attracting investments and to keep our currency and the financial markets stable. Not only has the peso taken a beating, even the equities market has suffered a steep decline given the growing risk-aversion among investors. They have rightly sought refuge in US dollar assets given the higher returns that the latter offer and even if the US economy has yet to show signs or a rebound.

**A more tolerant economy**

We certainly do not wish to be armchair economists but we believe that current domestic interest rates are lowest in years. In our humble opinion, we believe that our economy may be more tolerant than it appears and could probably withstand some room for interest rates to rise.

It might not hurt if monetary authorities take into account existing circumstances, and provide investors a reason (in the form of higher interest returns) to maintain their peso investments. Give a lot of thought to the local interest rate differential with that of the US, and the need to stabilize the peso. As shown in the chart below, the peso has lost ground vs. the US dollar and is poised to test its support towards P54.

**Dollar-peso rate**



*Source: Technistock*

Raising local interest rate by some extent could give the peso some attraction and consequently gain some ground versus the dollar. On the other hand, letting it slide further could actually be more detrimental to the economy. Government and many companies maintain foreign debts with interest rates linked to those in US treasury rates. A weak peso and higher US interest rates would translate to a double whammy in terms of higher interest charges and forex losses.

**A moderate hike will not hurt**

A slight raise in local interest rates might not restrict economic expansion in general, and loan growth in particular. In the case of consumer loans, there are new dynamics to consider. For one, most property companies have been enjoying strong cash flows that they are now able to provide partial financing, interest-free, for their clients and this has resulted to even higher sales. And as we mentioned in previous articles, many property companies enjoy cash purchases by OFWs. Such type of acquisitions now account for up to 50% of their sales. What could hurt property sales is not the slight increase in financing charges but the resulting higher unit prices owing to higher cost of imported construction materials when the peso further depreciates. The same is true for car and appliances sales. What could make these less affordable is not the spike in financing cost but the resulting higher tag prices due to a weaker peso. We understand that it is a tight balancing act for monetary authorities. However, let us give a little credit to the economy and the strength that it has gained so far.