Philequity Corner (May 19, 2014)
By Valentino Sy

BSP firmly in control

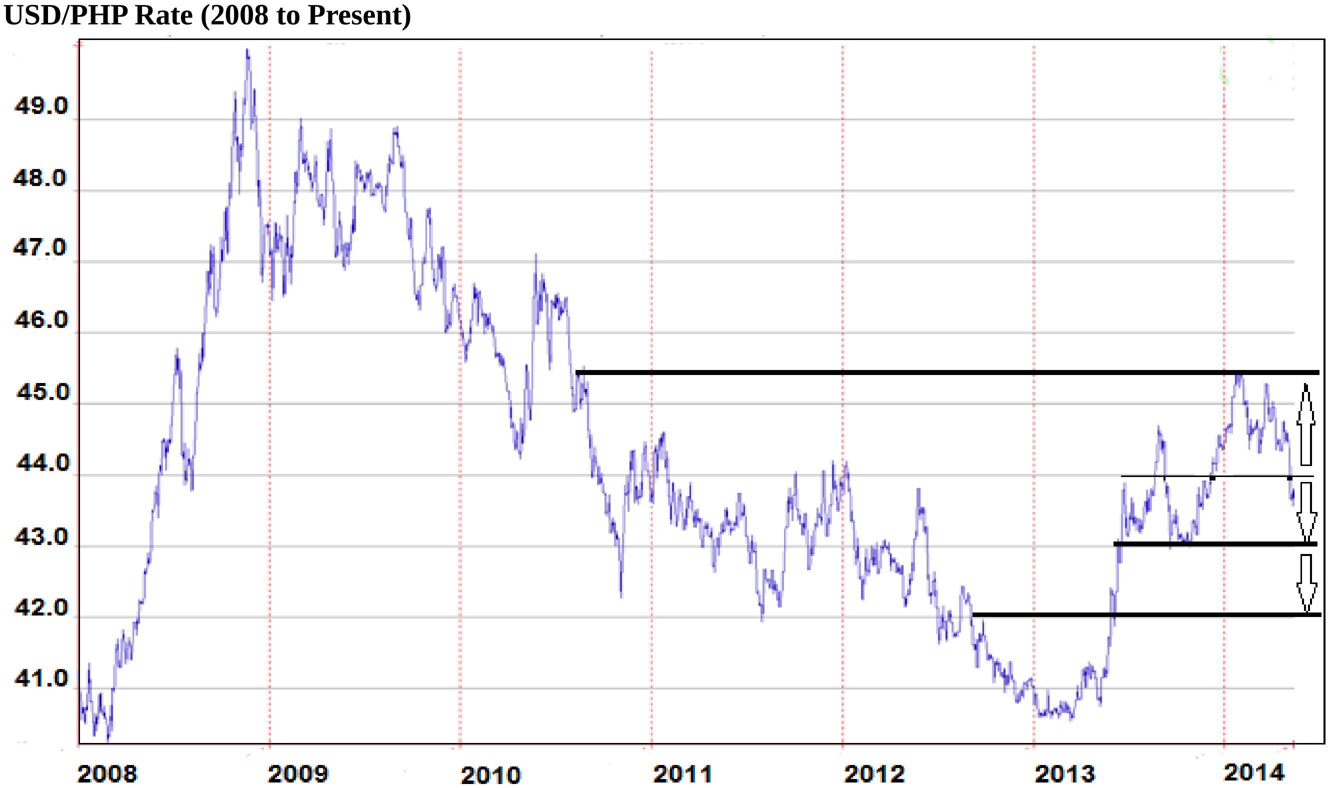
It is now the NBA playoffs. And just like in a 7-game series where the leading team has a commanding 3-1 lead, the BSP is now firmly in control after successfully defending against external shocks which caused excessive swings in the peso during the past months.

The better scenario

Previously, we presented two scenarios for the peso (see *Scenarios for the Peso*, May 5, 2014). The better scenario has now materialized. The peso broke below the 44 level which means that we are now looking for it to range between 43 and 45.50. If the 43 level is broken next, then we should expect the peso to trade between 42 and 45.50 longer-term, possibly for the next few years.

The peso breaking below 44 achieves two things. First, the Bangko Sentral ng Pilipinas (BSP) is now in a better position to curtail inflation given the pass-through effects of a stronger peso. Second, it gives the BSP a wider trading band to defend against sharp declines in the peso in case another EM currency scare arises similar to what transpired in August 2013 (see *The Best House in a Bad neighborhood*, Sept. 2, 2013) and in January 2013 (see *EM Currency Contagion*, Jan. 27, 2013).

USD/PHP Rate (2008 to Present)



Source: Fxtop.com, Wealth Securities Research

Peso rise to temper inflation

The rally in the peso is positive because it helps temper inflation which is now threatening to rise. Inflation inched up to 4.1 percent in April from 3.9 percent in March, prompting the BSP to slightly raise their inflation forecast to 4.3 percent this year, from their previous forecast of 4.2 percent.

A stronger peso is expected to contribute to lower inflation because of the impact of a stronger currency on prices of imported commodities, according to BSP Governor Amando Tetangco, Jr. It acts as a counter-balance to potential price pressures arising from higher food prices, transport and electricity costs.

Wider trading band brings the peso back to the "sweet spot"

From a technical perspective, breaking below 44 is critical because it allows for a much wider room for the peso to trade. This new and wider trading band lessens the risk that the peso will depreciate sharply beyond 45.50 – 46 in case another round EM currency scare arises. More importantly, this new trading band brings the peso back to our so-called "sweet spot" between 42 and 45 that is neither too hot nor too cold (see *Peso's Sweet Spot*, January 30, 2012).

Fed gives ample time for other CBs to adjust

Now that the Fed has announced its plan to taper, it is doing it slowly which now allows other central banks to adjust their own monetary policies. Unlike last year, when the Fed first announced the taper and everyone was caught off guard, now the Fed is telegraphing its moves so that others will not get behind the curve. This has given the BSP, as well as other central banks, ample time to adjust to their different unique situations.

Contagion risk significantly reduced

As in most emerging markets, contagion risk triggered capital to flow out of the Philippines last year at the onset of QE tapering. Foreign funds have since flowed back to the Philippines since early February, resulting in the reversal of the peso's depreciating trend.

But more importantly, we now see a significant reduction of contagion risk after troubled emerging market economies like India, Indonesia, Turkey, South Aftica and Brazil started fixing their problems (see *Best House in an Improving Neighborhood*, Feb. 24, 2014). In fact, the so-called "Fragile 5" currencies have on average recovered 10.5 percent against the US dollar from their respective lows.

EM Currencies vs. the US Dollar	Current Price	Recent Low	Date of Low	%Chg from Low
"Fragile 5" Currencies				
Indian Rupee	58.7825	68.845	8/28/2013	14.6%
Turkish Lira	2.0985	2.39	1/27/2014	12.2%
Brazilian Real	2.2148	2.4505	1/29/2014	9.6%
South African Rand	10.3552	11.3909	1/29/2014	9.1%
Indonesian Rupiah	11412.5	12281	12/27/2014	7.1%
			Average	**10.5%**
Asian Currencies				
South Korean Won	1024.16	1089.71	2/4/2014	6.0%
Philippine Peso	43.78	45.485	2/4/2014	3.7%
Malaysian Ringgit	3.2335	3.3511	2/4/2014	3.5%
Singapore Dollar	1.2514	1.283	1/23/2014	2.5%
Thai Baht	32.5	33.148	1/6/2014	2.0%
Taiwan Dollar	30.163	30.636	3/21/2014	1.5%
Chinese Yuan	6.2334	6.2674	4/30/2014	0.5%
			Average	**2.8%**

Source: Bloomberg, Wealth Securities Research

Positive political development in India is good for the Philippines

The election victory of pro-business Narendra Modi in India extended the rupee's rally to an 11-month high. The rupee closed at 58.7825 against the US dollar on Friday, up 14.6 percent from its all-time low of 68.845

against the US dollar registered in August 2013.

In Philequity's past articles, we underscored our worries on the possible loss of competitiveness of our BPOs to their Indian counterparts given the sizeable appreciation of the peso against the rupee in recent years (see *Too Much of a Good Thing*, July 9, 2012 and *Is the Peso Too Strong?*, Dec. 31, 2012). Hence, Modi's win and the strong recovery of the rupee is a welcome development for the Philippines.

BSP's wider policy arsenal

Lessons learned from the global financial crisis led the BSP to be more creative in its policy responses. The BSP now employs macroprudential measures together with traditional monetary policy to attain its price stability and financial stability objectives. The advantage of using macroprudential measures is that they are targeted and calibrated so that unintended consequences to other sectors of the economy are minimized. For instance, the recent hike in reserve requirements was intended to guard against potential price pressures that could arise from continued strong liquidity and credit conditions while avoiding raising policy rates that could threaten the country's economic growth trajectory.

In addition to monetary policy and macroprudential measures, the BSP also employs other unconventional tools such as verbal intervention and "friendly persuasion" on the banks and major players to pursue their objectives.

Don't fight the BSP

Naysayers continue to eat humble pie. When the peso-dollar rate was at 40.50, many analysts were saying it would reach 37 to 38 but were proven wrong. When the rate hit 45, many were saying it would hit 48 but were again wrong.

The BSP knows exactly what it is doing. Just like an NBA team with a commanding 3-1 lead in the playoffs or a boxer leading all scorecards after 11 rounds, the BSP is firmly in control. So, don't fight the BSP.

While the BSP remains market-oriented in its foreign exchange policy, it is always ready to exercise its mandate to smooth out excesses in exchange rate movements. Over the years, this policy has served the economy well. Keeping exchange rate movements market determined, but within reasonable bounds by curtailing excessive speculative moves, has helped businesses plan better.

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