

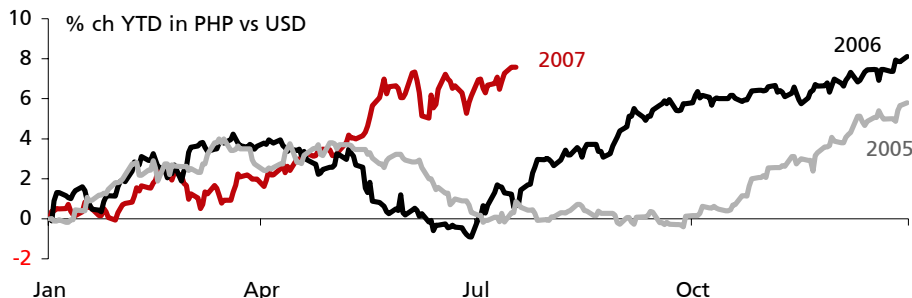
## USD/PHP outlook

Market		3Q07	4Q07	1Q08	2Q08	3Q08	4Q08
DBS New	45.27	45.0	44.5	44.0	43.5	43.0	42.5
DBS Old	--	46.0	45.5	45.0	44.5	44.0	43.0
NDF Fwd	--	45.2	45.1	45.0	44.9	44.9	44.9
Consensus	--	45.7	45.0	44.9	44.8	44.9	45.0

## We have upgraded our forecast for the Philippine peso

Despite worries about fiscal slippages in 2007, the Philippine peso continues to surprise on the upside, thanks to a positive balance of payments and capital inflows. To reflect the improved sentiment, we have strengthened our peso forecast for the next 18 months by 2.2-2.4%. USD/PHP is now expected to close this year at 44.5 instead of 45.5 previously, and to end the year 2008 at 42.5 instead of 43.0 previously.

### PHP did not depreciate in 2Q in 2007 as seen in previous years



Source: Reuters, DBS Research

The resilience of the Philippine peso was best demonstrated in 2Q07. Unlike 2005 and 2006, the peso did not return its gains in the second quarter. Instead, the peso broke out of its two-month consolidation between 45.65 and 46.65 on Jul 16, to a seven-year high at 44.95 on Jul 17. It has since bounced back to 45.27 on Jul 18.

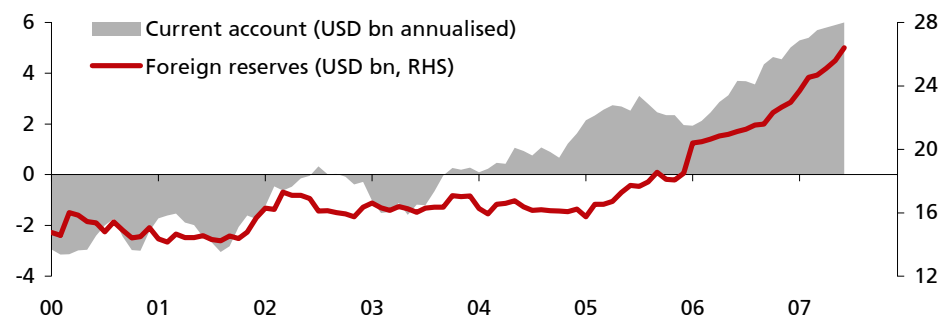
## Balancing fiscal slippages with robust current account surplus

In the first half of 2007, the budget deficit widened to PHP41.0bn vs the programmed target of PHP31.3bn. This was attributed to poor tax collections which have already resulted in the resignation of the commissioner of the Bureau of Internal Revenue last month. The Finance Department indicated that it will not cut spending, but turn to privatisation proceeds to meet this year's planned target of PHP63bn.

Fitch estimates that the full-year shortfall for 2007 may widen to PHP119bn if the asset sales fail. Moody's indicated that it would not upgrade the country's sovereign ratings unless fiscal consolidation is back on track. The World Bank is concerned that the slippage may result in the country backtracking on fiscal reforms.

In contrast to ratings agencies and international organisations, the market is taking the fiscal slippage news in stride. If the missed budget deficit targets had happened a few years ago, it would have surely hurt Philippine assets and its currency because of a current account deficit and flat foreign reserves.

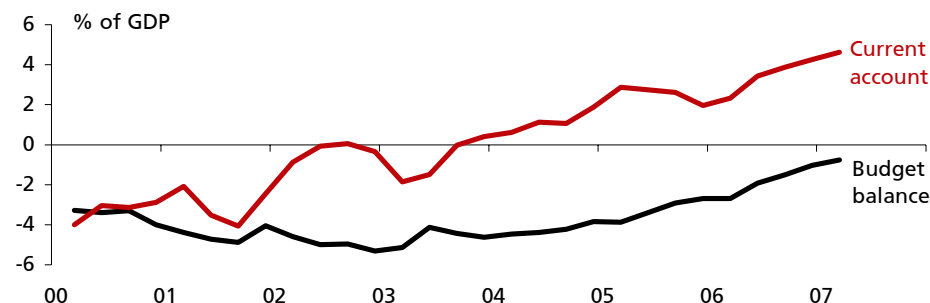
**International liquidity position improves**



Sources: CEIC, DBS Research

Since 2003, the current account balance has reversed from a deficit into a surplus position, thanks mainly to robust overseas foreign worker (OFW) remittances. In turn, this has set the stage for foreign reserves to accumulate rapidly from 2005 after years of stagnation.

**Current account surplus overwhelms budget deficit**



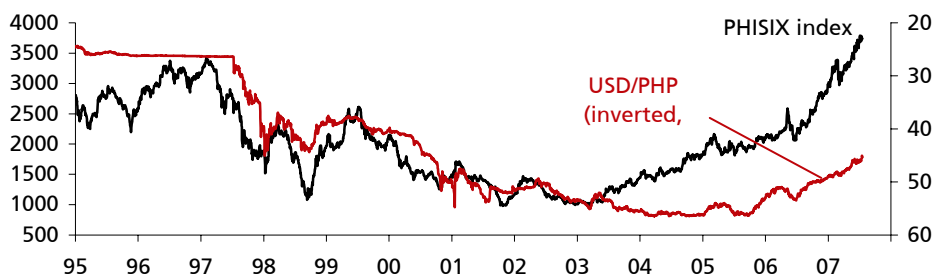
Sources: CEIC, DBS Research

Even if the full-year budget deficit misses this year's programmed target of PHP63bn, and widens to PHP100-120bn (1-2% of GDP) in 2007, this will be more than offset by the current account surplus, which stood at 4.6% of GDP in 1Q07.

**Peso is buoyant on record high equities**

Under the circumstances, the market is likely to be more tolerant with the government using privatisation proceeds to meet the tax shortfall. Moreover, given the disappointing privatisation efforts in recent years, success here should be taken as an affirmation of the positive investor sentiment currently fuelling Philippine stocks to record highs. In fact, the peso has been rallying since May 18, when the benchmark PHISIX stock market index rose on strong inflow to above its pre-Asian crisis high of 3447.60 seen in Feb 1997. Net foreign purchases of Philippine equities increased for the fourth straight quarter to a new record high of PHP37.2bn in 2Q07.

**Philippine peso has been rallying with record high stocks**



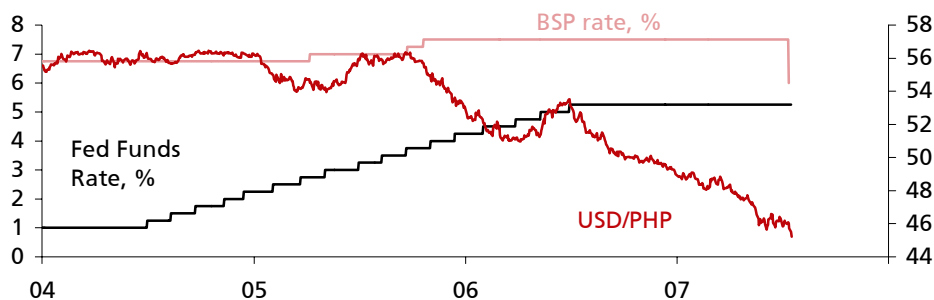
Sources: Bloomberg, DBS Research

**Monetary policy actions underline peso strength**

Interestingly, one of the most telling signs of the peso’s underlying strength comes from Bangko Sentral ng Pilipinas (BSP) itself. At its latest meeting on Jul 12, the central bank chopped 150 off its reverse repo rate to 6.00%. This is a significant move for the following reasons.

Until recently, one of the BSP’s main preoccupation was to ensure a stable peso and to protect the currency from the country’s volatile politics. One of the important ways it achieves this is by maintaining a healthy spread between its policy rate and its US counterpart. That was why it introduced a tiering system to allow it the flexibility to ease monetary policy without lowering the benchmark policy rate.

**BSP resorts to aggressively narrowing rate gap with US to curb peso strength**



Sources: Bloomberg, DBS Research

The central bank first realised in May that to ensure a stable peso, its job is no longer to prevent depreciation, but to slow appreciation from forex inflows, where excess liquidity had started to pose a challenge to monetary policy. That was why BSP on May 10 introduced three liquidity measures to pre-empt potential inflationary pressures from rapid liquidity growth.

Recognising that the peso has also been strong since US rate hikes stopped in Jun 2006, with the market looking for the next move in US rates to be a cut, the BSP scrapped the tiering system at its Jul 12 meeting and narrowed the BSP-Fed policy differential to 75bps. Moreover, the aggressive rate cut is also considered a less costly measure to curb currency strength in light of the preliminary net loss of almost PHP20bn incurred by the BSP from forex losses in the first five months.

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