Eli M Remolona: Inflation dynamics as influenced by the peso-dollar exchange rate

Speech by Mr Eli M Remolona, Jr, Governor of Bangko Sentral ng Pilipinas (BSP, the central bank of the Philippines), at the EJAP (Economic Journalists Association of the Philippines)-San Miguel Corp. Economic Forum, Manila, 8 July 2024.

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Introduction

[Secretary] Frederick Go, Secretary Ralph [Recto], Secretary Arsi (Arsenio Balisacan), Vice-President Cecile [Ang], Usec (Undersecretary) Jojit (Joselito Basilio), [National] Treasurer Sharon [Almanza], members of EJAP (Economic Journalists Association of the Philippines), and fellow public servants, magandang umaga po.

The job of the BSP (Bangko Sentral ng Pilipinas) is to provide a stable environment for the growth of investments in the economy. And so, today, I just want to make three points about what the BSP is doing in that regard.

First, I want to talk about the dynamics of inflation when inflation is driven by supply shocks, to help understand better what the BSP is trying to do. Second, I want to talk about the dollar peso exchange rate and why it is moving the way it does. And third, I want to talk about the implications of that for inflation.

Inflation dynamics

So, if you look at the picture, it depicts what happens to our inflation rate when inflation is driven by the supply side. Here, we break down the different components of our CPI (consumer price index) into the components that contribute to inflation.

If you look at the graph in the beginning, in the early part of 2022, it was mainly energy (yellow part of the bar) and then it shifted to food. Today, it has shifted to the red part of the bar. That is the price of rice.

And one thing you will notice is the roles of the different components of the CPI change over time. That is the nature of a supply-driven inflation. If it were demand-driven, it could be more even across the different components of inflation.

This is why we think the non-monetary measures that the government has put in place, especially EO (Executive Order) 62 are so helpful, because that will help us get to where we want to go, which is stable prices. By stable prices we mean inflation that is somewhere between 2.0 (percent) and 4.0 percent.

Smooth fluctuation

Now, how about the peso? These are the changes in the exchange rate since the beginning of the year. And you can see that the peso is in good company. You can see that the peso relative to our peers has been somewhat stronger. It depreciated, as it weakened against the dollar, but so have most of the currencies. And you can see that the peso is even stronger than the Swiss franc since the beginning of the year. The Swiss franc used to be a safe haven currency. While it is weaker than the Malaysian ringgit, and the Vietnamese dong, it is much stronger than the Indonesian rupiah, the New Taiwan dollar, the Thai baht, the South Korean won, and the Japanese yen.

And why is this? The strength of the dollar has been because the dollar has become the single most important safe-haven currency. When there are tensions, uncertainties around the world, it makes the dollar stronger. In fact, even when the uncertainty is in the US (United States), it makes the dollar stronger. In recent months, it has been about the messaging from the FOMC (Federal Open Market Committee) of the Fed. The Fed has been saying it is going to be high for longer, and that has weakened most of the other currencies against the US dollar.

But so, what? What happens when the dollar gets stronger, or the peso gets weaker is that some inflation comes in because our imports are all mostly invoiced in US dollars. If you look at the chart on the left, you have two bars. The one on the left is about what the effect of peso depreciation is on inflation. It was strong during the period before the shift to inflation targeting in 2002. Today, we are reaping the benefits of that shift because (as the second bar shows) the effect of the depreciation of the peso on inflation has become weaker.

What does that mean in terms of inflation today? If you look at the chart on the right, the red line is what the inflation rate has been. And then the broken blue line, is what inflation would have been had the peso not weakened against the dollar.

The difference is actually very modest. The difference between the red and the blue as of today is about 0.366. It is about a tenth of our inflation rate. So, *kayang-kaya.*

What we worry about is when the peso depreciates too sharply. We do not want too much volatility in the peso. We want the peso to move based on fundamentals. Too much volatility is bad for trade, for both imports and exports. So, we want to make the movement of the peso smoother, but we expect the peso to move according to fundamentals. So, those are the three points.

Last mile

Let me say that we are now in what we call the last mile. The last mile is the point [when] you are trying to be very careful in balancing supply and demand. When inflation is high, that means demand is too strong. Demand exceeds our capacity.

So, what we are trying to do is strike the balance between supply and demand so that we end up with stable prices. We are almost there. But we have to be more careful because there is a risk we might overdo it. There is a risk that might cause a lot of unnecessary loss of output.

Maraming salamat at mabuhay kayo.