Recent Issues in the Management of Macroeconomic Policies in the Philippines

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Introduction

The Philippines has managed to avoid the severe fallout from the regional financial crisis partly because it has barely recovered from the past spending and investment binge and banking crisis of the 1970s and 1980s. The short-term stabilization program and long-term economy-wide reform initiated by the Aquino administration (1986–1991) have begun to bear fruit. Trade, investment, and financial sector policy reform and the privatization program (more vigorously implemented during the administration of President Fidel V. Ramos who came to office in May 1992) have revived private sector investment because the reforms have significantly cut the costs of doing business and raised productivity and efficiency. The new public and private sector investment helped ease the infrastructure constraints in the economy, including the power crisis during 1992–1993. This and the restoration of peace and order and political stability have improved the investment climate.[1] The significant reduction of resources required for security purposes raised their availability for economic development. As a result, the economy has been growing back to a respectable level in terms of gross domestic product (GDP), averaging at 4.2 percent per annum between 1992 and 1996. Inflation rates were suppressed from the double-digit levels of 1981–1991 to single-digit levels from 1992 to 1997. After having been in deficit continuously for two decades, the cash position of the national Government has been in surplus since 1994. In nominal dollar values, exports grew by 21 percent annually between 1992 and 1997.

The completion of the full liberalization of foreign exchange in 1992, combined with those encouraging developments, has increased capital inflows to the country to finance its wide current account deficit. The current account deficit, as a percentage of GDP, rose sharply from 1.6 percent in 1992 to 5.5 percent in 1993 and stabilized at around 4.5 percent per annum from 1994 to 1997. Prior to the economy-wide liberalization, the access of the private sector to international capital markets was relatively limited. The access became greater as the country was graduated from the International Monetary Fund (IMF) Standby Arrangement in March 1993 and with the conclusion of the Paris Club rescheduling negotiations in 1994. To boost public confidence, including that of international investors, the Philippines, however, chose to voluntarily sign up on 11 March 1998 for a two-year IMF Extended Fund Facility that will give access to $1.37 billion in case of emergencies. At the same time, the compulsory regular consultations with the IMF and other multilateral financial institutions help shape the policies and improve coordination among Government bureaucracy who draw and implement the policies. The favorable market response to the issue of Samurai bonds in July 1996 and the Brady Exchange Program in September later that year signified significant improvements in the international creditworthiness of the Philippines.

Having recovered from a serious banking crisis in the 1980s, the banking system in the Philippines is in a better shape compared with, say, those in Indonesia and Thailand. To enhance the credibility of the monetary authority and improve the effectiveness of the monetary policy, the Philippines undertook a reform of the financial system between 1986 and 1993. The authorities toughened up prudential rules and regulations, which include capital adequacy and provisions for loan loss or doubtful accounts, compliance with the minimum risk-asset ratio, legal lending limits, and interlocking directorship (Lamberte and Llanto 1995, Paderanga Jr. 1996, and Intal and Llanto 1998).

The reform includes major restructuring and rehabilitation of the central bank, a number of State-owned financial institutions, and the deposit insurance corporation. To replace the old bankrupt Central Bank of the Philippines (CBP), a better organized and well-funded brand new central bank, *Bangko Sentral ng Pilipinas* (BSP), was established in 1993 (Republic Act No. 7653). Restructuring included transfer of the foreign liabilities of CBP

to the National Government and capital increase. Between 1986 and 1990, the CBP suffered from heavy losses as a result of successive currency devaluation, swap, forward cover and open market operations, and granting of emergency loans to distressed financial institutions. The collapsed State-owned banks, namely, Philippine National Bank (PNB) and Development Bank of the Philippines (DBP), were fully rehabilitated in 1986 by transferring their nonperforming assets to the National Government.[2] Established in 1916, PNB is the principal depository of Government funds. The reduction of political intrusion in the financial system significantly decreases the chronic moral hazard behavior and principal-agent problems in this system.

Economic Growth, Structural Changes, Employment, and Inflation

After a decade of economy-wide structural reforms, resolution of the power crisis during 1992–1993, and improvements in political life and security, the economy of the Philippines began to recover in 1994. Since then, it has been growing at a rapid pace. Real gross national product (GNP) rose by an annual average of 5.9 percent and real GDP by 5.2 percent from 1994 to 1997 (Table 1). Because of the positive net factor income from abroad, mainly workers' remittances, both the level and rate of growth of the GNP of the Philippines are higher than that of the GDP.[3] These rates of growth of national income are well above the average annual rate of population growth of 2.3 percent per annum, thus allowing an average annual increase in per capita income of around 2.7 percent.

Aggregate Demand and Sectoral Growth Rates

Unlike in the past two decades, growth in the 1990s has been driven by increased levels of private sector investment, high export growth, and decreased role of the public sector in the economy. Over one fifth of the annual GNP of the Philippines is now plowed back into physical investment. However, the buoyant accumulation of capital goods during the first half

Table 1: Share and Rate of Growth—Real Gross National Product by Industrial Origin (percent)

	Share[a]		Rate of Growth							
Item	1985	1995	1990	1991	1992	1993	1994	1995	1996	1997
Gross National Product (GNP)	**100.0**	**100.0**	**4.8**	**0.5**	**1.6**	**2.1**	**5.3**	**5.0**	**6.9**	**5.8**
Gross Domestic Product (GDP)	**103.8**	**97.3**	**3.0**	**(0.6)**	**0.3**	**2.1**	**4.4**	**4.8**	**5.7**	**5.1**
Agriculture, Forestry, and Fishery	25.5	20.9	0.5	1.4	0.4	2.1	2.6	0.8	3.1	2.8
Industry Sector	36.5	34.5	2.6	(2.7)	(0.5)	1.6	5.8	7.0	6.3	5.7
Mining and Quarrying	2.2	1.3	(2.6)	(2.9)	6.7	0.7	(7.0)	(0.8)	(1.5)	(3.2)
Manufacturing	26.1	24.6	2.7	(0.4)	(1.7)	0.7	5.0	6.8	5.6	4.0
Construction	5.3	5.4	4.9	(15.7)	2.8	5.7	8.9	6.5	10.9	16.3
Electricity, Gas and Water Supply	2.9	3.2	(0.7)	4.7	0.7	2.9	13.9	13.0	7.5	4.1
Services Sector	41.8	41.9	4.9	0.2	1.0	2.5	4.2	5.0	6.5	5.6
Transportation, Communication, and Storage	5.7	5.7	2.3	0.4	1.4	2.6	4.2	5.8	7.4	7.9
Trade	15.0	15.0	4.6	0.5	1.6	2.5	4.0	5.6	5.5	4.2
Finance and Housing	8.9	9.4	5.8	(1.1)	0.6	2.0	4.0	4.9	8.3	7.7
Services	12.2	11.8	5.9	0.5	0.4	2.8	4.8	4.1	5.7	4.6
Net Factor Income	(3.7)	2.7	75.3	198.1	237.1	2.5	54.9	12.8	52.2	23.0
Traded Sector[b]	**51.8**	**48.2**	**1.5**	**0.3**	**(0.5)**	**1.4**	**3.5**	**3.8**	**4.3**	**3.3**
Nontraded Sector[c]	**48.1**	**51.8**	**4.6**	**(1.4)**	**1.2**	**2.8**	**5.2**	**5.6**	**7.0**	**6.7**

[a] As percentage of GNP, except for traded and nontraded sectors, which are computed as percentage of GDP.
[b] Comprising agriculture, forestry and fishery; mining; and quarrying; and manufacturing.
[c] Comprising construction; electricity, gas and water supply; and services.
Sources: Bangko Sentral ng Pilipinas (BSP), *1996 Annual Report; Statistical Bulletin.* BSP, 1998. *Selected Philippine Economic Indicators.* February.

of the 1990s was mainly concentrated in the nontraded sector of the economy. This included the much needed investment in durable equipment in energy, transportation, and telecommunication to solve the supply-side constraints. Major power projects of the National Power Corporation (NPC) were completed in 1994 and modernization of water and air transport peaked in 1993–1994. Deregulation of the telecommunications industry has attracted substantial private sector investment and introduced market competition. These increased the number of telephone connections, which more than tripled between 1990 and 1995, and reduced rates. The pace of investment in construction and real estate slowed down with the BSP ruling on 5 June 1997 to cap the growth of bank credit to the real estate sector to no more than 20 percent of a bank's total loan portfolio. Investment in durable equipment grew strongly with the surge in private sector investment, particularly in the manufacturing industry.

The share of the agriculture sector (comprising crops, poultry and livestock, fishery, and forestry) in GNP slightly dropped from 25.5 percent in 1985 to 20.9 percent in 1995. During the same period, the contribution of the industry sector was relatively stagnant at around 35 percent. Similarly, the share of services in GNP was also stable at 42 percent. Manufacturing was the most important segment of the industry sector, contributing about 25 percent to the annual GNP in 1985 and 1995. The construction industry produced 5.4 percent while other industries (mining and quarrying and public utilities) generated 4.5 percent of GNP in 1995. The contribution of mining and quarrying to annual GNP sharply dropped from 2.2 percent in 1985 to 1.3 percent in 1995. In the service sector, trade was the biggest generator of GNP in 1995 (with 15 percent share), followed by services (11.8 percent); finance and housing (9.4 percent); and transportation, communication and storage (5.7 percent). As in other developing economies, services include mainly labor-intensive and low-technology activities that produce low value added.

After increasing by an average of 4.6 percent per annum during the height of the green revolution in 1965–1980, the growth rate of agricultural output decelerated to an average of 1.0 percent per annum in the 1980s and early 1990s. During the period 1980–1993, rice, the nation's staple food, grew by 2.9 percent per annum compared with average annual growth rates of the whole agriculture sector at 1.6 percent and of all crops (comprising rice, corn, coconut, sugarcane, banana, and other crops) at 0.8 percent. Other crops include fruits and vegetables, especially nontraditional export crops such as coffee and pineapple. During the same period, poultry and livestock grew by 7.7 percent per annum, and fishery by 1.6 percent. However, the forestry sector recorded a negative growth rate of 30 percent per annum. During this period, sugarcane and banana also registered negative annual growth rates of 3.1 and 0.5 percent, respectively. In 1992, all crops accounted for over 59 percent of agriculture value added, poultry and livestock for 24 percent, fishery for 16 percent, and forestry for 0.8 percent. Rice was the most important commodity in the group of crops as it constituted 16 percent of agriculture value added in 1992.

A number of factors contributed to the stagnation of the agriculture sector until the mid-1980s (Balisacan 1995). The insecurity and political instability slowed down the cultivation of new lands, while the uncertainty concerning the implementation of the Government's Comprehensive Agrarian Reform Program of June 1988 discouraged the flow of private investments into agriculture and encouraged conversion of agricultural lands into nonagricultural uses. The fall of public investment in the agriculture sector (especially on rural roads, irrigation, and research and development and extension services) severely affected production and productivity as well as processing and marketing. Meanwhile, the rise in Government interventions (including price and quantitative controls of agricultural inputs and products that affected domestic production, processing, distribution, and international trade) has acted as explicit and

implicit onerous taxation on agriculture. Moreover, the exhaustion of forest resources because of rapid deforestation in the 1960s and 1970s has decelerated the growth rate of the forestry sector.

Most of the distorted Government interventions in the agriculture sector were phased out starting recently. Moreover, a combination of the restoration of peace and order and political stability allowed the cultivation of new lands while the increase in public investment improved production, processing, and productivity of this sector. However, mainly because of a long drought, agricultural output stagnated in 1995 and grew by only 3.1 percent in 1996. The continuing El Niño reduced the rate of growth of the agriculture sector further down to 2.8 percent in 1997.

The growth rate of the industry sector peaked at 7 percent in 1995, but declined to 6.3 percent in the following year and to 5.7 percent in 1997. The service sector grew by over 6 percent per annum from 1995 to 1997. In the industry sector, construction had the highest growth rate from 1992 to 1997. Partly because of the new investment in public utilities and land-based industries, construction activities rose from 2.8 percent in 1992 to 8.9 percent in 1994 to further 10.9 percent in 1996 and 16.3 percent in 1997. Again, because of the new investment, the rate of growth of the electricity, gas, and water supply subsector peaked in 1994 and 1995 at 13.9 and 13.0 percent, respectively. In the service sector, the transportation, communication, and storage subsector, and the finance and housing subsector grew rapidly at an annual average rate of about 8 percent from 1995 to 1997.

Sectoral Employment

From 1980 to 1994, the working age population, those who are between 15 and 64 years old, grew by about 3 percent per annum. During this period, the labor force increased by 3.4 percent annually, which meant about 650,000 new entrants to the labor force every year. Owing mainly to the increasing rate of female labor force participation, the total labor force participation rate has been rising through time, from about 60 percent in the 1970s to roughly 63 percent in the 1980s and to around 66 percent in the 1990s. The progrowth policies have raised employment rate during the period 1980–1994 to sufficiently absorb new entrants to the labor force. The accumulated labor surplus was partly reduced by the increasing number of overseas contract workers (Esguerra 1995). Nevertheless, the unemployment rate in the Philippines is still relatively high at around 9 percent from 1993 to 1997. The underemployment rate is estimated at 20–23 percent.

The agriculture sector absorbed nearly 46 percent of the labor force in 1993 and 43 percent in 1996 (Table 2). The service sector (comprising wholesale and retail trade, transportation, storage and

Table 2: Distribution of Employment by Major Industry (percent)

Industry	1970	1975	1980	1985	1990	1993	1995	1996
Agriculture, Forestry, and Fishery	53.7	53.5	51.4	49.0	44.9	45.7	43.4	42.6
Mining and Quarrying	0.4	0.4	0.6	0.6	0.6	0.6	0.4	0.4
Manufacturing	11.9	11.4	11.0	9.7	10.1	10.1	10.2	10.0
Electricity, Gas, and Water Supply	0.3	0.3	0.4	0.4	0.4	0.4	0.4	0.4
Construction	3.8	3.1	3.6	3.4	4.4	4.6	5.1	5.6
Wholesale and Retail Trade	7.4	11.2	10.1	13.2	14.2	13.9	14.7	14.8
Transportation, Storage, and Communication	4.4	3.4	4.4	4.7	4.9	5.3	5.8	6.0
Financing, Insurance, Real Estate, and Business Services	na	na	2.0	1.7	2.0	2.1	2.1	2.3
Community, Social, and Personal Services	16.4	16.4	16.4	17.2	18.5	17.4	17.9	17.9
Industry not Adequately Defined or Reported	1.6	0.3	0.0	na	0.1	0.1	0.0	0.0

na = not available.
Sources: Reyes, Milan and Sanchez (1989) for 1970, 1975, 1980, and 1985; Bureau of Labor and Employment Statistics (BLES), *Current Labor Statistics*, for 1990 and 1993; National Statistical Coordination Board, *1997 Philippine Statistical Yearbook*, for 1995 and 1996.

communication, financial sector, community, social and personal services, and business services), which employed 38.7 percent of the labor force in 1993 and 41.0 percent in 1996, has been the main recipient of the labor force moving out of agriculture. The rapid growth of employment in this sector indicates the fast growth of low-productivity and low-paying jobs in the informal sector of the economy, which mainly produces nontraded goods and services.

The economic reform has been designed to develop an efficient industry sector, increase external competitiveness, and promote employment. Measures to achieve these objectives include creation of a sound macroeconomic environment, modifications in the tariff structure, dismantling of nontariff barriers, removal of the capital bias in the system of investment incentives, and promotion of cottage, small, and medium industries. These policies have changed the structure of the industry sector. But the percentage share of employment absorbed by industry has been hovering between 14 and 16.5 percent since the 1970s. The manufacturing sector provided between 10 and 12 percent of total employment, but its share in more recent years has been lower than in the 1970s.

Owing to their relatively large shares in employment, the agriculture and service sectors exert considerable influence on the overall performance and on the aggregate profile of poverty and income distribution.

Inflation Rates

Price inflation is generated by interactions between domestic and international markets for goods and services, labor markets, and financial (including foreign exchange) market. A combination of stabilization policy to suppress aggregate demand, economywide reforms in all three markets, and real peso appreciation has helped control inflation rate. The reforms in the market for goods and services included the phasing out of price and quantitative controls, adoption of measures to improve domestic market competition, and policies to reduce levels and variance of levies and taxes on domestic trade and exports. The trade policy reforms also liberalized imports and cut the levels and variance of import tariffs. Greater market competition decreased prices further and improved productivity. Prices of imported goods in the local market were reduced by trade liberalization, tariff cuts, and real peso appreciation.

Table 3: Consumer Price Index (CPI) and Inflation Rate

Item	1990	1991	1992	1993	1994	1995	1996	1997
				CPI (1988 = 100)				
All Items	128.1	152.0	165.6	178.2	194.3	210.0	227.7	239.2
Food and Beverages	127.6	147.2	157.3	166.9	180.7	197.9	217.4	221.6
Clothing	120.3	140.6	155.7	167.3	175.3	181.2	187.6	194.7
Housing and Repair	132.8	159.6	187.6	211.3	238.9	264.4	289.6	317.8
Fuel, Light, and Water	136.0	173.3	183.7	197.1	210.7	217.0	231.3	252.0
Services	129.3	171.4	183.6	198.0	215.5	229.4	251.3	284.5
Miscellaneous	120.5	140.0	158.2	171.5	190.3	192.1	184.7	188.4
				Inflation rate (%)				
All Items	14.2	18.7	8.9	7.6	9.0	8.1	8.4	5.1
Food and Beverages	11.9	15.4	6.9	6.1	8.3	9.5	9.9	1.9
Clothing	10.0	16.9	10.7	7.5	4.8	3.4	3.5	3.8
Housing and Repair	16.9	20.2	17.5	12.6	13.1	10.7	9.5	9.7
Fuel, Light and Water	23.7	27.4	6.0	7.3	6.9	3.0	6.6	8.9
Services	22.0	32.6	7.1	7.8	8.8	6.5	9.5	13.2
Miscellaneous	11.7	16.2	13.0	8.4	11.0	0.9	(3.9)	2.0

Source: BSP. 1998. Selected Philippine Economic Indicators. February.

The inflation rate has been suppressed from nearly 19 percent in 1991 to around 9 percent in 1992 and it has remained at a single digit thereafter (Table 3). The decline in the inflation rate of food and beverages and clothing has been due mainly to import liberalization. In the housing and repair sector, new construction of housing and commercial buildings relaxed the supply constraint and slowed the increase in rents. Moreover, new investment in public utilities also mitigated price increases in this sector.

Domestic Savings and the Financial Sector

Volatile economic conditions, political instability, and security problems have dampened public confidence, and restrained savings and investment and growth of the financial industry in the Philippines.

Domestic Savings

The aggregate savings ratio in this country, ranging between 16 and 20 percent of annual GDP during 1990–1996, was not only low by Asian (Association of Southeast Asian Nations [ASEAN] and East Asian) standard, but each sector of the economy—households, corporations, and the Government—saved considerably less than its counterpart in this region.[4] Considering that the gross national investment was between 20 and 24 percent of annual GDP, the resource gap in the Philippines hovered between 1 to 4 percent of annual GDP during 1990–1996. To narrow the gap, the Philippines, in recent years, has started to catch up with its neighbors by maintaining sound and stable macroeconomic management and introducing a number of policies to increase domestic savings. These included measures to control the inflation rate, raise positive real interest rate, and policies to promote a fast growth rate of household incomes as well as to affect the age and employment structures of the population by reducing the dependency ratio through a family planning program.

Government employees in the Philippines are required to participate in the Government Service Insurance System (GSIS) while private employees are encouraged to become members of the Social Security System (SSS). Both agencies are modeled after the Employment Provident Fund (EPF) in Singapore and Malaysia.

The corporate sector has been a net borrower in the Philippines. The relatively high savings rates of this sector are partly explained by the past repressive financial policies and industrialization strategies. The authorities in the Philippines, like their counterparts in other Asian countries, accepted the view that highly diversified private conglomerates and State-owned enterprises are to be the main instruments for the rapid industrialization process. Thus, the Government strengthened State-owned companies and supported private business by directing entry and exit of firms, and providing subsidized credit and other funds from State-owned institutions. Industrialization strategies included high rates of protection from imports, and special access to locally produced inputs and to Government procurements. A close relationship grew between the Government and these enterprises. The result is a long history and extensive record of State interventions, inward-looking trade and investment regimes, financial repression, patrimonialism, and cronyism.

For the first time after two decades of continued deficit, the cash position of the central Government recorded a surplus of nearly 1 percent of GDP in 1994. The consolidated public sector financial position improved significantly in the 1990s, from a deficit of close to 5 percent of GDP to a small surplus in 1996. The improvements, however, have been due partly to large receipts from the privatization of State-owned enterprises, particularly in 1994 and 1995. To generate a Government budget surplus in 1997, State-owned enterprises were required to remit a $210 million dividend due in 1998. Selling public sector assets is of course not a sustainable source of Government revenues, and the advance payments

distorted the fiscal picture. To raise sustainable revenues from internal taxes, the Government implemented the expanded value-added tax (VAT) in January 1996 and passed the Comprehensive Tax Reform Program in December 1997. Tax efforts and revenue collections are expected to increase with the program to strengthen tax administration. On the expenditure side, the Government reduces nondebt and nonpersonnel expenditures by, among others, decreasing the demand for public investment through privatization of State-owned enterprises. To make up for the reduction of public sector investment in public utilities, the Government attracts private sector investment through the build-operate-transfer (BOT) scheme. The surplus in the public budget helps control domestic aggregate demand, stabilizes public debt levels, and controls and reduces real interest rates.

Financial Sector Developments

STRUCTURE OF THE FINANCIAL SYSTEM

As in many other developing countries, in terms of total assets and number of offices, the banking system is the core of the financial system in the Philippines (Table 4). As of March 1998, there were 51 banks in the Philippines: 18 domestic expanded commercial banks (EKBs), 15 domestic commercial banks (KBs), 17 branch offices of foreign banks, and 1 land bank.[5] The list excludes DBP and also the Al-Amanah Islamic Investment Bank of the Philippines, which operates based on risk-sharing according to *Shariah* or Islamic laws. Both the EKBs and KBs are allowed to deal in foreign exchange transactions, but only the EKBs are licensed to exercise the authority of an investment house. Operating licenses for 10 of these banks were issued between October 1994 and December 1997.

The gradual financial sector reform, which started in 1980, has enhanced competition in the banking system through many avenues: first, the relaxation of barriers to new entrants to the banking industry rapidly increased the number of banks and their branches. Some of these were foreign institutions as

Table 4: Structure of the Financial System and Share in Assets, 1990–1997

Financial Institution	Number of Offices								Share in Assets (%)					Asset Growth (%)				
	1990	1991	1992	1993	1994	1995	1996	1997[a]	1992	1993	1994	1995	1996	1993	1994	1995	1996	1997[a]
Central Bank	1	1	1	1	1	1	1	1	35.0	27.6	22.6	19.6	19.0	(11.6)	(7.4)	4.6	23.3	na
Commercial Banks[b]	1,863	1,989	2,361	2,604	2,924	3,221	3,647	3,890	41.3	46.0	49.8	52.7	57.6	25.1	22.5	27.3	39.2	24.1
Thrift Banks	653	663	718	780	821	925	1,171	1,386	3.6	4.0	5.0	5.6	5.7	23.9	43.0	34.3	29.2	19.2
Savings Banks	270	285	316	334	347	367	426	500	2.2	2.4	3.3	3.5	3.0	22.1	54.7	27.6	11.9	14.3
Private Dev. Banks	211	202	218	250	265	310	432	547	1.0	1.2	1.3	1.7	2.1	30.6	28.4	48.8	58.5	29.0
SSLA[c]	172	176	184	196	209	248	313	339	0.4	0.4	0.4	0.5	0.6	16.9	17.1	40.4	52.0	10.0
Specialized Banks[d]	76	76	77	77	77	77	na	na		2.5	3.1	2.8	2.7	0.0	36.7	4.9	13.3	na
Rural Banks	1,045	1,063	1,140	11,195	1,274	1,346	1,514	1,650	1.1	1.2	1.3	1.4	1.5	22.0	24.2	29.8	31.1	12.1
NonBanks	3,849	4,069	4,613	5,282	5,977	6,871	9,161	9,913	16.5	18.1	18.4	17.9	16.3	23.5	15.1	16.7	16.1	4.7
Total	**7,487**	**7,861**	**8,910**	**19,939**	**11,074**	**12,441**	**15,494**	**16,840**	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**	**25.0**	**21.1**	**24.7**	**28.6**	**na**

na = not available.
a Preliminary data as of September 1997.
b Includes Land Bank of the Philippines, Development Bank of the Philippines starting February 1996, and Al-Amanah Islamic Investment Bank of the Philippines starting June 1996.
c SSLA = Stock Savings and Loans Associations.
d Consolidated with commercial banks in 1996.
Source: BSP. 1998. Selected Philippine Economic Indicators, February.

the reform allowed greater penetration of the domestic market by foreign banks. Second, the removal of the traditional functional specialization of financial institutions raised competition between banks and nonbank financial institutions (NBFIs) on both asset and liability sides of their balance sheets. Third, liberalization of the capital account permitted creditworthy companies to raise funds in international markets. This also created market segmentation as only the less reputable and probably more risky debtors borrow from the domestic banks.

Banks are the main external source of corporate financing. They mainly provide short-term loans backed up by collateral. Too much dependence on bank credit and, to some extent, on bonds, for funding makes the corporate sector in the Philippines heavily indebted. The other sources of corporate financing in the country include tax evasion and profits generated internally from various forms of economic rents.

DEVELOPMENT FUNCTION

Traditionally, banks and NBFIs in the Philippines borrow short and lend long at a high debt/equity ratio. During the past financial repression, the State-owned DBP provided medium-term and long-term credit programs with subsidized interest rates and low risks that can be easily rolled over. Following the financial sector reform, banks and finance companies turned to short-term, foreign currency-denominated borrowing in the interbank market or foreign currency deposit units (FCDUs) to fund long-term bank loans or investment projects. A significant portion of loans provided by banks and finance companies has been given to finance the real estate sector and consumer credit. Because of a combination of poor auditing and reporting, and cross guarantees within groups of companies, there is no reliable information on the levels of debt/equity ratio of the corporate sector in this country.

It should be noted, however, that the banking sector reform has not eliminated Government-directed lending. At present, a bank is required to channel at least 25 percent of its credit to agriculture, including agrarian reform. Between 1992 and 1995, 10 percent of total bank loan portfolio was given to small-scale firms. This was reduced to 5 percent in December 1996 and down to zero by the end of 1997. To decrease the banks' vulnerability, in April 1997, BSP set a 20 percent ceiling on banks' loan exposure to the property sector, including loans to real-estate builders and home buyers. Banks with exposure higher than the limit were given one year to comply with the rules. In addition, when property is used as collateral for a loan, banks are not allowed to lend more than 60 percent of the appraised value of that property. Prior to this, banks were generally prohibited from lending on a secured basis amounts exceeding 70 percent of the appraised value of land and buildings, and 60 percent of the appraised value of unimproved land.

PRUDENTIAL RULES AND REGULATIONS

The Philippines has not formally adopted the minimum standard of 8 percent risk-based capital-assets ratio as recommended by the 1988 Basle Capital Accord guidelines. However, banks have actually calculated their capital (tier 1 plus tier 2)[6] ratios based on the guidelines. This practice and the rehabilitation of PNB and DBP have strengthened banks' capital relative to the stock of nonperforming loans (NPLs) and resulted in higher than the required capital standard at 10 percent of on-balance-sheet risks as set by BSP. In 1989, the mandated minimum capital requirements for EKBs and KBs were raised to P1 billion and to P500 million, respectively. Effective November 1996, the capital requirements for EKBs and KBs were increased to P4.5 billion and P2.0 billion, correspondingly.

Banks in the Philippines are required to build adequate loan-loss provisions to complement capital in providing a safeguard against risks and potential losses. To calculate these, BSP classifies bank loans into five categories, namely: pass (secured loans with

no interest arrears and no reduction in principal); special mention (secured loans with interest arrears that do not exceed three months, without reduction in capital); substandard; doubtful; and loss. For substandard loans (secured loans with interest arrears that do not exceed six months without reduction in principal) banks are required to build provisions amounting to 25 percent of the unsecured portion. Doubtful loans (secured substandard for 12 months without at least a 20 percent repayment) need an extra minimum reserve requirement of 50 percent of the amount of the loan. For loss loans (secured loans classified as doubtful for 12 months) banks are required to build additional reserve amounting to 100 percent of the loans. The ratio of NPLs to total loans of the banking system was reduced markedly from 7.9 percent in 1990 to 5.3 percent in 1993 to 4 percent in 1995, but slightly increased to 4.7 percent in September 1997 (Table 5).

When domestic interest rates are high, there is a strong temptation for banks and their customers to denominate debt in foreign currency. The Government's commitment to stabilize the peso makes the risk of exchange loss appear small. Partly because of this, a large portion of the external debt is unhedged. This situation not only makes banks and their cus-

Table 5: Loans Outstanding of Commercial Banks, Classified by Economic Activity[a], 1990–1997

Item	1990	1991	1992	1993	1994	1995	1996	1997
Total Loans (in P billion)	**240.3**	**264.1**	**327.4**	**431.8**	**542.8**	**737.3**	**1,120.3**	**1,416.8**
				Share in total loans (%)				
Agriculture, Fishery, A41 and Forestry	11.2	13.3	11.8	10.7	9.2	8.1	5.7	5.0
Mining and Quarrying	2.6	2.1	2.1	2.5	1.0	1.2	0.9	1.1
Manufacturing	38.5	34.0	34.4	33.1	34.9	34.4	32.3	29.9
Electricity, Gas, and Water	1.3	1.3	1.2	2.4	2.4	2.2	2.8	3.0
Construction	2.7	2.6	2.5	3.2	3.3	3.4	3.9	3.6
Wholesale and Trade	14.5	16.8	16.3	15.7	17.5	17.7	16.1	16.3
Transportation, Storage, and Communication	3.8	3.4	3.4	3.9	4.8	6.1	6.1	7.1
Financial Inst., Real Estate, Business Services	16.9	18.3	20.1	16.7	18.3	16.8	21.8	24.6
Community, Social and Personal Services	8.6	8.1	8.2	11.7	8.5	10.2	10.5	9.3
Total	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**
				Annual growth rate (%)				
Agriculture, Fishery and Forestry		30.6	10.1	19.1	8.1	19.6	6.4	11.5
Mining and Quarrying		(10.5)	23.2	56.9	(48.1)	55.9	9.4	70.3
Manufacturing		(3.0)	25.6	26.9	32.5	33.9	42.5	17.3
Electricity, Gas, and Water		10.6	15.4	159.5	25.7	24.7	90.6	34.0
Construction		8.8	18.5	65.3	32.3	37.4	74.2	19.6
Wholesale and Trade		27.7	19.9	27.8	39.9	37.3	38.1	28.0
Transportation, Storage, and Communication		0.5	21.9	52.8	53.8	72.0	53.3	47.7
Financial Inst., Real Estate, Business Services		19.2	36.1	10.1	37.4	24.8	97.2	42.6
Community, Social, and Personal Services		3.4	25.4	88.4	(8.7)	61.8	57.6	11.4
Total		**9.9**	**24.0**	**31.9**	**25.7**	**35.8**	**51.9**	**26.5**
Memo Items				Percent[b]				
Loan to Deposits Ratio	96.8	87.6	96.6	99.1	101.9	111.6	131.7	132.8
LGR Minus GDPGR[c]	8.6	(9.6)	17.9	24.0	15.7	24.6	32.2	17.3
NFL to TBL[d]	(10.0)	(10.7)	(7.9)	(7.6)	(4.1)	0.0	10.8	12.9
Nonperforming Loans[e]	7.9	7.3	6.8	5.3	4.7	4.0	3.5	4.746[f]
M2 Multiplier	3.2	3.2	3.2	3.4	4.0	4.3	4.6	5.4
M2/Forex Reserves	1,417.9	497.5	442.5	479.7	526.2	574.6	448.6	513.6

[a] Peso and foreign accounts but excluding transactions of local banks' foreign offices.
[b] Except for M2 multiplier, in terms of ratio.
[c] LGR = loan growth rate. GDPGR = GDP growth rate.
[d] NFL = net foreign liabilities. TBL = total bank liabilities.
[e] As percentage of total loans.
[f] Preliminary data, as of end-September 1997.
Source: BSP. 1998. Selected Philippine Economic Indicators. February.

tomers more vulnerable; it also makes it harder for them to deal with the banking crisis, rise in interest rates, and sharp devaluation of the peso. The latter results in deterioration of banks' and firms' balance sheets because much of their debt is denominated in foreign currencies. The substantial fall of the external value of the peso in relation to foreign currencies rapidly increases the cost of renewing or rolling over the short-term floating rate of foreign borrowings in real terms. The indebtedness of domestic banks and firms rises and their net worth falls. This would be the case, for example, if domestic banks extend foreign currency-denominated loans to local borrowers for financing activities in the nontraded sector. The surge in interest rates causes interest payment to increase, resulting in the deterioration of the balance sheets of the banks and their customers.

The risks of maturity mismatches are higher for the unlisted banks, which cannot mobilize long-term sources of funding (by selling bonds, shares, and other types of securities) in stock markets. Selling equity in stock markets can be a way to spread or share the risks. Those who can issue local currency-denominated securities (such as stocks) can transfer the foreign exchange risk to foreign investors. The risks of maturity mismatches are higher as, again, most companies in the Philippines rely excessively on bank loans for financing, with land as the main collateral for credit. The high loans-to-value ratio of banks to companies such as property developers has exposed Philippine banks to sharp declines in real estate prices. This and the plunge in equity prices depress the market value of the collateral and assets of the banks. The liquidity problem becomes serious because there is no securitization of mortgages nor a well-developed secondary market for Government bonds.

The markets for equity and long-term debt instruments are relatively narrow and shallow. On the supply side, the growth of the capital market is partly hindered because of the reluctance of family-owned firms to raise capital by floating equities or debts to finance their expansion. If they are listed in the capital markets, they sell only a portion of the total equity and retain control of the majority shares of the companies. Business conglomerates in the Philippines, as in many other Asian countries, are family owned and controlled. These companies are run by the founding families who take up the top management positions rather than give them to professional managers. The availability of low-cost and risk-free loans during the past financial repression had reduced the incentive for firms to go public. On the demand side, market participants are confined to a limited number of institutional investors made up of large banks, insurance companies, and State-controlled pension funds. Through subsidiaries, the commercial banks in the Philippines are allowed to engage in capital market operations. BSP imposes a single limit of 25 percent of the unimpaired capital. In practice, however, such regulation of the legal lending limit is not well implemented. The latest example of this is the recent collapse of Orient Bank because of overlending to its sister company in the real estate business.

The swift transition to a market-based financial system and open capital account has not been followed by rapid progress in the implementation of prudential rules and regulations. This is partly due to the structural weaknesses in the legal and accounting systems (Intal and Llanto 1998). Moreover, after a long period of financial repression, bank supervisors and managers often lack the experience and skills required to supervise and examine the fast-growing number of banks and rapidly expanding powers of these institutions. The State-owned financial institutions (e.g., PNB, Land Bank of the Philippines, and DBP) suffered from erratic Government policies, such as the shifting of public deposits from these banks to BSP. After a long era of political intrusion under the Marcos regime, there is a principal-agent problem as regulators and supervisors may not be operating in the public interest. Meanwhile, private banks belong to business conglomerates and do not act tough on affiliated companies since they can expect financial assistance from BSP.

At present, there is tax discrimination between income from financial assets and that from real property. A 20 percent final withholding tax on interest income from bank deposits, treasury bills, and other securities is imposed. In contrast, capital gains on property accruing to individuals are subject to a tax of 5 percent of the grossly outdated selling price of the real property in the assessor's schedule. For administrative efficiency, the authorities in 1981 shifted to a secular individual income taxation because of the difficulty of taxing interest income on bank deposits and dividend income on a global basis.

Monetary Policy

Monetary policy has been utilized as the main tool to pursue a short-run stabilization objective in the Philippines. The policy heavily relies on the use of two principal instruments, namely: (i) sterilization intervention in the foreign exchange market, and (ii) change in the mandatory reserve requirement ratio. Other policy tools include transfer of public sector deposits between commercial banks and BSP. In addition, BSP imposes ceilings on both the rate of credit expansion and sectoral allocation of banks' credit. This mix of tight monetary policy, despite greater openness of the financial market and stable nominal exchange rate, has raised domestic interest rates higher than those in international markets. The pressure for higher domestic interest rates has increased further with the shift in Government policy for financing of public sector deficit from foreign sources to issuance of Government securities (treasury bills or T-bills), which overcrowded the domestic financial markets.

External Reserves and Sterilization Operations

Aside from financing a chronic current account deficit, capital inflows to the Philippines have also been used for accumulating foreign exchange reserves. Using the balance of payment identity, this can be written as:

$$K = CA + \Delta R \qquad (1)$$

where: Δ stands for changes, K is capital inflows, CA is current account deficit, and R is foreign exchange reserves.

The Government's commitment to stabilize the peso exchange rate requires the piling up of foreign reserves. In 1997, the country held foreign exchange reserves to cover 2.3 months' imports or 1.2 times of its short-term debt. According to some economic literature (Grilli and Roubini 1992), the need for external reserves increases in line with the rising levels of national income, import and foreign debt, and with closer integration of the national economy with the rest of the world. The latter exposes the economy to external shocks such as terms of trade changes, realignment of major vehicle currencies in international trade, contagious effects of currency crises in other countries, and fluctuations in trade and capital accounts that would cause variability in the balance of payments. Realignment of major currencies since the mid-1980s has encouraged the authorities in the Philippines to diversify the currency composition of its holding of foreign exchange reserves so as to ease the burden of rising imports and external debt repayments. To strengthen or raise external liquidity, BSP has also increased the stock of its standby commercial loans and entered bilateral repurchase agreements with other central banks in the Asia and Pacific region.[7]

In their study on the Indonesian economy, Woo and Nasution (1989) argued that the total stock of the short-term external debt should be counted as part of debt-service due each year. In their view, this more inclusive definition provides a better indicator of the short-term external liquidity of the economy. In a normal case, however, it is unlikely that the creditor would call in all short-term debt at once. Calvo (1994) stresses the need to build external reserve to face financial vulnerability because of financial deepening, particularly the rapid rise in vulnerable dollar-denominated deposits at local com-

mercial banks as shown by the rising ratio of M2/GDP. In a world of fractional reserve banking system and implicit deposit insurance, bank deposits are contingent liabilities of the central bank and the Government.

Nonsterilized capital inflows allow both nominal and real peso appreciation to help reduce domestic interest rates and inflation rates. On the other hand, when capital inflows fell in July 1997, BSP resorted to contractionary monetary policy and sold foreign exchange of about $4 billion to finance the current account deficit and defend the peso. Subsequently, the running down of foreign exchange reserves reduced the monetary base and hence the money supply, and raised domestic interest rates and their differentials with foreign rates. Formally, the identity of the monetary base is

$$\Delta B = \Delta D + \Delta R \qquad (2)$$

where: Δ stands for changes, B is monetary base (currency plus commercial bank reserves at the central bank), D is domestic credit of the central bank (to Government, commercial banks, and business sector), and R, again, is foreign exchange reserves.

Accumulation of external reserves is paid by money created by the central bank. To keep the monetary base constant, the monetary authorities can reduce domestic credit or deposit money banks loans by an equivalent amount. Such operation is called sterilization as the central bank does not allow the accumulation of the external reserves to be carried over to the monetary base and money supply. The operation changes only the balance between the domestic credit component and reserve component of the monetary base, keeping the supply of monetary base or money supply constant. Thus, using identity (2), if a ceiling on ΔB is imposed, then an increase in ΔR is sterilized by decreasing ΔD. ΔD can be reduced if the public sector and commercial banks reduce their borrowings from the central bank or increase their savings deposits in it.

In the early 1980s, CBP issued its own securities, the central bank certificate of indebtedness (CBCI), to reduce the excess liquidity created by the CBP itself as it rescued a number of financially distressed banks and NBFIs. Their problems originated from a combination of events. In 1983 the peso was devalued nearly 30 percent as the country's international reserves went down to an alarmingly low level. In October of that year, the Government declared a moratorium on debt repayment. The problems were compounded by the flight in 1984 of Dewey Dee, a Chinese businessman who was heavily indebted to these financial institutions. All of these, together with the political uncertainty and the coup attempts, caused severe bank runs and capital flight. To accommodate the surge of withdrawal of deposits and capital flight, CBP provided special credit facilities (in peso and foreign exchange) to banks and NBFIs that faced serious liquidity problems.

The CBCI was a flexible instrument for management of short-term liquidity as the central bank itself determines the issuance, auction system, counterparties, maturities, and settlement rules (Chandravarkar 1996). The dual issue of the central bank and Government securities posed problems of coordination, segmentation, and compression in the markets of these two competing financial assets. The heavy use of CBCI to reduce excess liquidity represents the expensive interest costs of the instruments that contributed to CBP losses in the 1980s. The financial losses not only eroded the credibility of CBP but also undermined the effectiveness of monetary policy because of the danger of monetization of the losses.

The increasing use of Government securities as an instrument for management of short-term liquidity began in 1986. The restructuring of the central bank and establishment of Bangko Sentral ng Pilipinas in 1993 completely changed the use of financial instruments for sterilization operations. T-bills are now the principal instrument for sterilization as BSP stopped issuing CBCI and mainly used the T-bills it

received from the Government. From its inception in 1993, BSP has obtained T-bills amounting to P10 billion as the first installment of its statutory capital of P50 billion. The change in the principal instrument for liquidity management has shifted the interest burden of sterilization operations from the central bank to the Government budget.

Central bank net credit to the national Government dropped significantly from P49 billion in 1986 to P29.5 billion in 1989 (Manasan 1994). This decline was due to the marked increase in the national Government's deposits in the central bank from P17.1 billion in 1986 to P79.2 billion in 1989 (Table 6). The rise in Government savings in the central bank came mainly from the increased issuance of T-bills to replace CBCIs as the principal instrument for open market operations.

Exchange Rate Policy

The exchange rate policy is the weakest element of the macroeconomic policy in the Philippines. In theory, the exchange rate is the single most important relative price and one of the most significant monetary transmission mechanisms in an open economy. Monetary transmission operates through exchange rate effects on net exports and interest rate effects on financial portfolio. The exchange rate policy,[8] jointly with other policies, can be used to remove distortions in the domestic economy and to help safeguard international competitiveness.[9] Such an active exchange rate policy is the principal instrument of export-oriented policy in many Asian countries. Under this policy, the authorities avoided the use of prolonged nominal and real exchange rate overvaluation as a main instrument for generating fiscal revenues and curbing domestic inflation and interest rates. Of course, international competitiveness is not determined by weak currency alone. Apart from the exchange rate, other factors affecting competitiveness are productivity and costs. For a given level of domestic productivity and costs, a weaker national currency lowers the dollar cost of producing in the country.

Figure 1 displays the movements of the real effective exchange rate (RER) indices of the peso

Table 6: Central Bank Assets and Liabilities[a], 1985–1997 (in P billion, end of period)

Item	1985	1986	1987	1988	1989	1990	1991	1992	1993	1994	1995	1996	1997
Assets													
Foreign Assets	20.7	51.4	41.9	45.0	53.2	57.6	122.4	133.5	164.0	173.8	203.6	308.8	350.5
Claims on Central Government	33.3	58.7	45.7	40.9	40.0	39.8	32.1	76.2	293.5	233.9	227.9	240.3	235.8
Claims on Local Government	na	na	na	na	na	na	na	na	na	na	na	na	na
Claims on Nonfinancial Public Enterprises	4.5	4.1	4.4	5.1	6.0	6.3	6.0	3.5	2.3	2.0	1.9	1.8	3.0
Claims on Deposit Money Banks (DMBs)	27.8	16.0	19.0	20.5	22.5	28.0	29.1	15.4	7.3	6.2	7.3	7.7	26.4
Claims on Other Financial Institutions	27.8	9.3	8.7	8.2	8.0	7.6	6.8	6.5	5.9	4.6	6.3	6.5	8.0
Liabilities													
Reserve Money	39.5	52.1	59.4	69.1	96.0	113.0	135.7	153.4	182.3	191.6	224.4	257.0	277.2
Of which: Currency Outside DMBs	24.0	29.3	35.4	40.6	52.9	61.9	69.4	74.3	84.1	95.7	110.9	123.0	143.6
Restricted Deposits	58.2	49.0	30.4	31.1	29.6	34.3	80.6	94.7	61.0	45.4	36.1	102.1	43.0
Foreign Liabilities	138.7	184.7	174.1	166.6	161.5	198.2	191.0	141.2	107.3	82.0	85.3	76.1	138.6
Central Government Deposits	8.7	17.1	47.6	64.4	79.2	81.8	96.7	168.2	120.2	108.7	99.2	127.4	91.1
Capital Accounts	3.1	3.6	4.2	4.1	4.3	6.6	6.6	6.6	21.1	26.5	30.0	30.1	40.3
Other Items (net)	(134.1)	(167.1)	(195.9)	(215.6)	(240.8)	(294.4)	(314.1)	(329.1)	(18.8)	(33.7)	(28.0)	(27.7)	33.6

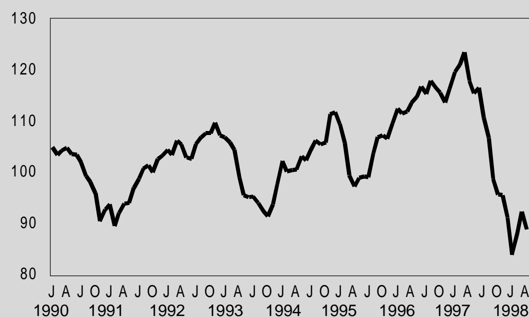
na = not available.

[a] Beginning July 1993, data reflect the financial restructuring of the Central Bank of the Philippines. The Bangko Sentral ng Pilipinas was created to take over the monetary authority functions of the former Central Bank of the Philippines.

Source: IMF, *International Financial Statistics,* various issues.

between 1990 and 1998. The RER calculation is based on relative consumer prices as a measure of domestic cost and price developments. Taken from Emerging Markets Data Watch, a publication of the Morgan Guaranty Trust Company, the indices are standardized so that 100 represents the state of competitiveness in 1990. Falling below 100 represents depreciation or weakening or cheapening of the national currency and a gain in competitiveness. On the other hand, rising above 100 indicates an erosion in competitiveness as domestic goods become more expensive relative to foreign products.

Figure 1: Real Effective Exchange Rate Index, January 1990–April 1998 (1990 = 100)



Source: J.P. Morgan, *Emerging Markets Data Watch,* various issues.

The International Financial Statistics (IFS) classifies the exchange rate arrangement in the Philippines under the category of independent floating system. This, however, does not prevent BSP from actively intervening in the foreign exchange market in order to stabilize the nominal value of the peso. Part of the capital inflows was sterilized. To defend the exchange rate from speculative attack, BSP unloaded more than $1 billion in the foreign exchange market in mid-1997. As this did not ease the pressures, BSP floated the peso on 11 July 1997 to defend its external reserves following the flotation of the Thai baht in the preceding week. In terms of the RER, the peso appreciated by 18 percent between 1990 and 1996. The monthly average of the nominal peso-dollar exchange rate, which reached P23.3 in 1990, had depreciated to P27.5 in 1993 but appreciated a little to P25.7 in 1995 and depreciated again to P29.5 in 1997.

A too rapid depreciation of the peso could cause significant adjustment costs in the short run. Although it enables families with members working abroad and people whose income is denominated in a foreign currency to maintain their purchasing power in terms of the peso, it decreases the purchasing power of those whose income is denominated in the local currency.

The cheaper peso increases the domestic prices of imported and import-intensive goods and services. This will result in a higher inflation rate and may erode the competitiveness of exports that require imported inputs. For example, the Philippines' biggest exports—electronic and electrical equipment—have a relatively high import content: more than 40 percent of the import value share relative to the export value in 1997. Thus, by increasing the cost of imported inputs, depreciation of the exchange rate reduces electronic goods production and their export and increases the price of such goods.

The cheaper peso also raises the external debt repayments of the corporate sector and banks, particularly those that have taken unhedged foreign currency loans. The balance sheets of banks and nonbank companies deteriorate further if their investments are mostly in the nontraded sector. Measured in foreign currencies, the peso depreciation also reduces the capital base of banks and nonbank companies. The weaker peso also causes fiscal distress because of the greater external debt-servicing expenditure of the Government budget.

The issue in exchange depreciation is not only the lower value of the exchange rate but also the policy behind it. It is important for the Government not to maintain an overvalued exchange rate for long—it is illusory to consumers who may receive a shock when the exchange rate suddenly decreases. The Government should also exercise caution in widely opening the capital account, as that is one avenue of speculative attacks. In opening the capital account, the Government must consider both its foreign reserves and also its ability to thwart speculative moves.

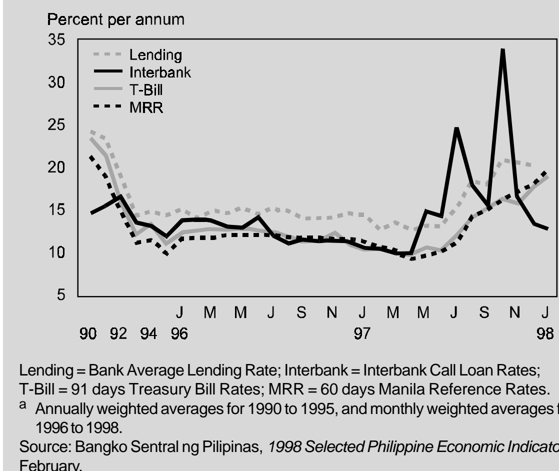
Policy to Reduce Interest Rates

The high interest rate policy was implemented during the stabilization period in 1991–1992. The stabilization program included sterilization of capital inflows. This operation, however, entails high domestic interest rates, thus driving a large wedge between domestic and international interest rates, and subsequently creating an additional incentive for banks and the corporate sector to borrow overseas. The floating of the peso since July 1997 has also contributed to the high domestic interest rates. To reduce the interest rate differentials, in July 1997 BSP applied a 30 percent reserve requirement against the foreign currency deposits of banks.

To bring down the intermediation cost of banks and, ultimately, interest rates, BSP reduced the reserve requirement ratio seven times during 1993–1997. The mandatory ratio for peso deposit liabilities and deposit substitutes was lowered from 24 percent in 1993 to 15 percent by May 1995, further down to 14 percent effective from January 1997 and to 13 percent effective from 4 July 1997. On top of the mandatory reserve ratio, the banks are also required to maintain an additional 2 percent reserve in the form of short-term market yielding Government securities (STMY-GS). Effective 15 June 1995, the common trust funds are subject to a 10 percent reserve ratio, excluding the required reserves that may be maintained in the form of STMY-GS: 4 percent effective 3 January 1997 and 3 percent beginning 4 July 1997. A minimum of 25 percent of the reserve ratios for both peso deposit liabilities and common trust funds has to be deposited with BSP, earning no interest; the balance is held in vaults and as Government securities.

The mix of fiscal and monetary policies has reduced the Government deficit, caused the exchange rate to slightly appreciate, and lowered the inflation rate. All of these decreased bank average lending rates from 19 percent in 1992 to 14.6 percent in 1995. Having reached the bottom at 12.9 percent in April 1997, the interest rates steadily rose back to

Figure 2: **Selected Domestic Interest Rates, 1990–January 1998[a]**



Lending = Bank Average Lending Rate; Interbank = Interbank Call Loan Rates; T-Bill = 91 days Treasury Bill Rates; MRR = 60 days Manila Reference Rates.
[a] Annually weighted averages for 1990 to 1995, and monthly weighted averages for 1996 to 1998.
Source: Bangko Sentral ng Pilipinas, *1998 Selected Philippine Economic Indicators,* February.

15.5 percent in August and to over 20 percent during the fourth quarter of that year (Figure 2). This raised the interest burden of domestic firms since bank credit is their main source of external financing. As a result, NPLs of the banking system rose from P30 billion in 1993 to P39 billion in 1995 and to P80 billion in September 1997. As a ratio to total loan, however, NPLs in the respective years declined from 5.3 percent to 4 percent then slightly increased to 4.7 percent.

The above policy mix, however, has not significantly diminished the wide gap in interest differentials between domestic and international rates, as well as between economic sector, region, and class of borrowers in the domestic economy. One key explanation for these differentials might be domestic market imperfections and the oligopolistic structure of both the financial markets and the real sector of the economy. These structural problems have led to asymmetric information (Stiglitz and Weiss 1981). The distribution of bank lending is heavily skewed towards large conglomerates that invested the funds mainly in the nontraded sector of the economy and in export industries that produce low value added. Moreover, the reputable large domestic firms also have favored access to lower interest rate loans from abroad while funds for other domestic enterprises have to be rationed through high interest domestic loans.

Lending Boom and Credit Policy

The financial sector reform and capital account liberalization precipitated a lending boom. Reduction in the reserve requirement ratio expanded the capability of banks to extend credit. Increases in financial savings and surges in capital inflows intermediated through the banking system raised their loanable funds. Greater exposure of the banks to foreign exchange risk is shown by a steady rise in the ratio of their foreign liabilities to total liabilities – from 10 percent in 1990 to 11 percent in 1996 and 13 percent in 1997. Foreign currency liabilities of banks were mainly in the form of foreign currency deposits held by residents, particularly Filipino overseas workers.

The surge in bank lending has also been encouraged by other factors, including increasing market competition, elimination of interest rate controls, and scaled-down selective credit policy, which have widely opened new opportunities as well as new problems and risks. The decline in credit rationing brought about by the reform allows banks to lend to marginal borrowers investing in riskier projects. Meanwhile, the more severe competition and downward pressure on franchise value may have induced banks to lend to this class of riskier borrowers and investment projects. Table 6 shows that the loans outstanding of commercial banks have been growing at a rapid pace, at an average of 34 percent per annum from 1992 to 1997. The overextension of the banking system is indicated by the loan/deposit ratio (LDR) and loan growth rate minus GDP growth rate. LDR in the Philippines steadily rose from 97 percent in 1990 to 99 percent in 1993 to 112 percent in 1995 and further to 133 percent in 1997. The gap between the loan and GDP growth rates increased from 8.6 percent in 1990 to 24 percent in 1993 to 25 percent in 1995 and then dropped to 17 percent in 1997.

Lifting the restrictions on bank lending immediately expanded credit to land-based industry and investment in infrastructure projects. The boom in commercial bank lending and surges in private capital inflows have driven up the prices of land and equity prices in the nascent and newly liberalized capital market. During the past financial repression, a directed credit program and selective credit policy had been two of the monetary transmission mechanisms in the Philippines to achieve the economic targets set by the authorities. In addition, the State-owned banks had also been used to implement policies of directed and selective credit.

Credit has boomed, but the internal capabilities of banks to administer and monitor the use of credit is inadequate. Reared in an earlier controlled environment, bank credit officers may not have the expertise needed to evaluate market risk. When the economy is booming, it is difficult to distinguish between good and bad credit risks because most borrowers look profitable and liquid.

Fiscal Policy

The pressure on monetary policy was eased by a significant reduction in the consolidated public sector deficit (measured as the excess of expenditures over current revenues for the Government and State-owned enterprises) and a shift toward noninflationary sources of finance. The rise in Government revenues and reduction in budget expenditures have significantly decreased public sector budget deficits. Since 1994, the cash position of the national Government has been in surplus. This alleviates pressures on financing, stabilizes public sector debt levels, helps reduce interest rates, and increases confidence in private sector-led growth strategy as it provides a greater flow of domestic savings for non-State investment.

Just as important as the decline in the public sector deficit, there has been a marked shift in the financing of the deficit from foreign sources and the central bank to noninflationary sources in the domestic economy. The latter include borrowing from commercial banks and direct borrowing from the public (using T-bills). One consequence of this shift will be a pickup in the growth of Government debt and an increase in interest payments in the Government budget expenditures.

Government Revenues

The rise in Government revenues as a share of GDP comes from four sources. First, the more rapid economic growth has expanded the tax base. Second, proceeds have come from the privatization of State-owned enterprises. Third, the comprehensive tax policy reform, first introduced in 1986, has broadened the tax base further. Fourth, better tax administration has led to improvement in compliance. The tax reform concurrently helps eliminate distortions, raises economic efficiency, and improves sectoral allocation of economic resources.

The corporate and individual income taxes have been the workhorse of the tax reform in the Philippines, generating over 32 percent of revenue since the early 1990s. Introduced in 1988, the VAT has contributed to over 13 percent of total tax revenues since 1991. The VAT rebates are increasing in line with the export performance of the Philippines, particularly the processing trade, which is exempted from the VAT. Concerned about the rising level of rebates, the authorities have undertaken more thorough verification because of suspicion of widespread fraud.

To improve tax revenue collections, the recent tax reform bills are widening the tax base by closing certain loopholes and improving compliance by strengthening tax administration and the credibility of Government to prosecute tax delinquents. Legislated in 1996 and 1997, the comprehensive tax reform covers domestic taxes, such as excise duties and corporate and individual income taxes. The increased revenues generated from domestic taxes are expected to replace the losses in custom revenues due to the tariff reform program, which provides for a low uniform tariff rate of 5 percent by the year 2004. The investment law of the Philippines, however, still offers a variety of tax incentives for new investors, such as import duty exemptions and tax holidays.

Expenditures

The desire to reduce or eliminate the budget deficit, amid the decline in revenue as a share of GDP, has meant strong pressure to keep budgetary expenditures under control. Subsidies to State-owned enterprises and demand for public investment have been significantly reduced with the privatization of these enterprises and the adoption of policies to attract private investment in education, health, and public utilities. However, mainly because of the existence of externalities, the involvement of the private sector in certain activities and sectors may be neither possible nor desirable. Most rural infrastructure, including roads, sanitation, basic education and extension services, irrigation, and water supply fall under this category. The Government will have to remain a key investor in this sector to promote rural development and channel the benefits of development to the poor.

Mainly because of the sharp increase in interest payments, national Government expenditures, measured as a percentage of GNP, rose from 13.4 percent in 1986 to 16.3 percent in 1987 and since then stabilized at about 17 to 19 percent from 1990 to 1997 (Table 7). At present, interest rates, personnel, and allotments to local government units account for about two thirds of the budgetary expenditures of the national Government. Personnel expenditures have been stable at about 6 percent of GNP. In 1994, these expenditures accounted for 35 percent of the current expenditures and 29 percent of the total expenditures of the central Government. The authorities have drawn up a plan for a civil service reform that will help contain the growth of personnel expenditures in the Government budget.

A number of present Government programs will potentially put pressure on its future expenditures. Pressure will come from (i) the possibly large stock and flow losses associated with housing loans under various public programs of the Unified Home Lending Program (UHLP); (ii) implicit pension debt of social security unless the authorities take corrective measures to address the causes of decline in funding levels to face the coming demographic transition; (iii) the unfunded compulsory health care insurance program, which covers a large segment of society;

Table 7: **National Government Financial Position, 1985–1997[a]**

Item	1985	1986	1987	1988	1989	1990	1991	1992	1993	1994	1995	1996	1997[b]
							P billion						
Total Revenues	69.0	79.2	103.2	112.9	152.4	180.9	220.8	242.7	260.4	336.2	361.2	410.4	471.8
Tax Revenues	61.3	65.4	85.9	90.3	122.5	151.7	182.3	208.7	230.1	271.3	310.5	367.9	412.2
Direct Taxes	18.7	19.1	21.8	27.4	37.6	49.4	61.1	70.1	74.5	91.9	111.2	na	na
Indirect Taxes	42.6	46.3	64.1	62.9	84.9	102.3	121.2	138.6	155.6	179.4	199.4	na	na
Nontax Revenues	7.7	13.8	17.3	22.5	29.9	29.2	38.5	34.0	30.2	64.9	50.7	42.6	59.7
Total Expenditures	80.1	110.5	119.9	136.1	172.0	218.1	247.1	258.7	282.3	319.9	350.1	404.2	470.3
Current Operating Expenditure	55.3	66.9	95.5	113.6	142.8	178.0	196.5	214.9	226.1	267.5	277.3	328.5	na
Personnel Services	22.5	25.0	32.5	40.8	51.4	62.2	72.4	74.3	78.7	92.7	109.1	135.4	na
Interest Payments	14.7	21.0	36.9	45.9	54.7	71.1	74.9	79.5	76.5	79.0	72.7	76.5	78.0
External Debt	4.2	5.8	12.6	13.7	13.7	17.5	18.6	16.4	20.3	19.2	21.1	17.5	19.6
Domestic Debt	10.5	15.2	24.3	32.2	41.0	53.7	56.4	63.1	56.2	59.8	51.6	59.0	58.4
Other Current Expenditure	18.1	20.9	26.1	26.9	36.7	44.7	49.2	61.1	70.9	95.8	95.5	116.5	na
Capital Expenditures	8.8	11.7	12.9	15.2	20.9	29.1	37.6	46.1	37.8	33.6	52.7	57.5	na
Equity & Net Lending	16.0	27.5	10.9	7.2	5.8	6.8	7.7	(6.9)	9.9	9.0	8.4	3.2	3.6
Capital Transfer	na	4.4	0.6	0.1	2.6	4.2	5.4	4.6	8.5	9.8	11.8	15.0	na
Surplus/Deficit	(11.1)	(31.3)	(16.7)	(23.2)	(19.6)	(37.2)	(26.3)	(16.0)	(21.9)	16.3	11.1	6.3	1.6
External Borrowing (net)	(0.3)	3.6	6.8	4.2	8.2	4.1	6.9	14.4	12.9	(11.6)	(13.3)	(5.9)	(6.8)
Domestic Borrowing (net)	11.5	27.7	9.9	19.0	11.4	33.1	19.4	1.6	9.0	(4.7)	2.3	(0.3)	5.3
Memo Items							Percent of GNP						
Total Revenues	12.5	13.5	15.5	14.4	16.8	16.9	17.6	17.7	17.4	19.4	18.4	18.0	18.4
Tax Revenues	11.1	11.1	12.9	11.5	13.5	14.2	14.5	15.2	15.3	15.6	15.9	16.1	16.1
Total Current Expenditures	10.0	11.4	14.4	14.5	15.8	16.6	15.7	15.6	15.1	15.4	14.2	14.4	na
Total Capital Expenditures	1.6	2.0	1.9	1.9	2.3	2.7	3.0	3.4	2.5	1.9	2.7	2.5	na
Surplus/Deficit	(2.0)	(5.3)	(2.5)	(3.0)	(2.2)	(3.5)	(2.1)	(1.2)	(1.5)	0.9	0.6	0.3	0.1

na = not available.
[a] Including central bank restructuring.
[b] Preliminary data.
Sources: BSP, *1996 Annual Report; Statistical Bulletin.* BSP, *Selected Philippine Economic Indicators,* February.

and (iv) spending commitments of Government-owned corporations to complement private investment under BOT-type schemes.

External Trade and the Balance of Payments

External Trade

Pushed by vigorous domestic growth as well as by a strong currency, a slowdown in world demand for export products, and more severe competition from low-cost producers such as the People's Republic of China (PRC) and countries in Indochina, the current account in the Philippines moved deeper into deficit. Measured as a percentage of annual GNP, the deficit grew from below 2 percent in 1991 and 1992 to 5.5 percent in 1993 and hovered around 4.2 percent per annum from 1994 to 1997 (Table 8). The widening current account deficit was financed by substantial surges in worker remittances, private transfers, and capital inflows. The latter began to soar in 1994, after the country liberalized its capital account in 1992 and privatized State-owned enterprises and public utilities in the following years. External reserves were built up between 1994 and 1996 because the overall balance of payment positions were in surplus, as the capital inflows were higher than the current account deficits.

Encouraged by the economy-wide liberalization, large increase in the productive capacity of export-oriented foreign direct investment, and strong demand in international markets, exports have been

Table 8: **Balance of Payments, 1990–1997 (in $ billion, unless otherwise indicated)**

Item	1990	1991	1992	1993	1994	1995	1996	1997[a]
Current Account, Net	(2.6)	(0.9)	(0.9)	(3.0)	(3.0)	(3.3)	(3.9)	(3.2)
(As percent of GNP)	(5.8)	(1.9)	(1.6)	(5.5)	(4.5)	(4.3)	(4.5)	(4.7)
Trade, Net	(3.3)	(1.7)	(1.7)	(3.7)	(3.9)	(4.2)	(4.5)	(3.5)
(As percent of GNP)	(7.4)	(3.7)	(3.1)	(6.7)	(5.9)	(5.5)	(5.2)	(5.3)
Goods, Net	(4.0)	(3.2)	(4.7)	(6.2)	(7.9)	(8.9)	(11.3)	(8.3)
(As percent of GNP)	(9.1)	(7.0)	(8.7)	(11.2)	(11.9)	(11.7)	(13.0)	(12.4)
Exports	8.2	8.8	9.8	11.4	13.5	17.4	20.5	18.4
Imports	12.2	12.1	14.5	17.6	21.3	26.4	31.9	26.6
Services, Net	0.7	1.5	3.0	2.5	4.0	4.8	6.8	4.7
Receipts	4.8	5.6	7.4	7.5	10.6	14.4	19.0	17.0
Payments	4.1	4.1	4.4	5.0	6.6	9.6	12.2	12.3
Transfers, Net	0.7	0.8	0.8	0.7	0.9	0.9	0.6	0.4
Inflow	0.7	0.8	0.8	0.7	1.0	1.1	1.2	1.2
Outflow	0.0	0.0	0.0	0.0	0.1	0.3	0.6	0.8
Capital and Financial Account, Net	1.8	1.9	1.9	2.8	4.5	4.4	8.6	4.4
Medium- and Long-Term Loans, Net	0.7	0.8	0.6	2.5	1.3	1.3	2.7	3.3
Investments, Net	0.5	0.7	0.7	0.8	1.6	1.6	1.2	(2.3)
Nonresident Investments in the Philippines	0.5	0.7	0.9	2.1	2.5	2.9	3.6	0.8
Resident Investments Abroad	0.0	0.0	0.2	1.3	0.9	1.3	2.5	3.1
Change in the NFA of KBs	0.6	0.0	0.3	(0.3)	0.7	1.6	4.2	3.0
Purchase of Collateral	na	na	(0.5)	na	na	na	na	na
Short-Term Capital, Net	0.0	0.4	0.7	(0.1)	1.0	(0.1)	0.5	0.4
Others, Net	1.0	0.6	0.7	0.5	0.3	0.1	(0.0)	(0.2)
Monetization of Gold	0.2	0.2	0.1	0.1	0.2	0.2	0.2	0.1
Revaluation Adjustments[b]	0.8	0.4	0.5	0.4	0.1	(0.1)	(0.2)	(0.2)
Net Unclassified Items	(0.3)	0.5	(0.2)	(0.5)	(0.0)	(0.6)	(0.6)	(2.2)
Overall BOP Position	(0.1)	2.1	1.5	(0.2)	1.8	0.6	4.1	(1.2)
(As percent of GNP)	(0.2)	4.6	2.8	(0.3)	2.7	0.8	4.7	na
GNP	44.1	45.7	53.9	55.3	65.7	76.2	87.1	87.0

na = not available, BOP = balance of payment, GNP = gross national product, KB = domestic bank, NFA = net foreign asset.
[a] January–September 1997, very preliminary data.
[b] Reflects changes in the exchange rate of the US dollar against Special Drawing Rights (SDR) and other third currencies which form part of the reserve assets and monetary liabilities of the Central Bank and discounts arising from debt reduction schemes.
Sources: ADB. 1997. *Country Economic Review; Philippines.* November. BSP. 1998. *Selected Philippine Economic Indicators.* February.

the driving force of the economic recovery since 1994. In nominal dollar terms, merchandise exports grew by over 18 percent in 1994 and by 29 percent in 1995 (Table 9). The rapid growth of export value, however, was driven by over 40 percent growth of exports of electronics, mainly semiconductor-type products, which contributed to about one half of the total export value in 1996–1997. This sector has a relatively high import content and, therefore, produces low value added. With the weakening in external demand, electronics export growth began to slow down in August 1996 and reduced overall export growth to nearly 18 percent in 1996.

The textiles and garments group, which also require high import content, is the second important contributor to export earnings. Its contribution to total export peaked at 23 percent in 1992 and declined to about 16 percent in 1995 and further to 11 percent during the first three quarters of 1997. With an erratic export growth rate ranging from 15 percent in 1992 to -3.7 percent in 1996, textiles and garments did not participate in the export boom. The share of machinery and transport equipment in total export earnings has steadily increased from around 3 percent in 1992 to 4.2 percent in 1995 and to over 10 percent during the first nine months of 1997. Exports

Table 9: Exports by Commodity Group, 1990–1997

Item	1990	1991	1992	1993	1994	1995	1996	1997[a]
				Value ($ billion)				
Agriculture	1.39	1.48	1.56	1.58	1.68	2.10	1.86	1.38
Forest Products	0.10	0.07	0.06	0.05	0.03	0.04	0.04	0.03
Minerals Products	0.72	0.58	0.63	0.69	0.78	0.89	0.77	0.57
Manufactures	5.71	6.43	7.30	8.73	10.62	13.87	17.11	15.61
Electronics & Elec. Eqpt./Parts and Telecom.	1.96	2.29	2.75	3.55	4.98	7.41	9.99	9.35
Garments, Textile Yarns/Fabrics	1.87	1.96	2.26	2.39	2.55	2.78	2.68	2.01
Chemicals	0.26	0.30	0.27	0.26	0.31	0.34	0.35	0.28
Machinery and Transport Eqpt.	0.15	0.18	0.29	0.36	0.47	0.74	1.30	1.92
Petroleum Products	0.16	0.18	0.15	0.14	0.13	0.17	0.27	0.19
Others[b]	0.11	0.10	0.13	0.20	0.26	0.38	0.49	0.58
Total Exports	**8.19**	**8.84**	**9.82**	**11.38**	**13.48**	**17.45**	**20.54**	**18.36**
				Share in total exports (%)				
Agriculture	17.0	16.7	15.8	13.9	12.4	12.0	9.1	7.5
Forest Products	1.2	0.8	0.6	0.4	0.2	0.2	0.2	0.2
Minerals Products	8.8	6.6	6.4	6.0	5.8	5.1	3.8	3.1
Manufactures	69.7	72.8	74.3	76.7	78.7	79.5	83.3	85.0
Electronics & Elec. Eqpt./Parts and Telecom.	24.0	25.9	28.0	31.2	37.0	42.5	48.6	50.9
Garments, Textile Yarns/Fabrics	22.8	22.2	23.0	21.0	18.9	15.9	13.0	10.9
Chemicals	3.2	3.4	2.7	2.3	2.3	2.0	1.7	1.5
Machinery and Transport Eqpt.	1.8	2.0	2.9	3.2	3.5	4.2	6.3	10.4
Petroleum Products	1.9	2.0	1.5	1.2	1.0	1.0	1.3	1.1
Others[b]	1.4	1.1	1.3	1.8	1.9	2.2	2.4	3.1
Total Exports	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**
				Annual growth rate (%)				
Agriculture	(2.2)	6.2	5.2	1.3	6.3	25.1	(11.2)	2.3
Forest Products	(51.8)	(23.2)	(21.9)	(21.1)	(42.2)	46.2	10.5	32.0
Minerals Products	(12.8)	(19.6)	9.0	8.4	13.7	14.5	(13.5)	(5.0)
Manufactures	9.9	12.7	13.5	19.6	21.6	30.6	23.3	26.0
Electronics & Elec. Eqpt./Parts and Telecom.	12.2	16.8	20.1	29.0	40.4	48.7	34.8	29.4
Garments, Textile Yarns/Fabrics	12.4	4.9	15.3	5.7	6.6	9.0	(3.7)	0.5
Chemicals	(6.5)	16.5	(11.8)	(2.2)	16.8	12.1	2.9	6.1
Machinery and Transport Eqpt.	30.4	20.7	59.1	26.0	29.2	58.0	74.9	125.0
Petroleum Products	63.2	12.9	(14.3)	(9.3)	(2.9)	29.5	59.6	3.8
Others[b]	37.3	(12.3)	30.0	56.2	25.6	49.4	28.3	54.2
Total Exports	**4.7**	**8.0**	**11.1**	**15.8**	**18.5**	**29.4**	**17.7**	**23.0**

[a] January–September1997. For growth, comparison is with the same period in 1996.
[b] Special transactions and re-export activities.
Sources: BSP, *1996 Annual Report; Statistical Bulletin.* BSP. 1998. *Selected Philippine Economic Indicators*, February.

of this group jumped by 61 percent in 1992, decelerated in 1993 and 1994, but soared again by 57 percent in 1995 and 76 percent in 1996. For the first three quarters of 1997, its exports rose by only 15 percent relative to the same period in 1996 but for the first time, its export share exceeded that of agriculture and forestry-based products.

The slowdown in exports of textiles and garments, footwear, and handicrafts in recent years indicates the negative effects of the real exchange rate appreciation on labor-intensive products. The BSP policy to float the peso in July 1997 and its depreciation since then should help reverse these falling trends, contain the foreign trade deficit, and push the growth of the traded sector of the economy. Semiconductor-type products, which face declining international prices, require more fundamental measures. The international prices of these products have

been decreasing because of weak demand and aggressive investment in many Asian countries (particularly in the PRC; Hong Kong, China; Republic of Korea; Malaysia; Philippines; Singapore; Taipei,China; and Thailand) during 1995 and 1996. International competitiveness can be improved by adopting measures that reduce labor costs and raise productivity.

Philippine total imports more than doubled during 1990–1996, with an annual average growth rate of 18 percent. Capital products and raw materials and intermediate goods formed the bulk of imports, reflecting the robust growth of investment and production in the domestic economy. On the other hand, the share of consumer good imports has grown steadily from around 8 percent in 1990–1992 to about 10 percent since 1994 (Table 10). The slight appreciation of the RER may have contributed to the rapid growth of imports, particularly that of consumer goods, which rose by an annual average of 22 percent in 1990–1996.

Worker Remittances

Receipts from services and inflows of transfers rose rapidly beginning in 1992 and 1994, respectively. The surges may be due to increasing inflows of worker remittances and a portfolio shift among nonresidents. Significant improvements in the banking system also restored confidence that resulted in greater use of banks in intermediating remittances (World Bank, 1988).

Capital Flows

Net private capital inflows more than doubled during 1990–1994 and continued their rapid growth in 1995 and 1996 (Table 11). The sharp decrease in long-term loans indicates the reduction in public sector borrowing as a result of the privatization of State-owned enterprises and public utilities. Privatization and greater investor confidence in the Philippine economy increased the inflows of foreign direct investment. Portfolio inflows started only quite recently with a relatively small amount. Improvement in the international creditworthiness of the Philippines is also reflected by the first issue of Samurai bonds in 15 years in July 1996 and a Brady Exchange Program in September of the same year. The dual issue of five-and-a-half and seven-year yen bonds in Tokyo allowed the Philippines to retire more expensive debts and replace them with cheaper ones, and develop benchmarks for future borrowings of economic agents from the Philippines in Japanese financial markets. Under the Brady program, the Philippines was permitted to retire 39 percent of its outstanding $1.6 billion of Brady bonds for uncollateralized 20-year fixed rate bonds at 225 basis points over the 30-year US Treasury bond rate. The collateral released in the retirement of par bonds in such transaction will make available $183 million in cash to the Philippines. Meanwhile, the bond exchange component reduced the debt stock by $84 million. In addition, the transaction developed a benchmark for future borrowings of the country’s economic units in international capital markets.

The Philippines has developed an FCDU market as an offshore financial market in Manila by providing it with regulatory and tax advantages over the domestic market. For example, foreign exchange deposits in this market are not subject to the 5 percent gross receipts tax and the 20 percent withholding tax on interest earnings of residents. Moreover, prior to June 1997, the FCDUs were not subject to reserve requirements. The FCDU market was originally intended as a regional financial center, to enable local financial institutions to provide clients in nearby countries with financial services (“out-out transactions”). In reality, however, it functions as a vehicle to encourage worker remittances and foreign exchange deposits by Filipinos, and to service creditworthy domestic firms (“out-in transactions”).

The recent foreign exchange liberalization permits exporters to retain their earnings in foreign currency. This and the rapid growth in worker remittances and trade and investment flows have raised the ratio of

Table 10: Imports by Commodity Group, 1990–1997

Items	1990	1991	1992	1993	1994	1995	1996	1997[a]
				Value ($ billion)				
Capital Goods	3.12	2.95	4.02	5.61	6.87	8.03	10.47	9.94
Power Generating and Specialized Machines	1.28	1.05	1.43	2.08	2.50	2.87	3.65	2.88
Telecommunication Eqpt. & Elect. Eqpt.	na	na	1.47	1.91	2.53	3.21	4.21	4.51
Raw Materials and Intermediate Goods	5.81	5.85	6.76	7.86	9.61	12.17	14.06	11.24
Unprocessed Raw Materials	0.86	0.84	0.95	0.98	1.28	1.56	1.72	1.26
Semiprocessed Raw Materials	4.95	5.01	5.81	6.87	8.33	10.61	12.34	9.97
Chemical	na	na	1.49	1.67	2.02	2.41	2.57	2.15
Manufactured Goods	1.79	1.71	2.14	2.59	2.89	3.57	3.95	3.16
Materials/Accessories for Manufacture of Electrical Equipment	1.11	1.21	1.40	1.81	2.71	3.77	5.13	4.06
Mineral Fuels and Lubricant	1.84	1.78	2.05	2.02	2.04	2.46	3.01	2.27
Consumers Goods	1.06	0.99	1.24	1.59	2.11	2.78	3.33	2.38
Special Transactions[b]	0.37	0.47	0.45	0.53	0.71	0.94	1.02	0.80
Total Imports	**12.21**	**12.05**	**14.52**	**17.60**	**21.33**	**26.39**	**31.89**	**26.62**
				Share in total imports (%)				
Capital Goods	25.6	24.5	27.7	31.9	32.2	30.4	32.8	37.3
Power Generating and Specialized Machines	10.5	8.7	9.9	11.8	11.7	10.9	11.4	10.8
Telecommunication and Electrical Equipment	na	na	10.1	10.9	11.9	12.2	13.2	16.9
Raw Materials and Intermediate Goods	47.6	48.6	46.6	44.6	45.0	46.1	44.1	42.2
Unprocessed Raw Materials	7.1	7.0	6.5	5.6	6.0	5.9	5.4	4.7
Semiprocessed Raw Materials	40.5	41.6	40.0	39.1	39.0	40.2	38.7	37.5
Chemical	na	na	10.3	9.5	9.5	9.1	8.1	8.1
Manufactured Goods	14.7	14.2	14.7	14.7	13.6	13.5	12.4	11.9
Materials/Accessories for Manufacture of Electrical Equipment	9.1	10.0	9.6	10.3	12.7	14.3	16.1	15.2
Mineral Fuels & Lubricant	15.1	14.8	14.1	11.5	9.6	9.3	9.4	8.5
Consumers Goods	8.7	8.2	8.5	9.0	9.9	10.5	10.4	8.9
Special Transactions[b]	3.1	3.9	3.1	3.0	3.3	3.6	3.2	3.0
Total Imports	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**
				Annual growth rate (%)				
Capital Goods	28.8	(5.4)	36.3	39.4	22.4	16.9	30.4	28.9
Power Generating and Specialized Machines	29.9	(18.3)	37.0	44.9	20.4	14.9	26.9	5.7
Telecommunication Eqpt. & Elect. Eqpt.	na	na	na	30.1	32.2	26.9	31.1	48.0
Raw Materials and Intermediate Goods	7.8	0.7	15.5	16.2	22.3	26.7	15.5	6.7
Unprocessed Raw Materials	6.8	(2.4)	12.6	3.6	30.3	22.2	10.1	(2.5)
Semiprocessed Raw Materials	8.0	1.3	16.0	18.3	21.2	27.4	16.3	8.0
Chemical	na	na	na	11.8	20.9	19.3	7.0	9.7
Manufactured Goods	0.4	(4.5)	24.8	21.1	11.7	23.5	10.5	4.4
Materials/Accessories for Manufacture of Electronic Equipment	25.0	9.2	16.0	29.1	49.9	39.1	36.0	9.5
Mineral Fuels and Lubricant	31.9	(3.1)	14.9	(1.7)	1.2	20.6	22.2	4.6
Consumers Goods	18.0	(6.7)	25.4	27.9	32.9	32.0	19.6	(6.8)
Special Transactions[b]	19.9	27.1	(5.9)	18.6	34.2	32.8	7.7	9.4
Total Imports	**17.2**	**(1.3)**	**20.5**	**21.2**	**21.2**	**23.7**	**20.8**	**12.4**

na = not available.
[a] January–September 1997. For growth, comparison is with the same period in 1996.
[b] Including articles temporarily imported and exported.
Sources: BSP. *1996. Annual Report; Statistical Bulletin.* BSP. 1998.*Selected Philippine Economic Indicators*, Feb.

Table 11: **Current Account Deficit and Capital Flows[a] (percent of GDP)**

Item	1991	1992	1993	1994	1995	1996	1997[b]
Current Account Deficit	2.3	1.6	5.5	4.6	4.4	4.7	4.5
Total Capital Flows	5.0	3.9	4.9	5.7	5.9	10.1	1.4
Net Private Capital Flows[c]	1.7	2.0	2.6	4.9	4.5	9.9	0.6
Net Direct Investment	1.2	1.3	1.6	2.0	1.8	1.6	1.4
Net Portfolio Investment	0.3	0.1	(0.1)	0.4	0.3	(0.2)	(5.3)
Other Net Investment	0.2	0.6	1.1	2.5	2.4	8.5	4.5
Net Official Flows	3.3	1.9	2.3	0.8	1.4	0.2	0.8
Change In Reserve[d]	-2.3	-1.5	-1.1	-1.9	-0.9	-4.8	2.1

[a] Net capital flows comprise net direct investment, net portfolio investment, and other long- and short-term net investment flows, including official and private borrowing.
[b] Preliminary data.
[c] Because of data limitations, other net investment may include some official flows.
[d] A minus sign indicates an increase in reserves (BOP surplus).
Sources: IMF, *World Economic Outlook*, October 1997. IMF, *World Economic Outlook; Interim Assessment*, December 1997.

foreign exchange deposits to peso deposits. The ratio is particularly growing during a period of peso appreciation. Attracted by the preferential treatment, foreign financial institutions channel much of their lending to domestic firms through the FCDU. However, the rapid growth of foreign currency deposits and lending through the FCDU erode the ability of the central bank to influence monetary policy and bank credit expansion.

Part of the capital inflows has been used by the authorities to accumulate external reserves.

External Debt

The mix of factors discussed above—fast growth of exports and worker remittances and the increase in nondebt private capital inflows—has significantly reduced the external debt burden of the Philippines. The World Bank considers a debt/GNP ratio of less than 48 percent as low risk and 40 to 80 percent as medium risk. As of December 1995, the Philippines' external debt stood at $37.8 billion, or 49 percent of GNP. In terms of the ratio of total debt service to exports, the World Bank considers 18 percent as the 'warning' threshold. The Philippines' figure for 1995 was under 15 percent, reduced sharply from 27 percent in 1990.

Short-term external debt stood at $5.3 billion in 1997. This figure, however, does not include the foreign exchange liabilities of banks.

For a number of reasons, the external debt exposure of banks in the Philippines is, nevertheless, not daunting. First, external borrowings of banks and their customers in the Philippines are closely monitored under the IMF programs. The Global Data Watch of the Morgan Guaranty Trust Company (3 April 1998) reported that the proportion of short-term debt to the Bank for International Settlements (BIS) to external reserves in the Philippines was only 69.4 percent in mid-1997 compared with 195 percent in Indonesia and 194.4 percent in Thailand. Second, having lived with currency volatility in the 1970s and 1980s, the corporate sector in the Philippines has hedged a good fraction of its external obligations. Moreover, BSP introduced in late December 1997 a hedging facility through commercial banks so as to cover or limit the risk of eligible borrowers with existing unhedged foreign exchange liabilities to FCDUs. Third, to slow down the rate of growth of foreign exchange intermediation by the banking sector, in June 1997, BSP prescribed a 30 percent liquid cover on all foreign exchange liabilities of FCDUs. Fourth, the prudential concern relating to exchange rate risks and maturity mismatches faced by individual banks can be minimized as long as the Philippines can maintain rapid growth of the economy and exports.

Conclusion

The macroeconomic performance of the Philippines has been strong in recent years as shown by respectable economic growth, rapid growth of exports, low inflation rate, and improved financial condition of the

banking system. These have enabled the country to exit from the IMF program and to regain access to the international financial markets. Its encouraging economic performance, however, has also been accompanied by a number of disquieting developments. The degree of overextension in the banking system and exposure to foreign exchange risk are rising. Probably because of market imperfections and the oligopolistic structure of the financial markets, interest rates are still persistently high. The fast-growing bank loans are largely invested in the nontraded sector of the economy and in the traded sector component that requires high imported inputs and produces low value added. All of these indicate the need to improve monitoring and supervision of the banking system. Better implementation of the rules and regulations governing the banking industry acts as a brake to prevent banks from making excessive risky loans.

The ongoing economic crisis in the Asian region has also affected external trade, labor remittances, and capital inflow to the Philippines. The crisis reduced its exports to neighboring countries. Devaluation of the currencies of its competitors and appreciation of the peso decreased its competitiveness in international markets. Economic difficulties diminished the capacity of neighboring countries to absorb workers from the Philippines. Moreover, the drying up of private sector capital inflows from Hong Kong, China; Japan; and the Republic of Korea cannot be replaced by rising inflows from Singapore; Taipei,China; and elsewhere. Aside from currency devaluation, international competitiveness can also be enhanced by increasing labor productivity, removing economic distortions, and eliminating antiexport policies.

To improve economic management and restore public confidence, the authorities have adopted a short-run stabilization program. The program includes measures to tighten fiscal and monetary policies, raise interest rates, control inflation rate, and allow the peso to float more freely. The experiences of other Asian countries indicate that these policies should be done carefully to allow the banking system and corporate sector to adjust smoothly to the new environment, particularly as they are highly leveraged and increasingly dependent on foreign borrowings.

The short-run stabilization program has also been supplemented with structural reform to remove distortions in the economy and to eradicate poverty. This reform covers policies on trade and investment, taxes, and the financial sector. The structure of Government expenditures (such as for education and basic health and rural infrastructure) also plays an important role in eradicating poverty. In the long run, the reform will extend further to legal and accounting frameworks to improve the market infrastructure. To further boost public confidence, including that of international investors, these efforts have been supported by the voluntary standby arrangements with the IMF.

Notes

[1]The administration of President Corazon Aquino was besieged by coup attempts at least once a year between 1987 and 1989. The most dangerous one occurred in December 1989, led by a group of disappointed soldiers who played an active role in toppling President Ferdinand Marcos in 1986 .

[2]Between 1981 and 1987, 161 small financial institutions, holding 3.5 percent of total financial system assets, closed. Five private banks were nationalized in varying stages of central bank supervision, and later privatized.

[3]As in any other developing country, it is difficult to estimate the national accounts in the Philippines partly because of the relative difficulty of measuring the significant informal and nonmarketable economic activity and the rapid growth of net factor income from abroad, mainly workers' remittances (World Bank 1996).

[4]The main problem of most studies on savings in less developed countries, including the Philippines, is the unreliable nature of the savings data. As pointed out earlier, this is partly due to the difficulty of measuring the national accounts. Moreover, savings tends to be calculated as a residual. As a result, it inherits all the statistical problems of other components of national income, particularly investment.

[5]The 18 domestic EKBs are Allied Banking Corporation, Asian Bank Corporation, Banco de Oro, Bank of the Philippine Islands, China Banking Corporation, Equitable Banking Corporation, Far East Bank and Trust Company, Metropolitan Bank and Trust Company, Philippine Bank of Communications, Philippine Commercial and Industrial Bank, PNB, Prudential Bank, Rizal Commercial Banking Corporation, Security Bank Corporation, Solid Bank Corporation, United Coconut Planters Bank, Union Bank of the Philippines, and Urban Bank. The 15 domestic commercial banks are Bank of Commerce, Bank of South East Asia, East West Banking Corporation, Export and Industry Bank, Global Bank (joint venture with Tokai Bank of Japan), International Exchange Bank, MayBank (formerly Philippine National Republic Bank; MayBank is classified as a domestic bank since it was incorporated in the Philippines but the major stockholder is Malaysian), Orient Bank, Philippine Banking Corporation, Philippine Trust Company, Philippine Veterans Bank, Pilipinas Bank, Traders Royal Bank, TA Bank of the Philippines, Inc., and Westmont Bank Philippines. The 16 foreign banks are Australia and New Zealand Banking Group, Bank of America NT&SA, Bangkok Bank Public Company Limited (Bangkok), The Bank of Tokyo-Mitsubishi Limited, The Chase Manhattan Bank, China Trust Philippine Commercial Bank Corporation, Citibank, NA, Dao Heng Bank, Development Bank of Singapore, Deutsche Bank AG, The Fuji Limited Bank, International Commercial Bank of China, ING Bank, Korea Exchange Bank, Banco Santander Philippines Incorporated, and Standard Chartered Bank. The land bank is the State-owned Land Bank of the Philippines. PNB and Union Bank have Government shares.

[6]Tier 1 capital or "core" capital includes stock issues as well as disclosed reserves without any limit. Tier 2 capital or "supplementary" capital consists of perpetual securities, "undisclosed reserves," subordinated debt with maturity exceeding five years, and share redeemable at the option of the issuers.

[7]The central banks include those of Australia; Hong Kong, China; Malaysia; Singapore; and Thailand under the Executive Meeting of East Asia and Pacific (EMEAP). EMEAP was established in February 1991. Other members of the organization are People's Republic of China, Republic of Korea, Japan, New Zealand, and the Philippines. In addition to cooperation in central bank facilities, the EMEAP has two other objectives, namely: financial market development and banking prudential supervision to improve the flow of information. The quick responses from other central banks in extending financial support to the Central Bank of Thailand for defending the baht during the crisis in mid-May 1997 was the first test of the EMEAP. The financial resources, however, were inadequate to solve the structural problems of the Thai economy: large current account deficit, low quality of investment, fragile banking system, and rigid exchange rate regime.

[8]The exchange rate policy includes devaluation, speeding up depreciation of the national currency, widening the intervention band in the band system, and raising transaction costs in the foreign exchange markets.

[9]It should be pointed out, however, that it is relatively easy to define competitiveness at the level of firms, but extremely difficult at the level of countries or economies.

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