

Amando M Tetangco, Jr: The state of the Philippine economy and policy directions of the Bangko Sentral ng Pilipinas

Speech by Mr Amando M Tetangco, Jr, Governor of the Bangko Sentral ng Pilipinas, at the monthly meeting of the Association of International Business Executives of the Philippines, Inc, Manila Polo Club, 17 May 2006.

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President Julian Lim of the Association of International Business Executives of the Philippines, distinguished officers and members of the AIBEP board, special guests, ladies and gentlemen, good evening.

I am pleased to join you tonight to address your regular monthly meeting. We appreciate your continued support of... and interest in... the Philippine economy.

As international stakeholders in business in the Philippines, I know all of you closely monitor the outlook on the Philippine economy as it affects your individual businesses and industries. In consideration of your varied interests, I would like to spend the next few minutes painting you a picture of the recent developments in the country's economy as well as its monetary, external and financial sectors. I would also like to share with you our vision of the future and the challenges that we anticipate along the way.

Recent economic developments

The Philippine economy continues to show resilience in the face of continued challenges.

In 2005, real gross domestic product (GDP) expanded over 5 percent on the strength of the services sector on the production side and sustained consumer expenditures on the demand side. This moderate growth of the economy helped create more jobs that lowered unemployment rate.

Please note that the expansion of the economy is being sustained without fueling further inflation, even as oil prices continue to climb to record high levels.

For instance, headline inflation fell from 8.5% in May 2005 to 6.7% in December. This year, after the implementation of the VAT rate increase initially pushed prices higher, we note a softening of prices ...with inflation easing from 7.6% in March to 7.1 percent in April.

The government's fiscal consolidation efforts are also showing positive results. The National Government (NG) deficit for the first quarter of 2006 was significantly lower than the programmed ceiling due to strong revenue performance. The fiscal deficit reached P67.6 billion as of March....lower and better than the programmed ceiling of P71.8 billion.

Meanwhile, the banking system continues to show positive trends as well. Loan quality continues to improve, while the capital adequacy ratio of the Philippine banking system continues to remain well above the international benchmark: as of September 2005, it stood at 17.6 percent, way above the international benchmark of 8.0 percent.

This is indicative of an increasingly sound banking sector that is better able to finance the funding requirements of a growing economy.

On the external front, the country's overall balance of payments position yielded a surplus of US\$2.4 billion in 2005, as foreign exchange inflows benefited from heavy remittances from overseas Filipino workers and inflows from foreign portfolio and direct investments. In turn, these foreign exchange inflows helped raise the country's gross international reserves (GIR) to a record year-end level of \$18.5 billion; this rose further to a new record high of nearly \$21 billion as of end April 2006, which provides ample cover for over 4 months of imports of goods and payments of services and income.

Such strong inflows and the confidence generated by increasing international reserves and tax reforms helped support the peso. The peso began to appreciate against the dollar in the last quarter of 2005, eventually ending the year at P53.61, from P56.18 in December 2004. This year, the peso continues its appreciation. The strong peso has helped moderate inflation in the midst of record high oil prices.

Monetary and external sector outlook and policy directions

As the government institution mandated to keep prices stable, the BSP has to contend with the effects of the continued rise in oil prices, the surge in liquidity growth from foreign exchange inflows, and the effects of whatever negative market sentiments on the exchange rate.

To address these risks to inflation and keep inflation expectations from spiraling away from our target, calibrated increases in BSP's benchmark interest rates were carried out in April, September and October 2005. These rate increases were made in tandem with a hike in reserve requirements in July to keep excess liquidity in check and prevent it from creating additional inflationary pressure.

In the second half of 2006, we expect inflation to follow a decelerating trend as the short-lived impact of the RVAT on prices of goods and services continues to taper off.

Nevertheless, average inflation is expected to tip past the government's target of 4.0–5.0 percent in 2006 due principally to high oil prices.

Given these risks and outlook for inflation, the BSP will exert all efforts to achieve the inflation target in the medium-term. The BSP will keep a close eye on incipient inflationary pressures, especially those coming from the demand side, and will stand ready to undertake the necessary monetary action. As a complement to monetary action, direct action to address supply-side risks would remain a key policy priority. To this end, the BSP will intensify further representation with relevant government agencies in support of supply-side intervention measures, particularly in keeping basic food supplies stable.

On the other hand, the BSP's exchange rate policy will continue to be anchored on our main mandate of price stability. Consistent with our inflation-targeting framework for the conduct of monetary policy, the BSP will continue to leave the determination of the value of the peso to market forces.

Of course, there is some scope for occasional BSP action to dampen sharp fluctuations in the exchange rate, principally to maintain order and stability in the foreign exchange market. This is intended to mitigate possible adverse effects of significant exchange rate fluctuations on inflation and inflation expectations.

External sector policy and outlook

On the external sector, we expect that the balance of payments (BOP) will remain strong. Current projections show that our BOP will yield a surplus of US\$1.6 billion on the back of continued dollar inflows from OFW remittances and foreign investments. Improving investor sentiment will continue to positively impact capital and financial accounts. On the other hand, remittances of OFWs are expected to grow by 10 percent in 2006, as the deployment of more workers escalates and as more high-salaried workers get jobs overseas.

We are often asked whether the strength of the OFW remittances is sustainable. We believe so. In particular, local commercial banks have broadened their reach through establishment of more remittance centers abroad, tie-ups with foreign financial institutions and introduction of innovative and faster means of remittance transfers to channel remittances through banks. Parallel to these, the BSP is undertaking specific action plans to reduce remittance costs in the Philippines and in host economies to encourage and facilitate remittances through formal channels.

The BSP has also initiated a nationwide information campaign for OFWs and members of their families on the opportunities for investing their foreign exchange savings in microenterprise activities and other alternative financial instruments. What we want to see is the transformation of our OFW families from being consumers to regular savers, investors and even entrepreneurs.

Banking sector outlook and policy

The BSP will continue to intensify its efforts to strengthen the country's financial system. For this purpose, the BSP's reform strategy is focused on two pillars: a healthy banking system as well as a deep and efficient capital market that, together, will effectively mobilize savings to fund economic development.

BSP's banking reform strategy is focused on the further clean up of the banks' balance sheets, aligning prudential regulatory framework with international standards, the further strengthening of risk

management, adherence to good corporate governance practices, stronger capital base of banks, and continuing enhancements in our payments and settlements system.

The extension of the Special Purpose Vehicle Act should provide banks the opportunity to continue to reduce their holdings of non-performing assets (NPAs). Apart from the SPV-related dispositions, the BSP now allows banks to enter into Joint Venture Agreements (JVAs) with real estate developers as a means to convert idle real estate and other acquired properties into income generating assets. This new regulation should create a favorable impact on the real estate market.

An expedient consolidation of the banking industry is also being encouraged through the combination of more stringent regulatory regime and international benchmarking of financial standards. In addition, the BSP's moratorium on the establishment of new commercial banks continues to be enforced. We also continue to enforce our policies of allowing entry of foreign banks only through the acquisition of existing domestic banks.

Efforts are now firmly underway for the adoption by local banks of International Accounting Standards and the implementation of the Basel II Accord, the new international capital standards reflective of the risks banks are exposed to. Our efforts in this regard include training programs for our personnel and BSP-supervised entities.

The BSP likewise continues to enhance its supervisory and regulatory authority by pursuing the full implementation of the consolidated and risk-based supervision framework and strengthening its enforcement of prompt corrective actions on banks and other financial institutions under its jurisdiction.

The BSP also continues its reform initiatives to speed up the development of the country's domestic capital market. Efforts to develop the needed infrastructure for this purpose were supported by regulatory changes. Among others, guidelines on investing in various investment products were issued to widen the array of available financial products in the capital market.

As a further incentive to... and protection for investors....the BSP also worked on the full implementation of the third-party custodian system that ensures proper delivery, accounting and monitoring of all securities sold.

The BSP also continues to cooperate with congress on the creation of a centralized credit information bureau system to improve the quality of financial information available to investors, enhance private sector access to credit, and minimize exposure to risks of financial intermediaries.

Concluding remarks

Ladies and gentlemen, I have just given you an update on the financial health of the country as well as an overview of the direction of the BSP monetary, external and banking sector policies.

We are hopeful that the reform agenda we have embarked upon will help us sustain our growth track.

However, you and I know that appropriate policy reforms of government do not by themselves translate into desired growth in output and incomes. The success of policymakers' efforts to sustain economic growth depends on the support and cooperation of the private sector.

The government cannot do everything on its own. To this end, I would like to see the partnership between industry groups like the AIBEP and the Bangko Sentral ng Pilipinas... develop and prosper.

With your support and cooperation, we can achieve broad-based growth in the years ahead, with the fruits of development shared equitably among our people.

On this positive note, I wish to thank all of you for inviting me here tonight. Mabuhay po kayong lahat!