

## **Amando M Tetangco, Jr: Highlights of economic performance in the Philippines over the past year and key challenges ahead**

Keynote address by Mr Amando M Tetangco, Jr, Governor of the Central Bank of the Philippines (Bangko Sentral ng Pilipinas), at the Corporate Planning Society of the Philippines' 2006 4th General Membership Meeting and Christmas Party, Manila, 28 November 2006.

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Ladies and gentlemen of the Corporate Planning Society of the Philippines, fellow workers in government, special guests. Good afternoon and welcome to the Bangko Sentral ng Pilipinas.

I am delighted that the Bangko Sentral is hosting your association's 4th general membership meeting. This provides us the opportunity to directly share with you our insights on vital inputs you need to firm up your plans for the coming years; after this, we can have a free-wheeling discussion so that we can also hear from you, learn about your concerns, and clarify certain issues. This is our way of supporting the cause of strategic planning in our country, the critical and essential function of creating a road map to achieve institutional goals that....taken together....sustain a nation's growth and development.

First, I will discuss the highlights of our economic performance over the past year and our expectations, moving forward. I will also touch on the key challenges ahead and how this will influence the policy direction of the Bangko Sentral.

### **The economy in perspective**

Well, as you are aware, our key economic indicators have been telling us that 2006 is bound to be one of our best years....as positive results have been broad-based. In fact, analysts have been describing 2006 as a defining moment for our economy, as it has turned around negative perceptions.... and raised investor confidence in our country.

Overall, our economy continues to grow, buoyed by the vibrant performance of key sectors notably manufacturing, trade and finance as well as the resurgence of agriculture, fishery and forestry. In fact, real Gross Domestic Product (GDP) accelerated to 5.5 percent during the first half of 2006 from 4.8 percent in the previous year.

Significantly, we were able to keep inflation at single-digit levels....even as our economy grew and absorbed record high domestic oil prices. In fact, we have been seeing a steady decline in inflation from a high of 7.6% in March this year to 5.4% last October, the lowest level since June 2004. Please note that this is within the Bangko Sentral's forecast range of between 5 to 5.7%.

As the institution mandated to stabilize prices, the Bangko Sentral is satisfied with this trend. Essentially, the continued softening of fuel prices and the strengthening of the peso supported the further deceleration in inflation in October.

Latest forecasts of the Bangko Sentral continues to indicate a generally declining path for inflation, with average inflation for 2007 expected to fall within the 4-5 percent target, barring unforeseen adverse shocks of course.

As a result, the Monetary Board, in its last policy meeting on November 2, kept the Bangko Sentral's benchmark policy rates unchanged, but reinstated a tiering of interest rates on bank placements with the BSP to encourage further bank lending. Treasury bill (T-bill) rates also declined across the board in early November, due primarily to the improved fiscal position of the National Government, manageable outlook for inflation and ample liquidity.

On the external front, the overall balance of payments position for the first six months of 2006 recorded a surplus of \$2.04 billion, an improvement from the US\$1.98 billion surplus recorded in the same period in 2005. The improvement resulted from higher inflows in current transfers, particularly from remittances of overseas Filipino workers (OFWs), higher exports and investment inflows.

During the first nine months this year, OFW remittances reached US\$9.1 billion, up 14.4 percent from the same period last year as more Filipinos found work overseas and banks became more aggressive in offering remittance services to OFWs. Based on this trend, we expect total OFW remittances in 2006 to set a new record and approximate \$12 billion.

I am also pleased to inform you that our country's gross international reserves (GIR) reached a new record-high level of US\$22.3 billion in October this year. Given the sustained uptrend in our international reserves, we have in fact pre-paid some of our foreign loans.

Likewise, these developments on the external front continue to sustain the appreciation of the peso versus the US dollar. I am sure you are all aware that the peso hit P49.60 to one US dollar yesterday, its highest level since 2002, as market sentiment continues to be positive. Better-than-expected fiscal performance is a key factor in this regard, as government spending remains restrained even with higher revenues generated from the Revised and the Expanded Value Added Taxes.

To summarize, ladies and gentlemen, we have better macroeconomic fundamentals as inflation continues to decelerate, the peso remains strong against the US dollar, and our fiscal position continues to improve, with actual surpluses posted in four months so far this year. As the Government adheres to the implementation of its economic reform program, we should see more positive developments, moving forward.

### **The financial sector reform agenda**

Similarly, our financial reform agenda has been generating positive results. In particular, the resources of the Philippine banking system reached record high levels as banks continued to register modest growth in deposits and capital accounts. This is significant... as banks account for more than 95% of the assets of the Philippine financial system.

In as much as our economy depends practically on the banking sector for its financial needs, it is imperative that banks are kept sound, healthy and responsive to the needs of its customers.

For your information, the Bangko Sentral supervises 41 operating universal and commercial banks with 4,277 branches, 84 thrift banks with 1,209 branches, and 754 rural and cooperative banks with 1,305 branches. These figures are as of June 30, 2006. With the series of mergers and consolidations that are taking place as banks seek to comply with more stringent capitalization requirements under Basel 2 and international accounting standards, we should see fewer, but stronger banks in the coming years.

The BSP remains steadfast in its efforts to help clean up banks' balance sheets to stimulate lending activity. So far, we have seen the non-performing loan (NPL) ratio of universal and commercial banks drop from a high of 17.4% in 2001....to 8.5% in December 2005.... and further to 7.43% last September.

Aggregate capitalization of the banking sector using the new and more stringent risk-based framework indicates that the banking industry's capital adequacy ratio (CAR) continues to exceed the statutory level set by the BSP at 10 % and the global standard of 8% set by the Bank for International Settlements.

Parallel to this positive development, outstanding loans of commercial and universal banks increased by 6.1% year-on-year in September to P1.597 trillion, the highest growth rate since May 2005.

While these may be modest compared to levels reached in the previous years and by international standards, the numbers nevertheless indicate the overall soundness of the Philippine banking system on account of continuing reforms in recent years. These include, among others, adherence to international best practices and the good governance tenets of fairness, accountability, transparency and social responsibility.

Capital market reform to broaden the funding sources of the economy, as well as to ease the vulnerability of banks to economic downturns, remains a priority for Bangko Sentral. In collaboration with other government agencies and the private sector, the Bangko Sentral worked for the completion of needed infrastructure that would enhance financial system integrity and overall market confidence. The operation of the fixed income exchange (FIE) and the implementation of the third-party custodian scheme are part of these initiatives to provide viable and sustainable alternative sources of funds.

### **The challenges ahead**

In the years ahead, the Bangko Sentral ng Pilipinas will remain focused on its mandate of ensuring price stability by adhering to its inflation target; ensuring that the banking sector remains sound and

able to meet the financial requirements of the economy; and ensuring the stability of the Philippine payments system to minimize or prevent systemic risks.

To pursue its price stability mandate, the Monetary Board, the policy-making body of the Bangko Sentral, will continue to rely on the following basic instruments: policy rates which are set every six weeks and influence the interest rates at which banks transact with their clients; reserve requirements or the share of depositors' money that banks must set aside to meet withdrawals; open market operations which allow the Bangko Sentral to influence the level of money circulating in the economy through the purchase or sale of government securities; and rediscounting which encourages banks to finance priority economic activities such as exports and microfinance.

The Bangko Sentral uses inflation targeting as a framework to maintain price stability. Under this strategy, the BSP calibrates its policy actions to achieve the rate of inflation agreed upon with other economic agencies of government. Adopted in 2002, this approach has served us in good stead. The challenge for us is to keep our forecasting tools on the money so that our policy rate decisions will generate the desired outcome when its full impact is absorbed by the economy 18 to 24 months down the road. Yes, ladies and gentlemen; this is the lag time we have to contend with in measuring the effectiveness of our policy response to ensure stable prices.

As the sole issuer of Philippine currency, the Bangko Sentral must also ensure that there is just enough money in circulation to meet the requirements of the country. The amount of money in circulation must not be too low that it could lead to higher interest rates and slower economic growth. On the other hand, money supply must not be too high that it will be inflationary and reduce the purchasing power of the peso. This is a complex and challenging balancing act.

As mentioned before, it is imperative that the banking sector remains sound and healthy as it provides the funding requirements of the economy, using essentially money entrusted to it by the people. In fact, funding for more than 70% of the resources of the banking system come from deposits which, as of June 2006, had reached P3.2 trillion.

Ensuring the stability of our payments and settlements system is equally important. As the bank of banks, the Bangko Sentral serves as an effective clearing house for high value inter-bank transactions as it holds cash balances of the banks. For this purpose, the Bangko Sentral operates a real-time gross settlement system which we call the Philippine Payments and Settlements System or PHILPASS which processes about 2,000 transactions with a total value of about 300 billion pesos....daily.

This is therefore a vital service as it minimizes settlement risks for high value transactions that may adversely affect the stability of the financial system.

I hope that you will continue to support Bangko Sentral's policies and programs; in the same manner, you can depend on our support....if there is convergence on what our respective institutions want to accomplish.

Indeed, with appropriate programs of cooperation and complementation, the government and the private sectors can unleash the synergy which could sustain growth and development of our economy; jobs and income for the man on the street; as well as peace and prosperity for our country.

Let us therefore work together to sustain our growth momentum and continue to implement our reform agenda. Remember, in the face of increasing global competition and millions of Filipinos who remain mired in poverty, we either innovate....or stagnate. Let us choose to innovate... together.

Maraming salamat sa inyong lahat.