Amando M Tetangco, Jr: The Philippine economy ten years after the Asian crisis

Speech by Mr Amando M Tetangco, Jr, Governor of the Bangko Sentral ng Pilipinas (Central Bank of the Philippines), at the International Symposium “Ten Years After the Asian Currency Crisis: Future Challenges for the Asian Economies and Financial Markets”, hosted by the Center for Monetary Cooperation in Asia (CeMCoA), Bank of Japan, Tokyo, 22 January 2007.

All the charts can be found on the Bank of Japan’s website presentation (190KB).

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Good morning to everyone. Honorable Governor Fukui, Managing Director de Rato, your Excellencies, my fellow governors, distinguished guests, ladies and gentlemen, I think this is really an auspicious time to gather around and take a look, assess the past 10 years since the 1997 Crisis. In doing this, I will try to focus on the Philippines. How it was affected by the Crisis… The policy response… What the effects of the policy package that was implemented have been… And what the future challenges and policy directions for us are.

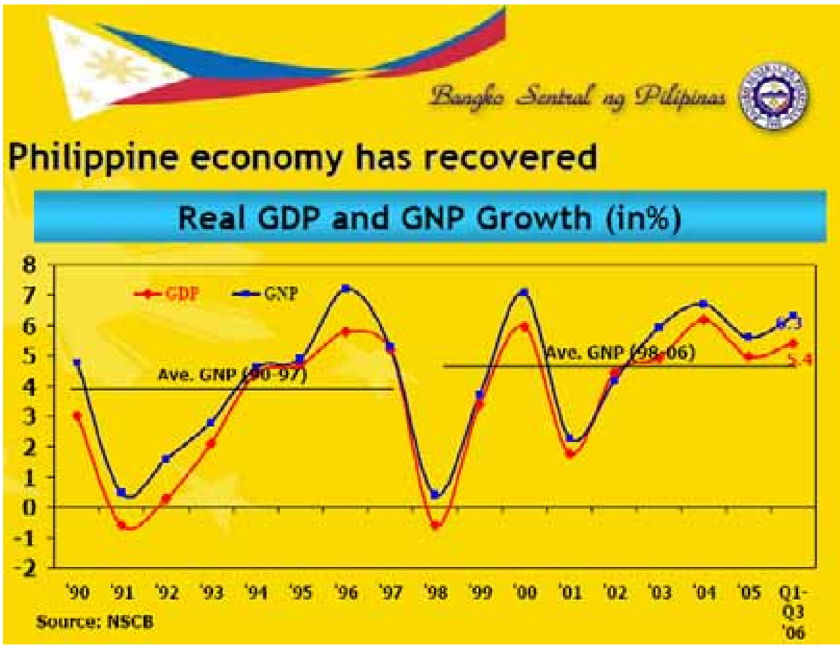
I have circulated a set of charts and I will be making my presentation in accordance with the order of the charts. I will focus on three areas. First, I will discuss why the impact of the Crisis on the Philippines had been moderate compared to other Crisis-hit countries. Second, I will share with you the reforms and policies we pursued to pull the economy back on its feet and lastly, I will discuss some of the current challenges that we face and the policy directions that we are pursuing to propel the economy to a higher growth path.

What was the impact of the Crisis on the Philippine economy? Like in the other countries in the region, a brief look at some of the indicators in the Philippines will show that: First, the peso significantly depreciated; Second, economic growth slowed down; Third, inflation picked up while the balance of payments shifted to a deficit; and, Fourth, the impact of the Crisis on the banking system took some time to manifest itself with the non-performing loans rising significantly after only about three to four years.

Nevertheless, the Philippines was one of the countries that was spared the harshest effects of the financial crisis and this may be attributed to three main factors. First, growth in the Philippines was at a more moderate pace, lower than other Crisis-hit economies in the run up to the Crisis and was at a more sustainable level. This is the argument of the “latecomer to the party” so the impact of the collapse was bearably moderate on us. Because of this, there was no significant buildup of asset bubbles, including those in the property markets prior to the Crisis.

Second, private consumption has historically been less volatile in the Philippines. This may partly be driven by workers’ remittances which tend to act as a source of buffer funds for consumption and a safety valve for employment in periods of external shocks. Third, major structural reforms in the Philippines were initiated in the decade prior to the Crisis. Reforms were implemented to strengthen the financial system. Progress had been realized in at least three important fronts: First was the restructuring of the Central Bank into a new and independent monetary authority that was more effective in discharging its mandate of promoting price stability and financial systems stability. Second was the improvement of prudential policies; including in the areas of capitalization requirements: limits on loans to related interests, provisioning, audit and reporting requirements, and limits on the exposure of banks to the real estate sector. Third was the liberalization of the entry of new banks into the system and the easing of restrictions on the entry of foreign banks. These led to an improvement in the regulatory environment and a more competitive and efficient financial industry. Thus, when the 1997 Crisis broke out, there was no widespread failure of financial institutions in the Philippines.

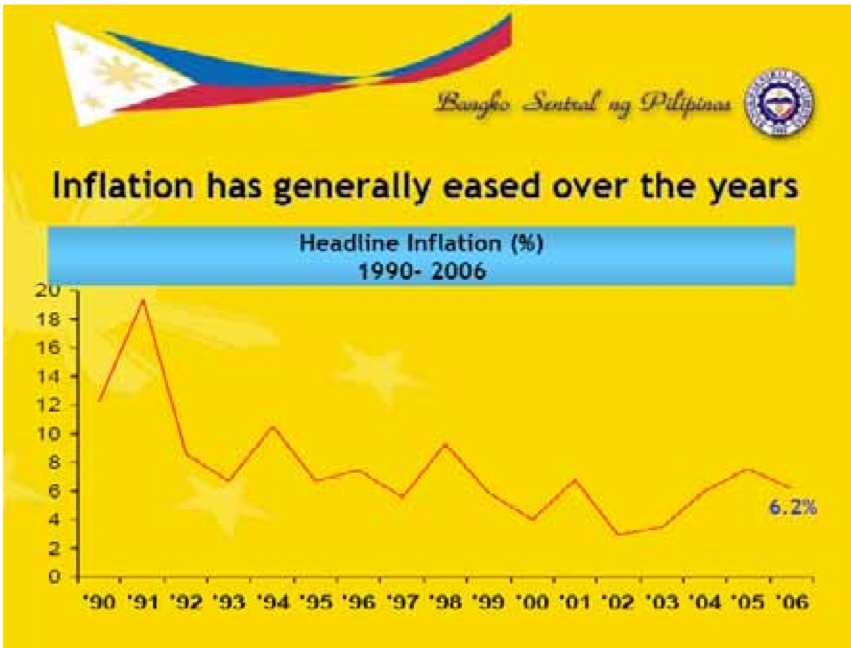
A trade liberalization program was also implemented, involving the reduction of the level and range of tariff rates. The tariff reform program helped mitigate some of the immediate impact of the Crisis, including on inflation. Foreign exchange liberalization was also pursued in the early 1990s. This included the removal of the mandatory surrender of foreign exchange receipts as well as the liberalization of foreign exchange purchases, investment flows and access to foreign loans. The foreign exchange deregulation allowed the Philippines to attain Article Eight status with the IMF in 1995 and the resulting capital inflows provided additional liquidity and depth in the foreign exchange and financial markets. Of course, the capital flows served as an additional mechanism for encouraging macroeconomic policy discipline.



On Chart 8, we show that the Philippines fairly quickly recovered from the Crisis, posting positive growth rates starting in 1999 on the back of the recovery in the agricultural sector and strong government spending. There was some slowdown following the downturn in global information technology cycle in 2001 but the economy eventually picked up momentum from 2002 onwards.

It should also be mentioned that the average GDP growth as well as GNP growth in the Philippines was higher in the post-Asian Crisis period compared with the pre-Crisis period. How did we recover and shift gears? The recovery was helped in part by supportive global economic conditions. More importantly, the authorities also continued to embrace reforms, well aware that reforms strengthen the institutional underpinnings of policies and the economy's flexibility in responding to shocks. However, we continued to face challenges, including those that are non-economic in nature and I am really talking about political developments at that time. These challenges hampered the dynamism of the business environment and contributed to weak investments. On the monetary front, the initial task of the authorities following the Crisis was to try to stabilize the financial markets while limiting the effects on inflation and, to some extent, on output. A tightening of monetary policy through higher interest rates and reserve requirements on bank deposits was implemented along with some administrative measures. This resulted in a tempered depreciation of the peso – relatively tempered although it was still quite significant – while avoiding a large uptick in interest rates that could have negatively or more negatively affected the corporate and household sectors.

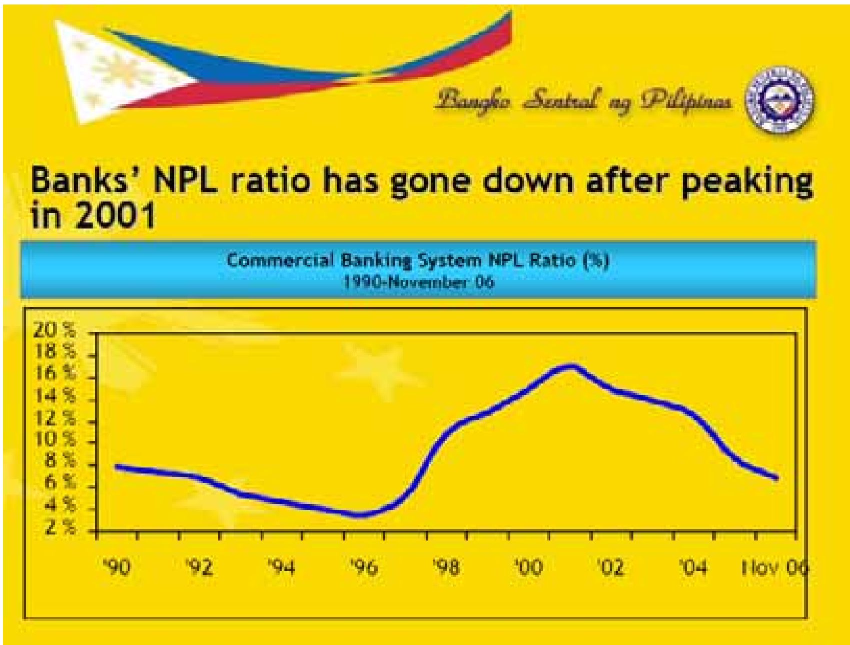
By the way, we had an ongoing IMF program at that time and when the Crisis started, this program was augmented with additional resources. As the inflation outlook began to improve, the BSP began to work on enhancing its policy framework. This led to the formal adoption of the inflation targeting approach to monetary policy in 2002. The inflation targeting framework has provided the BSP with a more information-intensive and forward-looking approach in which monetary policy decisions are based on the assessment of the future evolution of inflation and inflation expectations. This approach is also supplemented by tools like an early warning system and quarterly surveys of business and consumer expectations.



On Chart 10, we show that inflation, which picked up in 1998 to 9.3%, gradually trended downward to reach a low of 3% in 2002, the first year of implementation of inflation targeting. Inflation began to rise again beginning 2004, due mainly to oil price shocks. However, since mid-2005, price pressures have been easing, with 2006 inflation settling at 6.2%, but with the November and December numbers declining to within the target inflation bands of 4-5%.

On Chart 11, we show that during the period after the Crisis, we also took the opportunity to implement further reforms in the financial sector to enhance the system's capacity to withstand shocks. One of the key reforms was the passage of the General Banking Law of 2000. This law intends to modernize the legal framework governing the banking system. At the same time, it institutionalizes the critical mass of banking reforms in the areas of risk management, corporate governance, competition and even micro-finance. As the Central Bank considered it highly essential to address the asset quality issue, we pursued the passage of the Special Purpose Vehicle Act which provided the legal framework for SPVs, including the incentives for the disposal of banks' non-performing assets. It must be emphasized that this approach has not involved public funds and remains a private sector-led exercise.

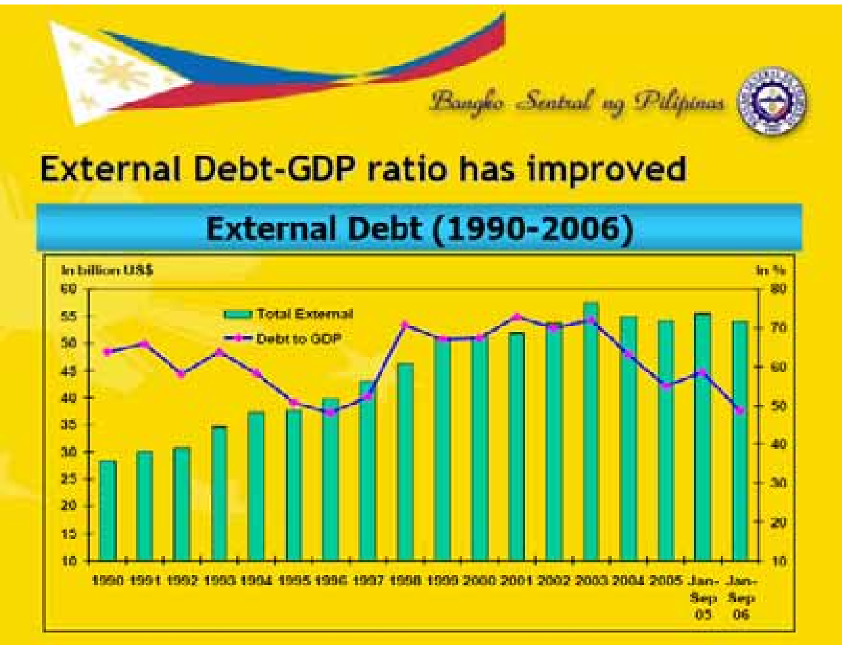
Much effort was also done to bring domestic prudential regulations closer to international standards and other best practices. We have defined the roadmap to make the banking system compliant with Basel II by July 2007 for the standardized approach and by 2010 for the internal ratings-based approach. While this has been happening, we have also begun the change over to international accounting standards last year and we expect that this will strengthen the transparency and disclosure requirements in financial reporting.



Now, on Chart 12, you can see that over time, the reforms have had positive effects on the financial sector. The impact on non-performing loans did not manifest itself right away as it is evident in the gradual rise in the NPL ratio shown in the chart. The ratio peaked at almost 19% of total loans in 2001, and has gone down to less than 7% as of the end of November 2006, closer to the pre-Crisis level. The implementation of a phased program of capital increases as well as the adoption of the risk-based capital adequacy framework helped build up banks' capitalization. As a result, the commercial banks' capital adequacy ratio has steadily gone up to about 19% as of March 2006. The industry's capital adequacy ratio exceeded the statutory level set by the Bangko Sentral at 10% and the BIS standard at 8%.

On Chart 14, we show here the fiscal consolidation program which is one of the key priorities of the national government to address the large budget deficit of the Philippines. However, fiscal reforms took time in coming, partly because of the need to generate consensus for the adjustments necessary to improve fiscal finances. The national government, nevertheless, persevered in implementing a fiscal consolidation program involving tax measures, expenditure streamlining and administrative reforms. On the revenue side, a landmark development was the increase in the value-added tax (VAT) rate from 10% to 12% and the broadening of the VAT base. Various efficiency-enhancing administrative measures were also implemented to help improve the tax take, including through improved audits. On the expenditure side, the government adopted a prudent approach to government-wide spending and this involved expenditure rationalization and close monitoring of revenue sources to better match these with government spending.

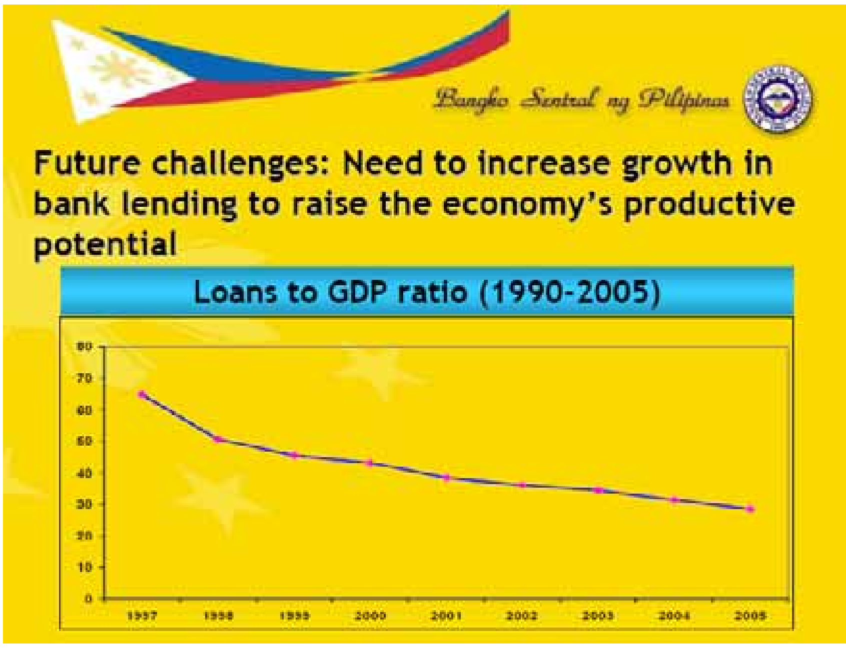
The passage of the VAT and its implementation in 2005-2006, we think, proved to be a turning point for the Philippine economy. It has allowed the accelerated pace of fiscal adjustment and has provided fiscal space for priority spending, including on infrastructure and social services. As a result, the fiscal position has improved after the widening of the deficit to as much as 5.3% of GDP in 2002. During the first nine months of 2006, the fiscal deficit to GDP ratio had gone down to 1.2%. Fiscal reforms which have been instrumental in the rapid pace of fiscal consolidation have also lifted investor confidence and contributed to a sharp fall in country risk premium. Favorable market sentiment has translated into strong dollar inflows from FDI and portfolio investments. Combined with a strong export earnings and OFW (overseas Filipino workers) remittances, these flows moved the peso to an appreciating trend starting with the last quarter of 2005. At the end of that year the Philippine peso had appreciated by 6% to the US dollar, and in 2006 until early 2007 this appreciation has continued and this has been in line with the movement of other regional currencies. The strong inflows of foreign investments in the past two years and the significant growth in remittances also allowed us to build up our international reserves, which now compare favorably with internationally accepted reserve adequacy benchmarks.



On Chart 18, we show that the turnaround in the fiscal position also reduced the need for borrowing by the government and helped improve debt sustainability. The availability of foreign exchange has also given us an opportunity to prepay part of our foreign debt. From a peak of 72.9% of GDP in 2001, external debt has gone down to 48.6% of GDP as of the end of September 2006. This has reduced the economy's vulnerability to roll over and exchange rate risks and to the moods and swings of international capital markets.

Amidst the improved economic conditions, some key challenges remain in lifting our growth to a higher gear. First is the need to sustain the economic reforms. Sustaining the reform momentum is essential in maintaining investor confidence and setting the stage for sustained higher growth. Sustained growth and stronger public finance, in turn, will help promote poverty reduction and build popular support for the government's reform agenda.

Second, there is a need to boost capital spending investment as its share of GDP has remained at a low level in the Philippines. To a large extent, this is the result of the rationalization of government-wide spending that was necessary to address the problem with the fiscal deficit. Weaknesses in the business climate, including regulatory impediments and governance issues, could have also constrained investment. To address this, the government has undertaken a strong effort to improve governance and there are indications that the situation has started to improve. The government has also embarked on a plan to boost capital spending. This will involve a substantial increase in spending on transportation, irrigation, energy and other infrastructure over the next few years. The government is also planning to focus on regional development, building up “super regions” in different parts of the country.



On Chart 22, we show that bank lending growth has continued to be moderate and this is the other challenge that we face. The modest growth in bank lending of certain recent years is due to a combination of demand and supply factors. On the demand side, borrowers have not borrowed heavily due partly to excess capacity and highly liquid positions of companies. The anemic demand for loans may also be traced to the changing nature of businesses. The emerging growth industries, such as trading and business process outsourcing, are less capital and credit-intensive. On the supply side, credit growth may have been constrained by the bank’s weak asset position, mainly in the form of non-performing loans. Moreover, with the adoption of risk-based supervision, banks and investors have become more risk-oriented. However, the present environment presents an opportune time for credit to grow at higher rates. Banks’ balance sheets have been improving as their NPLs continue to go down. We believe that the prevailing low-interest rate environment, as inflation decelerates and as the fiscal debts narrowed, should eventually also spur stronger loan demand for credit. This is expected to ignite the credit transmission channel of monetary policy and help boost growth further.

Lastly, we need to closely monitor and deal with capital surges, given the improving market sentiment towards the country. Foreign investment, as I mentioned earlier, has increased significantly as a result of the improvement in the macroeconomic fundamentals, evidently in the respectable economic growth in pro-fiscal position and easing inflation rates. This strong capital inflow poses several challenges, including the rapid appreciation of the domestic currency which could affect the competitiveness of the country’s exports. It could also lead to dramatic surges in liquidity growth which could affect the outlook for inflation and inflation expectations. Going forward, we at the Bangko Sentral, cognizant of these challenges, will remain watchful of the potential risks of a sustained acceleration of liquidity with a view to acting preemptively to address threats to price stability. We are also currently examining the foreign exchange regulatory regime which was last subjected to a full review in 1993. The BSP is looking at a measured pace of liberalization in line with efforts to strengthen domestic institutions including the financial system.

In conclusion, let me say that there have been important improvements in the economy and the prospects are positive. However, the authorities remain aware that the work is not yet complete. On the monetary front, the BSP will continue to focus on achieving the inflation target. Cautious monetary policy should allow us to see inflation move within the range for this year and next. On the external front, we will continue to institute market-driven measures to boost our external payment position and enable us to further build up our international reserves. On the fiscal front, we expect fiscal consolidation to continue on the back of the fiscal reforms pursued by the government. So in the coming years, the Central Bank, together with other economic agencies, will continue to focus on strengthening the economy in the short term and preserving the momentum for economic reforms that will sustain growth in the long term. The second part, I think, we will be discussing about regional financial and monetary cooperation. I will give my remarks at that point. Thank you very much.