

PHILIPPINES

Economic Update

Overview. Philippine economic growth strengthened through the first half of 2002, aided by rising growth rates in manufacturing and exports. Real GDP growth increased to 4.5% in the second quarter, raising growth in the first half of the year to 4.1%. The pace and nature of growth was, however, not sufficient to prevent unemployment from rising to 11.2% in July 2002 from 10.1% a year earlier. Inflation, at 2.9% in the 12 months ending September 2002, has remained subdued, allowing the monetary authorities to lower key policy interest rates by 800 basis points since the end of 2000. Market interest rates for government debt remain close to record lows (5.2% for 91-day T-bills at end-September), and bank lending rates have also declined. Aided by trade and current account surpluses in the first half of the year and early attainment of the Government's external financing objectives for 2002, gross international reserves of \$16.1 billion as of September remain well above short-term debt plus annual amortization and represent over five months of import cover.

Notwithstanding progress on the real economy, financial markets have weakened significantly since the first quarter of 2002—reflected in lower equity prices, thin trading volumes, depreciation of the peso, and rising spreads on Philippine bonds. The business confidence index also fell to its lowest level for the year in August though it recovered significantly in September. While concerns linked to the uncertain evolution of the global economy and the recent spate of bomb attacks in Mindanao and Manila have clearly impacted markets, fiscal policy has also been a central concern, in particular the overshooting of National Government deficit targets and under-performance on the revenue front—though revenue performance in recent months has shown improvement.

Fiscal policy concerns relate less to short-term financing ability—since stagnant bank lending to the private sector has provided a ready source of domestic financing for the Government—then to medium-term fiscal sustainability. In particular, there are concerns that without a sustained improvement in revenue performance (tax revenue/GDP is expected to decline for a fifth consecutive year in 2002), the Government's objective of reducing presently high levels of public debt will not be compatible with maintaining a minimum level of public spending to support essential

infrastructure and social needs. National Government debt/GNP is estimated at 60% while non-financial public sector debt is about 90% of GNP. Moreover, high levels of banking stress—with non-performing loans continuing to increase through mid-2002, five years after the onset of the Asian crisis—add to fiscal concerns, as they represent an important contingent liability for the public sector. With fiscal deficits targeted to fall in the medium term, and private demand expected to take the lead in sustaining growth, faster progress on bank and corporate restructuring remains a pressing issue.

Recent Economic Developments. The first half of 2002 witnessed rising growth, relative to 2001, in each major production category. Strong performances in fisheries and forestry offset declining second quarter production of some major crops (rice and corn) to deliver a first half agricultural growth rate of 3.5%. Industrial growth of 2.9% in the same period was led by manufacturing, which in turn benefited from the recovery of manufactured exports in the second quarter. A recovery in private construction and significant growth in mining and quarrying (from a low base) also contributed to the higher industrial output. Personal consumption played a key role in supporting domestic demand while net exports increased by 20% in the first half of 2002. By contrast, government consumption was flat while capital formation declined by nearly 5%.

A current account surplus of \$3.4 billion in the first half of 2002 reflected a trade surplus of below \$1 billion and robust growth of workers' remittances. The first half of the year witnessed a modest trade recovery, with both exports and imports shifting from negative to positive growth between the first and second quarters. Exports, which experienced double digit growth in each month between April and September, have been led by faster growth to developing countries in East Asia, whereas demand in the U.S. and Japan, the Philippines largest export markets, has been more restrained. There is, however, concern (across the region) that the recovery, particularly in electronics exports may again be threatened by global demand factors. On the capital account, net portfolio inflows jumped sharply reflecting non-residents' investments in government-issued bonds. Foreign direct investment, however, declined over the same period.

In contrast to developments in the real economy, which appear compatible with the target of 4-4.5% real GDP growth in 2002, financial markets have weakened in the second and third quarters. The Philippine stock market composite index fell by 20% between March and September 2002 though its year-to-date decline

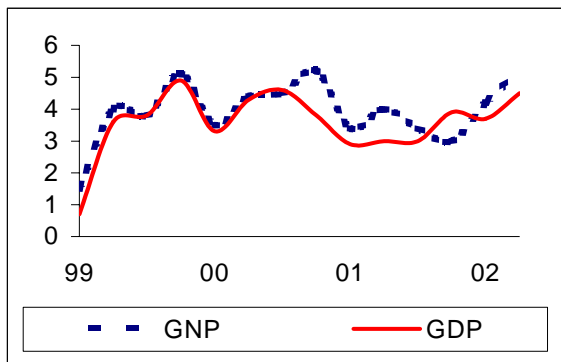
was more modest at 10%. As of mid October, the peso was trading at 14-month lows, while spreads on government bonds have risen sharply in recent months and by nearly 100 basis points in 2002. Non-performing loans of the banking sector, at 17.6% in August, remain close to their post-Asia crisis highs.

GDP and Production Components
(Percent change year on year, at constant prices)

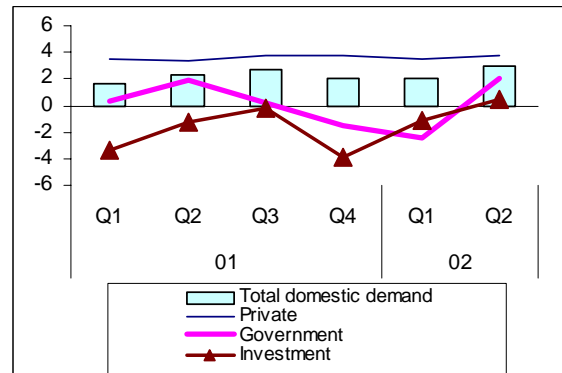
	2000			2001			2002	
	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2
Agri, Fishery, Forestry	5.9	3.2	3.0	3.6	1.7	5.9	4.6	2.4
Industry	3.6	4.1	0.6	2.0	1.9	0.9	1.3	4.3
o/w								
Manufacturing	6.1	4.4	3.4	2.4	2.6	3.2	2.4	5.0
Construction	-7.0	0.8	-9.7	-1.9	-1.1	-1.7	-2.2	-0.2
Utilities	3.4	4.5	4.0	2.7	4.3	-8.1	-8.4	6.3
Service	4.9	3.9	4.6	3.6	4.4	5.1	5.0	5.5
o/w								
Transp,Storage,Telecom	10.7	12.5	10.3	7.1	7.6	10.3	10.2	9.5
Trade	6.5	3.3	5.6	4.5	6.3	6.0	5.5	6.3
Finance	1.3	-0.2	3.3	1.5	0.4	-0.2	-0.6	4.1
Real Estate	-0.2	-3.2	-2.7	-0.6	0.0	1.6	2.3	1.0
GDP	4.6	3.8	2.9	3.0	3.0	3.9	3.7	4.5

Source: National Statistical Coordination Board

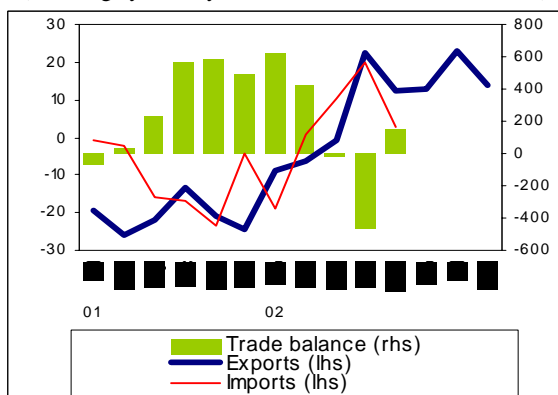
Growth rose in the first half of 2002



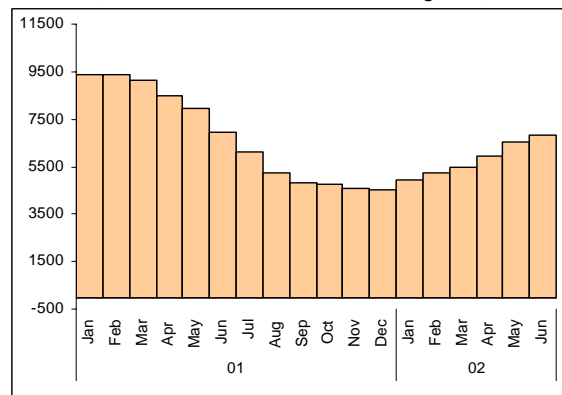
Driven by personal consumption
(% change, year on year)



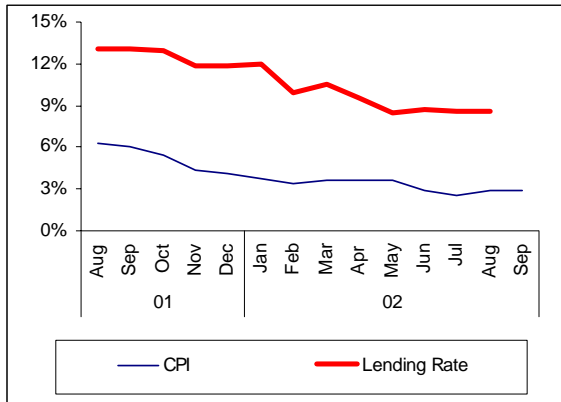
Rising net exports
(Merchandise exports and imports
(% change year on year, trade balance in USD million)



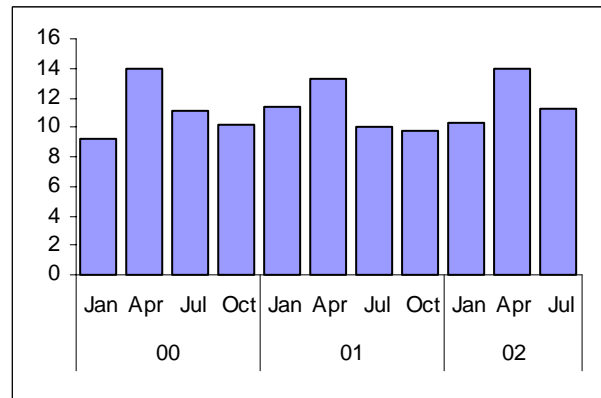
Recovering workers remittances
(in USD million, 12-month moving sum)



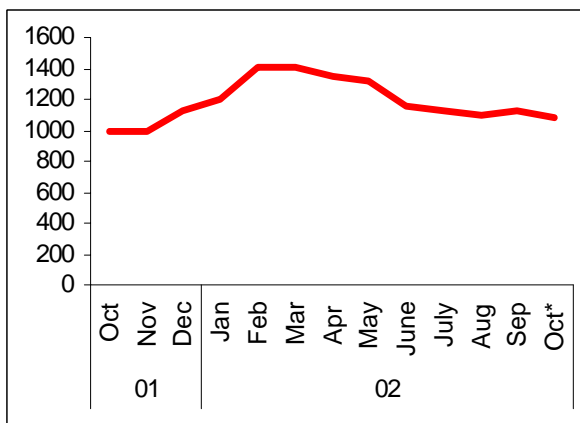
Aided by lower inflation and lending rates
(in percent)



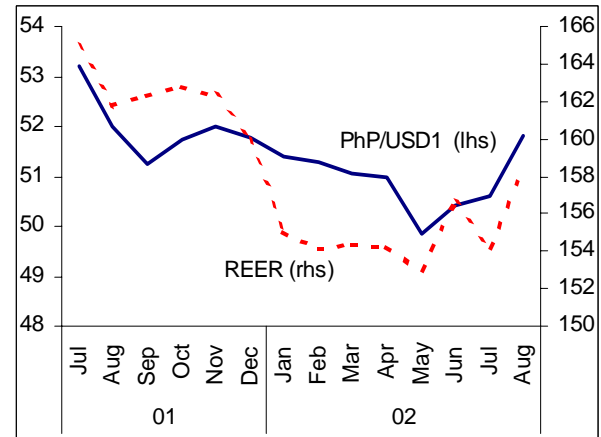
But unemployment remained high
(In percent)



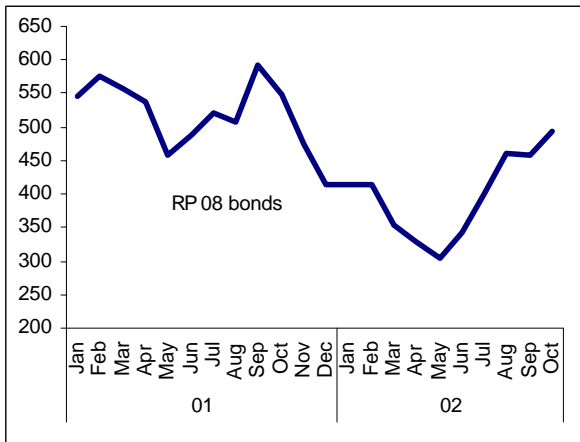
Equity markets weakened
(Philippine composite stock market index)



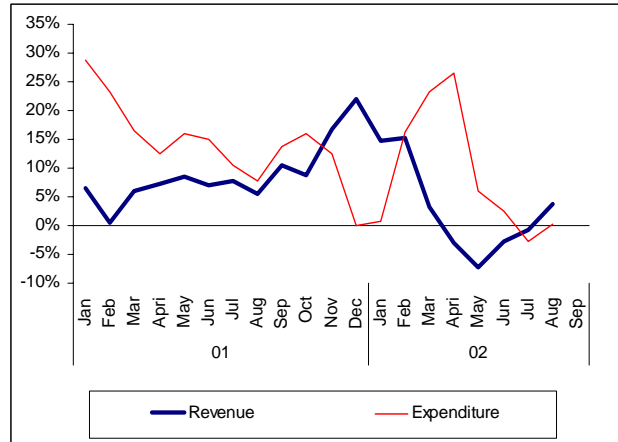
Together with the Peso
(Peso/USD and Real effective exchange rate)



While bond spreads increased
(in number of basis over comparable US Treasuries)



As Government spending exceeded revenue by a wide margin
(Percent year on year, 30months moving average)



Unemployment and Poverty. Rising unemployment rates in April (13.9 percent) and July 2002 (11.2 percent) relative to year-earlier rates (unemployment figures are compiled every three months) reflect a slower pace of job creation and have occurred despite slower growth of labor market entrants in 2002. They present something of a puzzle given the faster pace of production recorded during the same period. Slower job creation in agriculture in 2002 may reflect the nature of growth in the various agricultural sub-sectors, where weather-related slowdowns in rice and corn production may have adversely impacted labor demand. Slower job growth in industry may be the result of lags between output growth and labor demand; alternatively, it may reflect the relatively cautious stance of employers in the face of declining business confidence.

After falling sharply in the mid 1990s, from 34 percent in 1991 to 25 percent in 1997, poverty appears to have increased again, due in part to the Asia crisis. Data from the Family Income and Expenditure Survey (FIES), 2000 indicate that the poverty headcount index had risen by 2.4 percentage points since 1997; with rural poverty rising more than urban poverty.

Poverty Estimates, 1997 and 2000 (Headcount index)

	1997	2000
National	25.1	27.5
Rural	36.9	41.3
Urban	11.9	13.2

Source: A. Balisacan (2002), *Philippines Poverty Assessment Study (2001)*

Policy Issues

Reversing the deterioration in public finances, implementing power sector reforms and addressing structural weakness in the banking and corporate sectors remain vital areas of the policy agenda.

Fiscal Policy and Administration. The government's budget deficit through September 2002 reached P166 billion versus an initial full year target of P130 billion (3.3% of GDP) reflecting both a deliberate acceleration of spending in the first half of the year to support economic recovery, and an unintended revenue shortfall. Tax revenue through September 2002 was only 1% higher in nominal terms compared with the same period of 2001, although tax revenue in both August and September 2002 rose by nearly 15% vis-à-vis the corresponding months of 2001. And BIR

(Bureau of Internal Revenue) collections, which account for more than two thirds of total tax revenue and had been lagging for much of the year, recovered by 31% in September 2002.

The September budget deficit nonetheless increased to P22.4 billion, reflecting a 22% jump in interest payments and a smaller 2.8% increase in non-interest expenditure. For the full January-September 2002 period, however, higher-than-targeted spending on personnel, maintenance and capital outlays were the major contributors to a 2% spending overrun relative to program, whereas interest payments were below target reflecting lower than anticipated borrowing costs. The National Government deficit/GDP ratio in 2002 is now expected to exceed 2001's ratio of 4%, and deficit targets for 2003 and the medium term will have to be reviewed.

Based on quarterly targets of the Department of Finance (DOF), the revenue shortfall in the first semester was P36.6 billion, or 12%. Tax revenue alone had a shortfall of 16% (or P44.4 billion), with the BIR accounting for 75% of the tax revenue shortfall. Collections from BIR's Large Taxpayer Service, which accounts for about 58% of total BIR collections, fell by nearly 8% (year on year terms, January-June). A comparison of January-June 2002 collections with the same period last year indicates that, with the exception of the VAT, major tax collections fell across the board, with excise taxes and total taxes on net income and profit falling, respectively, by 7.4% and 5.8%.

In response to the challenge of increasing revenue collection, the BIR has implemented several new revenue measures, some of which are expected to have an impact in the short term. The most promising initiative is the Reconciliation List for Enforcement (RELIEF) project, which uses industry VAT input benchmarks to target firms for audit and employs third party data to cross check firms' reported sales and purchases. Initial results indicate that: (i) significant discrepancies exist between reported and derived sales data, thus confirming previous studies that suggest high levels of evasion; and (ii) approximately two-thirds of VAT taxpayers claim input credits that exceed the benchmarks (as ratios of VAT sales to purchases). BIR is informing taxpayers of these detected discrepancies and giving them the chance to make payments under a tax amnesty program that expires in November 2002. The RELIEF project coupled with the amnesty should continue to have a positive impact on 4th quarter collections. In addition, a number of

collectors in the BIR have been suspended as a result of alleged corruption. Although the BIR commissioner, who was in charge of leading the administrative transformation process, resigned in August, the new commissioner has committed himself to continue with the administrative measures started by his predecessor and to intensify tax collection efforts.

A sustained effort to strengthen tax administration and policy will clearly be needed if the decline in real tax revenue over the past five years is to be substantially reversed. In an effort to enhance administration, key leaders of Congress recently sponsored a bill to create an Internal Revenue Management Authority (IRMA). The bill proposes to establish an organization that will increase managerial flexibility and strengthen the performance and accountability of the primary revenue collection agency of government. On the policy front, the real value of excise taxes on alcohol and tobacco products needs to be restored to its 1997 level, and indexed to avoid further erosion—as the Government intends. And losses incurred through tax incentives need to be reduced and capped in a manner that is not detrimental to private investment. On the expenditure side, the procurement bill, whose objective is to enhance the effectiveness of public expenditure management by increasing accountability and transparency, and thereby reducing corruption opportunities, is now at an advanced stage of deliberation in Congress.

Power Sector Reform. Enactment of the Electric Power Industry Reform Act (EIRA) in June 2001, and related implementation rules and regulations (IRR) in February 2002, provide the overall framework for far reaching structural reform towards the development of an open and competitive power sector. In accordance with the provisions of EIRA, recent achievement of reform progress include: (a) promulgation of the Distribution Code and Grid Code in December 2001 and Wholesale Electricity Spot Market rules in June 2002; and (b) approval of the National Power Corporation (NPC) privatization plan in October 2002.

In September 2002, the House of Representatives approved a bill to provide the National Transmission Company (Transco) with the mandate to transfer its franchise to a private concessionaire for up to 50 years. The bill, is currently under consideration by the Senate. Approval of the bill is a critical pre-condition for the privatization of Transco, currently scheduled for early 2003. Further, special care has to be taken to balance the needs of investors with the desires of

consumers for lower tariffs in a financially sustainable manner. In particular, the recent decision of the Energy Regulatory Commission on the reduction of the NPC tariff has exacerbated NPC's liquidity problems and increased its already large external financing requirements.

Financial Sector

The Philippines' financial system is dominated by banking. Deposit money bank assets make up over 80 percent of financial assets. Banking itself is highly concentrated, with the largest six commercial banks controlling around 60 percent of all bank assets, and commercial banks themselves are often parts of larger business conglomerates. Short-term commercial bank lending of at most 90 days' maturity provides the main source of external finance for corporations, which tend to be less heavily leveraged and more reliant on retained earnings to finance investment than in most East Asian countries. The contractual savings sector (public and private pension plans, life insurance companies) makes up a second and much smaller segment of the financial system. Capital markets are even less significant as a source of financing for the private sector. They cater primarily to government domestic borrowing. Several features of the financial system, such as the underdevelopment of capital markets, the focus on short-term financing, and the bias towards intra-group lending, reflect the perceived weaknesses in investor and creditor rights.

While the Philippines did not experience a systemic financial crisis in 1997-98, financial volatility and a weak economy for much of the interim period have contributed to deterioration in the asset quality of the banking sector. The adverse impact of these developments has also resulted in a reduction in the turnover of shares and commercial paper in the equities market, and contributed to a financial system under stress.

NPLs and Capital Adequacy. The health of the banking system deteriorated between 1997 and mid 2002. Return on equity and assets have declined steadily, reducing returns on normal banking business. The asset quality of banks has also declined over the last several years. The ratio of commercial bank non-performing loans (NPLs) to total loans surged from 4.7 percent from end-1997 to 10.4 percent by end-1998. Since then NPLs continued to grow to 18.1 percent in June 2002 (though they had dropped to 17.6 percent as of August) reflecting relatively weak economic activity

and stagnant bank lending over much of this period, the episodes of financial market volatility as well as a tightening of reporting standards.

The reported aggregate capital adequacy ratio appears reasonably high (16.8 percent for the banking system at end-March 2002). However, possible inadequate provisioning for non-performing assets and continuing deterioration in asset quality suggest that capital may be overstated. Adjusting for provisioning and other factors, including deferred charges and equity investments, would reduce the effective CAR. The central bank (BSP) introduced a new risk-based capital adequacy requirement for banks effective July 2001. This measure is an important step in bringing the quality of the authorities' prudential supervision closer to the international capital adequacy standards set by the Basle Committee.

Progress has been achieved over the past year in resolving the problems of two large banks. Equitable Bank has recovered most of the deposits it lost, repaid all of its liquidity support, and arranged for an injection of Tier II capital. With regard to the Philippine National Bank (PNB), the Government entered into an agreement with the private owner to convert much of the earlier liquidity support into equity, so that both would own equal shares in the bank. PNB is to focus on rebuilding profitable businesses (developing consumer banking, increasing low cost deposits, improving FX remittance business, etc) while pressing ahead with efforts to reduce NPLs and enhance the value of acquired assets for resale.

Strengthening the bank regulatory and supervisory framework. To mitigate against future problems, the BSP has been strengthening BIS capital standards since July 2001, and required banks to report their accounts on a consolidated basis starting September 2001. To tighten provisioning requirements and regulatory oversight, banks are required to reappraise their foreclosed assets every two years beginning January 2002.

To deal with problem banks in a more timely and effective way, additional fundamental reform is needed. Under the present system, the regulatory authorities face a number of obstacles in taking over and closing banks, as they are not explicitly empowered to intervene in distressed banks without shareholder approval. This situation makes it difficult for the central bank to be as effective as it might be in enforcing prudential regulations, and creates a situation

where bank owners may not face sufficient incentives to properly manage their risks.

To improve the regulatory and supervisory framework, the banking authorities would need stronger legislative authority to intervene in distressed banks without fear of undue legal repercussions. Implementation of a comprehensive consolidated supervisory framework, incorporating risk-focused surveillance and examination techniques, to address the risks inherent in a sector dominated by financial conglomerates would also be beneficial. The BSP has entered into a Memorandum of Agreement with the Securities and Exchange Commission (SEC) to facilitate tighter review of activities of certain financial groups which will potentially be of assistance in the interim.

The Philippines has not adopted a centralized arrangement for dealing with NPLs and repossessed assets on the books of the banks. This reflects the less severe impact of the Asia crisis on Philippine banks and firms, the difficult fiscal situation in the interim years, and the view of the authorities that private initiatives may be best suited to address the non-performing asset situation. Following this approach, the Government has been working on legislation that will permit banks to sell assets to specially designed private sector special purpose asset vehicles (SPAVs, or Asset Management Companies). This could have a positive impact, but in their commentary on earlier versions the draft bill, market experts had expressed concerns about a general bias towards borrowers rights and the ability of the proposed bill to deliver the desired results. The Senate recently passed (on 3rd reading) its version of the bill, which enjoys stronger support from the banking community. The bill is next scheduled for Bicameral conference committee in November.

Strengthening of anti-money laundering measures. The authorities introduced an Anti-Money Laundering Act in September 2001, criminalizing money laundering, and the BSP has issued a Model Anti-Money Laundering Manual for Banks and Other Covered Financial Institutions to promote compliance. Financial institutions are also being encouraged to introduce appropriate internal procedures for the reporting of suspicious transactions. Several accounts with suspicious transactions have since been closed. The Anti-Money Laundering Council (AMLC) won its first case, a procedural victory involving the extension of a freeze order. In early August, Congress agreed to lower the threshold amount from P4 million to

P500,000. These steps are commendable, but the Philippines continues to remain on FATF's (Financial Action Task Force) list of non-cooperative countries and remaining weaknesses in the Act will need to be addressed if the Act is to be effectively implemented.

CORPORATE SECTOR DEVELOPMENTS AND POLICY

The investment outlook is mixed. Business fixed investment picked up in the first half of 2002—13% increase in the first quarter and 9.8% in the second quarter (quarter on quarter). However, going forward the outlook for fixed investment is uncertain—investment project approvals fell 50% year-on-year in the first half of 2002. The September Business World-Roper ASW Business Confidence survey also supports this trend. The September index was the lowest for the past six months. About 75 percent of the survey respondents indicated that they would invest less in the next six months.

The banking system continues its cautious approach to corporate lending. Credit to the private sector contracted slightly in 2002 through July. However, lending to some segments has grown. For example, mortgage lending increased on the back of robust growth in the number of licensed residential projects particularly in the middle-cost housing segment.

While systematic efforts to accelerate corporate restructuring remain stalled, in part due to delays in the passage of the SPAV Bill, a few companies are moving to restructure their balance sheets. For example, in September, PLDT successfully restructured and refinanced \$1.3bn short-term debt obligations through a combination of 5-year and 10-year bond issue and multi-currency term loans.

The formal protection of creditors under law as well as under bankruptcy protection and workout arrangements in the Philippines is weak. Secured creditors do not have adequate protection from stay of foreclosure and do not necessarily enjoy a priority in payment. Creditors do not have adequate say in reorganization of distressed borrowers, or over management. Several steps toward reform have, however, been taken in recent years, including the December 1999 'Rules and Procedures on Corporate Recovery' and the December 2000 Interim Rules of Procedure on Corporate Rehabilitation. The proposed Corporate Recovery Act aims to further strengthen creditor rights and ease the foreclosure process.

Progress is being made under the Securities Act of 2000 to strengthen corporate governance, improve disclosure standards, as well as impose stiffer penalties for fraudulent practices in the capital market. To improve governance of stock exchanges, actions are being taken to improve its compliance enforcement and surveillance capabilities, and demutualization was completed in 2001.

In order to raise investor confidence and promote development of capital markets, in April 2002, the SEC promulgated a Code of Corporate Governance applicable to listed corporations. This code requires corporations to adopt corporate governance rules and principles in accordance with the code. These rules have to be in a manual form and must be submitted for approval to the SEC. The manual has to be made available for inspection by any stockholder of the corporation. Corporations were required to submit their manual for SEC approval by September 2002 and make the rules effective starting January 1, 2003.