

Philippine Economic

Outlook

FEBRUARY 2001

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Introduction

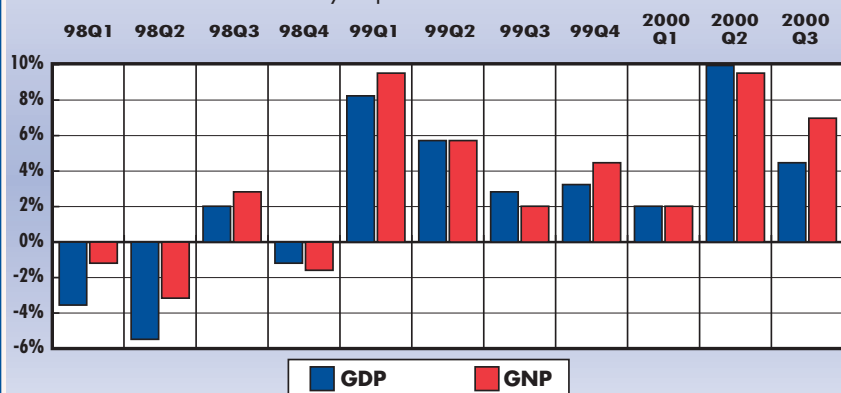


The new administration of President Gloria Macapagal-Arroyo, only days old as this is written, brings with it the hope that an ambitious economic reform agenda can be restarted and expanded. The task, however, is daunting. Now added to a long list of vital reforms, such as restructuring and privatization of the electric power sector, is renewed pressure to quickly address the problems of corruption, poor corporate transparency, and weak governance. Markets will give her a brief "honeymoon" period in which to assemble her economic team, but only quick and decisive action to define and implement a reform agenda can capture and retain the interest of businesses and individuals faced with global investment opportunities.

Last year saw several key economic reforms passed, including new laws on electronic commerce, vital in the new global "e-economy." A new banking law further opens the sector to foreign participation and strengthens regulatory protection for depositors. A new securities law, once fully implemented, will help restore confidence in the equity market and potentially revive this as a source of investment capital. A new law opening the retail trade sector to foreign investment can increase competition and provide Philippine consumers with better services and lower costs. However, other reforms have bogged down; in addition to power sector reform (which remains stuck in the legislature), further bank reforms are needed to expand regulators' ability to protect depositors and to make the Philippines an effective partner in the international fight against money laundering by easing overly stringent bank secrecy laws. The

QTR.-to-QTR. GDP & GNP GROWTH

Seasonally Adjusted Annualized Rates



Philippines also needs to clearly reiterate its intentions to liberalize its trade and investment regimes in line with its ASEAN and WTO commitments. Other key areas for reform include government procurement, and redefining the role of government financial institutions such as the Social Security System (SSS) and the Government Service Insurance System (GSIS).

The government's efforts to shore up the economy are hampered by fiscal difficulties, particularly on the revenue side. With the national government's 2000 fiscal deficit more than doubling the original target, it is clear that new steps to improve the revenue outlook are needed. It is heartening that newly-appointed Finance Secretary Alberto Romulo has identified improving revenue collections as a high priority for the new administration. In addition to addressing enforcement problems at the Bureau of Internal Revenue, the integrity of the Bureau of Customs (consistent with WTO commitments on valuation methodologies) must also be protected.

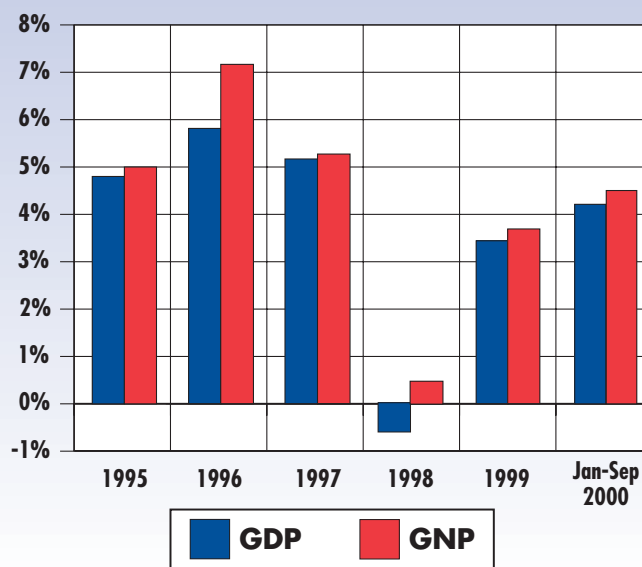
The Philippine economy for 2000 offers a few bright spots: preliminary indications suggest that domestic output for the whole year grew more than 3.5%, and inflation bettered government targets coming in at 4.4%. But slowing reforms and political uncertainty did not help; new investments shrank significantly in 2000 and are unlikely to grow again until reforms are clearly back on track. If President Macapagal-Arroyo is able to quickly assemble a solid team and implement meaningful and lasting reforms, 2001 could still be a good year for the Philippines.

Output and Inflation

Seasonally-adjusted figures (which lack detail) show that quarter-on-quarter economic growth slowed during the third quarter of 2000. Nevertheless, the more widely-used gauge of overall economic activity — measured as the year-on-year change of seasonally-unadjusted data — suggests that the Philippine economy held its ground despite internal and external pressures and events (including the Mindanao conflict, a weakening peso, and oil price increases). Third-quarter real Gross Domestic Product (GDP) grew 4.8% year-on-year. Gross National Product (GNP) increased by 5.7% from 1999's comparable level, the fastest year-on-year GNP expansion since the fourth quarter of 1997.

On the production side, the industrial and service sectors put in improved year-on-year rates of expansion. Industrial growth accelerated from 3.5% in the second

REAL YEAR-TO-YEAR GDP & GNP GROWTH



quarter to 4.4% in the third quarter. Manufacturing (up 6.7% year-on-year) and, to a lesser extent, the utilities sub-sector, drove industrial expansion, making up for the continued contraction in construction activity. Relatively favorable weather conditions pushed agricultural growth from 4.8% (second quarter) to 5.5% (third quarter). Only the service sector (up 4.9% year-on-year) did not better its second-quarter performance (5.5%). Transportation and communication-related services accelerated and the trade sub-sector sustained its 6.5% second-quarter growth pace; however, financial, real estate, and private services increased at slower rates. On the expenditure side, exports, personal consumption, and capital formation all contributed to the acceleration in overall demand. Total capital formation reversed four consecutive quarters of year-on-year declines on the back of smaller net inventory withdrawals. Total fixed-capital investments fell year-on-year for a fourth straight quarter despite a revival in durable equipment demand, reflecting the continued weakness in construction-related spending.

On a cumulative nine-month basis, real GDP in 2000 increased by 4.2% and GNP by 4.5% from their corresponding 1999 levels. The higher economic expansion has been spurred mainly by the private non-agricultural sector. Agricultural sector growth (up 3.3% over 1999's comparable nine-month level) slowed following 1999's rebound from 1998's drought-depressed harvests. Industrial output grew 4.1% after barely expanding during the first nine months of 1999, spurred by manufacturing's 6.3% expansion. The service sector grew at a faster 4.6% clip, with the stronger performances of trade and transport/communications offsetting slower rates posted by financial, private,

and government services. On the demand side, total capital expenditures (up 0.5%) barely budged from 1999's comparable level but, as of September, had at least avoided a further drop from consecutive declines in 1998 and 1999. The pace of net inventory withdrawals has been slowing (consistent with the acceleration in manufacturing activity), suggesting that stocks may be nearing depletion. Durable equipment investments broke from two years of decline with a modest 2.9% expansion, but weak construction spending (declining since 1998) pulled down overall fixed-capital expenditures for a third straight year.

Economic growth is expected to have slowed during the fourth quarter due to higher business costs and poor weather that hurt agricultural output. The impeachment of President

Estrada added yet another layer of uncertainty, shaking already jittery foreign exchange and financial markets. Given third-quarter figures, officials remain hopeful that the domestic economy will have mustered at least 3.5% growth in the fourth quarter to hit a full-year expansion of 4% (the lower end of the government's GDP growth target). Most private economists estimate actual GDP growth in 2000 as somewhat lower, and are concerned about prospects for 2001. The recent political turmoil has unfortunately overshadowed important accomplishments such as stronger banking and securities laws, e-commerce legislation, retail trade liberalization, and resumption of air links between the Philippines and Taiwan.

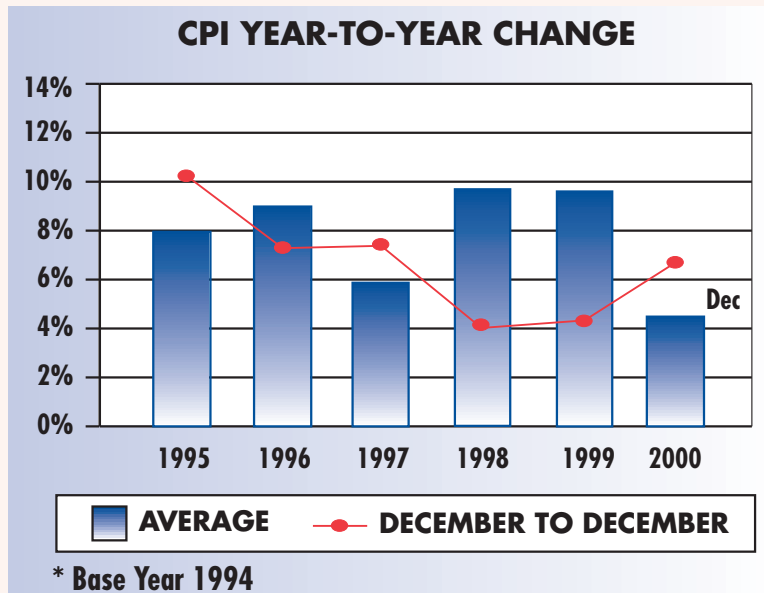
Hopes for the new administration of President Gloria Macapagal-Arroyo may combine with election-related spending (through the nationwide elections to be held on May 14) and declining inventories to boost 2001 growth prospects, but uncertainties cloud the economic horizon. Agriculture remains a wild card with expectations of another (albeit milder) dry spell. The government will continue to struggle with fiscal difficulties. Global economic growth is expected to slow. These factors place the burden of spurring economic expansion on private domestic demand. However, the rapidly changing political and

business climate may temper investment and employment prospects which, combined with the threat of weather-related setbacks on agricultural incomes, could hold back a more robust economic recovery. Our current forecast is for real GDP growth in the 3.2% to 3.9% range in 2001, assuming the new administration is able to quickly gain its feet and push its reform agenda forward. Over the long run, sustaining a higher growth path will depend on

boosting investor confidence, continuing with market-based reforms, and restoring fiscal stability.

Year-on-year consumer price inflation continued to accelerate in the latter part of 2000. By October, the Philippine consumer price index had risen by 4.9% year-on-year, jumping to 6% in November (partly reflecting weather-related disturbances on the heavily-weighted food basket), and accelerating

further to 6.6% in December. The fourth quarter witnessed further oil price adjustments, higher minimum wages, and government-approved transport fare increases. Still, inflation for 2000 was lower than expectations, averaging 4.4% (below the government's targeted 5-6% average range for the full year). However, we expect cost-push factors to reflect on overall price levels in the new year, exacerbated by weather-related supply-side pressures. Our current forecast for 2001 is for inflation in the 6.5% to 7.5% range. Effective 2001, the Bangko Sentral ng Pilipinas (BSP, the central bank) announced a shift from a monetary to inflation-targeting framework to better fulfill its goal of price stabilization.



Labor and Employment

The unemployment rate (computed as the average of quarterly surveys conducted in January, April, July, and October) jumped from 9.7% in 1999 to 11.1% in 2000. The agricultural sector mainly accounted for the higher unemployment rate, reflecting weather-related disturbances and a deceleration from 1999's post-drought expansion. The industrial sector also provided less employment than in 1999, marking a third consecutive

year of job losses. This reflected continued weakness in construction activity, layoffs and business closures, and conservative hiring policies as businesses struggled with higher operating costs. The service sector generated more jobs than in 1999, but these were not enough to absorb the labor force's new entrants. Another dry spell also could adversely affect agricultural employment.

Large disparities between the rural and urban sectors continue to pose important longer-term policy challenges. Agriculture absorbs about 40% of the employed but accounts for barely a fifth of Philippine GDP. Unemployment and underemployment rates are far more severe in rural than in urban areas. Rural residents make up the bulk of the Philippine population living below government-estimated poverty thresholds. The sector's low productivity has hampered its ability to efficiently supply industries with needed inputs, and low rural incomes limit the otherwise higher growth potential that could be spurred by a stronger consumer base.

Following a series of oil price and transportation fare increases during the last half of 2000, the Regional Tripartite Wages and Productivity Board for the National Capital Region (NCR) issued an order, effective November 1, 2000, raising the daily minimum wage in Metro Manila by P26.50 to P250. The minimum wage for workers in agriculture and micro-enterprises was hiked by P15.00 per day, to P213. According to the Department of Labor and Employment, the order covered some 700,000 minimum wage earners of the 3.5 million workers in Metro Manila. Other regions around the country also raised minimum daily wages, but they remained lower across-the-board than in the NCR. The Trade Union Congress of the Philippines (TUCP) and other moderate labor groups appealed the order, arguing it did not provide substantial relief to workers and their families. TUCP also appealed the exemption of export firms from the order, arguing that exporters benefit more from a depreciating peso. There has been no ruling on TUCP's appeal. A bill seeking a legislated wage increase is pending in the House of Representatives.

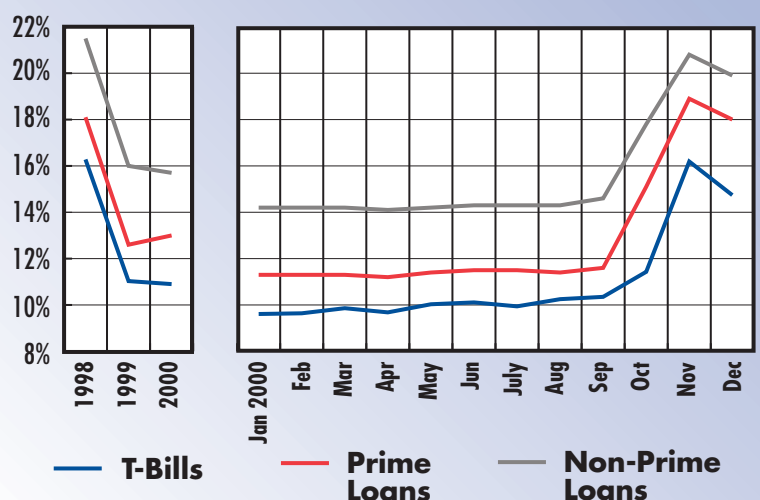
There were 60 strikes in 2000, a 3% increase from the year before. The National Conciliation and Mediation Board resolved 39% of the strikes recorded in 2000. Meantime, the Congressional Labor Commission, created in 1997 to recommend revisions in the Labor Code, is set to complete its often-delayed work in early 2001, but legislation will not be considered until after the national elections in May.


Financial Markets

On October 13, 2000 the BSP hiked overnight rates by four percentage points (to 15% and 17.25% for borrowing and lending rates, respectively). That adjustment — a response to foreign exchange volatility and widening spreads on dollar-denominated Philippine debt — topped the three increases (225 basis points in all) announced between April and September 2000. The BSP also raised reserve requirements on commercial bank deposit liabilities and trust accounts by a total of four percentage points between October 13 and 20 to limit funds available for speculative trading activities. The increases applied to "liquidity reserves" (which, unlike statutory reserves, earn market-based yields) to keep additional upward pressure off intermediation costs and lending rates. During December, the BSP rolled back overnight rates by a total of 150 basis points, encouraged by a calmer foreign exchange market and moderating bid rates for government debt papers. The BSP announced two more rate cuts (totaling 100 basis points) during the first two weeks of the new year on the heels of a 50 basis-point cut by the U.S. Federal Open Market Committee. The partial rollback (to 12.5% and 14.75% for borrowing and lending rates, respectively) reflected concerns that a protracted, high interest rate regime could choke the Philippine economy's fragile recovery, trigger more loan defaults, and aggravate the fiscal situation by raising debt-servicing costs.

The peso's decline dampened investor appetite for government-issued Treasury bills and bonds from late September to all of October. Foreign exchange uncertainties combined with the widening fiscal gap and the BSP's rate increases to drive up bid rates. The P3 billion weekly bond auctions were under-subscribed and the government reject-

AVERAGE DOMESTIC INTEREST RATES





ed all tenders during that period. The uncertainties adversely affected investor appetite even for Treasury bills (issued with shorter-term maturities of 91, 182, and 364 days) and steepened the yield curve. During October, the government awarded only P6.3 billion of that month's scheduled P20 billion T-bill offerings. In late October, the government suspended weekly bond auctions and reduced the offered volume for 182-day and 364-day T-bill instruments, replacing them with shorter-term 42-day and 70-day "cash management bills" (CMBs). The market was more receptive, but the government had little choice except to allow rates to rise to more realistic levels. The government also allowed T-bill rates to adjust. The accepted average rate for the 91-day paper jumped from 9.892% during the October 30 auction to 16.723% on November 6.

The elevation of impeachment charges from the Lower House to the Senate on November 13 actually improved the economic mood and restored some calm to the foreign exchange market, raising investor appetite for regular T-bills. By late November, the government reverted to its normal schedule (i.e., the government stopped offering CMB's, resumed T-bond sales, and increased T-bill offerings to the usual P4 billion level scheduled weekly). The government took advantage of improved sentiments to raise funds from a 25-year T-bond issue on November 25. That offering had originally been scheduled for October but was overtaken by the unfavorable events. The government raised P6.3 billion from that offering at a coupon rate of 18.25%. The longest-term T-bonds (20-year maturity) before that were issued in April 1997 at a 14.38% coupon rate.


Rates on 91-day T-bills softened further during December (averaging 12.93% during 2000's last auction) with the rollback of the BSP's overnight rates. Rates on the longer-term government papers also softened but were relatively stickier coming down as political anxieties hovered and the government's fiscal deficit continued to widen. Commercial banks' fourth-quarter published loan rates rose and tapered with movements in BSP and Treasury rates. Prime rates were averaging nearly 17% at the end of December and non-prime rates at 18.8% — still considerably higher than the published 11.8% (prime) and 14.8% (non-prime) rates at the end of September. Looking ahead, we expect average domestic interest rates to be higher during 2001, dictated by a combination of currency, fiscal, and inflation developments.

The hoped-for revival in bank lending has been modest thus far. Outstanding loans of the commercial banking system (inclusive of inter-bank credits) grew by an average year-on-year rate of 2.6% during the first ten months of the year (nowhere near the almost 30% average yearly rate

at which commercial bank credits had expanded before the Asian crisis). Total loan portfolio grew 3% relative to the end-1999 level, outpaced by the nearly 30% expansion in commercial banks' non-performing loans (NPLs) over that same period. As a result, banks' NPL ratios (12.3% at the end of 1999) continued to rise, reaching 15.7% by September, before declining to 15.6% in October. Foreclosed assets increased by 22% between end-1999 and October 2000 which, added to NPLs, pushed up the aggregate peso value of commercial banks' "non-performing assets" by 27% over that ten-month period. Restructured loans — without which NPLs would be higher — accounted for 5.3% of total commercial bank loans, up from 3.4% at the end of 1999 and less than 1% before the Asian crisis. Bankers doubt NPLs have peaked, noting that businesses are struggling with higher operating and financing costs and slowing demand. Overall, however, generally healthy capital adequacy ratios (about 17% on average) and adjustments in loan-loss reserves (up from 5.7% of total commercial bank credits as of end-1999 to 6.5% as of mid-2000) have helped the banking system avoid systemic risk.

Urban Bank, a commercial bank which bank regulatory authorities promptly closed in April 2000 (a day after the bank's self-declared bank holiday), expects to reopen within the first quarter of 2001 under the ownership and management of Bank of Commerce. Meanwhile, at least three foreign banks with local commercial-bank subsidiaries are working to expand their local presence in response to more liberal foreign investment provisions under the "General Banking Law of 2000." Signed in May, the GBL replaced outmoded 1948 legislation and provided a temporary seven-year window during which foreign banks are allowed 100% ownership of a domestic commercial or thrift bank (up from the previous 60% ceiling). The GBL also allows the BSP to adopt internationally acceptable, risk-based capital adequacy standards (such as those of the Bank for International Settlements). Other important GBL provisions reflect efforts to strengthen disclosure and transparency, bank supervision (including explicit authorization for the BSP to examine banks' subsidiaries), and the quality of bank management.

The BSP continues to encourage consolidation in the banking system through time-bound incentives and a temporary moratorium on the issuance of new bank licenses. From September to December 2000, the BSP approved in principle three acquisitions and mergers involving 3 commercial banks, 2 thrift banks, and an investment house. That raised to 12 the number of such arrangements approved during 2000. The BSP has approved 27 acquisitions or mergers thus far since the



Asian crisis (involving 23 commercial, 15 thrift, and 2 rural banks, as well as 7 non-bank intermediaries). In August, the BSP gave banks until the end of 2000 to meet, without penalty, increased minimum capital requirements which were supposed to take effect at the end of 1999. Late in 2000, 10 commercial banks, 43 thrift banks, and 153 rural banks had yet to meet those requirements. About 17 merger proposals are pending BSP approval. The BSP has also demonstrated greater resolve in weeding out weak financial institutions. Smaller-capitalized thrift and rural banks have been more severely affected by the shakeout but make up only about 10% of total banking system assets. Four more thrift and rural banks closed between September and December 2000, for a total of 23 closures during the year. The 4 thrift, 1 commercial, and 18 rural banks that closed during 2000 constituted about 0.6% of the total resources of the Philippine banking system. It is worth noting that the judiciary is not always helpful; cases are often brought against government examiners for “abuse of power” in closing banks; cases brought against bank owners and managers for fraud often languish.

The sale of the government’s shares in Philippine National Bank (PNB) to taipan Lucio Tan in a July bidding fell through when the buyer reneged on putting up a standby letter-of-credit in September as security for the installment sale. PNB — the sixth largest commercial bank by assets but bleeding from a large NPL ratio (over 35%) — received a P10 billion capital boost in early October via a stock-rights offering. However, the bank almost simultaneously received P25 billion in liquidity assistance from the BSP and the Philippine Deposit Insurance Corporation for heavy deposit withdrawals (triggered by the government shares’ aborted sale and uncertainties over the results of the stock rights deal). Lucio Tan’s group reportedly controls about 80% of PNB directly and by proxy. PNB and the BSP are ironing out details of the bank’s rehabilitation plan. Meanwhile, the stock rights offering has diluted the government’s PNB stake from over 30% to 16%.

The BSP has been working to strengthen anti-money laundering regulations following a June 2000 report by the Paris-based Financial Action Task Force (FATF) listing the Philippines as “non-cooperative” in the international fight against money laundering. Recent BSP circulars prohibit banks from issuing cashier’s or manager’s checks payable to cash or bearer (in effect, requiring identification of the payee); and require banks to keep parallel customer-identification records for numbered foreign-deposit accounts. The BSP also imposed tighter reporting requirements on non-bank foreign exchange trading firms, which

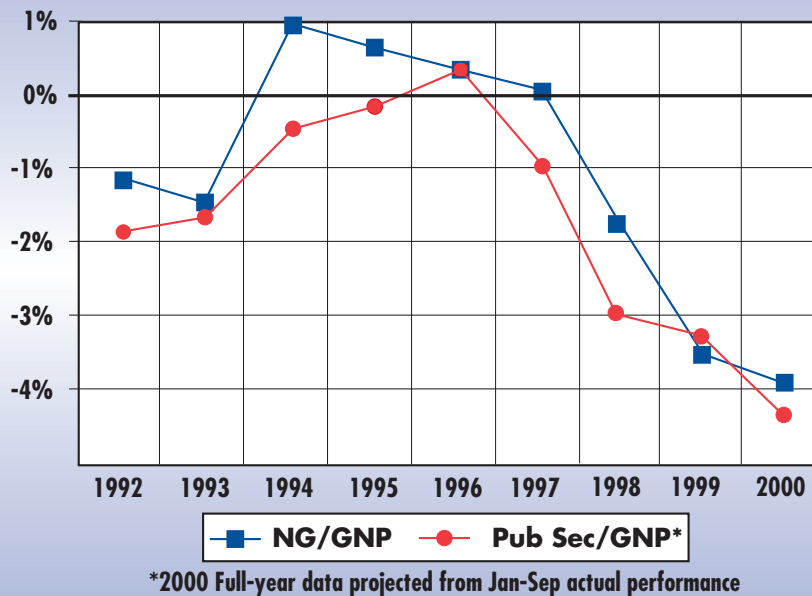
BSP officials cited as helpful in discouraging money laundering activities. Other regulations reiterated customer identification requirements and introduced a suspicious-transactions reporting system. In December, the BSP established a special committee to set up a database and draw up guidelines to evaluate reports on suspicious transactions. Administrative measures are fast running out, however; legislation is still needed to criminalize money laundering and to relax bank secrecy laws.

Longer-term prospects towards a more transparent and credible equities market brightened with the July 2000 passage of the “Securities Regulation Code” (SRC, which rewrote the 1982 “Revised Securities Act”). The SRC provides for the demutualization of the Philippine Stock Exchange (PSE). It also strengthens investor protection by codifying the full disclosure approach to the regulation of public offerings; tightening rules on insider trading; segregating broker-dealer functions; requiring mandatory tender offer requirements; and significantly increasing sanctions for violations of securities laws and regulations, as well as mandating steps to improve internal PSE (and other exchange) management. However, the Philippine stock market continues to be mired by regional and domestic developments, including deepening perceptions of political and economic risks from a slew of bad news (including the BW Resources stock manipulation scandal and the Mindanao conflict). During the fourth quarter, the political scandal surrounding President Estrada took center stage, dealing already thinning and languishing trades yet another blow. The Philippine Stock Price Index (PHISIX) sank to a two-year intra-day low of 1,243.98 (October 19) before improving on bargain-hunting. Traders noted that foreign funds had largely abandoned the market even before the gambling scandal erupted, which prevented the Phisix from falling more sharply. The PHISIX closed 2000 at 1,494.50, down 30.3% from the end of 1999.

Fiscal Performance

By August 2000, the national government’s fiscal deficit (P69.8 billion) had exceeded the original P62.5 billion target. By end-2000, the deficit had ballooned further to P136.1 billion (about 3.9% of GNP). That revenue shortfall reflected dismal privatization sale receipts (off target by P17 billion) and weak internal revenue collections (off by nearly P44 billion). Full-year expenditures exceeded the programmed level by P12.4 billion. The government shelled out P13.8 billion more than planned in interest payments (to finance the deficit). The national govern-

PUBLIC SECTOR & NG SURPLUS/DEFICIT AS % OF GNP



ment's fiscal gap bloated the consolidated public sector deficit (which includes government-controlled firms, social security agencies, and the Bangko Sentral ng Pilipinas). The public sector deficit stood at P83.5 billion (3.3% of GNP) as of September 2000 versus the programmed level of P55.7 billion (2.2% of GNP) for that nine-month period, and may have ended 2000 at around P150 billion (4.3% of GNP).

Presented for congressional approval in July 2000, the Estrada administration's original proposal for a P725 billion budget authorization for 2001 — including an P85 billion (2.2% of GNP) deficit ceiling — has since been overtaken by events. 2001 revenue targets are widely seen as unrealistic, given 2000's dismal performance. Major macroeconomic assumptions for the 2001 fiscal year (including 4.5% to 5.5% real GNP growth and an average foreign exchange rate of P42/US\$), are now seen as unrealistic. On December 19, the Lower House approved a P715 billion budget authorization, making P10 billion in outright and contingent cuts to the executive branch's original proposal (mainly cutting capital, and operations and maintenance expenditures). Members of the Senate finance committee indicated they were considering larger cuts than the Lower House made. It remains unclear if the Senate will be able to finalize the new budget before the body recesses in early February; in the meantime, a supplemental budget for 2001 (beyond the 2000 budget, which remains in force) has been passed to provide funds to hold elections in May. As it struggled to gain popu-

larity, the Estrada administration adopted revenue-eroding measures the government could ill-afford. The 3% duty on crude oil and selected petroleum products was suspended from November 2000 to January 2001, translating to an estimated revenue loss of P1.2 billion over the three-month period.

By all indications, the government faces another challenging year of fiscal juggling. Facing reality, President Macapagal-Arroyo's fiscal team announced it planned to revise its 2001 deficit target from the original proposal of P85 billion to between P130-145 billion. Newly-appointed Secretary of Finance Alberto Romulo has said that increasing revenue collections will be one of the new administration's highest priorities; if such efforts fail, even those levels could be surpassed. The Philippines' tax-to-GNP ratio is among the poorest in the

region, hitting no more than 16.3% (posted in 1997) in more than two decades. 1999 saw that ratio sink to 13.8%, which deteriorated further to barely 13% last year. It is especially worrisome that tax collection performance continued to languish despite what was supposed to have been 2000's stronger, broader-based economic recovery. Weak tax administration has been a long-standing problem; a recent study estimated that about 60% of value-added taxes and individual income taxes escaped collection in 1999. Major cases against tax evaders have languished in the courts. Uneven tax collection has increased public resistance to higher or new taxes and fees. The Government continues to discuss the possibility of a broader reorganization in the Bureau of Internal Revenue

On the expenditure side, the large (about 70%) share of "non-discretionary" budget items (i.e., personnel-related expenses, debt service payments, legally mandated transfers to local government units) leaves the government little leeway for fiscal maneuvering. Personnel costs alone eat up more than a third of the budget pie. Combined with revenue difficulties, it has become extremely difficult for the government to address the country's glaring infrastructure, health and education needs, which in turn are exacerbated by a population growth rate (about 2% annually) that is among the highest in Asia.

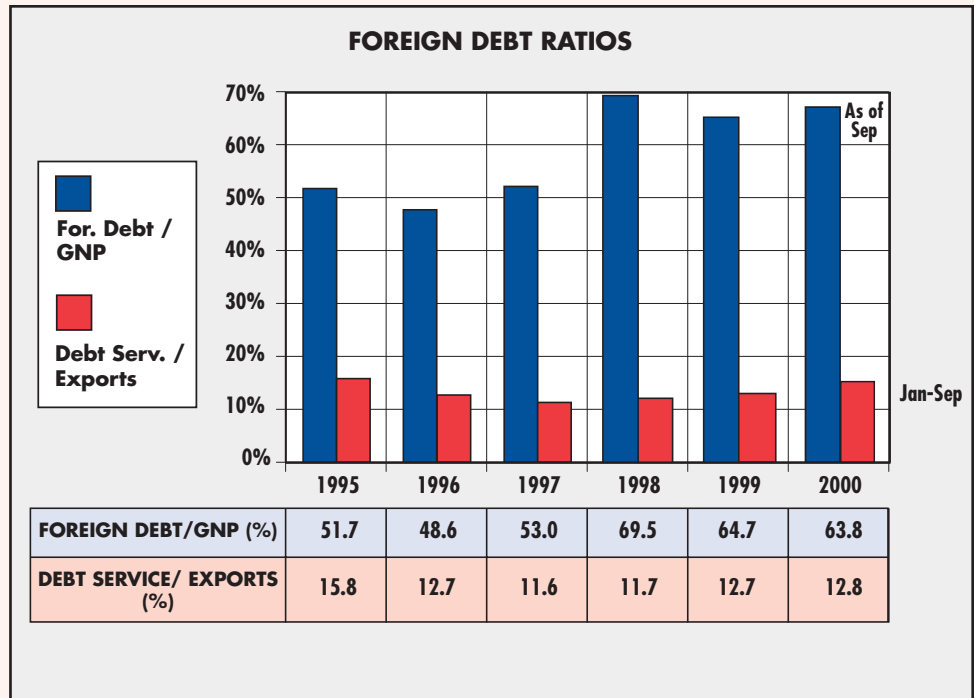
Structurally weak public finances pose a serious threat to the Philippines' long-term growth potential. Fiscal prob-

lems have eroded the intended gains of past tax restructuring programs and could increasingly complicate monetary policy. More aggressive efforts (and stronger political will) are required to achieving long-term fiscal viability. Fiscal reform has become all the more urgent if the Philippines is to muster the resources needed to meet the challenges of an increasingly competitive world economy.

Foreign Debt and Debt Service

The national government had planned to borrow \$1.6 billion from foreign debt markets last year for budget financing purposes. However, after raising over \$1.1 billion from a global bond issue (US\$800 million in March) and a samurai bond float (US\$330 million in July), spreads demanded by voluntary capital markets became increasingly prohibitive as political concerns and negative publicity dampened investor interest. In mid-January, secondary-market spreads on Philippine bonds maturing in 2008 stood at more than 650 basis points over U.S. Treasuries (3.7 times the spread on similar Thai debt), up from 480 basis points in September and 285 basis points a year ago. The government turned instead to the domestic market to plug its foreign borrowing shortfall. In late August, the government issued P8 billion (about \$178 million) in “privatization bonds” (which give holders the option to acquire shares in government-owned assets slated for privatization); and, in September, tapped banks’ foreign currency deposit units by launching a \$400 million syndicated loan.

The Philippines’ two-year \$1.4 billion standby arrangement with the International Monetary Fund (IMF) — which should have ended in March 2000 but was twice extended — ended in December. After drawing \$314 million from the facility in early August (bringing total drawings to \$1.1 billion), the Philippines was unable to draw the last \$300 million tranche, mainly because its burgeoning deficit far exceeded the IMF-agreed target. Failure to restructure the power sector and to privatize and rehabilitate the Philippine National Bank also prevented the



Philippines from drawing another \$400 million from multilateral funding agencies before the end of the year. The government and the IMF have agreed on a periodic review of economic and policy developments in the Philippines under a “post-program monitoring” framework (which will not involve financial support from the Fund).

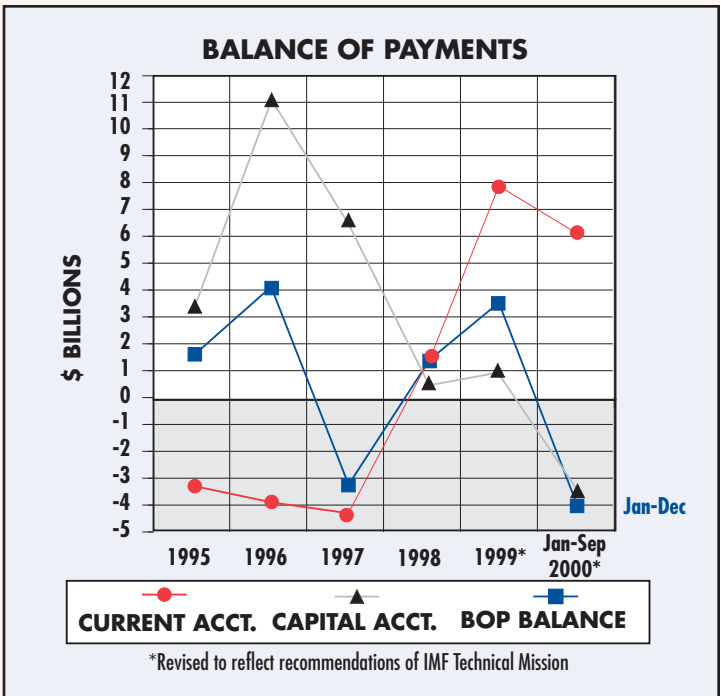
In November, two credit rating agencies (Standard & Poor and Moody’s Investor Service) downgraded the country’s sovereign outlook from “stable” to “negative,” citing escalating political risks. Other ratings agencies maintained their “stable” outlook but indicated that uncertainties surrounding the Philippines’ ratings prospects had increased. If the new administration is able to ‘hit the ground running’, it may face slightly better prospects in raising funds from voluntary capital markets at more affordable terms. To finance development objectives at the least cost for the 2001 budget year, the government intends to source foreign-denominated loans mainly by tapping banks’ foreign currency deposit units and by accelerating loan draw-downs from bilateral and multilateral funding agencies. However, official development donors have long complained of implementation delays. The country’s portfolio of unutilized official development assistance (ODA) is currently estimated at about \$13 billion. The government’s envisioned 2001 budget-financing strategy will be an important test of its ability to accelerate utilization of already committed ODA resources.

The Philippines’ recorded foreign debt stood at \$51.9 billion as of September 2000, down from \$52.4 billion as of March. Higher investments by residents in Philippine

debt papers issued abroad (considered as resident-to-resident transactions and excluded from the external debt stock) and revaluation adjustments from a stronger U.S. dollar more than offset net inflows of foreign borrowings. Over 89% of outstanding foreign debt was medium- to long-term and nearly half represented concessional credits from bilateral and multilateral lenders. The foreign debt service burden remained manageable, equivalent to 12.8% of merchandise and service exports during the first nine months of 2000. Nevertheless, the debt service ratio has been creeping upward since 1998 as foreign debt service payments expanded at a faster pace than export income. Over the longer-term, vulnerabilities to unexpected reversals in export performance highlight the importance of improving the weak state of government finances and attracting non-debt sources of balance of payments financing.

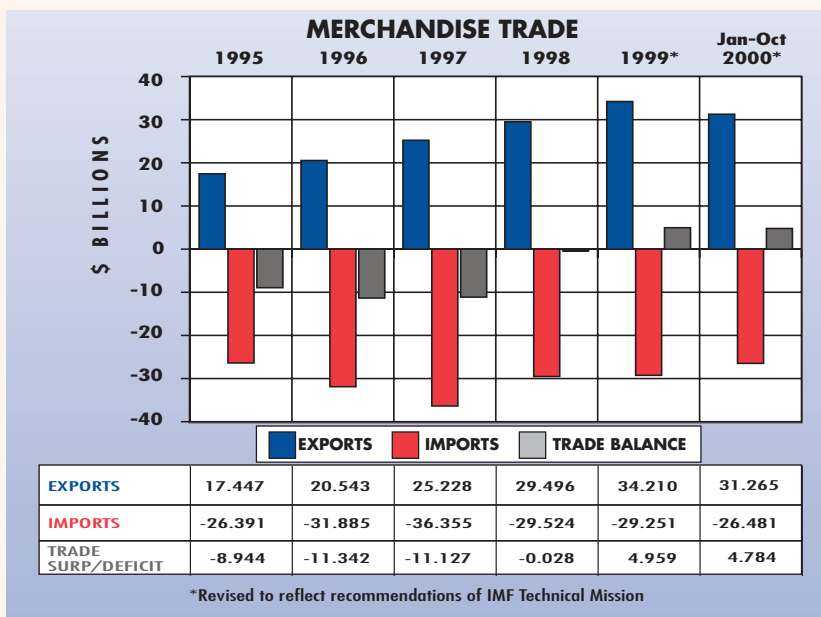
Merchandise Trade and Balance of Payments

Detailed BOP statistics through September showed the Philippines' balance of payments position at a deficit of \$532 million. Year-on-year, the current account surplus widened from \$5.5 billion (7% of GNP) to \$6.1 billion (7.6% of GNP) as the merchandise trade surplus increased. The capital and financial account, which ended 1999 about \$1.6 billion in the red for the full year, slipped further to a \$3.7 billion deficit through the first nine months of 2000. Net foreign direct and portfolio investments shrank to less than \$1.5 billion from over \$4 billion during 1999's comparable nine-month level. Net foreign



direct investments increased from \$569 million to \$1.3 billion, but net inflows of portfolio capital dwindled to \$159 million from \$3.6 billion the year before. Net repayment of foreign loans and short-term trade credits more than wiped out the reduced, combined surplus in the direct and portfolio investment accounts. Although detailed statistics are not yet available, preliminary estimates indicate the country's overall BOP deficit ended 2000 at \$407 million. The Philippines last posted a BOP deficit in 1997.

The ten-month merchandise trade surplus widened to \$4.8 billion from 1999's \$3 billion nine-month level. Overall export growth (7.7%) slowed to a single-digit rate for the first time since 1992 but outpaced the import bill's 2.9% year-on-year expansion. With economies of major export markets anticipated to slow in 2001, export earnings are unlikely to expand at pre-2000 rates. Ten-month non-oil imports were about flat year-on-year, with most of the import bill's overall increase reflecting the impact of much higher world oil prices. Meanwhile, the export slowdown mainly reflected the slower growth in export receipts from shipments of electronics and telecommunications parts and equipment. That category (which contributes about 60% to merchandise export earnings) slowed to 3% growth after expanding by an average annual rate of 30% since the mid-1990s. Industry analysts attributed the slowdown to softer prices for



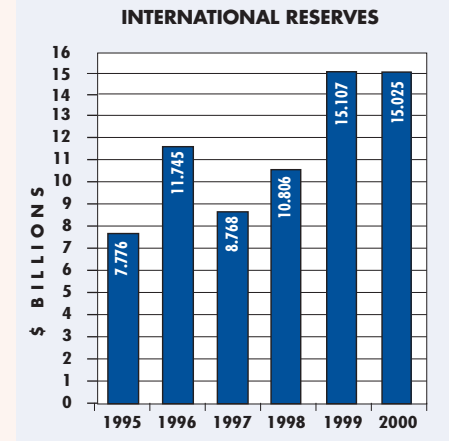
“maturing” products and technologies. They also noted that exports were bound to taper after the investment surge seen in the electronics industry from 1994 to 1997 (about \$1.5 billion/year) came on stream. Investments in the electronics sector registered with the Philippine Economic Zone Authority and the Board of Investments slowed in 1998 and 1999, averaging \$730 million during that two-year period. Investments through September 2000 increased to \$1 billion, concentrated on expansion (rather than new) projects. Industry players (dominated by multinationals) see new opportunities with the strengthening of the information technology and e-commerce sectors, but caution that the industry’s sustained expansion will depend on attracting fresh investments to cope with rapid technological changes.

Last year marked the second and third consecutive years, respectively, of trade and current account surpluses for the Philippines. Looking forward, BOP vulnerabilities remain — primarily a possible reversion to trade and current account deficits should economic growth accelerate. The Philippines’ trade and current accounts have historically posted surpluses during periods of weak economic growth. Long-term BOP stability will also depend heavily on the Philippines’ ability to maintain and attract foreign direct investments in a more and more fiercely competitive world economy.

Foreign Exchange Rate and International Reserves

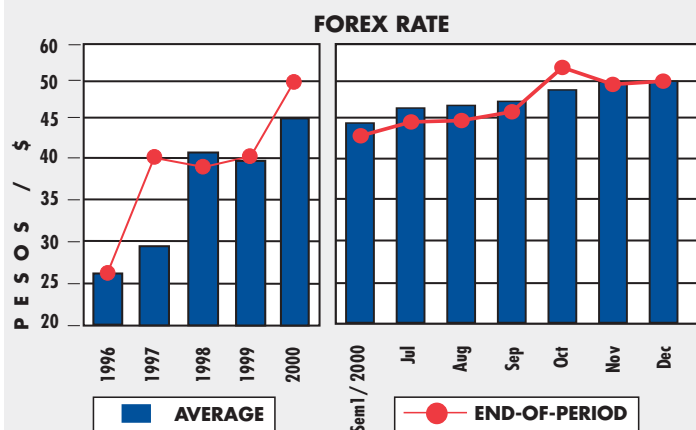
Already weakened by a new wave of regional and domestic news and rumors, the peso sank to new lows during the fourth quarter as political crises shook the foreign currency market. After closing September at P46.15/US\$, the peso

first hit a new intra-day low of P46.61 on October 6, breaching January 7, 1998’s previous P46.50/US\$ record. By late October, the peso weakened below the P51/US\$ mark and hit a new intra-day record low of P51.95/US\$. The peso was especially volatile between mid-October and mid-November, with intra-day differences between high and low trades occasionally breaching P1 and, at one point (November 6), widening to as much as P2.55. Before October, the peso was trading at between 3 to 4 currency units weaker than the baht. That difference had widened to as much as 7.75 units by late October, demonstrating the heavy impact of political developments on the currency.



The BSP moved to smoothen out foreign exchange volatility by increasing domestic interest rates and occasionally injecting liquidity into the foreign exchange market. October also witnessed a succession of BSP moves to discourage panic-driven or speculative plays. Those measures included an “expanded” Currency Risk Protection Program (CRPP), a non-deliverable forward hedging facility originally opened in December 1997. The “expanded” CRRP covers outstanding foreign exchange obligations as of September 30, 2000 (from the previous December 1997 cut-off) and, subject to certain conditions, also covers the requirements of naturally-hedged companies such as oil and export firms (previously ineligible under the earlier CRRP). The BSP also tightened reporting requirements on foreign exchange trading corporations (whether bank-affiliated or not); and imposed documentation requirements for foreign currency purchases of US\$10,000 or more from bank-affiliated foreign exchange trading companies (basically equating the regulations with those long imposed on banks).

The foreign exchange market calmed considerably after the articles of impeachment reached the Senate on November 13. It strengthened to as much as P49.12 during November 22 intra-day trades, also aided by thinner demand after the third-quarter import season and seasonally higher (pre-Christmas holiday) dollar remittances from Filipino overseas workers. However, the peso began to weaken as the December 7 impeachment-trial date approached, hovering tightly around the P50/US\$ mark during that month. At 6.85 units, the peso-baht differential closed 2000 improved



*End-of-period data refers to average foreign exchange rate on last trading day of indicated period.

from late October but still significantly wider than before the fourth quarter. These suggest that anxieties linger and an “uneasy calm” hovers over the foreign exchange market. The local currency closed 2000 at P50.01/US\$, 8.4% weaker than at the end of September and down 24.2% from the end of 1999. By mid-January, the peso had slipped precipitously to a new intra-day low (just shy of P56/US\$) and the peso-baht differential had widened to more than 11 units. The installation of the new Macapagal-Arroyo administration on January 20 helped the peso recover somewhat, but volatility will likely remain tied to political developments in the short term.

Reflecting developments in the balance of payments, the BSP’s gross international reserves (GIR) — generally declining after peaking at \$16 billion in March 2000 — ended 2000 at \$15 billion. That level fell short of the BSP’s US\$16.1 billion goal. Lethargic imports prevented a radical decline in terms of months of import cover. The end-2000 GIR cushion equaled 4.5 months’ worth of goods and services imports (compared with March’s buffer of 4.8 months) and equaled more than 2.5 times the Philippines’ recorded short-term foreign debt. Considered as “secondary reserves,” the BSP also estimated that banks’ foreign currency deposit units (FCDUs) had about \$13.9 billion in deposits as of September 2000, about 90% of which represented deposits of Philippine residents.

Challenges and Prospects

While casual observation might suggest that political turmoil in the Philippines has supplanted economic issues, the fact is that political turmoil has had a direct and material effect on the economy. Recent political events have again made clear to the Filipino people the painful costs of corruption and weak governance. One positive outcome of current events is a renewed commitment, at all levels of society, to seriously address these issues. Corruption and weak governance, however, underpin many of the economic weaknesses cited in this report. A weak tax effort reflects problems within government revenue agencies; the fiscal deficit is further exacerbated by waste and corruption in government spending. Corruption and governance concerns also depress investor enthusiasm, whether for direct investments, equity products or securities. Similar observations can be made for many other areas of the economy. For example, government financial institutions such as the Social Security System and the Government Service Insurance System have often engaged in transactions that seem to have more political rather than financial benefit. (Agriculture is a notable exception; while one can find corruption and gov-

ernance problems here too, agricultural output is affected by the even more fickle problems of weather.)

The new President has clearly stated her commitment to addressing weak governance and corruption. To restore business and investor confidence, this commitment must quickly be translated to action. The most pressing challenges in the near-term are restoring fiscal balance and resuming the path of economic reform. Key reforms such as restructuring the power sector seem very close; a sharp push to finalize the legislation would cheer investors considerably. Another key step would be new legislation to criminalize money laundering and relax bank secrecy, making it harder for criminals to hide their illicit profits. Given that only a few days remain in the legislative session, the new President will also have to make full use of executive orders and other non-legislative measures to push a reform agenda. While only scratching the surface of an anti-corruption agenda, these are real steps that could be completed in a short time to boost confidence in the Philippine economy.

What are the prospects for the future? If the Philippines is able to embark on a quick pace of economic reform, a growth path of 5-6% a year, or even better, is well within reach. The vibrant democracy of the Philippines, combined with a well-educated, hard-working, and English-speaking populace continue to make the country a strong prospect for foreign investment and a potential major player in the new “digital economy.” The more quickly President Macapagal-Arroyo can move beyond the political crisis and refocus the country’s attention on securing a significant place for the Philippines in Asia and the world economy, the better.

PROJECTIONS FOR 2001: SELECTED INDICATORS

	<u>1999</u>	<u>2000</u>	<u>2001</u>
	Actual	Estimate ^a	Forecast ^b
GDP Growth (Year-on-year, %)	3.3	3.9	3.2-3.9
GNP Growth (Year-on-year, %)	3.7	4.2	3.4-4.1
Average Year-on-Year Inflation (1994=100, in %)	6.6	4.4	6.5-7.5
Average 91-day T-bill rate (%)	10.20	9.88	11.0-12.0
Average Forex Rate (Pesos/US\$)	39.04	44.19	48.00-51.00
Exports (\$ Billions)	34.2	37.7	41.1-41.5
Growth (Year-on-year, %)	18.8	10.2	9-10
Imports (\$ Billions)	29.3	32.2	35.1-35.7
Growth (Year-on-year, %)	4.1	9.9	9-11
Trade Balance (\$ Billions)	4.9	5.5	5.4-6.4

^aActual full-year data for T-bill rate, forex rate and inflation; other figures are Embassy estimates based on partial 2000 data

^bEmbassy projections as of December 2000

Sources (1998 and 1999 data): National Economic and Development Authority, BSP

PHILIPPINES: KEY ECONOMIC INDICATORS

(In Million USD, unless otherwise noted)

	1998	1999	2000 <i>p/</i>	
Domestic Economy				
Population (millions, 2000 census)	72.4	73.8	75.3	
Population growth (%)	2.02	2.02	2.02	
GDP (current) <i>a/</i>	65,497	76,653	75,190] full-year est. from Jan-Sep data
GNP (current) <i>a/</i>	68,850	80,727	79,320	
Per Capita GDP, current dollars <i>a/</i>	905	1,039	998	
Real GDP (% change, yr.-on-yr.)	(0.6)	3.3	4.2	Jan-Sep
Real GNP (% change, yr.-on-yr.)	0.4	3.7	4.5	Jan-Sep
Consumer Price Index (ave. % change, yr.-on-yr. 1994=100)	9.7	6.7	4.4	
Production, Employment, Fiscal Accounts				
Unemployment rate (%) <i>b/</i>	10.1%	9.7	11.1	
Industrial prod. (1985=100), % change yr.-on-yr.	(2.1)	0.9	4.1	Jan-Sep
Nat'l gov't budget surplus (deficit) <i>a/</i>	(1,222)	(2,856)	(3,078)	
as % of GNP	(1.8)	(3.5)	(3.9)	
Consolidated public sector surplus (deficit) <i>a/</i>	(2,034)	(2,570)	(1,965)	Jan-Sep
as % of GNP	(3.0)	(3.2)	(3.3)	Jan-Sep
Interest Rates (%)				
Weighted Average T-bill rate <i>f/</i>	16.30	11.02	10.90	
Weighted Average prime loan rate <i>c/</i>	18.12	12.61	12.97	
Balance of Payments <i>g/</i>				
Exports (FOB)	29,496	34,210	31,265	Jan-Oct
Growth (% , yr.-on-yr.) <i>g/</i>	16.9	18.8	7.7	Jan-Oct
Imports (FOB)	29,524	29,251	26,481	Jan-Oct
Growth (% , yr.-on-yr.) <i>g/</i>	(18.8)	4.1	2.9	Jan-Oct
Trade Balance	(28)	4,959	4,784	Jan-Oct
Current Account balance	1,546	7,903	6,141	Jan-Sep
as % of GNP	2.2	9.8	10.8	Jan-Sep
BOP surplus/(deficit)	1,359	3,595	(407)	
Foreign Debt, as of end of period <i>c/</i>				
Debt service paid	5,095	5,999	4,610	Jan-Sep
Debt service (% of exports of goods and services)	11.7	12.7	12.8	Jan-Sep
BSP International Reserves, as of end of period				
	10,806	15,107	15,025	
Exchange Rate (pesos/\$)				
Average exchange rate	40.89	39.09	44.19	
Closing ave. exchange rate <i>d/</i>	39.14	40.30	49.99	
Foreign Direct Investment (BSP registrations) <i>e/</i>				
Total (cumulative, since 1973)	9,305	11,412	12,803	Nov
U.S. (cumulative, since 1973)	2,722	2,806	3,052	Nov
U.S. share (%)	29.2	24.6	23.8	Nov
U.S.-Philippine Trade (Phil. Data) <i>b/</i>				
Philippine exports to U.S., FOB	10,098	10,444	9,293	Jan-Oct
Growth (% , yr.-on-yr.)	14.6	3.4	5.8	Jan-Oct
Philippine imports from U.S., FOB	6,562	6,365	4,136	Jan-Oct
Growth (% , yr.-on-yr.)	(7.9)	(3.0)	(22.9)	Jan-Oct
Philippine trade balance with U.S.	3,536	4,079	5,158	Jan-Oct
U.S. share of Philippine imports (%)	22.3	20.7	15.6	Jan-Oct

a/ originally peso values, converted to USD; *b/* annual figures computed as average of quarterly surveys (Jan/Apr/Jul/Oct); *c/* excludes "net due to" accounts of foreign commercial banks; *d/* average on last trading day of indicated period; *e/* principally exercised to enable foreign exchange purchase from the banking system for capital repatriation and profit remittances; *f/* weighted average for all maturities; *g/* 1999 and 2000 figures reflect recent IMF-recommended technical revisions (but 1999 export and import growth rates were computed using unrevised 1999 data for comparability with 1998 figure); *h/* 2000 figures reflect revisions suggested by an IMF technical mission, while full-year 1998 and 1999 data are unadjusted figures.

Sources: National Economic and Development Authority; Department of Finance; Bangko Sentral ng Pilipinas