

REPORT ON ECONOMIC AND FINANCIAL DEVELOPMENTS

4th QUARTER 2001

TABLE OF CONTENTS

A. Overview	3
B. Real Sector	5
☒ Production.....	5
☒ Stock Market Developments	8
☒ Labor, Employment and Wages.....	9
C. Monetary Sector	10
☒ Reserve Money.....	11
☒ Domestic Liquidity.....	11
☒ Net Domestic Assets.....	12
☒ Prices.....	13
☒ Domestic Interest Rates.....	14
☒ Financial System.....	17
D. Fiscal Sector	20
☒ National Government Cash Operations	20
E. External Sector	21
☒ Balance of Payments.....	21
☒ International Reserves	24
☒ Exchange Rate	26
☒ External Debt.....	28
☒ Foreign Interest Rates.....	32
☒ Other Major External Sector Developments.....	31
F. Financial Condition of the BSP	35
☒ Balance Sheet.....	35
☒ Income Statement.....	36
G. Conclusion: Challenges and Future Policy Directions	37

Statistical Tables

A. OVERVIEW

The Philippine economy demonstrated steadfast growth during the fourth quarter of 2001 despite the daunting challenges it faced—the global economic slowdown, the cyclical downturn in the technology sector which led to the slump in the export sector, and the uncertainties brought about by the 11 September terrorist attacks in the US and their aftermath. Economic growth was accompanied by relatively low inflation which, together with the move by most central banks in advanced economies to cut interest rates, created room for a calibrated monetary easing by the Bangko Sentral ng Pilipinas (BSP). The expansionary monetary policy during the quarter led to the trend decline in market interest rates, which provided broad support to the economy's growth objective in the face of a weak external environment. This paved the way for the creation of more employment opportunities for Filipino workers. Meanwhile, the banking system remained generally stable amid the challenges it faced and continued to perform efficiently its functions of fund intermediation and risk management. On the external front, the overall balance of payments (BOP) yielded a surplus despite difficult global economic conditions which dampened export demand. At the end of 2001, gross international reserves (GIR) reached a comfortable level and were more than sufficient to cover the country's short-term debt.

Economic growth remains sustainable. Economic growth continued to proceed at a healthy pace despite the global economic downturn. Real Gross National Product (GNP) and real Gross Domestic Product (GDP) grew by 3.7 percent and 3.8 percent, respectively, during the fourth quarter of 2001, bolstered by personal consumption and investment spending on the demand side, and by the agriculture and services sectors on the supply side. The resiliency of these sectors along with prudent macroeconomic policies provided the stimulus supportive of the growth of domestic demand in an environment where the external sector remained weak.

Employment rate improves. The Philippine labor force survey for the month of October 2001 showed that the employment rate rose to 90.2

percent from 89.9 percent in the comparable period last year. Relative to the July 2001 employment rate, the October employment rate was 0.3 percentage point higher due mainly to the increase in the number of wage and salary workers in the services sector. On an annual basis, employment across all major sectors expanded, with the services sector posting the highest employment increment of 9.5 percent, followed by the agricultural and industry sectors at 8.2 percent and 5.3 percent, respectively.

Inflation continues to slowdown. During the fourth quarter of 2001, the inflation rate decelerated to 4.7 percent from 6.4 percent in the previous quarter, and from 5.9 percent in the same quarter a year ago. This was due primarily to lower inflation for major food items and non-food items such as fuel, light and water (FLW) as well as services. The decrease in FLW inflation was due to the lower cost of imported crude oil. The inflation rate during the quarter was well below the 6.0-7.0 percent government target for the whole year of 2001.

Interest rates continue to drop. Domestic interest rates recorded a trend decline during the fourth quarter of 2001. This decline was influenced by the easing of domestic monetary policy, which, in turn, reflected the easing of policy rates by the central banks of major international economies. Key policy rates were reduced four times during the quarter, bringing the overnight borrowing (RRP) and lending (RP) rates to 7.75 percent and 10.0 percent, respectively as of end-December 2001. The average yield for T-bills, all maturities, reflected a decline to 10.8 percent during the fourth quarter from an average of 11 percent in the previous quarter. Yields on the 91-day T-bills, however, recorded a higher average of 9.4 percent during the fourth quarter compared to the previous quarter average at 9.3 percent due to the interest rate spike in October when the market was clouded with uncertainty following the 11 September terrorist attacks in the US. By December, however, the 91-day T-bill rate declined to an average of 8.9 percent. Bank lending rates, however, lagged behind the softening trend of T-bill rates, reflecting a higher quarter average range of 12.99-14.57 percent compared to the third quarter average of 12.81-14.42 percent.



Domestic liquidity improves moderately. As of end-December 2001, domestic liquidity or M3 rose by 6.8 percent on an annual basis compared to the 4.6 percent growth registered in the comparable period last year. On a quarterly basis, the level of domestic liquidity increased by 4.7 percent, a reversal of the previous quarter's decline of 1.6 percent, reflecting largely the combined impact of the seasonal rise in demand for liquidity to support increased consumer spending during the holidays as well as the sustained easing of monetary policy as reflected in the cuts in the BSP policy rates and the reduction in the liquidity reserve requirements.

Deficit of the National Government narrows. The National Government incurred a deficit of ₱24.9 billion during the fourth quarter, lower than the previous quarter's deficit of ₱44.3 billion. The deficit was ₱0.1 billion higher compared to the revised program for the quarter on account largely of expenditures exceeding the target level.

External payments position turns positive. The country's balance of payments yielded a surplus of US\$1.116 billion compared to the US\$702 million deficit recorded in the previous quarter and the US\$19 million surplus during the same period last year. This development may be traced to the significant reduction in the net outflows of the capital and financial account, even as the current account recorded a lower surplus. The current account posted a surplus of US\$2.121 billion, lower than the US\$2.502 billion surplus in the fourth quarter of 2000, due mainly to lower net receipts from trade in goods which overshadowed the impact of lower services payments and higher income receipts during the quarter. Meanwhile, the capital and financial account improved as portfolio and direct investments remained significant and as lower net outflows were recorded in the other investment account.

International reserves higher. The BSP-GIR stood at US\$15.7 billion as of end-December 2001, significantly higher than the end-September 2001 level of US\$14.5 billion. The level of reserves was equivalent to 5 months of import of goods and payments of services and income. In terms of debt cover, the level of reserves was more than twice the amount



of short-term debt based on original maturity. Alternatively, it could cover over 100 percent of short-term debt based on residual maturity.

Peso appreciates slightly. The peso appreciated slightly by ₱0.35 from the level in the previous quarter to average ₱51.83/US\$1 during the fourth quarter. The strengthening of the peso toward the yearend reflected the stable conditions in the domestic currency market, the positive developments in the balance of payments, and the decoupling of the country's prospects from those of Argentina. The fourth quarter of the year was also marked by lower exchange rate variability as the effects of the measures implemented by the BSP to help ease pressure on the peso starting in the third quarter further took hold. The value of the peso in terms of the average nominal effective exchange rate (NEER) index vis-à-vis its major trading partners appreciated slightly. Similarly, the real effective exchange rate (REER) index indicated a real appreciation against major trading partners.

Financial system remains broadly stable. Despite the global economic slowdown and uncertainties, the Philippine banking system remained broadly stable during the fourth quarter. The policy initiatives of the BSP and their timely implementation helped the banking system hold its ground amid the challenging environment. The system's resources continued to grow, asset quality improved slightly, and the number of operating units expanded. The aggregate resources of banking institutions expanded by 0.8 percent during the period on account of the growth in both bank deposits and capital base. Similarly, the capital buffer of commercial banks (KBs) remained adequate as their capital adequacy ratio, using the modified Basle formula, stood at 13.5 percent at end-September 2001, slightly lower than the 14.4 percent registered at end-July but well above the statutory minimum prescribed capital adequacy ratio of 10 percent. Meanwhile, the quality of banks' assets improved slightly as indicated by the decline in the ratio of non-performing loans (NPL) of the banking system to 17.3 percent as of end-December from 17.9 percent as of end-September. The NPL ratio dropped due to the decline in the level of NPLs accompanied by the rise in total loans. Banking reforms during the quarter were directed toward further enhancing the BSP's supervisory and regulatory powers and

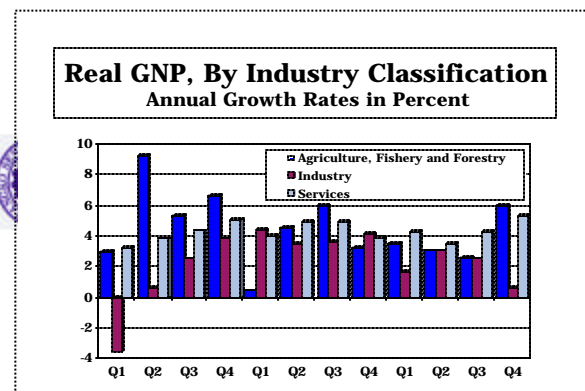
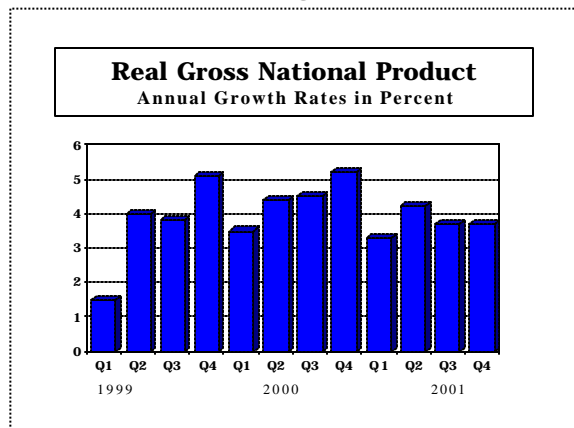


bringing the country's regulatory regime closer to international standards.

B. REAL SECTOR

✦ Production

The economy exhibited a relatively strong performance during the fourth quarter of 2001, despite concerns about the 11 September terrorist attacks against the United States which exerted significant repercussions on the growth of the world economy and that of emerging markets. Real GDP grew by 3.8 percent from 3.3 percent during the third quarter. This higher-than-expected growth led to a whole-year GDP growth of 3.4 percent, slightly higher than the government's target of 3.3 percent. The fourth quarter's growth performance was one of the highest in the region, indicative of the continued resiliency of the Philippine economy (Table 1). Meanwhile, real GNP grew slower than the 5.2 percent expansion recorded during the fourth quarter of 2000 as the growth of net factor income from abroad (NFIA) eased to 1.7 percent from 33.5 percent during the same quarter last year. The decelerated growth of NFIA reflected the slower pace of remittances by overseas Filipino workers (OFWs) and the sharp contraction in interest and dividend income from abroad. Nevertheless, the Government's growth target for real GNP of 3.7 percent for the whole year of 2001 was achieved.



Aggregate Output

Growth during the quarter was driven largely by the

agriculture and services sectors whose annual output rose by 5.9 percent and 5.3 percent, respectively. Industrial growth slowed significantly as manufacturing activity was dampened by reduced demand for major export products.

On the strength of solid contributions from the palay, poultry and fishery subsectors, the agriculture, fishery and forestry (AFF) sector expanded by 5.9 percent. This rate of growth was more than twice its growth during the third quarter and well above the 3.2 percent expansion it posted during the same quarter in 2000. The Government's continued commitment to the development of the agricultural sector through the implementation of the Agriculture and Fisheries Modernization Act (AFMA) along with favorable weather conditions propelled the good performance of agriculture.

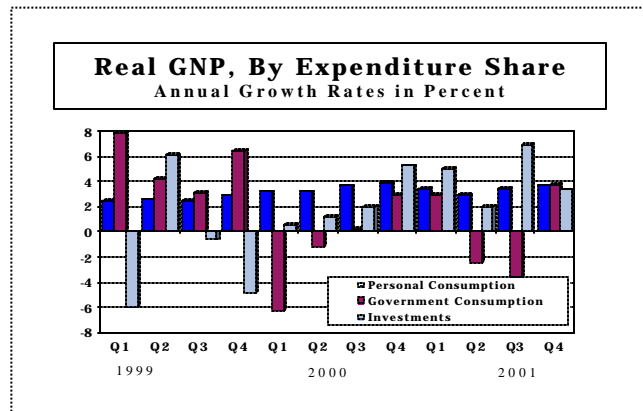
Another major contributor to economic growth during the quarter was the services sector, which registered an accelerated output growth of 5.3 percent compared to the 3.9 percent growth during the same period last year. Except for private services, output in all subsectors rose, led by the transportation, communication and storage subsector. Driven by the continued boom in telecommunications, this subsector grew by 10.7 percent in the fourth quarter, its highest quarterly expansion for 2001 albeit lower than the 12.5 percent growth recorded during the comparable period in 2000.

The global economic slowdown and the aftermath of the 11 September attacks against the United States took their toll on the industry sector, which grew marginally by 0.6 percent during the fourth quarter compared to the 4.1 percent growth during the same period last year. In particular, the rate of expansion in manufacturing output decelerated to 0.8 percent from 4.4 percent during the same quarter in 2000, reflecting the weakness in the exports of semiconductors and electronic products. Likewise, growth in construction subsector reverted to negative terrain as it retreated by 0.6 percent after two consecutive quarters of expansion in 2001.

Aggregate Demand



As external demand weakened due to the global economic downturn and the slowdown in the high-technology sector, domestic demand continued to be the main source of growth during the period. Government spending led the expansion in the GDP. Government



consumption expenditures increased by 3.8 percent, a turnaround from the 3.5 percent contraction registered during the third quarter and higher than the 3.0 percent increase during the fourth quarter of 2000. Increased government spending for the agricultural sector and the provision of additional benefits to government workers during the latter part of the 2001 accounted for the expansion in government consumption (Table 1a). Undaunted by the slack in the global economy, consumer demand also remained strong as personal consumption expenditures increased by 3.7 percent from 3.5 percent during the previous quarter, albeit lower than the 3.9 percent increase during the last quarter of 2000. This was fueled by expenditures on transportation and communications, which continued to increase to 15.0 percent from 13.4 percent during the fourth quarter of 2000. In particular, increased spending in telecommunications was manifested by the surge in the total volume of international calls made and short messages sent.

Meanwhile, investment and exports bore the brunt of the global economic slowdown, downturn in the high-technology sector and the aftermath of the 11 September attacks against the U.S. After posting a 7 percent rise during the previous quarter and a 5.3 percent expansion during the final quarter of 2000, capital formation grew at a decelerated pace of 3.4 percent. This reflected the contraction in fixed capital formation, particularly construction and durable equipment. Excess capacity in the manufacturing sector limited business firms' need to undertake additional investment. Exports dipped sharply by 9.2 percent during the fourth quarter after exhibiting a favorable performance of a

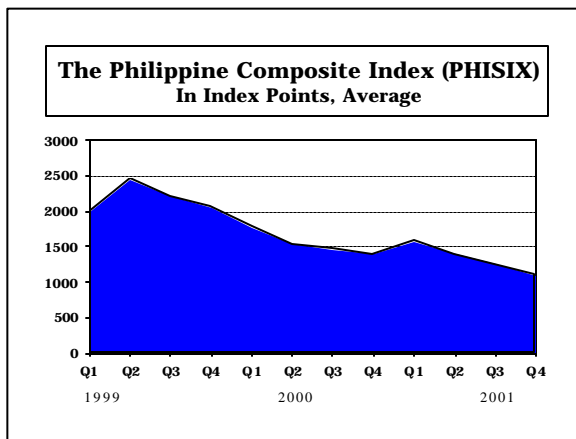


25.2 percent increase during the same period last year as the retreat of the high technology sector depressed exports of electronic goods, which account for about 60 percent of total exports.

❖ Stock Market Developments

Developments in the Philippine stock market reflected the generally cautious mood of investors. The average Philippine Stock Exchange Composite Index (Phisix) during the quarter fell by 12.4 percent to 1,096.7 index points during the fourth quarter of 2001 relative to the previous quarter (Table 2). On an annual basis, the Phisix plunged by 21.4 percent compared to the same period in 2000.

The bearish mood in the local bourse reflected largely the negative developments in the global market such as the slowdown in the global economy and technology sector, the September 11 terrorist attacks on the United States and their aftermath as well as concerns in the domestic front including perception of a relatively weaker-than-expected economic activity telling on corporate profit prospects, doubts on the ability of the Government to meet the budget deficit target, and the peace and order condition particularly in Mindanao.



The value of transactions traded in the fourth quarter of 2001 declined by 5.7 percent to ₱31.3 billion from the third quarter level on account mainly of the substantial drop in the value of shares traded in the commercial and industrial sector (₱5.5 billion). Meanwhile, the gains in the value of shares traded in the banking and financial services (₱3.3 billion),

and the property (₱0.5 billion) sectors mitigated the drop in the value of transactions traded in the stock market. Likewise, the value of



transactions traded contracted sharply by 55.6 percent from the level last year.

The volume of transactions traded in the fourth quarter also declined by 31.5 percent to 28.3 billion shares from 41.3 billion shares in the previous quarter. The sharp drop in the volume of trading was influenced mainly by the contraction in trading activity in the commercial/industrial (7.0 billion shares) and mining (7.9 billion shares) sectors. By contrast, the volume of transactions traded in the banking and financial services, property, and oil sectors increased during the review period. On an annual basis, the volume of transactions in the fourth quarter declined by 26.9 percent from that recorded in the same quarter in 2000.

Despite the bearish mood in the market, market capitalization, defined as the closing price of stocks multiplied by the number of outstanding shares, as of end-December 2001 increased by 3.9 percent to ₱2.14 trillion relative to the previous quarter. Similarly, stock market capitalization in U.S. dollar terms rose by 4 percent during the comparable period, while the average daily turnover in peso terms contracted by 3.4 percent to ₱624.7 million as of end-December from ₱646.7 million as of end-September.

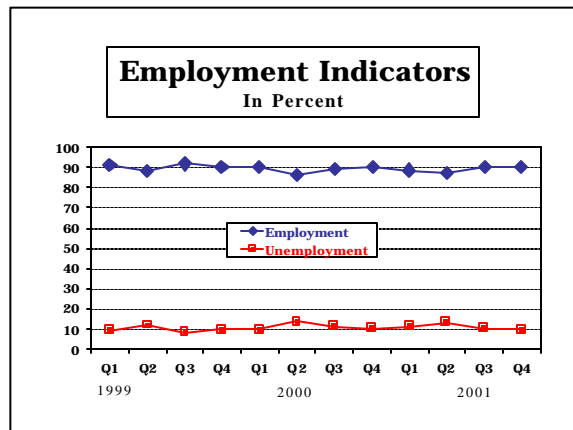
Following the increase in the U.S. Dow Jones Industrial Average and the Nikkei Index of Japan by 11.3 percent and 7.9 percent, respectively, the average stock indices of regional bourses as of the end of the quarter rose across the Asian region compared to the previous quarter.¹ The Hang Seng Index of Hong Kong, the Straits Times Index of Singapore, the Kuala Lumpur Stock Exchange (KLSE) Index of Malaysia, and the Stock Exchange of Thailand (SET) rose by 14.9 percent, 23.0 percent, 13.1 percent, and 9.2 percent, respectively, compared to their levels in September 2001.

¹ Except for the Philippine Stock Exchange (PHISIX) and the Jakarta Stock Exchange of Indonesia, which contracted by 5.8 percent as of end-December 2001 compared to the previous quarter



❖ Labor, Employment and Wages

The Philippine labor force survey for the month of October 2001 showed that the unemployment rate declined to 9.8 percent during the quarter in review from 10.1 percent in the same period last year. Correspondingly, the employment rate rose to 90.2 percent from 89.9 percent in the comparable period last year. Relative to the July 2001 employment rate, the October employment rate was 0.3 percentage point higher due mainly to the increase in the number of wage and salary workers in the services sector (Table 3).



Employment across all major sectors expanded on a year-on-year basis. In spite of the increase in the number of company closures in the fourth quarter of 2001,² the labor market firmed up as the number of jobs generated exceeded the number of jobs lost. The services sector posted the highest employment increment of 9.5 percent due to increased number of workers engaged in wholesale and retail trade; transportation, storage and communication; and financing, insurance, real estate and business services. The services sector's share to total employment increased to 47.0 percent from 46.5 percent. Employment in the agriculture sector likewise increased by 8.2 percent due mainly to the increase in the number of unpaid family workers and wage and salary workers. The agriculture sector maintained its share to total employment at 37.4 percent. In the industry sector, employment rose by 5.3 percent in the construction and manufacturing sub-sectors.

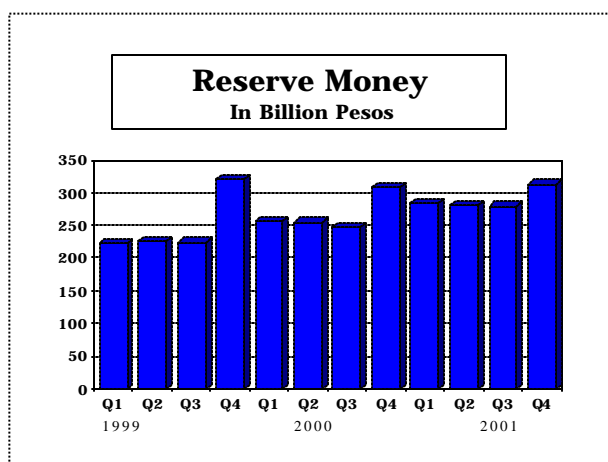
² Based on the Establishment Termination Reports submitted by employers to DOLE Regional Offices, 96 establishments were closed for the period October-November 2001, compared to only 73 in the comparable period last year.



However, the industrial sector's share to total employment decreased by 0.4 percentage point, from 16.0 percent to 15.6 percent.

C. MONETARY SECTOR

☒ Reserve Money



Reserve money (RM) as of end-December 2001 increased by 11.9 percent to ₱312.9 billion from the end-September 2001 level of ₱279.5 billion (Table 4). The ₱33.3 billion rise in the RM level during the review quarter reflected the ₱28.7 billion rise in the net foreign assets (NFA) of the BSP and the ₱4.6 billion increase in Net Domestic Assets (NDA).

The increase in the NFA can be attributed mainly to the 7.6 percent rise in the gross international reserves during the quarter due, in turn, to the proceeds of bond and note flotations and loan drawdowns. Meanwhile, the expansion in the NDA could be traced mainly to the expansionary impact of the payments made by the BSP on its maturing obligations under the reverse repurchase (RRP) window as well as the increase BSP holdings of Treasury Bills as banks' sold back to the BSP some of their government securities (GS) holdings following the two-percentage point reduction in liquidity reserves requirement effective 18 December 2001. Banks' withdrawals from their special deposit accounts (SDAs) with the BSP to fund their end-of-year liquidity requirements also contributed to the expansion in NDA during the quarter.

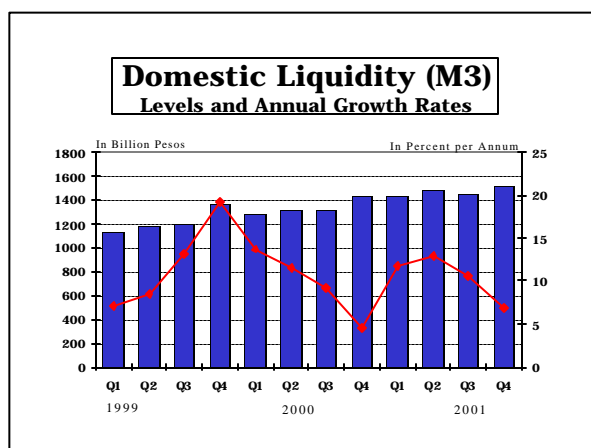


On an annual basis, the level of RM expanded by 1.5 percent due largely to the 18.2 percent increase in the NDA. The year-on-year expansion in the NDA was brought about by withdrawals by the NG of its deposits from the BSP, maturing BSP borrowings under the RRP window, and banks' withdrawals from their SDAs with the BSP.

❖ Domestic Liquidity

As of end-December 2001, domestic liquidity or M3 stood at ₱1.5 trillion, reflecting a 6.8 percent year-on-year growth from the 4.6 percent growth registered in the comparable period of the previous year.

On a quarterly basis, M3 increased by 4.7 percent, a reversal of the previous quarter's decline of 1.6 percent (Table 5). The expansion in M3 during the quarter could be attributed largely to the seasonal rise in demand for liquidity to support increased consumer spending during the holidays as well as the sustained easing of monetary policy as indicated in the four



successive cuts in the BSP policy rates for a total of 125 basis points during the fourth quarter and the 2 percent reduction in liquidity reserves.

By composition, peso demand, savings and time deposits and deposit substitutes, which comprised about 87.0 percent of total domestic liquidity, increased by ₱34.5 billion or 2.7 percent during the fourth quarter relative to the previous quarter's level. Currency in circulation, which accounted for the remaining component of M3, increased by ₱34.8 billion or by 21.8 percent during the period in review. Meanwhile, M4, which is defined as domestic liquidity (M3) plus foreign currency deposits (FCDs) of non-bank residents, reached ₱2.1 trillion as of end-December. On an annual basis, M4 registered an



expansion of 4.9 percent in December 2001, from 6.7 percent in the comparable period a year ago. On a quarterly basis, M4 increased by 2.8 percent, despite a 1.8 percent decline in the foreign currency deposits of residents during the period in review.

The financial deepening ratio (defined as M3/GNP), a measure of the level of domestic mobilization of financial resources in the economy, increased slightly to 39.5 percent by the end of the fourth quarter of 2001 from 38.7 percent at the end of the previous quarter.

✧ **Net Domestic Assets**

The net domestic assets (NDA) of the monetary system reached ₱1.8 trillion as of end-December 2001. On an annual basis, the growth of NDA decelerated to 1.3 percent from 8.0 percent in the comparable period of the previous year.

Compared to its year-ago level, the growth of net domestic credits (NDC), a major component of NDA moderated to 1.0 percent from the 8.6 percent registered in the comparable period of 2000. Public sector credits continued to expand in December by about 11.4 percent, due mainly to increasing investments in government securities. Meanwhile, private sector credits contracted by 3.0 percent year-on-year as of end-December, as credit activity was restrained by the presence of spare capacity in the manufacturing sector—which limited the demand for new loans—and the still high levels of bank's NPL's, prompting banks to maintain a cautious lending stance. As of end-December 2001, loans outstanding of commercial banks (KBs) stood at ₱1.4 trillion, reflecting a 3.6 percent contraction from its year-ago level. The level of outstanding loans declined across all sectors with the exception of the wholesale and retail trade and the community, social and personal services sector, which grew by 4.5 percent and 19.8 percent, respectively.

As a percentage of GDP, domestic credits stood at 58.0 percent as of end-December 2001, from 59.0 percent as of end-September 2001.

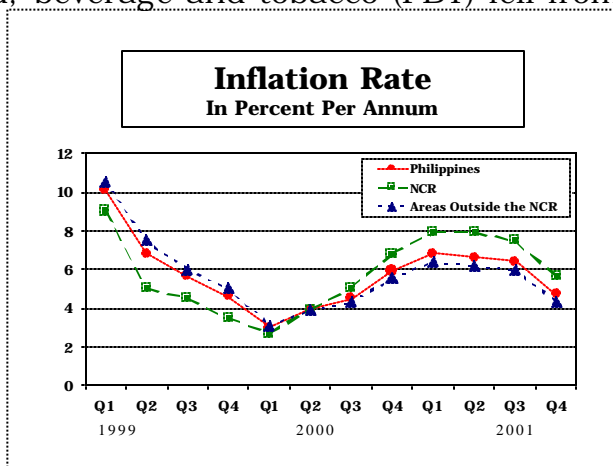


The ratio of domestic credits to the country's GDP remained low compared to those of other Asian countries, such as Taiwan (158.3 percent), Malaysia (116.3 percent), Korea (95.6 percent), but was comparable to that of Indonesia (61.3 percent).

✧ Prices

The headline inflation rate for the fourth quarter of 2001 declined to 4.7 percent from 6.4 percent in the previous quarter (Table 6). This rate was lower than the 5.9 percent recorded in the same quarter a year ago.

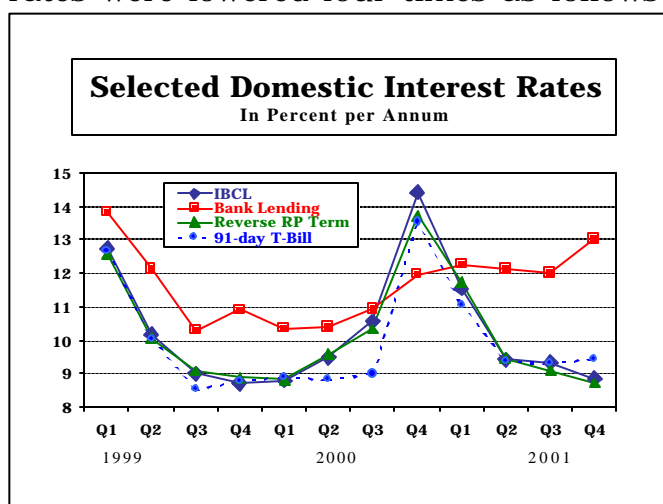
The decline in the fourth-quarter inflation could be attributed to lower inflation rates across all commodity groups. The downtrend in prices was due to favorable supply-side factors notably the lower prices in food and oil products as well as continued prudence in monetary policy. The inflation rate for food, beverage and tobacco (FBT) fell from 4.6 percent in the third quarter to 2.9 percent in the fourth quarter. The decline was the result mainly of lower prices for rice, corn and fruits as well as vegetables during the review period. Meanwhile, the inflation rate for non-food items fell from 8.4 percent in the third quarter to 6.4 percent in the fourth quarter as year-on-year inflation declined in the following commodity groups: services, which include gasoline and petroleum products (from 11.6 percent to 7.5 percent), as lower oil prices exerted a dampening influence on the price of transport services, fuel, light and water (from 11.9 percent to 10.1 percent); housing and repairs (from 7.3 percent to 6.7 percent); clothing (from 4.0 percent to 3.3 percent); and miscellaneous items (from 4.2 percent to 3.2 percent).



In terms of geographical location, the average inflation rates for both the Metro Manila area and areas outside Metro Manila (AOMM) fell to 5.6 percent and 4.3 percent, respectively, in the fourth quarter from 7.5 percent and 6.0 percent, respectively, in the previous quarter (Tables 6a and 6b).

❖ Domestic Interest Rates

Domestic interest rates recorded a trend decline during the fourth quarter of 2001. Sustaining the downtrend which started in March 2001, this quarter's decline essentially reflected the easing mode of monetary policy following the worldwide trend toward a reduction in interest rates. The benign inflation environment and the subdued inflation outlook as well as relative stability in the foreign exchange market provided the authorities with room for further monetary easing. During the period, key policy rates were lowered four times as follows: by 25 basis points effective 5 October; 50 basis points effective 9 November; and by another 25 basis points each effective 7 and 14 December for an aggregate of 125 basis points for the whole quarter. As of end-December 2001, the overnight borrowing (RRP) and lending (RP) rates stood at 7.75 percent and 10.0 percent, respectively.



Following the decline in policy rates, the monthly average yields for government securities trended downward. Across maturities, yields slid from an average of 11.5 percent in October to 9.9 percent in December, pulling down the average yield for the quarter to 10.8 percent from 11.0 percent in the previous quarter and 14.8 percent in the comparable period of the previous year. In part, the softening in the yields reflected the improved liquidity condition of banks and the



market's preference for Treasury issues as lending remained restrained. By maturity, yields on all tenors generally softened during the quarter, except for the 91-day issues which recorded a higher average at 9.4 percent compared to the previous quarter's 9.3 percent (Table 7). This developed due to the interest rate spike in October, as the market was clouded with uncertainties following the 11 September terrorist attacks in the U.S. By December, however, yields of 91-day T-bill rates declined to an average of 8.9 percent.

The decline in bank lending rates during the fourth quarter lagged behind the softening of the Treasury bill rates, as bank lending rates averaged higher on a quarter-on-quarter basis. Bank lending rates during the fourth quarter averaged at 12.99-14.57 percent compared to the third quarter average at 12.81-14.43 percent. Likewise, the average spread of domestic lending rates (using the low end of lending rates of banks) over the benchmark T-bill rates reflected a slight increase of 4 basis points to 3.56 percent from the previous quarter's 3.52 percent.

Meanwhile, the average yield on savings and time deposits rose by 72.4 basis points to 7.47 percent and by 63.1 basis points to 9.51 percent, respectively, during the fourth quarter. At the interbank call loan market, the rates dropped by 45 basis points to average 8.86 percent during the quarter, indicative of the ample liquidity in the banking system.

The interest rate differential (net of taxes),³ computed as the difference between the 91-day T-bill rate and the 90-day London Interbank Borrowing Rate (LIBOR), widened to 5.14 percent from 4.18 percent registered in the previous quarter.

During the quarter, real interest rates on T-bills, savings and time deposits generally rose. The interest rate on T-bills (all maturities) averaged higher by 164.9 basis points compared to the previous quarter's rate while savings and time deposits rates increased by 255 and 245.7 basis points, respectively, in real terms.

³ Net of the 20 percent withholding tax



❖ **Financial System**

Performance of the Banking System

Even as global uncertainties prevailed during the fourth quarter of 2001, the banking system remained resilient and stable. The policy initiatives of the BSP and their timely implementation enabled the banking system to hold its ground amid the challenging environment. The system's resources continued to grow, asset quality showed a slight improvement, and the number of operating units expanded.

As of end-December 2001, aggregate resources of the banking institutions expanded by 0.8 percent to record ₱3.4 trillion on account of the growth in banks' deposits and capital base. KBs continued to account for the bulk or three-fourths of the system's resources (Table 8).

Banks' asset quality also improved as indicated by the reduction in the NPL ratio of KBs in the fourth quarter to 17.4 percent from the previous quarter's 17.9 percent. The NPL ratio dropped due to the decline in the level of NPLs accompanied by the rise in total loans. Despite the decline in the NPL ratio, KBs continued to build up their loan loss provisions (LLP) as a buffer against possible loan defaults. Consequently, the ratio of LLP to NPL rose to 45.2 percent in December, higher by 1.7 percentage points from 43.5 percent in September.

Compared to other countries in Asia, the local KBs' NPL ratio of 17.4 percent was higher than that of Indonesia (12.1 percent),⁴ Korea (3.8 percent),⁵ Malaysia (10.5 percent),⁶ Thailand (10.5 percent).⁶ It is

⁴ As of December 2001, banking system

⁵ As of September 2001, commercial banks only

⁶ As of December 2001, commercial banks only



instructive to note that the relatively lower NPL ratios of other emerging-affected economies could be attributed to the offloading of their NPLs to public restructuring agencies. In the case of the Philippines, however, no public funds were used to acquire non-performing assets or to infuse capital in weak banks. If NPLs still held by the AMC's are added to those in the banking system, the NPL ratios of these Asian countries would be comparable, if not higher than that of the Philippines. The ratio is estimated at 55 percent for Indonesia, 25 percent in Thailand, and in the 17-19 range percent in Korea and Malaysia.⁷

KBs' capital adequacy ratio (CAR), using the modified Basle formula, stood at 13.5 percent as of end-September, slightly lower than the 14.4 percent registered in July, but still above the minimum prescribed statutory capital adequacy ratio of 10 percent. The modified Basle formula took effect on 1 July 2001.

Meanwhile, the number of head offices of banks fell to 937 in September from 938 in June due to the ongoing consolidation of the banking system. There were 44 commercial banks, 107 thrift banks and 786 rural banks. During the third quarter, the first microfinance bank was given authority to operate in line with the BSP's policy thrust to support the Government's poverty alleviation program through micro-financing, which involves the grant of small loans typically ranging from ₱2,000 to ₱150,000. In terms of the combined total number of head offices and branches, the operating network of banks rose to 7,581 units in September from 7,555 units in June, recording an additional 26 operating units (consisting of one head office and 25 branches).

Banking Reforms

During the last quarter of 2001, the BSP continued to implement reforms aimed at enhancing the BSP's supervisory and regulatory powers and bringing the country's regulatory regime closer to international standards. In particular, the following regulations were issued:

⁷ Asia Economic Monitor 2001, Asian Development Bank



- **Adjustment on the minimum required general loan loss provisions.** The BSP adjusted the minimum required general loan loss provisions to make them more consistent with international practices (Circular No. 313 dated 27 December 2001). In particular, the Circular: (a) lowered the provisioning ratio from two percent to one percent of the outstanding balance of unclassified loans other than restructured loans (less loans which are considered non-risk under existing laws/rules/regulations); and (b) imposed a 5 percent reserve on the outstanding balance of unclassified restructured loans (less the outstanding balance of restructured loans which are considered non-risk under existing laws/rules/regulations), to reflect the higher risks attached to such loans even if they are presently performing. These adjustments represent a fine-tuning of policy to reduce disincentives to the lending activities of banks with otherwise sound loan portfolio.
- **Amendment of guidelines on the adoption of the risk-based capital adequacy framework.** The BSP amended Circular No. 280 dated 29 March 2001, which provided guidelines on the adoption of the risk-based capital adequacy framework (Circular No. 310 dated 10 December 2001). In particular, the Circular provided for the inclusion of local government unit (LGU) bonds, which are covered by Deed of Assignment of Internal Revenue Allotment of the LGU and guaranteed by the LGU Guarantee Corporation, among the on-balance sheet assets which are assigned 50 percent risk weight.
- **Amendment on the regulations on the transfer of the voting shares of stocks in banks.** The BSP amended the regulations on the transfer of the voting shares of stocks in banks which require Monetary Board (MB) approval as contained in Subsection X126.2.d of the Manual of Regulations for Banks (Circular No. 309 dated 16 November 2001). The amendments of the Circular provided for the following: 1) prior MB approval on any/series of sale/s or transfer/s that will result in ownership or control of more



than 20 percent of the voting stock of a bank by any person, natural or juridical or which will enable such a person to elect or be elected as a director of such bank; and 2) sanction for any violation of the provisions of said subsection.

- **Approval of the guidelines governing the issuance of long-term negotiable certificates of time deposits (LTNCDs).** The BSP approved the guidelines governing the issuance LTNCDs with a minimum maturity of five years to deepen capital markets (Circular No. 304 dated 25 October 2001). The negotiability feature of LTNCD is expected to contribute to the growth of long-term debt instruments and the development of the secondary market.
- **Issuance of the implementing rules and regulations of the Anti-Money Laundering Act of 2001.** The BSP issued the rules and regulations implementing Section 9 of R.A. No 9160 (also known as the Anti-Money Laundering Act of 2001) on banks' customer identification, record keeping and reporting requirements for covered transactions (Circular No. 302 dated 11 October 2001). Among other things, the rules and regulations provided for the following: 1) required banks to record the true identity of their clients; 2) prohibited anonymous accounts, accounts under fictitious names and other similar accounts; and 3) allowed peso and foreign currency non-checking numbered accounts. Moreover, the issuance provided that: 4) the BSP should conduct annual testing to determine the existence and identity of the owners of such accounts; 5) banks should maintain records of all transactions for 5 years from the dates of transactions; 6) banks should preserve/store records of closed account for at least 5 years from the dates the accounts were closed; and 7) banks should report to the Anti-Money Laundering Committee all covered transactions within 5 working days from their occurrence. The rules and regulations also provided that the reporting by banks does not violate R.A. Nos. 1405, 6426, and 8791, and other similar laws. In addition, the issuance also provided for the sanctions and penalties for violations of these rules.



- Approval of the use of the 5- and 10-year Special Purpose Treasury Bonds as alternative compliance with the agrarian reform credit requirement and as eligible reserves for trust duties.** The BSP allowed the use of the proposed ₱50 billion worth of 5- and 10-year Special Purpose Treasury Bonds (SPTBs) as alternative compliance with the agrarian reform credit requirement under Sec. 4(a) of P.D. No. 717, and as eligible reserve for trust duties, provided that: (a) the proceeds of the bonds will be used exclusively for the agrarian reform sector in keeping with the spirit and intent of the law; (b) such bonds shall not be hypothecated in any way or earmarked for any other purposes; (c) in case the bonds are the subject of a repurchase/resale agreement, only the buying/lending bank may use such bonds as compliance with the agrarian reform credit requirement during the holding period; and (d) that the repurchase/resale agreement shall be for a term of at least thirty (30) days without pre-termination during the first 30 days. (Circular No. 301 dated 2 October 2001)

D. FISCAL SECTOR

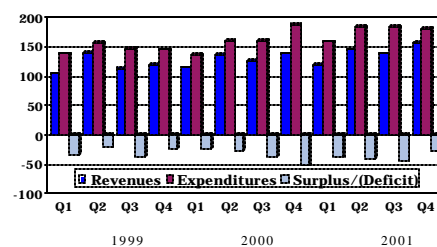
❖ National Government Cash Operations

The cash operations of the NG registered a ₱24.9 billion deficit during the fourth quarter of 2001, ₱19.4 billion lower than the previous quarter's deficit of ₱44.3 billion (Table 9). This improvement was due both to the ₱18.4 billion increase in revenues and the ₱1.0 billion decline in expenditures. However, compared to the revised program for the quarter, the deficit was ₱0.1 billion higher as actual expenditures exceeded its target level by ₱9.2 billion. This, however, was mitigated



2001 4th Quarter Report

Cash Operations of the National Government
In Billion Pesos



by the ₱9.1 billion overperformance in revenue collections.

The ₱18.4 billion increase in actual revenues during the quarter was largely due to the ₱14.0 billion increase in the tax collections of the Bureau of Internal Revenue (BIR). This was partially offset, however, by the ₱2.4 billion decline in the revenue collections of the Bureau of Customs (BOC) due to the contraction in imports. Non-tax revenue sources likewise improved by ₱7.5 billion due mainly from higher fees and other charges.

Meanwhile, the ₱1.0 billion drop in expenditures over the previous quarter was due mainly to lower interest payments, and partly to the declines in net lending, allotment to LGUs and equity contributions. These contractions, however, were partially offset by the higher miscellaneous operating expenses and subsidies to government corporations.

On the financing side, net borrowings from foreign and domestic sources amounting to ₱27.5 billion and ₱24.9 billion, respectively, were used to finance the deficit in the budgetary (₱24.9 billion) and non-budgetary (₱14.2 billion) accounts as well as withdrawals from the Government's cash balance amounting to ₱13.2 billion.

Compared to the same quarter of the previous year, the NG deficit for the fourth quarter was lower by ₱26.3 billion as a result of higher revenues generated and reduced government spending.

E. EXTERNAL SECTOR

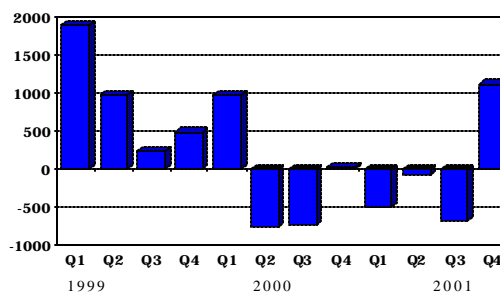
✧ Balance of Payments

The country's BOP position yielded a surplus of US\$1.116 billion in the fourth



2001 4th Quarter Report

Balance of Payments
In Million US Dollars



quarter of 2001, significantly higher than the US\$19 million surplus registered in the comparable period last year (Table 10). Behind this development was the significant reduction in the net outflows of the capital and financial account even as the current account recorded a lower surplus.

Current Account

During the review quarter, the current account continued to post a surplus of US\$2.121 billion, albeit lower by 15.2 percent from the US\$2.502 billion surplus posted in the comparable period in 2000. This developed on account mainly of lower net receipts from trade in goods, which overshadowed the lower services payments and higher income receipts during the quarter.

Merchandise Trade. For the fourth quarter of 2001, the trade-in-goods balance—while continuing to be in surplus—narrowed by 33.3 percent to US\$1.658 billion from US\$2.485 billion last year as the decline in exports of goods outpaced that of imports. Exports of goods declined by 20.5 percent to US\$7.980 billion from US\$10.035 billion in the same period last year following the weak demand from the country's major trading partners, namely the U.S. and Japan, as well as the slowdown in the information technology sector. Exports of electronics, the leading export earner since the nineties, experienced a year-on-year contraction of 28.4 percent during the quarter in review following the decline in demand for and prices of semiconductors and electronics microcircuits. Garments exports dropped similarly by 11.8 percent to US\$569 million. Machinery and transport equipment exports also posted a slight deterioration of 1.2 percent from the previous year's level of US\$1.677 billion. Meanwhile, imports of goods contracted by 16.3 percent to US\$6.322 billion in the last quarter of 2001 from its year-ago level of US\$7.550 billion as imports of all major commodity groups experienced contractions. Capital goods imports fell by 8.4 percent to US\$2.665 billion from last year's level of US\$2.910 billion due mainly to the decline in imports of telecommunication equipment and electrical machines as well as power generating and specialized machines. Similarly, imports of raw materials and intermediate goods dropped by



18.0 percent to US\$2.456 billion from US\$2.995 billion due largely to reduced imports of materials and accessories used for the manufacture of electrical equipment. Meanwhile, imports of mineral fuels and lubricants dropped to US\$687 million from the year-ago level of US\$1.062 billion. The 35.3 percent contraction was brought about by lower imports of petroleum crude as the average price declined to US\$20.19 per barrel from US\$31.12 during the comparable period a year ago.

Services. The last quarter's deficit in trade in services narrowed down to US\$494 million compared to US\$743 million in the comparable period in 2000. The decline was due to lower net outflow in freight (reflecting the decline in imports), financial and other business services, particularly professional and technical services. These helped cushion the effect of lower receipts from travel, an aftermath of the September 11 terrorist attacks in the US.

Income. The surplus in the income account rose to US\$855 million from its year-ago level of US\$659 million. Behind the 29.7 percent growth was the combined impact of the 12.4 percent increase in receipts from workers' remittances and the 2.0 percent decline in net payments of investment income. The increase in workers' remittances was attributed mainly to the expanded coverage of the monitoring system, which, aside from commercial banks, now includes foreign exchange corporations and thrift banks.⁸ Without the improvement in coverage, the US\$1.626 billion receipts from OFWs in the fourth quarter would have amounted to only US\$1.450 billion, almost the same level as last year. Meanwhile, lower interest payments due, in turn, to global decline in interest rates accounted for the reduction in repayments of investment income.

Current Transfers. Meanwhile, net current transfers amounted to US\$102 million, little changed from the US\$101 million level last year.

⁸ Monitoring of OFW remittances coursed through thrift banks and foreign exchange (forex) corporations commenced only in 2001.



Transfers receipts were largely in the form of gifts, grants and donations from individuals and non-governmental institutions.

Capital and Financial Account

During the review quarter, the capital and financial account showed a substantial improvement as the net outflow declined by 56.1 percent to US\$1.320 billion from US\$3.010 billion in the same period last year. This developed on account mainly of higher net inflows of portfolio and direct investments as well as lower net outflows of the other investment.

Capital Account. The capital account for the review quarter yielded a deficit of US\$6 million from the year-ago deficit of US\$2 million following higher net migrants' transfers abroad.

Direct Investment. Net inflows of direct investments amounted to US\$160 million, higher compared to the US\$108 million registered a year earlier. Behind this development was the increase in non-residents' investments in equity capital as investors geared up with the expected pick-up in economic activity by the second half of 2002, and lower net outflow arising from the repayment of intercompany loans.⁹ Direct investments were channeled mainly to the manufacturing, telecommunication sectors as well as banks and financial institutions.

Portfolio Investment. The portfolio investment account posted a net inflow of US\$1.191 billion during the review quarter, a reversal of the US\$182 million net outflow in the same period last year. This development was attributed mainly to the marked increase in non-residents' investments in government notes and bonds issued abroad coupled with residents' divestments of their investments in debt securities abroad.¹⁰

⁹ Under the Balance of Payments Manual, Fifth Edition, intercompany loans are treated as part of direct investments.

¹⁰ See section on International Reserves for related discussion



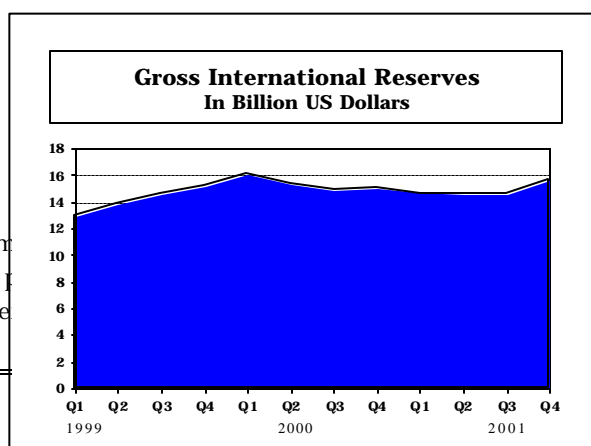
Other Investment. Meanwhile, the other investment account registered a lower net outflow of US\$2.665 billion compared to the US\$2.934 billion posted during the comparable quarter in 2000. This can be traced to higher net withdrawal by local banks of their deposits with foreign banks as well as the notable reduction in trade credit receivables. The favorable performance in these accounts, however, was partly offset by the higher net outflow arising from the repayment of loans by the private non-banks sector.

❖ International Reserves

The BSP's GIR, including the reserve position in the IMF, stood at US\$15.658 billion as of 31 December 2001, 7.6 percent higher than the end-September 2001 level of US\$14.549 billion (Table 11). At this level, reserves were equivalent to 5.0 months worth of imports of goods and payment of services and income or 2.6 times the amount of the country's short-term external debt as of end-December 2001 based on original maturity. Alternatively, equivalent to 1.3 times the amount of the country's short-term external obligations based on residual maturities.¹¹

The growth in international reserves during the fourth quarter of 2001 was due mainly to the major foreign exchange inflows arising from: (1) the deposit by the National Government (NG) of the proceeds of its bond flotations, i.e., RP Euro Bond (US\$444 million) and RP Shibosai Bond with NEXI guarantee (US\$365 million); issuance of RP US\$-denominated Treasury Bills (US\$119 million); and drawdowns from the ADB Power Sector Reform Loan (US\$100 million)

¹¹ Short-term obligations based on residual maturity plus principal of public and private sectors falling due in the next 12 months.



and ADB Non-Bank Financial Program Loan (US\$75 million); (2) the BSP's issuance of US\$550 million worth of four-year fixed-rate notes; and (3) investment income (US\$153 million). The impact of these inflows, however, was partly offset by the debt service requirements of the NG (US\$660 million); and the BSP (US\$108 million); and net withdrawals by the PNOC from its foreign currency deposit with the BSP (US\$71 million).

Classified by component, the bulk of reserves were in the form of foreign investments (81.7 percent), while the remainder consisted of gold (14.1 percent), foreign exchange (3.4 percent), and combined Special Drawing Rights and reserve position in the Fund (0.8 percent).

These developments led to an increase in the BSP's net international reserves (NIR) to US\$11.391 billion as of 31 December 2001, 10.4 percent higher than the end-September 2001 level of US\$10.318 billion.

✧ **Exchange Rate**

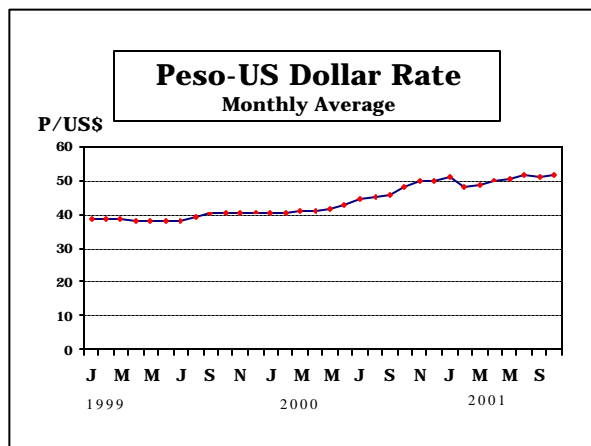
Trends in the Peso-Dollar Rate

The peso appreciated slightly by ₱0.35 to average ₱51.83/US\$1 during the fourth quarter of 2001 vis-à-vis the average peso-dollar rate



recorded a quarter ago, reversing the depreciation trend of the peso that started in the third quarter of 1999 (Table 12).¹²

The peso averaged ₱51.73/US\$1 at the start of the quarter in October but weakened to ₱51.99/US\$1 in November due to heightened uncertainty after the September 11 terrorist attacks in the U.S. as well as on concerns about the global economic slowdown. As market conditions stabilized, the peso began to exhibit an appreciating trend toward the latter part of December supported by continued inflows of foreign investments and remittances from overseas Filipino workers. This developed despite the weakening of most regional currencies in line with the movement of the Japanese yen, which fell to its lowest in three years, and the economic and political turmoil in Argentina. This reflected the improving sentiment of investors on Philippine economic prospects and the decoupling of the country's prospects from those of Argentina.



The fourth quarter of the year was marked by lower exchange rate variability as the effects of the measures implemented by the BSP starting the third quarter to help ease the pressure on the peso took hold. Volatility, as measured by the standard deviation of the daily peso-dollar exchange rate, declined to ₱0.23 during the fourth quarter, from ₱1.06 a quarter ago. Another indicator of volatility, the average trading range, also suggested stable foreign exchange market conditions as the

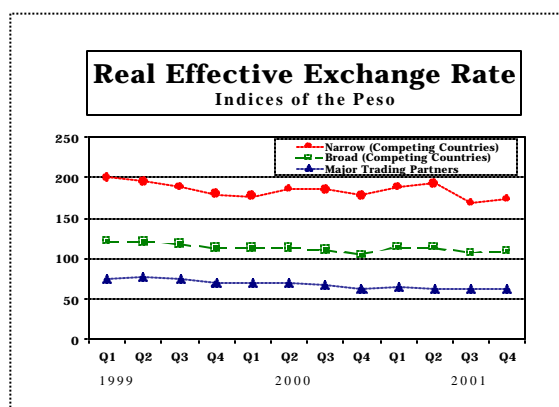
¹² Dollar rates or the reciprocal of the peso-dollar rates were used to compute for the quarterly percent changes.



average daily high-low difference narrowed to ₱0.12 during the last quarter compared with the previous quarter's ₱0.22.¹³

The peso's movement against the US dollar mirrored the trend of other regional currencies during the year. Compared to its level as of 2 January 2001, the peso-dollar rate as of end-December 2001 depreciated by 2.8 percent. Most Asian currencies likewise depreciated against the US dollar during 2001, including the Japanese yen (by 13.1 percent), the Indonesian rupiah (by 7.7 percent), the Singapore dollar (by 6.5 percent), the New Taiwan dollar (by 5.6 percent), the South Korean won (by 4.3 percent), and the Thai baht (by 2.0 percent). Meanwhile, the Hong Kong dollar and the Malaysian ringgit maintained their exchange rate pegs.

Nominal and Real Effective Exchange Rates



The value of the peso in terms of the nominal effective exchange rate (NEER) index vis-à-vis the country's major trading partners increased during the fourth quarter of 2001.¹⁴ The average NEER of the peso appreciated slightly in nominal terms by 0.90 percent to 13.06 index points from 12.94 index points in the third quarter of the year. Compared with the broad and narrow baskets of currencies of competitor countries,¹⁵ the peso also

¹³ The average trading range is computed as the average of the daily difference between the highest and lowest peso-dollar exchange rates of done transactions at the Philippine Dealing System (PDS).

¹⁴ The NEER index represents the weighted average exchange rate of the peso vis-à-vis a basket of foreign currencies such as the US dollar, the Japanese yen, the Deutsche mark and the British pound. Major trading partners include the US, Japan, Germany and the UK.

¹⁵ The broad basket is composed of the currencies of Singapore, South Korea, Taiwan, Malaysia, Thailand, Indonesia and Hong Kong, while the narrow basket is composed of the currencies of Indonesia, Malaysia and Thailand.



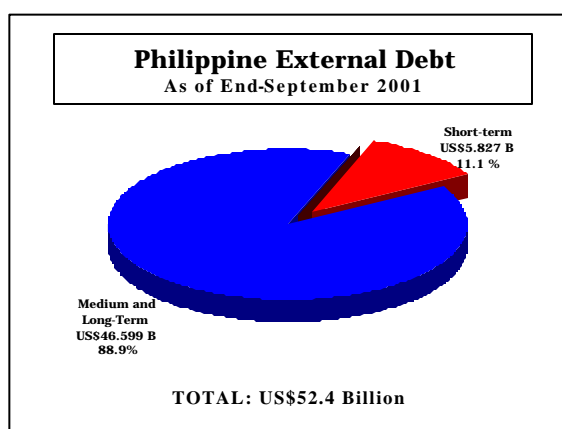
appreciated in nominal effective terms during the same period, by 2.5 percent and 4.0 percent, respectively. This was due to the appreciation of the peso against the US dollar during the period while most currencies in the currency baskets depreciated against the US dollar.

The peso shed some competitiveness as the nominal appreciation of the peso translated into real appreciation. The peso's real effective exchange rate (REER) index against the currencies of the country's major trading partners indicated a real appreciation of 0.5 percent to 61.87 index points compared to the quarter-ago average of 61.57 index points.¹⁶ This could be attributed to the peso's nominal appreciation, which more than offset the narrowing of inflation differential between the Philippines and the major industrialized countries in the basket. Relative to the broad and narrow currency baskets of competitor countries, the peso's competitiveness similarly declined as the REER indices against these baskets of currencies appreciated by 1.6 percent and 2.1 percent, respectively. While the inflation gap tightened between the Philippines and the countries in the narrow and broad baskets, it was not enough to offset the nominal appreciation of the peso (Table 12c).

▣ External Debt

The country's external debt stock increased by 3.0 percent to US\$52.4 billion as of end-September 2001 from the end-June 2001 level of US\$50.9 billion (Table 13).

The increase was traced largely to the upward revaluation



¹⁶ The REER index is derived from the NEER index adjusted for inflation differentials vis-à-vis trading partners or competing countries.



adjustments of US\$904 million as the US dollar depreciated against most currencies. Other contributory factors were the net loan availment of the public and private sectors amounting to US\$717 million. Late reporting entries as well as corrections of past periods' transactions further brought up external debt by US\$188 million. These were offset partly by the downward adjustments of US\$134 million arising from the net transfer of Philippine debt papers from foreign holders to residents, and the US\$144 million decline in foreign liabilities of commercial banks.

Loan availments in the third quarter were used to finance power and energy projects, communication, transportation and other infrastructure projects and for budgetary support.

The maturity profile of the country's external debt continued to be largely long-term. Debt with maturities of more than one year accounted for 88.9 percent of total debt as of end-September 2001 while the balance of 11.1 percent consisted of short-term liabilities. The average maturity of medium- and long-term (MLT) debt remained unchanged at the previous quarter's average of 16.4 years with the debt maturity of the public sector and the private sector averaging at 19.4 years and 10.1 years, respectively.

Classified by borrower, the public sector continued to account for the bigger share of total debt at 64.6 percent as of end-September 2001, a slight change from the 64.3 percent posted in the previous quarter. The increase was due to US\$849 million worth of revaluation adjustments and the BSP's net short-term loan availment of US\$400 million. Correspondingly, the share of private sector dropped marginally to 35.4 percent from 35.7 percent.

By creditor type, official creditors (multilateral and bilateral institutions) provided 48.7 percent of total credits. Foreign holders of bonds, notes and certificates of deposits accounted for 24.5 percent of the total external debt. Banks and other financial institutions comprised 21.7 percent of foreign obligations.



In terms of currency composition, the country's external debt was largely denominated in US dollars (56.2 percent) and Japanese yen (26.0 percent). Multi-currency loans from the World Bank and the Asian Development Bank comprised 9.3 percent of total external debt.

About 54 percent of the country's MLT foreign debt carried fixed rates while 43 percent had variable rates. The other 3 percent was non-interest bearing. Average cost of fixed rate credits was 5.76 percent, while average margin over base rate for obligations with floating interest rates was 1.47 percent.

Based on preliminary estimates, the ratio of debt service to exports of goods and receipts from services and income reached 16.3 percent in the fourth quarter, higher compared to the 14.4 percent recorded both in the third quarter of 2001 and in the fourth quarter of 2000 (Table 14). The quarter-on-quarter increase in the ratio was mainly due to the significant increase in principal payments, which negated the impact of the slight improvement in exports of goods and receipts from services and income. Meanwhile, on a year-on-year basis, the increase in the debt service ratio was attributed to lower exports of goods, services and income, which offset the decline in the debt service burden.

❖ **Foreign Interest Rates**

Key foreign interest rates trended downward in major financial markets during the last quarter of 2001. The September 11 terrorist attack in the US and aftermath significantly heightened uncertainty and concerns about the global economic slowdown, which further dampened domestic economic activity.

To boost US economic activity and improve market confidence, the Federal Open Market Committee (FOMC) lowered its target for the federal funds rate thrice during the review period, for a total of 125 basis



points to 1.75 percent.¹⁷ It likewise reduced the discount rate to 1.25 percent during the quarter in review.¹⁸ Consequently, US interest rates declined with the actual federal funds rate plummeting by 132.83 basis points to 2.1751 percent and the discount rate falling by 141.30 basis points to 1.6497 percent, respectively. Similarly, the US prime rate dipped by 139.57 basis points to average 5.1706 percent¹⁹ (Table 15).

In other major financial markets, similar rate cuts were made. In the Eurozone, the Governing Council of the European Central Bank (ECB) lowered all its key interest rates by 50 basis points with the minimum bid rate on the main refinancing operations²⁰ reaching 3.25 percent and interest rates on the marginal lending facility²¹ and deposit facility²² reaching 4.25 percent and 2.25 percent, respectively. Similarly, the Monetary Policy Committee of the Bank of England cut its repo rate twice during the quarter by 75 basis points to 4.0 percent, while the Bank of Canada lowered its target for the overnight rate by a total of 125 basis points to settle at 2.25 percent. Consequently, the 90-day London Interbank Offered Rate (LIBOR) fell by 132.46 basis points to 2.1502 percent during the quarter in review.²³

¹⁷ The Federal funds rate refers to the interest rate banks charge each other for overnight loans.

¹⁸ The discount rate is the interest rate charged by the Federal Reserve banks on their loans to banks.

¹⁹ The prime rate is the interest rate banks charge their most creditworthy customers.

²⁰ Main refinancing operations are regular liquidity-providing reverse transactions with a weekly frequency and a maturity of two weeks. It is the Eurosystem's most important open market operation, playing a key role in steering short-term interest rates, managing the liquidity situation in the market and signaling the stance of monetary policy. The minimum bid rate refers to the minimum interest rates at which counterparties may place their bids.

²¹ The marginal lending facility is a standing overnight facility administered by National Central Banks (NCBs) and used by counterparties to obtain liquidity from the NCBs against eligible assets. The interest rates on the marginal lending facility normally provide a ceiling for the overnight market interest rates.

²² The deposit facility is another standing facility used by counterparties to make overnight deposits with the NCBs. The interest rate on the deposit facility normally provides a floor for the overnight market interest rate.

²³ The LIBOR is the rate at which banks in London offer Eurodollars in the placement market.



Meanwhile in Asia, the 90-day Singapore Interbank Offered Rate (SIBOR) also dipped by 131.96 basis points to 2.1539 percent, in consonance with the rate cuts by the US Federal Reserve.²⁴ Moreover, the Bank of Japan (BoJ) retained its official basic discount rate at 0.10 percent during the review period.

❖ Other Major External Sector Developments

Hopes of a US-led global recovery were fueled by the stronger-than-expected GDP growth rate of 1.4 percent during the fourth quarter, after the contraction in the third quarter. The US economy expanded by 1.2 percent for the whole of 2001.

Consumer confidence increased as shown by strong consumer spending, which rose by 6.0 percent, the biggest increase since the 6.2 percent posted in the second quarter of 1998. Record car sales were the main driver behind the 39.2 percent gain in durable goods spending as consumers took advantage of the zero-percent financing for purchases of new cars. Government spending also grew by 10.1 percent in the fourth quarter, the largest increase since 1978. These two factors combined, which more than offset the decline in business spending, largely accounted for the positive GDP growth rate.

The US Federal Reserve's strong response to the economic slowdown, particularly after the 11 September event contributed to the better-than-expected GDP growth rate. For the fourth quarter alone, the US Fed reduced its target funds rate three times, by a cumulative 125 basis points to 1.75 percent, the lowest level in 40 years. The Federal Reserve cut its interest rates 11 times in 2001.

The Eurozone economy also posted positive GDP growth rate of 0.6 percent during the review quarter, lower than the 1.4 percent recorded in the third quarter. Economic sentiment in the Euro area has taken a

²⁴ The SIBOR is the rate at which banks in Singapore offer Eurodollars in the placement market.



turn for the better, buoyed up by an improvement in consumer sentiment, as revealed by the European Commission's economic sentiment index. Household spending was the strong point of the Eurozone economy in 2001, boosted by the ECB's successive reduction in its key interest rates.

The economies of some Asian countries also managed to weather the weak external environment brought about by the global economic downturn. In particular, the GDP growth rate of People's Republic of China was a positive 6.6 percent in the fourth quarter of 2001. The strong domestic demand combined with the expansion of fixed asset investments was the main engine that boosted economic growth during the review quarter. South Korea's GDP also grew by 3.7 percent in the fourth quarter, fueled mainly by an increase in industrial production. Also, during the fourth quarter, the credit rating agency Standard and Poor's upgraded the country's long-term foreign currency and local currency issuer credit and senior unsecured debt ratings to BBB+ from BBB and to A+ from A, respectively.²⁵ The outlook was stable. At the same time, the credit rating agency raised its short-term foreign currency issuer credit rating on Korea from 'A-2' to 'A-3'. The upgrade was driven in recognition of its continued progress in structural reforms, resilient foreign exchange reserves, a good level of flexibility in the country's foreign exchange policy, labor force and fiscal position.

Macroeconomic Performance of Selected Asian Countries Year-on-Year Growth (in percent) For the Year 2001

²⁵ An obligation/obligor rated 'A' is considered more susceptible to the adverse effects of changes in circumstances and economic conditions than obligations/obligor in higher rated categories AA and AAA. However, the obligor's capacity to meet its financial commitment on the obligation is still strong. An obligation/obligor rated 'BBB' is considered as exhibiting adequate protection parameters. However, adverse economic conditions or changing circumstances are more likely to lead to a weakened capacity to the obligor to meet its financial commitment on the obligation. The plus or minus sign shows the relative standing within the major rating categories.



Country	Gross Domestic Product				Inflation			
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
Hong Kong	2.3	0.5	-0.3		-1.9 ^{r/}	-2.0 ^{r/}	-1.0	-2.0
Indonesia	4.0	3.5	3.5	1.6	9.4	11.2	12.8	12.7
Japan	0.1	-0.8	-0.5	-1.2	-0.1	-0.5	-0.7	-1.1
Korea	3.7	2.7	1.9 ^{r/}	3.7	4.3	5.3	4.3	3.3
Malaysia	3.1	0.5	-1.3	-0.5	1.5	1.6	1.4	1.2
Singapore	4.7	-0.5	-5.6	-6.6	1.7	1.7	0.8	-0.3
Thailand	1.8	1.9	1.5	1.8	1.4	2.6	1.7	1.0
People's Republic of China	8.1	7.8	7.0	6.6	-0.2	0.2	-0.5	-0.1
Taiwan	0.7	-2.4	-4.2	-1.9	-0.6	0.3	0.3	-0.5

^{r/} Revised

Sources: Chinese Economic Indicator Center (CEIC), Telerate, Hong Kong Monetary Authority,

Bank Indonesia, Bank of Japan, Bank of Korea, Bank Negara Malaysia, Monetary Authority of Singapore, Bank of Thailand

Indonesia's economy also recorded a positive growth of 1.6 percent, albeit at a slower pace due mainly to the slowdown in exports. Meanwhile, the country's long-term foreign currency sovereign credit and senior unsecured debt ratings were lowered by Standard and Poor's to 'CCC' from 'CCC+',²⁶ revising the outlook to negative from stable. The downgrade reflected the credit agency's anticipation of debt rescheduling in Indonesia, especially after the meeting of Indonesia's official creditors at the Paris Club.

Other Asian economies continued to weaken, led by Japan, which continued to experience deflationary recession during the fourth quarter, posting a negative growth rate of 1.2 percent. The fourth quarter was marked by the persistent downtrend in consumer and business

²⁶ An obligation/obligor rated 'CCC' is considered currently vulnerable to nonpayment and is dependent upon favorable business, financial, and economic conditions for the obligor to meet its financial commitment on the obligation. In the event of adverse business, financial or economic conditions, the obligor is not likely to have the capacity to meet its financial commitment on the obligation.



confidence, a rising debt burden and the poor performance of the banking sector. The slow implementation of structural reforms further weakened the economy, prompting Standard and Poor's to downgrade its long-term local and foreign currency sovereign credit ratings to 'AA' from 'AA+', while maintaining the negative outlook.

Meanwhile, Singapore's real GDP fell anew, registering 6.6 percent contraction during the fourth quarter. All major sectors, led by the manufacturing and services sectors, registered a weak performance due largely to the continued drop in the global demand for electronics. Malaysia was also affected by the global downturn as real GDP contracted by 0.5 percent in the fourth quarter. The manufacturing sector posted the biggest decline due to shrinking exports of electrical and electronic products.

The economic contraction in most Asian countries was accompanied by lower inflation, with Singapore, China and Taiwan registering negative inflation rates for the fourth quarter of 2001. Hong Kong and Japan continued to be deflationary. Taiwan's economy contracted for the third straight quarter, due mainly to a significant decline in exports and domestic consumption.

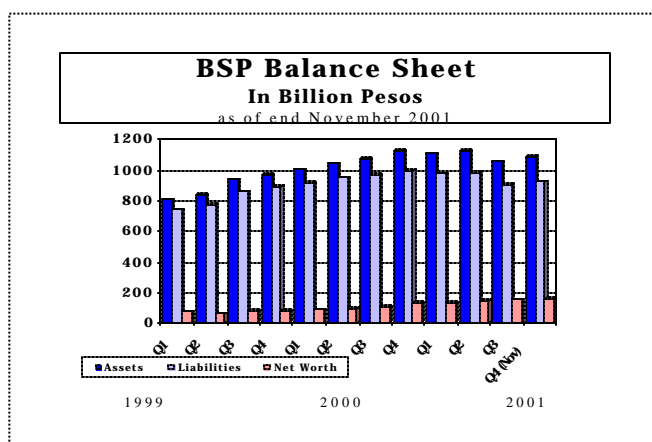
Monetary authorities across Asia implemented interest rate reductions and reform measures to respond to the general decline in economic activity. In Korea, the central bank cut its overnight call rate four times for a total of 125 basis points. In Japan, monetary policymakers raised the main operating target and the outstanding balance of the current accounts. Current accounts are reserves set aside by private financial institutions to meet withdrawals from customer deposits, among other things. The BoJ's strategy of increasing the outstanding balance of current accounts was aimed at providing ample liquidity in financial markets to encourage domestic and business spending. Moreover, the BoJ also undertook reform measures to strengthen money market operations. Specifically, the BoJ actively purchased commercial paper (CP) and asset-backed securities, and improved the conduct of money market operations by increasing the frequency of bill purchasing operations and allowing eligible



counterparties to participate in the outright purchase of Japanese Government Bonds (JGBs), JGB repo operations, CP operations and bill selling operations. In Malaysia, Bank Negara Malaysia issued savings bonds, reduced lending rates and liberalized the eligibility criteria of special funds.²⁷ The measures were aimed at promoting domestic economic activities and providing an impetus for growth in investment. Meanwhile, the Bank of Thailand reduced its benchmark 14-day repurchase rate by a total of 25 basis points to 2.25 percent to stimulate the domestic economy.

F. FINANCIAL CONDITION OF THE BSP

✧ Balance Sheet



The preliminary and unaudited BSP balance sheet as of end-November 2001 indicated that the BSP's assets expanded by ₱28.7 billion compared to the level recorded at end-September 2001. Liabilities rose by ₱18.3 billion, resulting in a net worth of ₱162 billion during the same period,

₱10.4 billion higher than the level at the end of the previous quarter (Table 16).

Total assets rose by 2.7 percent to reach ₱1.1 trillion in end-November 2001. The growth in BSP assets was attributed largely to the

²⁷ Special Funds include the following: Rehabilitation Fund for Small and Medium Industries (RFSMI), Fund for Small and Medium Industries 2 (FSMI 2) and New Entrepreneurs Fund 2 (NEF 2).



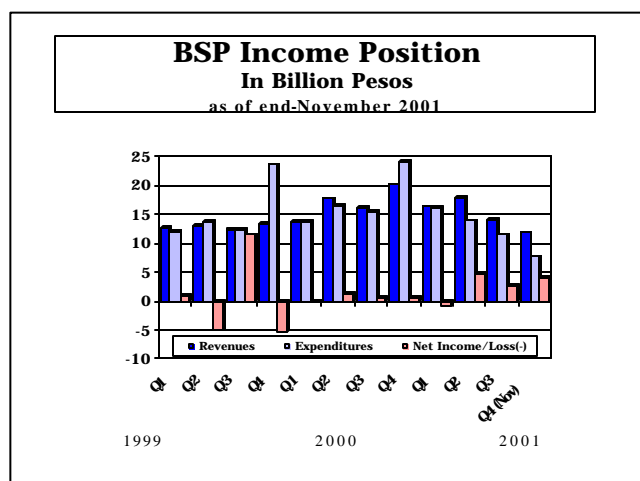
₱22.9 billion build-up in international reserves (IR); the ₱7.0 billion hike in investments in domestic securities and the ₱5.3 billion increase in other assets. The increase in IR was due largely to the US\$550 million proceeds of the flotation of BSP Fixed Rate Notes in November. Moreover, the ₱0.67 depreciation of the peso from ₱51.355/US\$1 in end-September 2001 to ₱52.024/US\$1 in end-November 2001 contributed to the expansion in IR by about ₱23 billion. However, the expansionary impact on the IR of these transactions was offset in part by the outflow of foreign exchange for the debt servicing of the National Government's external debt. Holdings of domestic securities increased during the period under review, as the BSP was a net buyer of Treasury bills. Meanwhile, increased deferred charges/credits on gold contributed to the expansion in other assets.

On the liabilities side, expansions were noted in foreign bonds payable (₱29.4 billion) and currency issue (₱15.8 billion). The combined expansion in these accounts more than offset the decreases noted in BSP debt instruments (₱20.4 billion) and deposit liabilities (₱13.3 billion). The increase in foreign loans payable was due to the US\$550 million flotation of BSP Fixed Rates Notes. On the other hand, currency issue increased in anticipation of the public's preference for cash during the Christmas holidays.

❖ Income Statement

Based on preliminary and unaudited data, the BSP's financial operations yielded a net profit of ₱10.25 billion for the period October-November 2001 (Table 17).

Revenues amounted to ₱11.8 billion, the bulk of which came from interest income on international reserves (₱8.0 billion) and domestic securities



(₱2.0 billion). Expenses reached ₱7.7 billion including ₱5.3 billion in interest expenses on BSP's loans and deposit liabilities.

The BSP gained ₱6.14 billion from foreign exchange fluctuations during the period under review.

G. CONCLUSION: Challenges and Future Policy Directions

Despite a challenging external and domestic environment, the economy continued to grow, inflationary pressures were weak, and the exchange rate was broadly stable in the fourth quarter. Various factors were behind this favorable economic performance: one, the steadfast pursuit of fiscal discipline; two, the pursuit of a carefully considered monetary policy; and three, the passage of vital structural reforms. These efforts contributed to laying down the foundations for sustained economic recovery and improving the economy's ability to weather shocks.

Going forward, the Philippine economy faces a number of challenges in both the domestic and external fronts, and policymakers must address these challenges in order to ensure macroeconomic stability and sustainable growth over the medium term. The challenge in fiscal policy is well known. The Government was successful in containing the 2001 budget deficit. However, this progress must be maintained over the medium term if the Government is to meet its commitment to a balanced budget by 2006. Fiscal authorities face the task of improving revenue mobilization and rationalizing fiscal expenditures but will need to do so without compromising the need to address social and development objectives.

On the part of monetary authorities, the task is to ensure an enabling environment in which recovery can take place. For the BSP, the task of contributing to macroeconomic stability and sustainable



growth is linked to its responsibilities of preserving price stability to support sustained non-inflationary economic growth, and promoting a sound and stable financial system. The challenge for monetary policy is to bring about low, stable and predictable inflation while ensuring that adequate liquidity is available to provide for the requirements of the growing economy. In this regard, the BSP's commitment to the price stability objective is expected to be enhanced by the adoption of inflation targeting as the framework for monetary policy, which it has started in January 2002. The new framework provides a consistent, transparent and focused framework for the conduct of monetary policy that will help enhance the BSP's credibility, efficiency, and accountability in its monetary policy actions.

The easing of monetary policy in 2001 has provided increased support to the growth of aggregate demand, and its impact is expected to continue to work its way through the economy in line with the expected lag of monetary policy. However, overall demand still remains relatively weak given the still fragile global economic conditions and the presence of spare capacity in the manufacturing sector. Reflecting this and the banks' cautious stance, bank lending continues to be sluggish. The BSP's monetary policy stance going forward will thus remain on a cautious footing. In particular, the authorities will continue to monitor closely factors affecting the inflation outlook to ensure that inflationary risks are addressed appropriately, in line with the BSP's price stability objective.

In particular, movements in international oil prices, the probable increase in power rates and the possibility of reduced agricultural output due to the El Niño weather phenomenon will need to be carefully monitored and assessed. Meanwhile, the expected end of the monetary easing cycle in the world's major economies, notably the US and euro area, will have implications for further monetary easing in the Philippines, as narrowing interest rate differentials could generate exchange market pressures that could feed into inflation and inflationary expectations.



The need to strengthen the banking sector is also a key ingredient to sustainable growth. A priority in this area is to address the non-performing loan problem of the banking system which continue to dampen lending activity. The BSP, for its part, is supporting the creation of private asset management companies (AMCs) as vehicles for reducing the non-performing assets in bank portfolios. Progress on legislative action on the creation of special purpose asset vehicles (SPAVs) has been made, and its passage would provide a fillip to bank lending, and ultimately to the economy's growth potential.

Meanwhile, the BSP has continued to implement measures to strengthen the financial system. Considerable progress has already been made in the following areas: 1) the continued upgrading of supervisory practices through the fine-tuning of BSP's forward-looking and risk-based approach to supervision; 2) issuance of rules and regulations to implement the provisions of the General Banking Law (GBL) of 2000; and 3) passage of the anti-money laundering legislation and its implementing rules and regulations. The BSP has also been implementing BIS capital standards since July 2001. In the months ahead, the BSP will continue with its work on the drafting of the rules and regulations to implement the remaining provisions of the GBL. Prospectively, the BSP will also be working closely with Congress on the proposed amendments to the BSP Charter to upgrade the legislative framework for banks.

Overall, the Philippine economy has laid firm foundations for growth for 2002 and beyond. To date, there are encouraging developments which have provided the basis for greater optimism that the Philippine economy is now on a fundamentally better track. First, the expected generally favorable supply-side developments in 2002 combined with weak aggregate demand—given the presence of spare capacity, the still soft labor market, and the broadly stable exchange rate—should translate into relatively quiescent price movements for the rest of the year. Second, the year-on-year contraction in exports has been cut significantly to only 9 percent in January 2002 from an average of 20 percent over the last 9 months in 2001, with exports of electronics and machinery and transport equipment posting a month-on-month



expansion. This could well be an indication of the start of the export sector's recovery. Third, the upgrade in the outlook for the Philippines from negative to stable—covering the Philippines' Ba1 long-term foreign currency ceiling for bonds, as well as the Ba2 long-term foreign currency ceiling for bank deposits—by the Moody's Investors Service should bolster expectations for increased foreign inflows leading to a further build-up in reserves. These developments, together with a supportive external environment and the appropriate policy reforms of Government should provide us with greater confidence that a broad-based and meaningful economic growth in the medium-term can be achieved.

