

REPORT ON ECONOMIC AND FINANCIAL DEVELOPMENTS

Fourth Quarter 2002



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A. OVERVIEW

The last quarter of 2002 saw the Philippine economy record the strongest growth since the 1997 Asian financial crisis. Robust output growth was accompanied by subdued inflation, increased money demand, sustained export growth, improved bank asset quality and a comfortable level of foreign exchange reserves. Underpinning the economy's expansion was the strong performance of services and the continued recovery of the industry sector. Inflation continued to decelerate amid favorable price movements in food and fuel products as well as largely subdued demand-pull factors. With the benign inflation environment, the Bangko Sentral ng Pilipinas (BSP) left its policy interest rates unchanged during the quarter as the monetary policy stance continued to lean towards caution. Domestic market interest rates, meanwhile, were generally higher compared to the previous quarter. The rise in interest rates was fueled mainly by investor concerns about the risk of war in the Middle East, domestic peace and order conditions, and fiscal slippages. The fiscal deficit for the quarter exceeded the program level as a result of below-target revenue performance and higher-than-programmed spending. Meanwhile, the banking system remained broadly sound and stable, with reduced non-performing loans ratio, continued asset growth and comfortable capitalization levels. On the external front, current account surplus improved during the third quarter compared to a year ago on higher net receipts of income and strong export growth. The recovery of electronic exports largely fueled the continued expansion of exports.

✎ **Output growth accelerates.** The economy posted a strong fourth quarter growth as real Gross Domestic Product (GDP) expanded by 5.8 percent, the highest rate since the third quarter of 1997. Real Gross National Product (GNP) likewise grew to a record high of 7.2 percent during the quarter. The continued strength of services, the sustained recovery of industry and the turnaround in agriculture fueled the acceleration of economic activity during the quarter. This helped in the rise of employed persons by 0.5 percent during the period. The unemployment rate, however, increased to 10.2 percent in the last quarter of 2002 from 9.8 percent a year ago as more people entered and rejoined the labor market.

- ✧ **Inflation environment remains benign.** Price conditions continued to be tame as headline inflation further decelerated to 2.6 percent in the fourth quarter of 2002 compared to 2.8 percent in the previous quarter. This development was attributable to favorable price movements for food, beverages and tobacco, fairly stable prices for non-food items as well as subdued demand-pull pressure.
- ✧ **Domestic interest rates move higher.** Domestic interest rates rose in the fourth quarter. The increase in market interest rates reflected, in part, investors' concerns over the risk of war in the Middle East, the fiscal performance and the depreciation of the peso. However, the BSP's neutral monetary policy stance and the generally liquid financial system contributed to the moderation of the increase in interest rates during the quarter.
- ✧ **Domestic liquidity expands.** As of end-2002, domestic liquidity or M3 rose year-on-year by 9.5 percent to ₱1.7 trillion, sustaining the uptrend seen beginning July. The expansion in money demand was a result in part of the increase in investments in government securities and expansion in the net foreign assets of the banking system. Meanwhile, the financial deepening ratio (defined as M3 divided by GNP), which indicates the level of domestic mobilization of financial resources in the economy, rose slightly to 39.4 percent as of end-2002 from 38.7 percent as of September 2002.
- ✧ **The banking system remains resilient.** The total resources of the banking system registered an improvement of about 2.1 percent compared to the previous quarter. Banks' asset quality likewise improved as the non-performing loan (NPL) ratio declined to 14.9 percent in end-2002 from 16.2 percent in September 2002. The decline in the NPL ratio resulted partly from increased foreclosure and restructuring efforts as well as actual collections. Meanwhile, the banking system's capital adequacy ratio (CAR), based on the old framework, rose to 17.3 percent as of end-September 2002 from 16.5 percent in the end of the second quarter. Available data based on the new risk-based capital adequacy framework, show a ratio of 16.8 percent in June 2002 for commercial banks (KBs), almost the same level recorded during the previous quarter. These CARs far exceeded the BSP's statutory norm of 10.0 percent and the Bank for International Settlements (BIS) standard of 8.0 percent.

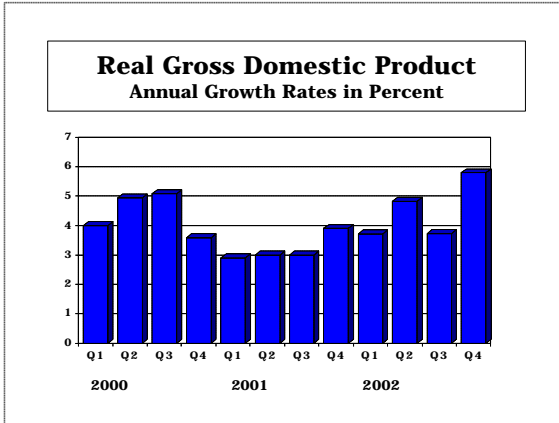
- ✘ **Fiscal deficit exceeds programmed level.** During the fourth quarter of 2002, the cash operations of the National Government (NG) registered a deficit of ₱46.2 billion, exceeding the target by ₱22.5 billion. This was on account of the ₱8.8 billion shortfall in revenues and the ₱13.8 billion excess of expenditures over the program level.
- ✘ **Current account surplus improves.** The current account improved by 77.6 percent year-on-year to \$984 million in the third quarter on account of higher net receipts of income and transfers and lower net outflow in trade-in-services. The increased net surplus in the income account resulted from the 15.6 percent rise in the remittances of overseas Filipino workers (OFWs) due to the greater number of OFWs deployed. At the same time, the merchandise trade surplus in the third quarter increased slightly by 6.0 percent to \$267 million as growth of exports at 18.2 percent nearly matched that of imports at 18.6 percent. The export performance reflected largely the recovery in electronics exports, which grew by 22.9 percent year-on-year during the quarter.
- ✘ **Foreign reserves remain at comfortable levels.** The country's gross international reserves (GIR), which includes the reserve position in the International Monetary Fund (IMF), stood at US\$16.18 billion as of end-2002, about 1 percent higher than end-September 2002 level. The growth in GIR during the last quarter of 2002 was mainly due to deposits of the NG and National Power Corporation (NPC) of the proceeds of their bond and loan issuances, as well as BSP's income from investments abroad. The end-2002 GIR level was equivalent to 4.8 months worth of imports of goods and payment of services and income. Alternatively, the international reserves were about 2.8 times the amount of the country's short-term debt based on original maturity and 1.3 times the country's short-term debt falling due within the next 12 months.
- ✘ **The peso is slightly weaker.** The peso tracked a depreciating trend during the fourth quarter, weakening by 3.3 percent in nominal terms to an average of ₱53.24:US\$1 compared to ₱51.51:US\$1 in the previous quarter. The weakness of the peso during the quarter was largely on account of concerns over the country's fiscal performance, the escalating conflict in the Middle East, and the bombing incident in Bali, Indonesia. The peso slightly recovered by year-end on the strength of seasonal remittances of OFWs. Despite the depreciating trend of the peso during the quarter, it was generally less volatile during the period, with the

standard deviation of the daily peso-dollar exchange rate declining to P0.16 during the fourth quarter compared to P0.20 during the third quarter.

B. REAL SECTOR

✦ Production

Record high economic performance during the fourth quarter capped the close of 2002, which saw the strongest rate of economic

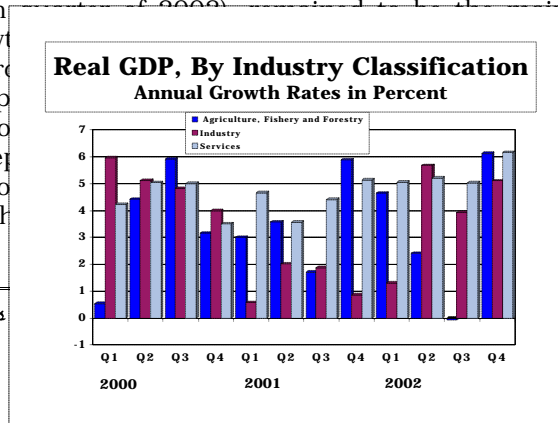


growth since the 1997 Asian financial crisis. During the period, growth of real GDP reached the highest rate achieved since the third quarter of 1997 as it expanded by 5.8 percent from 3.9 percent during the same period last year (Table 1). From a 9.5 percent contraction in the same period of the previous year, Net

Factor Income from Abroad (NFIA) rose by 31.3 percent as the compensation of OFWs reverted to double digit growth and as the contraction in property income slowed down during the quarter.

Aggregate Output

On the production side, the continued strength of services, the sustained recovery of industry and the turnaround of agriculture fueled economic growth during the last quarter of 2002. Services, the biggest sector in the economy (accounting for more than 40 percent of total GDP for the fourth quarter of 2002), expanded by 6.1 percent since the first quarter of 2002. The industry sector expanded by 6.1 percent during the fourth quarter of 2002, up from 5.1 percent during the third quarter of 2002. Agriculture, fishery and forestry contracted by 0.5 percent during the fourth quarter of 2002, down from 0.5 percent during the third quarter of 2002.



period in 2001, all subsectors surpassed their respective performances during the comparable period in 2001. In particular, the trade subsector rose by 6.2 percent during the fourth quarter of 2002 from 6.0 percent during the same period of the previous year amid increased retail outlets (giant local retailers opened new malls in regions outside Metro Manila), improved agricultural output and higher merchandise imports. Noteworthy also was the performance of the finance subsector, which reversed its 0.2 percent contraction during the same period in 2001 to a 4.7 percent expansion during the quarter in review. The turnaround in the finance subsector was largely due to the recovery of banking services (relative to the same quarter last year) as banks shifted to other income-generating activities such as trading in government securities and other fee-based activities, and the expansion of the insurance industry. Ownership of dwellings and real estate likewise surged to 2.3 percent from 1.6 percent during the fourth quarter of 2001 on the back of greater demand for residential lots and leasing activities. Private services also rose by 6.5 percent during the final quarter of 2002 from 4.6 percent during the same period in 2001 due to the growing popularity of establishments offering varied personal services, such as fitness centers, salons and spas. In a similar vein, government services expanded significantly by 6.2 percent during the quarter in review from 3.6 percent recorded during the comparable period in 2001 due to the increased employment in the government pursuant to the lifting of Administrative Order No. 5 (which called for the freeze hiring for government personnel and other austerity measures) since the beginning of 2001.

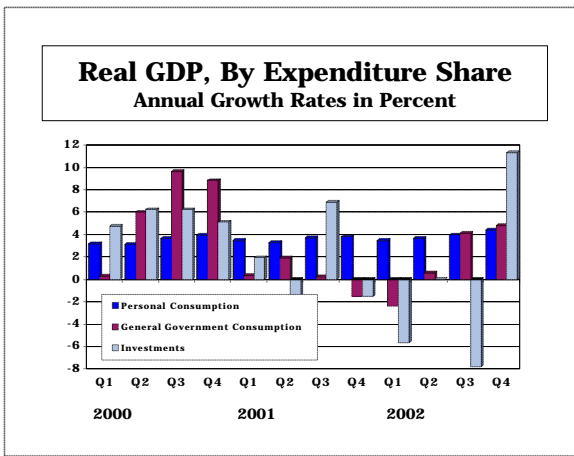
The industry sector was second to the services sector as a major driver of economic growth as it contributed 1.7 percentage points to overall GDP growth during the fourth quarter. The sector grew by 5.1 percent from a marginal expansion of only 0.9 percent in the same period in 2001. The sector sustained its recovery during the quarter amid the substantial gains posted by mining and quarrying (due to the ramped up Malampaya Gas production) and to the continued expansion of the manufacturing sector (due to tariff reduction on inputs in December, recovery of exports and surge in imports on consignment in the fourth quarter). The construction subsector also exhibited a rebound (from a 1.7 percent decline in the fourth quarter of 2001 to a 0.3 rise during the same period in 2002) as private construction for housing and trade establishments, such as malls, rose significantly during the quarter. The electricity, gas and water subsector also fared remarkably well—expanding by 5.5 percent after contracting by 8.1 percent during the last quarter of 2001—due to the

improved performance of rural electric cooperatives, private electric utilities and independent power providers.

Meanwhile, agriculture, fishery and forestry (AFF) sector, which contributed 1.3 percentage points to GDP growth during the fourth quarter of 2002, grew by 6.1 percent from 5.9 percent during the same period last year. With the recovery of palay production during the quarter, the agriculture and fishery subsector recovered from the 0.1 percent contraction during the third quarter of 2002. The timely implementation of the Quick Turnaround (QTA) planting scheme by the government, coupled with favorable weather conditions and expansion in irrigated areas, provided the boost in palay production during the fourth quarter. In particular, the QTA was part of the *Ginintuang Masaganang Ani* (GMA) Rice Program of the Department of Agriculture (DA). It aimed to compensate for the possible loss in rice output brought about by drought and flooding that accompany the El Niño phenomenon. Under the scheme, irrigated rice areas which had been harvested in August or early September were immediately replanted with early maturing rice varieties and certified seeds within two or three weeks to make up for the delays in planting during the second quarter. Farmer participants to the program could also avail of fertilizer on credit under the Quedan and Rural Credit Guarantee Corporation (Quedancor).

Aggregate Demand

On the demand side, personal consumption expenditure (PCE) contributed largely to the fourth quarter growth of GDP, as it rose by



4.4 percent during the last three months of 2002 from 3.8 percent during the same period in 2001 (Table 1a). This is the first time that PCE growth exceeded 4.0 percent since the second quarter of 1998. Supported by the low inflation and low interest environment,

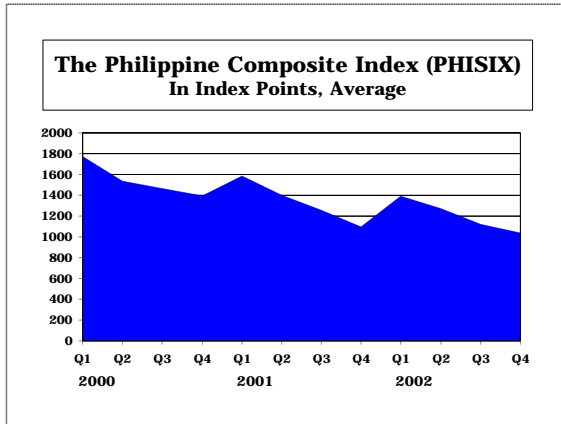
expenditures on food, transportation and communication, and miscellaneous services underpinned the surge in PCE growth during the quarter. Government consumption also recorded an expansion of 4.8 percent during the quarter from a 1.5 contraction posted during the same period last year, due to increased spending on personnel services resulting from the lifting of Administrative Order No. 5 and the provision for additional Christmas bonus to government employees.

Meanwhile, the 11.8 percent upsurge in private construction for housing and trade establishments halted the slump in investments which recovered from the 1.5 percent contraction during the last three months of 2001 to post an expansion of 11.3 percent during the same period in 2002.

Exports and imports of goods and services posted significant gains during the final quarter of 2002. Total exports and imports rose by 3.5 percent and 15.3 percent, respectively, during the last three months of 2002—reversing their 15.1 percent and 11.9 percent contractions recorded during the comparable period in 2001. The growth in merchandise exports was led by the 25 percent surge in the exports of semiconductors and electronic microcircuits, following the rebound in the electronics sector in the international market. The increase in exports of semiconductors and microcircuits was a reversal from the 32.8 percent decline posted in the fourth quarter of 2001. This was complemented by the all-time increase of 71.3 percent in imports on consignment basis, which were mostly raw materials for the electronics and semiconductor industry. The one-percent cut in tariff rates in December for capital goods and other inputs not locally produced as well as the reduction to zero percent in tariff rates for 40 information technology (IT)-related product lines also provided a boost for imports during the final quarter of 2002.

Exports of nonfactor services recovered as the level increased by 2.4 percent, a marked reversal from the 46.4 percent contraction during the same period in 2001. This resulted from the 14.9 percent increase in travel during the fourth quarter of 2002 from a 45.2 decline in the same quarter of 2001. The rise in travel receipts is equivalent to a 6.9-percent point contribution to the growth of the exports sector. Despite the issuance of negative travel advisories to the Philippines, tourist visits increased during the quarter as the government intensified its tourist promotion programs. It was noted that the increase in the number of tourists from neighboring Asian countries, particularly from East Asia, compensated for the slack in tourist arrivals from Western countries.

✎ Stock Market Developments



Activity in Philippine equities markets remained subdued during the quarter, with trading marked largely by caution due to domestic and external concerns combined. The average Philippine Stock Exchange Composite Index (PHISIX)—the main barometer of stock market performance—

dropped by 7.2 percent to 1,038 index points during the fourth quarter of 2002 from 1,118.6 index points during the previous quarter and by 5.3 percent compared to the 1,096.6 index points registered during the same quarter in 2001 (Table 2).

Despite the continued benign inflation, early indications of a strong third quarter GDP growth as well as higher export receipts, stock market activity was not boosted. Several factors affected investors' sentiment in the local bourse, including: the termination of the \$925-million deal for the purchase of Philippine Long Distance Telephone Company (PLDT) shares from the Hong Kong-based First Pacific Co., Ltd. by the Gokongwei Group; the controversy over the Philippine International Air Terminal Co., Inc.'s (PIATCO's) \$650-million Ninoy Aquino International Airport (NAIA) Passenger Terminal 3 contract; the Supreme Court's decision to order cash-strapped Meralco to refund to its subscribers excess charges collected since 1994; fear over the resurgence of terrorism; the looming war between Iraq and a US-led coalition; weak global equities particularly that of the United States; the NG's widening budget deficit; and the weakening of the peso.

During the quarter in review, the lethargic market activity was reflected in the 21.9 percent decline in the aggregate volume turnover and the 55.1 percent reduction in the total value of transactions compared to the previous quarter. The volume turnover dropped in the following sectors: the banking and financial services sector by 67.2

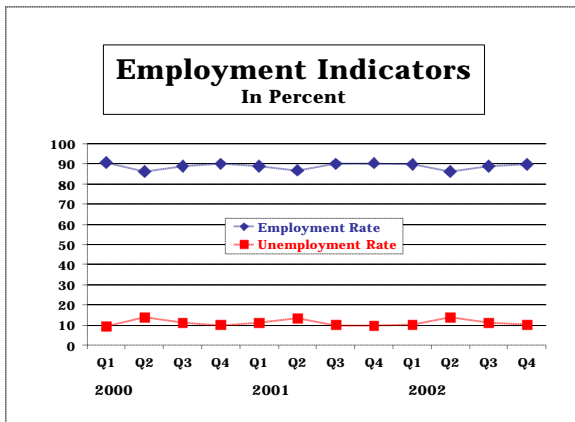
percent to 90 million shares; the oil sector by 48.4 percent to 2,332 million shares; and the commercial and industrial sector by 25.7 percent to 5,188 million shares. There were, however, increases in the volume turnover of the small and medium enterprise (SME) sector by 300 percent to 4 million shares, the mining sector by 111.9 percent to 1,943 million shares and the property sector by 2.9 percent to 1,478 million shares.

In terms of value, banking and financial services declined by 74.8 percent to ₱2,802 million, oil issues by 62.5 percent to ₱6 million, commercial and industrial issues by 50.5 percent to ₱13, 254 million, property issues by 36.8 percent to ₱ 3,146 million and mining issues by 8 percent to ₱23 million. Only the SME issues increased by 650 percent to ₱15 million.

✕ Labor, Employment, and Wages

Despite the record real sector performance during the quarter, labor market conditions remained soft. Based on the results of the labor force survey of October 2002, the unemployment rate during the fourth quarter stood at 10.2 percent, slightly higher by 0.4 percentage point from 9.8 percent in the same period last year (Table 3). The increase in unemployment rate was a result of the 1.0 percent expansion in the labor force exceeding the 0.6 percent increase in the number of employed persons. Compared to the third quarter 2002, the 10.2 percent unemployment rate was slightly lower by one percentage point.

Meanwhile, employment in the industry sector fell slightly by 0.3 percent, particularly in the manufacturing and mining and quarrying subsectors. The industry sector's share to total employment fell to 15.4 percent from 15.6 percent in the same period last year.

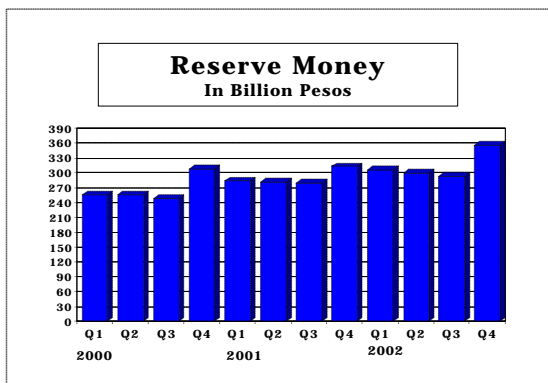


The number of employed workers during the quarter in review rose to 30.3 million from 30.1 million in the same period last year. However, the employment rate declined marginally by 0.4 percentage point to 89.8 percent from 90.2 percent a year ago. The increase in the number of employed persons was attributed to the jobs generated in the agriculture and services sectors. Employment in the agriculture sector was slightly up by 0.5 percent, but its share to total employment remained at 37.4 percent in the comparable quarter last year. Similarly, employment in the services sector posted an increase of 0.8 percent due largely to the rise in employment from the wholesale and retail trade, repair of motor vehicles, motorcycles and personal and household goods subsector. The services sector's share to total employment expanded moderately to 47.2 percent during the quarter from 47.0 percent for the same period last year.

Nominal and real wages in the National Capital Region (NCR) improved in the third quarter 2002 from the comparable period last year. Nominal wages in the agricultural and non-agricultural enterprises rose to ₱263.25 and ₱303.33 from ₱230.75 and ₱270.83, respectively. Real wages in agricultural and non-agricultural enterprises increased to ₱155.95 and ₱179.70 from ₱140.79 and ₱165.24, respectively.

C. MONETARY SECTOR

☒ Reserve Money and Base Money



The level of reserve money (RM) as of end-December 2002 rose by ₱62.9 billion or 21.4 percent to ₱356.1 billion from the end-September 2002 level of ₱293.2 billion (Table 4). This developed as the BSP has kept its overnight borrowing and lending rates steady at 7.0 percent and 9.25

percent, respectively since 15 March 2002. Compared to the level registered at end-December 2001, the RM level also rose by 13.8

percent due largely to a 20.5 percent growth in the net foreign assets (NFA) of the BSP resulting from the build-up in gross international reserves.

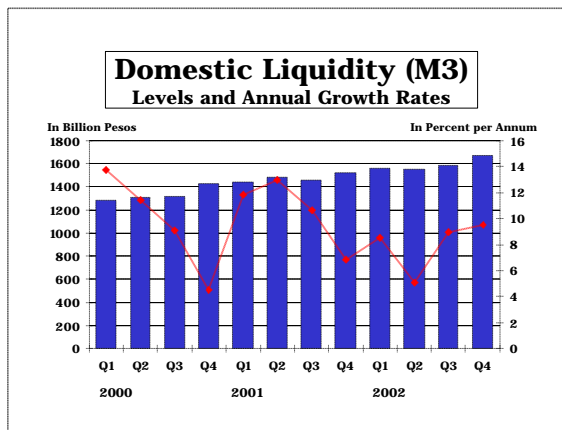
The ₱62.9 billion increase in the RM level during the fourth quarter can be traced mainly to the ₱17.2 billion and ₱45.6 billion expansion in the BSP's NFA and net domestic assets (NDA), respectively.

The improvement in the NFA of the BSP in the fourth quarter was due largely to the build-up in international reserves on account of increased National Government deposits arising from the proceeds of the RP Global Bonds and various program loans as well as the proceeds from the bond issuances of the National Power Corporation (NPC) and the Power Sector Assets and Liabilities Management (PSALM). Meanwhile, the increase in the NDA during the reference quarter was mainly the result of the unwinding of banks' placements with the BSP under the reverse repurchase (RRP) window to be able to finance the seasonal rise in demand for liquidity during the holidays.

Meanwhile, the level of base money as of end-November increased by ₱16.1 billion or by 4.0 percent relative to the end-September 2002 level due mainly to the higher level of reserve money.

✧ Domestic Liquidity

The level of domestic liquidity or M3 reached ₱1.7 trillion as of end-December 2002, reflecting a 5.2 percent increase relative to the level in the previous quarter. This quarter-on-quarter growth is higher than the 2.1 percent rise recorded in the same quarter a year ago. As of end-December 2002, M3 grew by 9.5 percent year-on-year, sustaining its uptrend for the sixth consecutive month (Table 5). The growth in money demand reflected in part, the increase in investments in government securities and



expansion in NFA of the monetary system, which is comprised of the BSP and the banking system.

The seasonal inflow of dollars, including those from remittances of OFWs during the holiday season helped boost the NFA position of banks. In addition, the steady rise in public sector credits supported the 4.9 percent year-on-year improvement in net domestic credits (NDC) in December 2002 after posting marginal growth rates during the previous two months.

Net domestic credits to the public sector, particularly to the NG, rose by 13.1 percent year-on-year, due to the strong demand for government securities, which was supported by ample liquidity in the system. Credits to local governments also recorded a hefty increase of 35.7 percent in December 2002. While private sector credits increased by only 1.2 percent year-on-year in December 2002, this reflected a marked improvement compared to the year-on-year declines recorded in the past 15 months.

As a percentage of GDP, NDC declined to 55.6 percent as of end-December 2002 from 57.9 percent in the same period last year. Compared with selected Asian countries, the country's NDC to GDP ratio was lower than those of Indonesia (61.1 percent), Korea (104.2 percent), Malaysia (120.9 percent) and Taiwan (156.6 percent).¹

By composition, peso demand, savings and time deposits, and deposit substitutes, which comprised about 86.8 percent of total domestic liquidity, rose by ₱29.7 billion or 2.1 percent from the previous quarter's level and by ₱119.2 billion or 9 percent from the comparable level of the previous year. Currency in circulation—which accounted for the remaining 13.2 percent of M3—increased by ₱52.5 billion or 31.3 percent from the previous quarter's level and by ₱25.4 billion or 13.0 percent from the comparable level of the previous year. Meanwhile, M4—defined as domestic liquidity (M3) plus foreign currency deposits (FCDs) of non-bank residents—reached ₱2.3 trillion as of end-December 2002, 7.9 percent and 11.0 percent higher compared to its quarter-ago and year-ago levels, respectively. The strength of foreign exchange inflows from OFWs and the recovery of exports contributed to the continued expansion in FCDs of non-bank residents.

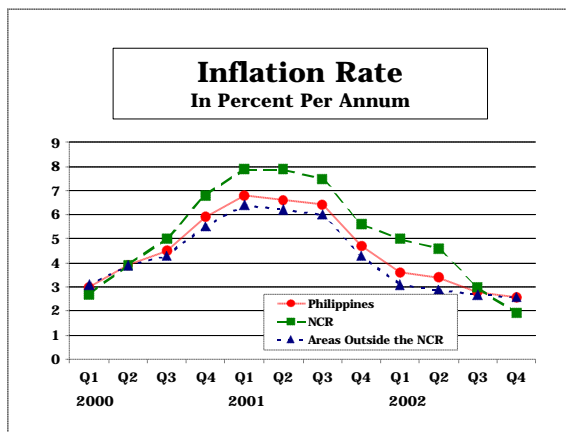
The financial deepening ratio (defined as M3 as a percentage of

¹ Data on the NDC to GDP ratios were for the fourth quarter of 2001 for Indonesia; those for Taiwan and Korea were both for the first quarter of 2002 while that for Malaysia was for the second quarter of 2002.

GNP), which indicates the level of domestic mobilization of financial resources in the economy, remained relatively stable at 39.5 percent as of end-December 2002 from 38.7 percent as of end-September 2002.

☒ Prices

The inflation environment remained benign in the fourth quarter of 2002, largely on account of lower food and non-food prices as well as subdued demand-pull inflationary pressures. Headline inflation continued to decelerate in the fourth quarter to an average of 2.6 percent from 2.8 percent in the third quarter (Table 6).



Lower inflation during the quarter was traced mainly to favorable movements in the prices of food, beverages and tobacco (FBT) as well as fairly stable non-food prices. The inflation rate for FBT slowed down to 1.6 percent during the review quarter from 2.0 percent in the previous quarter. Favorable supply conditions tempered the price movements of major food products, such as fish (from 2.1 percent to 1.5 percent); beverages (from 2.7 percent to 2.5 percent); tobacco (from 3.0 percent to 1.8 percent); dairy products (from 1.9 percent to 1.8 percent), as well as the fall in prices of fruits and vegetables (by 0.9 percent against a 2.6 percent rise in the previous quarter) and meat prices (by 1.4 percent compared to a 0.4 percent increase). However, the year-on-year inflation rate of rice and corn both rose to 3.6 percent from 2.9 percent and 2.5 percent, respectively.

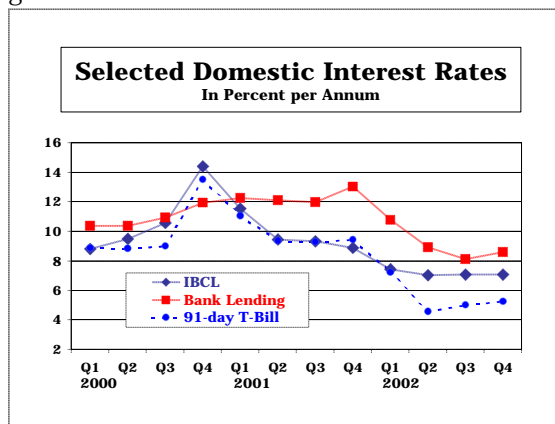
Year-on-year inflation rates for non-food items likewise continued to decelerate during the fourth quarter, averaging at 3.6 percent from 3.7 percent in the previous quarter. This was traced to lower inflation for clothing (from 2.5 percent to 2.4 percent); housing and repairs (from 4.7 percent to 3.8 percent); and miscellaneous items (from 1.7 percent to 1.6 percent).

The benign trend in prices across commodity groups reflects in part the muted demand-side influences on consumer prices. This may be attributed to the limited pricing power on the part of producers amid indications of weakness in domestic demand. Although private consumption spending continues to be buoyant, the economy continues to show signs of slack capacity. Capacity utilization in the manufacturing sector, for example, has remained below normal levels at 74.8 percent as of December 2002. Labor market conditions also remained soft with the unemployment rate in the fourth quarter at double-digit levels. Credit demand also continues to be relatively subdued, although bank lending activity has shown steady and modest improvement in the past few months. Total commercial bank loans increased by 2.4 percent year-on-year in December 2002, reflecting the fourth consecutive month of year-on-year growth. Such indications of slack suggest that economic activity still has to strengthen further before consumer prices begin to rise.

In terms of geographical location, the average inflation rate in the National Capital Region (NCR) eased to 1.9 percent during the review period from 3.0 percent in the previous quarter (Table 6a). Likewise, the inflation rate in areas outside the NCR slowed down to 2.6 percent from 2.7 percent in the previous quarter (Table 6b).

✧ Domestic Interest Rates

Despite the neutral monetary policy during the quarter, as a result mainly of the benign inflation environment and the still mixed signs of improvement in domestic demand, domestic interest rates generally trended upwards. This reflected market concerns over continued fiscal slippage and the depreciation of the peso, which fueled expectations of higher interest rates in the near future. Banks' apparent appetite for government securities, amidst moderate loan activity and ample liquidity, and the continued



efforts of the Bureau of the Treasury (BTr) to limit increases in interest rates by rejecting excessively high bid rates likewise contributed to the moderation in interest rates during the period.

During the quarter in review, the BSP maintained its neutral monetary policy stance, keeping its key overnight borrowing and lending rates at 7.0 percent and 9.25 percent, respectively. Despite a generally favorable inflation environment and the 50 basis-point sizable policy rate reduction by the US Federal Reserve of its federal funds target rate from 1.75 percent to 1.25 percent during the quarter, the BSP kept its policy rates unchanged in recognition of the presence of some downside risks to inflation outlook.

Nonetheless, despite the BSP's neutral monetary policy stance, yields on government securities rose anew in the last quarter of 2002 due to market expectations of higher interest rates fueled by concerns over the ability of the fiscal authorities to contain the government budget deficit, the increasing risk of conflict in the Middle East that could impact negatively on prices as well as on OFW remittances, and the depreciation of the peso. The bellwether 91-day T-bill rate went up by 24.2 basis points to 5.25 percent, the 181-day tenor by 54.9 basis points to 6.41 percent, and the 364-day tenor by 119.9 basis points to 7.13 percent (Table 7).

Tracking the movement of yields on government securities, the range of bank lending rates also went up to 8.15–10.04 percent in the fourth quarter from 8.04–9.82 percent in the previous quarter. Similarly, interest rates on savings, and time deposits and short-term promissory notes (Manila Reference Rates) across all maturities went up by 24.2 basis points, 2.3 basis points and 75.0 basis points, respectively, to average 3.60 percent, 4.20 percent and 6.38 percent during the quarter. By contrast, interbank call loan rates dipped by a slight 1.9 basis points to 7.07 percent during the quarter in review compared to the rate registered in the third quarter, due to improved system liquidity.

Meanwhile, interest rate differentials widened sharply from 320 basis points in the third quarter to 370 basis points in the fourth quarter of 2002 due to a combination of higher domestic interest rates and lower foreign interest rates.² Real (i.e., nominal interest rates adjusted for inflation) interest rates generally mirrored nominal trends as they trended upwards during the quarter in review.

² The interest rate differential in this report is defined as the difference between the bellwether 91-day Treasury bill rate and the 90-day London Interbank Offered Rate.

✧ Financial System

The financial system managed to post gains despite the mounting uncertainties brought about by the heightened tension in the Middle East as well as renewed pressures on the exchange rate which threatened to weaken further financial activity. Resources of the banking system registered an uptrend, the quality of its loan portfolio posted an improvement while its capital adequacy ratio remained relatively high. The favorable performance of banks was supported by the higher-than-expected growth of the economy and the proactive reforms to strengthen the banking system.

Preliminary data show that the financial system's total resources reached ₱4.3 trillion in 2002, higher by 2.1 percent compared to the previous quarter's level (Table 8). The increase was more than double the growth recorded in the previous quarter. The growth in resources was fueled mainly by the 2.5 percent expansion in the assets of banks, which comprised 83.6 percent of total resources. By type of bank, commercial banks (KBs) accounted for 75.4 percent of the financial system's aggregate resources, followed by thrift banks (TBs) with 6.3 percent and rural banks (RBs), 1.9 percent. The remaining 16.4 percent comprise the resources of non-banks, which recorded a 0.14 percent decline from the third quarter.

As of September 2002, the operating network of the financial system, comprising of head offices and branches, increased from 17,587 to 17,782 (Table 8a). In terms of head offices, the increase in the number of financial institutions was due primarily to the increase in the number of pawnshops. The number of banks on the other hand, recorded a decline reflecting the merger and consolidation thrust of the BSP.

Performance of the Banking System

Asset Quality. The banking system's asset quality sustained its improvement in the fourth quarter. Non-performing loans (NPLs) as a percent of total loans reached 14.9 percent at end-December 2002 from 16.2 percent as of end-September 2002 (Table 8b). The NPL ratio started its steady decline as early as May but a more significant reduction was observed beginning September 2002 due to the impact of BSP Circular No. 351 dated 19 September 2002. The Circular allowed banks to exclude from the computation of NPLs those classified as "Loss" which are fully covered by allowance for probable

losses, provided that such loans are also deducted from total loan portfolio and interests on these loans shall not be accrued. For commercial banks, the NPL ratio would still be lower than the September level at 15.8 percent, even without the redefinition. Banks' increased foreclosure and restructuring efforts as well as actual collections also contributed to the decrease in the banking system's NPL ratio.

The banking system's NPL ratio at the end of the fourth quarter of 2002 remained above that of its regional counterparts. In particular, Malaysia, Thailand, Korea and Indonesia posted NPL ratios of 9.3 percent, 10.09 percent, 1.9 percent and 8.1 percent, respectively,³ as most of these countries' NPLs were purchased by asset management companies (AMCs) established in 1997 and 1998 for this purpose.⁴ In the case of the Philippines, the disposition of at least half of the non-performing assets (NPAs) of financial institutions is expected to be facilitated by the passage of Republic Act No. 9182 or the Special Purpose Vehicle Act (SPVA) on 10 January 2003.⁵ Unlike the AMCs of other Asian countries, which are state-owned, the SPVs will be put up by private investors. Under the law, the role of the government will be limited to granting tax and other incentives that would reduce transaction costs attendant to asset transfers. It has been estimated that the SPVA should cut costs related to selling NPAs by 15-20 percent.⁶

Capital Adequacy Ratio. Based on the old capital adequacy framework, the banking system's capital adequacy ratio (CAR) as of September 2002 (as measured by net worth-to-risk assets) was higher at 17.3 percent compared to the 16.5 percent posted as of end-June 2002. Meanwhile, the CAR of KBs also increased to 17.3 percent from 16.5 percent during the same period. The improvement in the CAR was traced to both the increase in capital reserves of banks and the reduction in risk assets. Using the risk-based framework,⁷ the CAR of KBs stood at 16.8 percent in June 2002, almost the same level recorded at end-March 2002. The CAR ratios—using both the old and

³ Source: ARIC Financial Indicators, ADB website. Malaysia (December 2002, commercial banks); Thailand (November 2002, commercial banks); Korea (September 2002, commercial banks); and Indonesia (September 2002, financial system).

⁴ NPL purchases by AMCs were 39.3 percent for Malaysia (November 2001); 60.1 percent for Thailand (January 2002); 77.12 percent for Korea (September 2002); and 91.72 percent for Indonesia (December 2002).

⁵ Supervisory Research and Studies Office, Bangko Sentral ng Pilipinas

⁶ UBS Warburg, Philippine Banks, 16 January 2003

⁷ BSP Circular No. 280, dated 29 March 2001, approved the guidelines for the adoption of the risk-based capital adequacy ratio along the criteria prescribed by the Bank for International Settlements (BIS).

new frameworks—exceeded the statutory level set by the BSP at 10.0 percent and the Bank for International Settlements (BIS) standard of 8.0 percent.

To date, the Philippines' CAR is the highest in the region compared to those of Malaysia (12.8 percent), Thailand (14.1 percent) and Korea (10.8 percent).⁸

Loan-Loss Provisions. Notwithstanding the decline in banks' NPL ratio, loan-loss provision as a percent of total NPLs further improved to 50.2 percent as of the fourth quarter compared to the 47.6 percent recorded during the previous quarter, reflecting banks' prudent stance in providing adequate cover for their distressed loans.

Bank Lending. The continuing improvement in the quality of banks' asset led to the more active credit activity. Commercial bank lending recovered to post an encouraging growth rate of 2.4 percent at ₱1.4 trillion in fourth quarter, double the increase recorded in third quarter. The recovery in credit demand reflected the impact of past monetary easing measures and the robust growth of the domestic economy. By sector, the growth in bank lending can be traced to the significant improvement in the following: agriculture, fisheries and forestry (27.5 percent); financial institutions, real estate and business services sector (6.0 percent); and manufacturing (1.7 percent). The manufacturing sector posted a turnaround after a 17-month year-on-year contraction.

Real Estate Exposure of Banks. The outstanding loans of KBs to the real estate sector as a percent of total loans exhibited a downtrend at 10.53 percent as of September 2002 from 10.79 percent in June 2002. This level of exposure remains well below the 20.0 percent ceiling set by the BSP. The bulk of banks' total loans to the real estate sector went to the development of commercial properties and housing subdivisions, acquisition of residential and commercial properties as well as construction of infrastructure projects.

Banking Measures

The BSP continued to implement measures aimed at maintaining stability and strength in the banking industry and helping it gear up to the challenges brought about by nagging financial and political uncertainties. These measures focused on:

⁸ Source: ARIC Financial Indicators, ADB website. Malaysia (December 2002); Thailand (November 2002); and Korea (March 2002).

Strengthening the BSP's Oversight Function. To ensure liquidity in the system and protect depositors' interest, the BSP authorized government and private depository banks (other than the BSP) to maintain a fifty (50) percent liquidity floor with respect to deposits of, borrowing from, and all other liabilities to, the Government and government entities.⁹ The reserves maybe in the form of transferable government securities, which represent direct obligations of the National Government. The amended rules exclude negotiable government securities from other liabilities (*Circular No. 355 dated 9 October 2002*).

To implement the remaining provisions of the General Banking Law of 2000, the BSP issued guidelines that would govern the use by banks of any or all their branches as outlets for the presentation and/or sale of the financial products of their allied undertakings or of their investment house units (*Circular No. 357 dated 8 November 2002*).

Enhancing Risk Management. The BSP approved the guidelines incorporating market risk in the risk-based capital adequacy framework for universal banks and commercial banks. Under the new ruling, universal/commercial banks are required to measure and apply capital charges for market risks, in addition to the credit risk capital requirement. Whenever banks fall below the prescribed risk-based capital adequacy ratio, the distribution of the net profits shall be limited or prohibited by the BSP, and banks shall be required to use that part, or all of the net profits to increase their capital accounts until the minimum requirement has been met (*Circular No. 360 dated 3 December 2002*).

Enhancing Corporate Governance. The BSP required that the grounds for the disqualification and the procedures in the watch-listing of erring directors/officers/employees of banks, quasi-banks and trust entities be applied as well as to other institutions under the BSP's jurisdiction, except for the ground for disqualification arising from failure to attend the seminar conducted or accredited by the BSP required of the board of directors (*Circular No. 363 dated 17 December 2002*).

Other Measures. The BSP allowed the proposed zero coupon bond issue by the Home Insurance Guaranty Corporation (HIGC) of up to ₱7.0 billion 5-year regular series and up to ₱3.9 billion 7-year

⁹ This is inclusive of the required reserves against deposits and/or deposit substitutes.

special series intended to finance its guaranty servicing of socialized and low-cost housing projects, as alternative compliance with the agrarian reform credit requirement and as reserve for trust and other fiduciary duties. Likewise, investments made by banks in HIGC's proposed bond issues shall be allowed as alternative compliance with the 10 percent agrarian reform credit requirement subject to certain conditions: 1) the bond shall not be hypothecated or earmarked for any other purpose; and 2) in case the bonds are 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, provided that the repurchase/resale agreement shall be of a term of at least thirty (30) days without pre-termination during the first thirty (30) days (*Circular No. 356 dated 9 October 2002*).

The BSP issued new guidelines to govern the availments under the BSP Rediscounting Facility. The new guidelines allow the BSP to accept loan papers covering all economic activities except for the following: (1) interbank loans; (2) DOSRI loans; (3) extended/restructured loans; (4) past due loans; (5) unsecured loans; (6) personal consumption loans; and (7) loans for capital assets acquisition (*Circular No. 354 dated 1 October 2002*).

To further promote the development of SMEs, the BSP postponed the implementation of the market-based pricing mechanism for rediscount loans from 4 October 2002 to 3 October 2003. Furthermore, the regular reserve requirement was also reduced to 6 percent for demand deposits, deposit substitutes, and the NOW accounts of thrift banks, and demand deposits and NOW accounts of rural/cooperative banks (*Circular No. 363 dated 18 December 2002*).

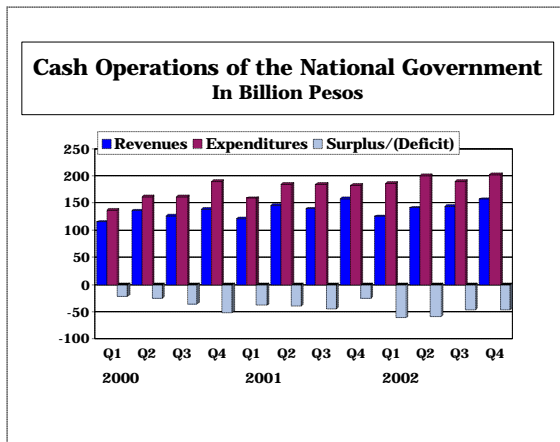
The BSP allowed the proposed zero coupon bond issue by the Home Insurance Guaranty Corporation (HIGC) of up to ₱7.0 billion 5-year regular series and up to ₱3.9 billion 7-year special series intended to finance its guaranty servicing of socialized and low-cost housing projects, as alternative compliance with the agrarian reform credit requirement and as reserve for trust and other fiduciary duties. Likewise, investments made by banks in HIGC's proposed bond issues shall be allowed as alternative compliance with the 10 percent agrarian reform credit requirement subject to certain conditions: 1) the bond shall not be hypothecated or earmarked for any other purpose; and 2) in case the bonds are 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, provided that the repurchase/resale agreement shall

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D. FISCAL SECTOR

☒ National Government Cash Operations

During the fourth quarter of 2002, the cash operations of the National Government (NG) posted a deficit of ₱46.2 billion (Table 9). This was ₱0.6 billion lower than the previous quarter's deficit, as total revenues increased by ₱13.3 billion (9.3 percent) slightly outpacing the ₱12.7 billion (6.7 percent) rise in expenditures. Compared to the program for the period, the fourth quarter's deficit was higher by ₱22.5 billion as revenues fell short of the target by ₱8.8 billion and expenditures exceeded the target by ₱13.8 billion.



The ₱13.3 billion increment in revenues from the previous quarter was due primarily to the higher tax collections of the Bureau of Internal Revenue (BIR) and the Bureau of Customs (BOC), which increased by ₱11.4 billion and ₱1.5 billion, respectively. The improvement in revenues in the fourth quarter reflected the

revenue enhancing measures adopted by the government such as the over 1,000 demand letters sent to delinquent value-added taxpayers beginning September 2002. As of November 2002, more than 60.0 percent have complied and over ₱1.0 billion have been settled in cash with the rest to be paid on installment. Moreover, an electronic filing and payment system has been expanded for all types of tax payments. Non-tax revenue collections likewise contributed ₱0.6 billion to the increase in total revenues, which came largely from privatization proceeds and investment income of the BTr. Privatization proceeds include the sale of assets of the Manila Manor Hotel and Philippine Phosphate Fertilizer Corporation (PHILPHOS).

Meanwhile, the ₱12.7 billion rise in expenditures was for the most part accounted for by the ₱17.5 billion increase in other current operating expenses, which was partially offset by the lower interest payments on foreign borrowings during the quarter.

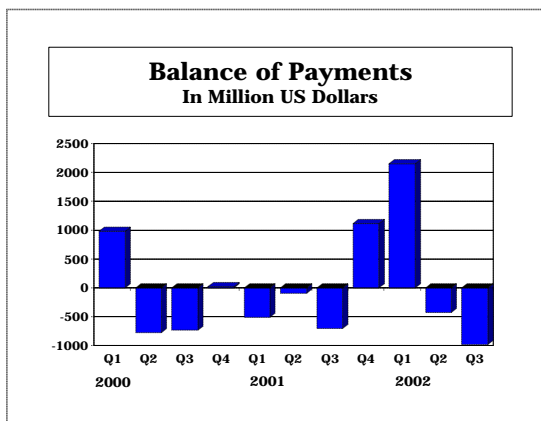
On the financing side, net borrowings from domestic and external sources amounting to ₱36.7 billion and ₱13.7 billion, respectively, were used to finance the deficits in the budgetary (₱46.2 billion) and non-budgetary (₱0.2 billion) accounts, and to augment the Government's cash balance (₱4.0 billion). In contrast, during the third quarter, withdrawals from the Government's cash balance largely financed the deficits in the budgetary and non-budgetary accounts.

Compared to the year-ago level, the NG deficit in the fourth quarter of 2002 was higher by ₱21.3 billion as expenditures substantially increased by ₱20.0 billion and revenues fell by ₱1.3 billion.

E. EXTERNAL SECTOR

✎ Balance of Payments¹⁰

The country's balance of payments (BOP) in the third quarter of 2002 posted a higher deficit of \$978 million from \$702 million a year ago. This developed due to the higher net outflow in the capital and financial account even as the current account posted stronger performance (Table 10).



Current Account

¹⁰ The BOP statistics for the fourth quarter of 2002 will be released to the public upon the release by the National Statistics Office (NSO) of the revised import figure for the year 2002 in April 2003.

During the review quarter, the current account balance yielded a surplus of \$984 million, 77.6 percent higher than the year-ago level. Underpinning this development were the higher net receipts of income and transfers combined with lower net outflow in trade-in- services.

Merchandise Trade.¹¹ The trade-in-goods surplus in the third quarter of 2002 increased modestly by 6.0 percent from the level same period last year to \$267 million, with export and import growth moving closely in tandem.

Export growth of 18.2 percent for the third quarter marked the second consecutive quarter of export recovery after five successive quarters of decline.¹² The export performance reflected the recovery in electronics exports which grew by 22.9 percent from last year—second quarter in a row of double-digit growth—breaking the slump for the last five successive quarters since the beginning of 2001 on account of the slowdown in global demand for electronics.¹³ The expansion in exports of machinery and transport equipment, petroleum products and garments also helped improve the export performance. It is noteworthy to mention, that exports of garments which expanded by 13.3 percent during the review quarter, marked its first positive year-on-year growth after experiencing successive five quarterly contractions. The stronger performance of garment exports can be partly attributed to the success of the Government's strategy to tap the high-end markets and to shift reliance from traditional quota-driven markets such as the U.S. to non-quota markets such as Japan, United Arab Emirates, Hong Kong, and Mexico in preparation for the impending quota phase-out in 2004.

Meanwhile, imports grew by 18.6 percent to \$8,895 million from \$7,497 million a year ago. Raw materials and intermediate goods—which accounted for about 40 percent of total imports—posted the highest increase due mainly to the 53.5 percent rise in materials/accessories for the manufacture of electrical equipment. Imports of capital goods, in particular office and EDP machines and aircraft, boats and ships, also increased by 29.7 percent.¹⁴ By contrast, mineral fuels and lubricants imports by fell due to the decline in the volume of imports.

¹¹ Data on imports used are based on the unadjusted import series.

¹² Per BPM5 concept

¹³ Exports of electronics accounted for over half of the total export revenues for the last six years and thus performance of this commodity strongly dictates total export performance.

¹⁴ Based on National Statistics Office concept

Services. The trade-in-services account in July-September 2002 posted a lower net outflow of \$375 million from a net outflow of \$516 million a year ago, bolstered by the nearly fourfold rise in net receipts from travel. The Government's aggressive promotion program to attract both local and foreign tourists and the weaker peso that discouraged foreign travel helped propel the trade-in-services account.

Income. The surplus in income account increased by 33.9 percent from the level a year ago to \$940 million. Behind this development was the 15.6 percent rise in the remittances of OFWs, a major source of foreign exchange of the economy. Higher number of newly hired and rehired OFWs which rose by 3.5 percent during the third quarter from last year's level, contributed to the expansion in OFW remittances.

Current Transfers. The current transfers recorded a higher surplus of \$152 million relative to the \$116 million surplus posted for the same period in 2001. These came mainly in the form of donations from individuals and non-governmental institutions.

Capital and Financial Account

During the review quarter, the net outflow in the capital and financial account widened to \$2,505 million from \$295 million in the same period last year due to the weaker performance of all the major sub-accounts following heightened risk aversion among investors.

Capital Account. Capital account deficit of \$5 million was nearly unchanged from last year's level of \$6 million.

Direct Investments. Direct investments during the quarter in review reversed to a net outflow of \$39 million from a net inflow of \$432 million a year ago due mainly to the repayment by local subsidiaries of loans granted by their foreign affiliates. Net equity capital infusion, however, continued to remain positive at \$173 million, albeit lower by 12.6 percent compared to last year's level of \$198 million. Residents' investments in equity capital abroad intended for wider global market penetration also contributed to the net outflow in the direct investment account.

Portfolio Investments. The portfolio investments reverted to a net outflow of \$645 million from a net inflow of \$479 million during the same quarter last year attributed mainly to the residents' purchases of foreign-denominated bonds issued abroad in the

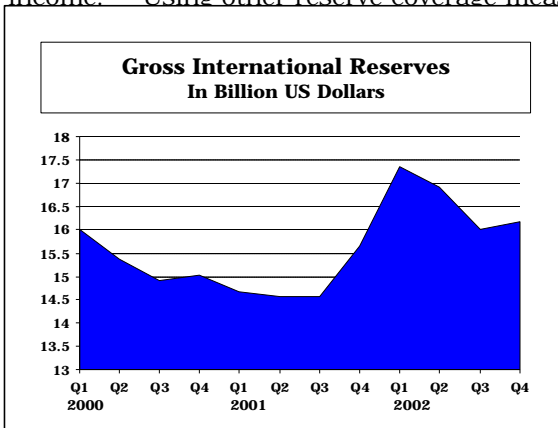
secondary market and the decline in non-residents' investments in equity securities.

Other Investments. The net outflow in other investments widened by 51.3 percent to \$1,816 million. Behind this development were the repayment of non-residents' maturing foreign currency deposits in local banks as well as the debt service by both public and private sectors of their maturing obligations.

Data based on the change in net international reserves of the BSP as of end-December 2002 relative to the level as of end-September 2002 indicated that the overall BOP position for the fourth quarter of 2002 was a deficit of \$91 million.

✧ International Reserves

The country's gross international reserves (GIR), including the reserve position in the International Monetary Fund (IMF), climbed to US\$16.18 billion as of 31 December 2002. This was 0.97 percent or \$155 million higher compared to the end-September 2002 level of US\$16.02 billion (Table 11). The end-2002 GIR level was equivalent to 4.8 months' worth of imports of goods and payment of services and income.¹⁵ Using other reserve coverage measures, the level of reserves



is 2.8 times the amount of the country's short-term foreign liabilities based on original maturity and 1.3 times based on residual maturity.¹⁶

The growth in GIR during the last quarter of 2002 was mainly due to deposits with the BSP by the NG and by the NPC of their loan/bond proceeds, as well as the BSP's income from its investments abroad.¹⁷ These inflows were, however, partly offset by the disbursements for settlement of the BSP's

¹⁵ Computed using estimated adjusted imports of goods

¹⁶ Short-term debt based on residual maturity refers to principal payments of the public and private sectors falling due within the next twelve (12) months.

¹⁷ Deposits by NG and NPC included proceeds from RP Global Bonds (\$495 million), JBIC-Co-Financing Power Sector Reform Loan (\$101 million), and ADB-Power Sector Reform Loan

maturing external obligations and servicing of the NG foreign exchange requirements.

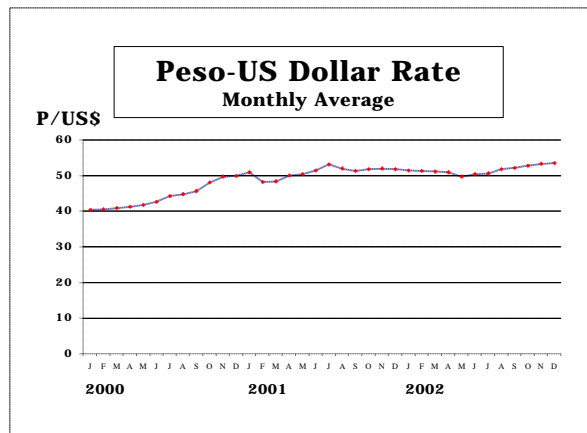
In terms of composition, a large part of reserves were in the form of foreign investments (77 percent), with the remainder in gold (19 percent), foreign exchange (3 percent) and in combined Special Drawing Rights (SDRs) and reserve position in the Fund (1 percent).

The net international reserves (NIR) level rose to US\$12.84 billion as of end-December 2002 from the end-September 2002 level of US\$12.61 billion.

✧ Exchange Rate

Trends in the Peso-Dollar Rate

The peso depreciated by 3.3 percent or by ₱1.74 centavos against the US dollar to average ₱53.24/US\$1 during the fourth quarter of 2002 from an average of ₱51.51/US\$1 in the previous quarter (Table 12 and 12a). Relative to the same quarter last year, the peso weakened by 2.6 percent.



The weakening trend of the peso, which started in the middle of the second quarter, continued through the last quarter of 2002. The depreciation of the peso was largely on account of concerns over the country's fiscal deficit, the escalating conflict in the Middle East, and the bombing incident in Bali, Indonesia last October. The peso, however, slightly recovered towards the end of December 2002 on the strength of the seasonal remittances of overseas Filipino workers.

Despite the heightened depreciation pressure, the exchange rate was less volatile during the fourth quarter compared to the third

(S100 million) in November 2002; and NPC's \$300 million Zero Coupon Notes (\$148 million) and PSALM's bond issuance in Japanese yen (\$451 million) in December 2002.

quarter. The standard deviation of the daily peso-dollar exchange rate declined from ₱0.73 to ₱0.36. The average peso-US dollar trading range likewise declined to ₱0.16 during the fourth quarter relative to the previous quarter's ₱0.20.¹⁸

Notwithstanding, the appreciating trend of most Asian currencies against the US dollar, the peso-dollar exchange rate depreciated by 2.7 percent as of end-December 2002 relative to its level as of 2 January 2002. Most Asian currencies appreciated against the US dollar during the same period, including the Indonesian rupiah (16.5 percent); the Japanese yen (9.7 percent); the South Korean won (1.1 percent); the Singapore dollar (by 6.2 percent); the Thai baht (2.8 percent); and the New Taiwan dollar (by 1.0 percent). By contrast, the Hong Kong dollar depreciated by 0.11 percent.

Nominal and Real Effective Exchange Rates

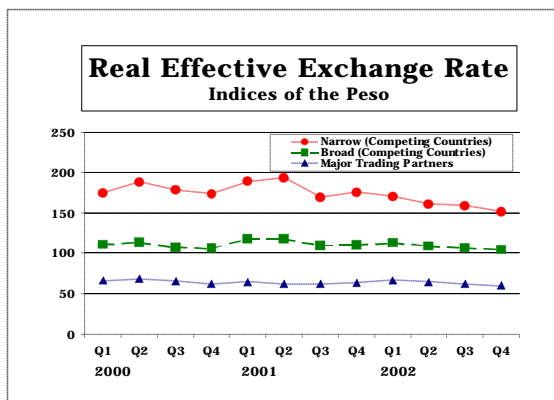
In terms of the nominal effective exchange rate (NEER) index, the value of the peso vis-à-vis the country's major trading partners depreciated by 3.3 percent during the last quarter of 2002 compared with the previous quarter (Table 12b).¹⁹ Meanwhile, compared with the broad and narrow baskets of currencies of competitor countries, the peso depreciated in nominal effective terms during the same period by 1.9 percent and 2.1 percent, respectively.²⁰ This developed as the peso depreciated against the US dollar while most currencies in these currency baskets registered nominal appreciation against the US dollar.

¹⁸ 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).

¹⁹ 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. However, efforts are underway to replace Deutsche mark with Euro in the series under major trading partners.

²⁰ 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.

The external competitiveness of the peso improved as the



nominal depreciation of the peso translated into a real depreciation. The real effective exchange rate (REER) index of the peso relative to the currencies of the country's major trading partners depreciated by 3.2 percent to 60.46 index points during the fourth quarter. This could be attributed largely to the peso's

nominal depreciation. Likewise, relative to the broad and narrow currency baskets of competitor countries, the country's external competitiveness also improved as reflected in the decline in the REER by 2.6 percent and 4.2 percent, respectively, during the same quarter. The nominal depreciation of the peso vis-à-vis the US dollar as well as the narrowing price differential between the Philippines and the countries in these baskets was mainly behind this development.

External Debt

The country's outstanding external liabilities declined by 2.4 percent to US\$53.6 billion as of end-September 2002 from the end-June 2002 level of US\$54.9 billion (Table 13).

Net repayments of US\$540 million mainly of medium and long-term foreign loans and redemption of bond issues contributed to the reduction in the debt stock during the quarter in review. Major payments included the BSP's prepayment to offshore creditors of the balance of its term loan facility due March 2004 (US\$389 million),²¹ payments on IMF credit (US\$148 million), the full redemption of the NPC of its bonds (US\$150 million), payment of build-operate-transfer related loans (US\$136 million) and payment of the private corporations' maturing loan and bonds (US\$220 million). These outflows, however, were partially offset by foreign inflows from bonds and loans obtained by both the public and private sectors.²²

²¹ The BSP prepaid a total of US\$740 million of loans and floating rate notes (FRNs) due March 2004. Of the amount, only US\$389 million was owed to non-residents.

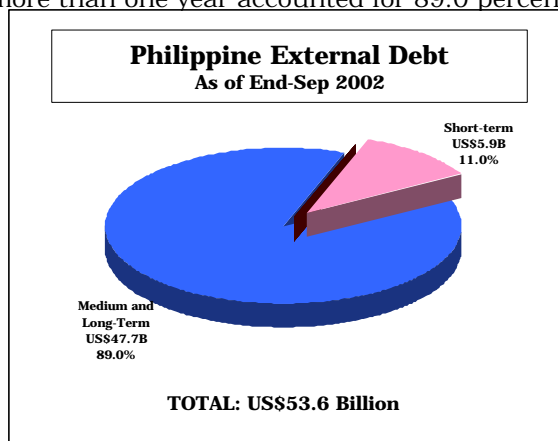
²² Public sector foreign inflows included the NG's US\$300 million 5-year global bond issue and US\$99 million co-financing from JBIC under the Power Sector Restructuring Program as well as the BSP's US\$159 million representing the non-resident portion of its US\$675

The net transfer in holdings of Philippine debt papers from non-residents to residents and revaluation gains from foreign exchange adjustment amounting to US\$426 million and US\$311 million, respectively, also accounted for part of the decline in the level of external liabilities. Revaluation gains resulted largely from the continued depreciation of the Japanese yen against the U.S. dollar, from JP¥ 119.54 as of end-June 2002 to JP¥122.50 as of end-September 2002. Yen-denominated liabilities comprised more than one-fourth of total external debt. Decline in liabilities reported by commercial banks by US\$112.66 arising from net withdrawals of foreign currency deposit by non-residents also decreased the level of external debt during the quarter.

These reductions in external debt were offset, however, by an upward adjustment of US\$97 million to reflect audit findings and late reporting of prior periods' transactions.

The maturity profile of the country's external debt reflected the continued prudence in the management of the country's external debt. Debt with maturities of more than one year accounted for 89.0 percent

(from 89.4 percent last quarter) or US\$47.7 billion,²³ of total external debt while the balance consisted of short-term liabilities. The average maturity of medium-and long-term (MLT) debt rose to 16.4 years from 16.2 years during the previous quarter, with the debt maturity averaging at 19.0 years from 18.8 years last quarter for the public sector and unchanged at 10.4 years for the private sector.



Fifty-five percent of the country's MLT debt carried fixed rates while 42 percent had variable rates. The remaining 3 percent were non-interest bearing.

million 5-year syndicated bank loan to refinance prepayment of its US740 million loans and FRNs.

²³ Of the US\$47.74 billion MLT liabilities, 84.8 percent have maturity of more than five years.

Classified by borrower, the public sector continued to account for the bigger share of total debt at 65.0 percent as of end-September 2002. In terms of level, however, public sector debt went down to US\$34.8 billion compared to US\$35.7 billion as of end-June 2002 due largely to increased holdings by residents of Philippine sovereign debt papers that were originally issued abroad and to revaluation gains. Similarly, private sector debt, accounting for 35.0 percent of total debt, declined to US\$18.8 billion from US\$19.2 billion at the close of the second quarter as a result primarily of net loan repayments.

By creditor type, official creditors (multilateral and bilateral institutions) provided 45.5 percent of total credits. Foreign holders of bonds, notes and certificates of deposits accounted for 26.2 percent of the total external debt. Banks and other financial institutions comprised 23.5 percent of foreign obligations. The balance of 4.8 percent represented suppliers' credits and liabilities to other creditors.

In terms of currency composition, the country's external debt was largely denominated in US dollars (56.0 percent) and Japanese yen (25.7 percent). Multi-currency loans from the World Bank and the Asian Development Bank comprised 9.0 percent of total liabilities. The remaining 9.3 percent of foreign obligations are denominated in other currencies.

Meanwhile, preliminary estimates showed a decrease in the ratio of debt service to exports of goods and receipts from services and income to 15.4 percent in the fourth quarter of 2002 compared to 18.1 percent recorded in the third quarter of 2002 (Table 14). This developed following the decline in principal and interest payments even as exports of goods and receipts from services and income declined during the quarter in review.

✧ **Foreign Interest Rates**

Key interest rates in major foreign markets softened during the quarter as most industrial countries, aided by moderate inflation, have maintained accommodative monetary policy stance in order to provide support to economic recovery.

In the US, the Federal Open Market Committee (FOMC) cut its federal funds target rate by 50 basis points to 1.25 percent in

November, a new 40-year low.²⁴ It was the first rate reduction for the year, following 11 cuts made in 2001. The US Fed also cut the discount rate by 50 basis points to 0.75 percent.²⁵ The cuts were aimed at stimulating the US economy, which has been showing signs of weakness due to heightened geopolitical risks and the stock market slump. The monetary easing was seen as a critical confidence boost to consumers, investors and businesses worried about the economy's direction. However, with the federal funds rate very near the rate of inflation, some economists are worried that the US Fed has little ammunition left should the US economy fail to respond. With lower Fed rates, US prime rates also dipped by an average of 29.17 basis points to 4.46 percent during the period (Table 15).²⁶

In the Euro zone, the 90-day London Interbank Offered Rate (LIBOR) continued to decline in the last quarter of 2002 by 25.65 basis points to 1.55 percent, following cuts in key interest rates in the US and the Euro area.²⁷ In December, the European Central Bank (ECB) lowered its benchmark rate by half a percentage point to 2.75 percent after holding it at 3.25 percent since November 2001.²⁸ Weak economic growth in the 12-nation euro zone and an uncertain economic outlook, combined with growing evidence that inflationary pressures were easing, persuaded the ECB to cut rates to encourage spending by business and consumers and stimulate economic activity. Similarly, the Swedish central bank cut its borrowing cost for the second time since the US Fed cut its rates in early November.

Meanwhile, the Bank of England (BoE) kept its official dealing rate or repo rate unchanged at a 38-year low of 4 percent in December as concerns over a booming housing market outweighed worries of a weak global recovery. The BoE has kept its policy rates steady since November 2001, which has helped fuel consumer spending and a boom in housing prices that has shielded the British economy from the worst of the global slowdown.²⁹

²⁴ The federal funds rate is the interest rate banks' charge to one another on overnight loans. Beginning in 1995, the FOMC began to explicitly state its target or intended level for the federal funds rate.

²⁵ The discount rate is the rate charged by the Federal Reserve when commercial banks and other depository institutions borrow "overnight" from the Fed.

²⁶ The US prime rate is the rate charged on corporate loans of large US Money Center Commercial Banks.

²⁷ The rate at which banks in London offer to lend money (from their dollar-denominated deposits, i.e., Eurodollar deposits) to one another. Usually used as a yardstick for lenders involved in high value transactions.

²⁸ The ECB lowered its lending cost four times in 2001 to 3.25 percent.

²⁹ The BoE cuts its key rate seven times in 2001 to 4 percent.

In Asia, the 90-day Singapore Interbank Offered Rate (SIBOR) likewise declined by 25.32 basis points to average 1.57 percent during the quarter, amidst indications that the Singapore economy was slowing down. By contrast, benign inflation and strong economic performance has allowed the Bank of Korea to maintain its benchmark overnight call rate at its current level of 4.0 percent during the quarter. In Japan, amid an economy that has yet to show clear signs of recovery, the Bank of Japan (BoJ) introduced measures to shore up the economy during the period in review. In particular, the BoJ revised guidelines for money market operations to strengthen its capacity to provide liquidity and promote a favorable environment for financial institutions to extend loans.³⁰

✧ Other Major External Sector Developments

Market sentiment was cautious in the fourth quarter of 2002 due to the uncertainties in the external front. In particular, the threat of a US-led military offensive against Iraq—which contributed to the volatility in world oil prices—and the terrorist bombings in Bali, Indonesia and the Philippines adversely affected investor and consumer confidence in emerging Asian economies. World economic recovery became hesitant as the year advanced and performance became very uneven. During the period in review, the US economy slowed down, activity in the Euro area remained sluggish and Japan continued to be in a deflationary condition. On the other hand, despite the deceleration in its economic performance during the quarter, Emerging Asia continued to outperform most regions in the world particularly with regard to exports.

The US economy slowed down in the fourth quarter of 2002 as real GDP grew by 1.4 percent year-on-year compared to the 4.0 percent rise registered in the third quarter.³¹ The impending war with Iraq, huge stock market losses and soft labor conditions weakened consumer and business sentiment during the review period. The deceleration of the economy during the quarter reflected a sharp contraction in consumer spending and the downturn in exports and

³⁰ Among the changes made included raising the operating target for money market operations from the current outstanding balance (of the current accounts of the BoJ) of around 10 to 15 trillion yen to around 15 to 20 trillion yen; increasing its outright purchase of long-term government bonds from the current 1.0 trillion yen per month to 1.2 trillion yen per month; and extending maturities for bills purchased in bills purchasing operations from six month or less to a year or less.

³¹ Data released on 28 February 2003 by the Bureau of Economic Analysis, an agency of the US Department of Commerce, which provide comprehensive and up-to-date statistics on the US economy.

private inventory investments. These factors were offset partly by the acceleration in federal government spending and residential fixed investments, and the move by the US Fed to cut the federal funds target rate by 50 basis points to 1.25 percent in November 2002. In addition, unemployment rate eased to 5.7 percent in December 2002 from 6.0 percent in the previous month due to the seasonal increase in hiring during the holiday season.

In the Euro area, activity picked up slightly with the initial estimate for GDP in the fourth quarter of 2002 showing a growth of 1.3 percent from 0.9 percent in the preceding quarter.³² Behind the slight uptick in growth were the increase in private consumption spending and relative stability in exports. However, these were partly offset by the decline in investments as well as in agricultural and industrial output. Unemployment remained high at 8.5 percent in December 2002 due mainly to a significant rise in the number of unemployed in Germany as the country continued to struggle towards a recovery from the recession it experienced in the second half of 2001.

The Japanese economy continued to post positive real GDP growth, which reached 2.4 percent during the fourth quarter up from the 1.8 percent recorded in the last quarter.³³ Exports of capital goods, particularly to East Asia, provided the main thrust of growth as domestic demand remained weak. However, nominal GDP—before adjustments for deflation—continued to drop as the economy continued to struggle out of a deflationary spiral. The GDP deflator, which follows general price trends, dropped for the 19th consecutive quarter to 2.2 percent in the last three months of 2002. Consumer and corporate services prices continued to decline despite the rise in import prices due to higher crude oil prices overseas. Labor market conditions remained severe as unemployment reached 5.3 percent, which is considered to be high in a nation where lifetime employment is a traditionally viewed as the norm. Based on these developments, combined with the deterioration in the country's public finances,³⁴ Fitch Ratings downgraded Japan's credit rating to AA- from AA.³⁵

Meanwhile, Asia's emerging economies continued to post economic growth rates higher than in all other region's across the

³² Data released by the Statistical Office of the European Commission (Eurostat) on 6 March 2003.

³³ Data released by the Bank of Japan on 17 February 2003.

³⁴ Public debt is estimated to reach 150.0 percent of GDP.

³⁵ The downgrade followed earlier moves made by Moody's Investors Service to cut Japan's sovereign rating by two levels to A2 in May and by Standard and Poor's to reduce Japan's rating to a fourth-ranking AA- in April.

globe. This growth performance of the region was brought about, in large part, by improving intra-regional trade relations, particularly between China and its Asian neighbors, as well as regional trade liberalization initiatives, which was reflected in the significant rise in intra-regional trade.

**2002 Performance of Selected Asian Countries
Year-on-Year Growth Rates (In percent)**

| Country | Gross Domestic Product | | | | Inflation | | | |
|--|------------------------|-----|------|------|-----------|------|------|------|
| | 4Q | 3Q | 2Q | 1Q | 4Q | 3Q | 2Q | 1Q |
| People's Republic of China (PROC) | 8.1 | 8.1 | 8.0 | 7.6 | n.a. | -1.6 | -2.6 | -1.2 |
| Hong Kong | 5.0 | 3.3 | 0.8 | -0.5 | -2.9 | -3.5 | -3.2 | -2.7 |
| Indonesia | 3.8 | 4.2 | 3.9 | 2.7 | 10.3 | 10.4 | 12.6 | 14.5 |
| Japan | 2.4 | 1.8 | -0.2 | -3.0 | -0.5 | -0.8 | -0.9 | -1.4 |
| Korea | n.a. | 5.8 | 6.4 | 5.8 | 3.3 | 2.6 | 2.7 | 2.5 |
| Malaysia | 5.6 | 5.8 | 4.1 | 1.3 | 1.8 | 2.1 | 1.9 | 1.4 |
| Singapore | 3.0 | 3.8 | 3.8 | -1.5 | 0.2 | -0.4 | -0.4 | -0.9 |
| Taiwan | 4.2 | 4.8 | 4.0 | 1.2 | n.a. | -0.2 | 0.0 | -0.1 |
| Thailand | n.a. | 5.8 | 5.1 | 3.9 | 1.4 | 0.3 | -0.2 | 0.3 |

Sources: Bank of Japan, Hong Kong Monetary Authority, Bank of Korea, Bank Negara Malaysia, Bank of Thailand, Bank Indonesia, Monetary Authority of Singapore, Bloomberg, Chinese Economic Indicators Center, Telerate, and ADB-ARIC Macroeconomic Indicators.

Leading Asia's growth performance was China's economy, which continued to post a substantial 8.1-percent growth rate during the period. China's emergence as a major player in international trade and its accession to World Trade Organization (WTO) membership has increased the country's market share in world exports, particularly in footwear, apparel and household products.

Taiwan, one of China's trading partners, beat market expectations as its GDP rose by 4.2 percent during the quarter in review. Robust exports to Mainland China combined with a recovery in the demand for electronics, steel products and machinery were behind its economic expansion. Nonetheless, Standard and Poor's cut Taiwan's ratings for foreign and local currency debt to AA- due to concerns over the slow pace of banking reform.

Hong Kong's economy, following the revival of external trade, registered faster growth at 5.0 percent in the last quarter of the year from 3.3 percent in the preceding quarter. Exports to markets in East Asia were particularly robust, offsetting the continued decline in consumer spending. Exports to the US and the European Union also

picked up in the latter part of the year. Investment spending rose modestly during the quarter and helped in boosting growth.

Malaysia's growth momentum was sustained throughout the year with real GDP reaching 5.6 percent in the fourth quarter of 2002. The main impetus to growth emanated from the hefty increase in private consumption and the continued recovery of exports and investments. The sources of growth were also broad-based, with expansion recorded in all sectors of the economy. The growth in the services and mining sectors accelerated while output growth in the manufacturing sector remained favorable.

Despite the bombing incident in Bali, the Indonesian economy grew in the fourth quarter, albeit at a slower pace of 3.8 percent compared to the 4.2 percent registered during the previous quarter. Private consumption—which rose to 4.5 percent during the review quarter from 3.9 percent in the third quarter—along with government spending, continued to be the main drivers of the growth in GDP. The positive economic developments in Indonesia was also buoyed up by a strong rupiah due, in part, to positive market sentiment brought about by the government's pursuit of structural reforms and the relative political stability in the country.

Meanwhile, real GDP growth in Singapore slowed down to 3.0 percent in the fourth quarter from 3.8 percent in the preceding quarter. This was largely due to the slower pace of recovery in major industrialized countries as well as heightened geopolitical tensions. The growth of the economy was propelled largely by the continued growth in the services-producing industries and the manufacturing sector.

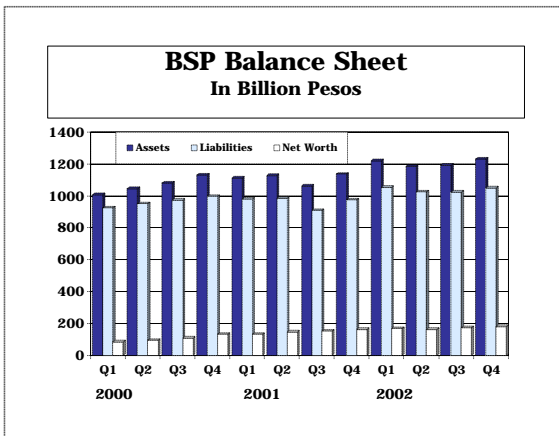
The growth in the emerging economies in Asia was accompanied by slight increases in the year-on-year inflation rates for some countries (South Korea, Singapore and Thailand) and moderation of inflation for others (Indonesia and Malaysia). However, deflationary pressures continued to dampen the recovery efforts of Japan and Hong Kong during the fourth quarter.

F. FINANCIAL CONDITION OF THE BSP

✧ Balance Sheet

Based on the unaudited financial statements in the fourth quarter of 2002, the assets and liabilities of the BSP expanded by ₱37.9 billion and ₱28.5 billion, respectively. As a result, net worth rose to ₱9.5 billion or 5.5 percent compared to the previous quarter. On an annual basis, the BSP's net worth at ₱181.4 billion as of December 2002 was 12.4 percent higher than the year-ago level (Table 16).

The expansion in BSP assets during the fourth quarter was due mainly to increases in international reserves and loans and advances. The hike in international reserves was accounted for largely by the increase in foreign investments and in the price of gold, coupled by the depreciation of peso vis-à-vis the US dollar during the period.

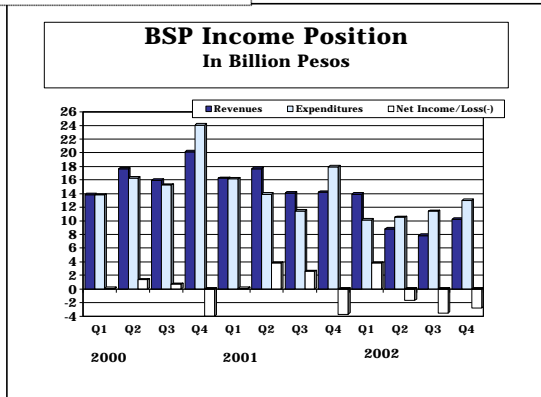


The expansion in BSP liabilities was caused by the ₱70 billion rise in currency issue as the BSP provided additional liquidity to the banking system to cover the usual hike in domestic demand during the Christmas season. Additional liquidity was channeled mainly through the repayment

of BSP's RRP borrowings from banks, which declined by ₱52.3 billion in the last quarter of the year.

✕ Income Statement

Based on unaudited data, the BSP's operations resulted in a net income of ₱1.98 billion for the



fourth quarter of 2002. This was higher than the ₱1.2 billion income realized in the previous quarter. The fourth quarter 2002 net income was a turnaround from the ₱2.3 billion net loss recorded for the same

period last year (Table 17). For the whole year 2002, accumulated earnings of the BSP amounted to ₱3.6 billion.

The main source of income was the ₱5.06 billion realized gains from exchange rate fluctuations as the Philippine peso depreciated by about ₱0.807 in the fourth quarter.

During the period, revenues rose by 29.9 percent due mainly to higher interest income on international reserves, while expenses increased by 14.2 percent owing largely to a substantial hike in interest expenses.

G. CONCLUSION: Challenges and Future Policy Directions

The last quarter saw the economy advance at a record pace of 5.8 percent, the highest since the third quarter of 1997 when the Asian crisis broke out. Growth was underpinned by the hefty expansion in the services sector and the gains in the industry and agriculture sectors.

The economy gained its momentum amid a benign inflation environment. Inflationary pressures were reined in by lower food prices and subdued aggregate demand pressures. Headline inflation continued to decelerate in the fourth quarter to an average of 2.6 percent from 2.8 percent in the third quarter. The low inflation environment in turn, enabled the BSP to keep its policy rates unchanged since March 2002.

But even as the BSP's policy rates remained steady, market rates generally trended upwards, reflecting investors' concerns over the continued fiscal slippage and the depreciation of the peso during the period, which fueled expectations of higher interest rates in the near future.

The outlook for inflation suggests generally manageable price conditions, with the average inflation moving broadly along the government's target range of 4.5 to 5.5 percent in 2003. Demand-pull factors are not expected to have a strong influence on inflation due to the overall weakness in demand while the El Niño weather phenomenon will likely have a transitory effect on food prices. For 2003, the monetary authorities will keep a firm hand on inflation as threats to price stability mount following the build-up of tension in the Middle East which has translated into higher oil prices and the

depreciation of the exchange rate. The underperformance of the fiscal sector and the El Niño phenomenon are likewise seen as potential sources of upward risks to inflation. The run-up in oil prices and the large budget deficit, however, would have a significant bearing on price movements and will therefore need closer monitoring.

Foreign exchange policy will continue to adhere to a market-determined exchange-rate arrangement with some scope for the BSP to provide liquidity to ensure orderly market conditions. The BSP will also continue to monitor developments in the foreign exchange market to assess their impact on the inflation and inflationary expectations so that appropriate responses are taken to ensure the attainment of price stability.

Fiscal consolidation continues to rank high among the concerns that must be addressed by policymakers to boost the market's confidence in the medium-term prospects of the country. With the uncertainty in the current global environment contributing to increased investor risk aversion, the need for fiscal prudence becomes imperative as this could likely lead to a higher cost of foreign borrowing. Market nervousness about fiscal underperformance and debt sustainability could also contribute to higher country risk premia.

In the financial sector, the disposition of non-performing assets is expected to take off the ground with the signing into law of the Special Purpose Vehicle Act (SPVA). The issuance of implementing guidelines of the SPVA would set in motion the sale of distressed assets of financial institutions, which have limited bank lending to the productive sectors of the economy. It has been estimated that the tax breaks and other incentives granted by the law will result in a 15-20 percent savings in transactions costs.

With the SPVA in place, the BSP is now turning its efforts to the passage of other crucial legislative initiatives which include the amendments to the BSP Charter, Securitization Act, the rationalization of financial sector taxes including the removal of Documentary Stamp Tax (DST) on secondary trading and a reasonable corporate recovery code. The amendments of the BSP charter aims to strengthen supervisory oversight and enhance the effectiveness of the BSP. The Securitization Act will create a favorable environment for a wide range of asset-backed securities that will generate liquidity for the private and government sectors for productive use and spur the development of the secondary market. Activity in the secondary market will also benefit from the lifting of DST on secondary trading.

For insolvent enterprises, the corporate recovery act rationalizes the rules for the resolution of their debts.

To complement national initiatives to deepen the capital market, the BSP launched its real time payments system, issued guidelines on bancassurance and paved the way for the establishment of a Fixed Income Exchange. The Philippine Payment System (PhilPaSS), a real-time payments infrastructure system, allows the BSP to monitor the liquidity positions of participating banks throughout the day on a transaction-by-transaction basis so that settlements are made only when banks have sufficient funds, thereby minimizing settlement risks. Bancassurance, meanwhile, is expected to boost the financial services sector as branch networks of banks are now allowed to serve as outlets for the sale of insurance products of their allied undertakings. Moreover, the establishment of a Fixed Income Exchange will provide a formal and organized exchange for debt securities and other fixed income investments as well as enable banks to properly mark-to-market their investment portfolio in accordance with international best practice.

The weak global economic environment due to geopolitical tensions, increase in oil prices and the sustained weakness of the global economy pose new threats to the stability of the banking system. To weather these new challenges, banking reforms will continue to focus on risk management, strengthening of supervisory framework and the promotion of corporate governance. In risk-based supervision, regulators put greater emphasis on the assessment and identification of risks, ensuring that appropriate supervisory activities address these risks. The assessment of risk incorporates both a current and prospective view of the institution's risk profile. An offsite supervisory tool which would monitor risk management capability of banks is the formal adoption of the risk-based capital adequacy framework by banks. The new capital adequacy formula allows supervisors to gauge if banks are able to absorb losses from risks. Consolidated supervision, meanwhile, recognizes the need to supervise financial conglomerates to assess the overall financial health of these complex institutions. In this regard, the BSP has reorganized its Supervision and Examination Sector to implement integrated supervision of parent banks and their subsidiaries and affiliates. On corporate governance, prudential standards are being strengthened to align these with international best practices. Among the measures adopted were, the expansion of duties and responsibilities of the board of directors for a more prudent and efficient administration of banks and quasi banks and requiring banks to report information on non-

performing loans and other risk assets; loan loss reserves; return on equity and insider loans in the banks' financial statements.