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Annex 1: Monetary and Banking Policies
A. OVERVIEW

The Philippine economy performed strongly in the third quarter of 2003, amid political concerns that kept market players jittery following a failed mutiny in Makati in July, the uncertainty over the political plans of the President and the Congressional investigations of certain bank accounts allegedly involving public funds.

Real Gross Domestic Product (GDP) grew by 4.4 percent in the third quarter of 2003 from 3.8 percent in the second quarter. Services remained the main engine of growth, following improved performances from the trade, transportation, communication, and storage and private services, and bolstered by the better-than-expected growth of agriculture. On the demand side, growth in consumer spending continued to drive the economy, supported by higher overseas remittances and expanding income in the rural areas arising from the improved performance in agriculture. The low interest rate-environment following the BSP’s move to ease monetary policy in July provided additional push for economic growth. Consumer prices remained relatively low, notwithstanding a slight rise to 3.1 percent in the third quarter from 3.0 percent in the second quarter. This developed despite a higher-than-programmed fiscal deficit, which reached ₱63.1 billion during the period. Meanwhile, the financial system remained resilient backed by a relatively high capital adequacy ratio.

On the external front, the BOP position improved as the easing of geopolitical tensions and the SARS threat resulted in smaller net outflows in the capital and financial accounts. The country’s international reserves position remained healthy at US$16.1 billion from the previous quarter’s level. Amid the generally robust external position, the BSP kept a close watch against speculative activity in the foreign exchange market as the peso depreciated against the US dollar by 3.2 percent to average ₱54.58:US$1 in the third quarter of the year due largely to the combination of seasonal factors and the political noise surrounding the May 2004 presidential elections.

The economy records strong growth. The country’s GDP grew by a robust 4.4 percent in the third quarter of 2003 from 3.8 percent despite the security concerns as an aftermath of the failed Oakwood mutiny. Growth was fueled by the hefty increase in agriculture and services. On the demand side, personal consumption was the main driver of growth, contributing 3.6 percentage points to the rise in GDP. The country’s Gross National Product (GNP) likewise improved significantly due to the surge in remittances of overseas Filipino workers (OFW). For the first nine months of the year, GDP growth accelerated to 4.3 percent from 3.9 percent while GNP expanded by a hefty 5.7 percent from only 3.2 percent in 2002.
The stock market sustains rally. Positive market sentiments generated by the lower-than-expected fiscal deficit, the 25 basis-point cut in the BSP’s policy rates as well as the lifting by the President of the state of rebellion on account of the failed mutiny boosted trading in the stock market. The Philippine Stock Exchange Composite Index (PHISIX) rose by 10.9 percent to average 1,243.6 index points in the third quarter from 1,121.5 index points in the second quarter of 2003.

Inflation registers mild uptick. Higher oil prices pushed average headline inflation to 3.1 percent in the third quarter of 2003, slightly higher than the 3.0 percent average posted in the previous quarter and the 2.8 percent average recorded in the same quarter a year ago. Despite the slight uptick in the third quarter, the average inflation rate for the first 10 months of the year reached 3.0 percent, significantly below the Government’s full-year target of 4.5-5.5 percent for 2003.

Growth of money demand decelerates. As of end-September 2003, domestic liquidity (M3) grew by 3.4 percent to reach ₱1.6 trillion, or a deceleration from the 9.0 percent a year ago. The slower pace of growth stemmed from the sharp deceleration in the growth in net foreign assets (NFA) of the monetary system during the period traced to the slower accumulation of foreign currency-denominated assets and payment of liabilities.

BSP eases policy rates. Amid ample liquidity in the financial system and the moderate pressure on prices from wage and food supplies, the BSP reduced its policy rates on 2 July 2003 by 25 basis points to 6.75 percent for overnight borrowing and 9.0 percent for overnight lending, representing the lowest levels recorded since May 1992.

Average market interest rates dip. Market rates followed the downtrend in the BSP’s policy rates as reflected in the reduction in the bellwether 91-day T-bill rate by 136.2 basis points to 5.3 percent. Lending rates likewise softened by 65.3 basis points to 9.4 percent in the third quarter. Interbank call loan rates also declined by 31.2 basis points to 6.8 percent during the quarter.

The financial system remains resilient. The continued increase in banks’ resources, relatively high capital adequacy ratio and the improvement in asset quality reflected the banking system’s resilience.

The fiscal deficit of the National Government (NG) widens. The fiscal deficit of the National Government (NG) reached ₱63.1 billion in the third quarter of the year, 34.8 percent higher than the level posted during the same period last year. Although revenue collections were better than
expected, expenditures surpassed the target by a larger amount resulting in a larger fiscal gap.

**Balance of payments (BOP) position improves.** The BOP deficit was cut significantly to US$167 million in the third quarter compared to the year-ago deficit of US$978 million. The improvement in the BOP position resulted from the surplus in the current account and the smaller net outflows in the capital and financial account due to the easing of geopolitical tensions and the Severe Acute Respiratory Syndrome (SARS) threat.

**The level of foreign reserves remains comfortable.** The country’s gross international reserves (GIR) rose by US$312 million to US$16.1 billion from the previous quarter’s level. The increase was traced to the inflows arising from the proceeds of NG bond/loan issuances and the BSP’s income from investments abroad. The end-September 2003 level of reserves was equivalent to 4.5 months’ worth of imports of goods and payment of services and income. Alternatively, this level of reserves was 2.5 times the amount of the country’s short-term foreign liabilities based on original maturity and 1.3 times based on residual maturity.1

**The peso depreciates.** The peso weakened against the US dollar during the third quarter by 3.2 percent to average P54.58/US$1. The peso which was P53.41/US$1 level at the beginning of the quarter, reached its lowest at P55.53/US$1 on 26 August 2003. The weakness of the local currency was due largely to seasonal factors, including the slowdown in overseas workers’ remittances and demand for dollars to cover import requirements and service end-quarter obligations.

**Management of external liabilities remains prudent.** Despite the increase in external debt to US$56.1 billion as of end June 2003 from US$55.8 billion in the previous quarter, a high proportion (88.9 percent) of total external liabilities were in medium and long-term maturity.

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1 Refers to the adequacy of reserves to cover outstanding short-term external debt on original maturity basis plus principal payments on medium- and long-term loans of the public and private sectors falling due in the next 12 months.
B. REAL SECTOR

B.1. Production

The Philippine economy continued to grow amid domestic and external shocks such as the El Niño phenomenon, the persistent political controversies, security concerns arising from the US-Iraq conflict, and the SARS outbreak. During the third quarter of 2003, the country’s GDP expanded by 4.4 percent from only 3.8 percent posted in the same quarter last year (Table 1). The increase was supported by the improved performance of the agriculture, fishery and forestry (AFF) sector and strong performance of the services sector. The country’s GNP also improved significantly due to the expansion of the Net Factor Income (NFI) from Abroad, which was bolstered by the robust inflows from remittances of the country’s OFWs. GNP rose by 5.9 percent during the third quarter of 2003, significantly higher than the 3.1 percent growth in the third quarter 2002. For the first nine months, the growth in GDP and GNP accelerated to 4.3 percent and 5.7 percent in 2003 from 3.9 percent and 3.2 percent in 2002, respectively.

Aggregate Output

On the production side, all sectors expanded during the period July-September 2003. The major gainers for the period under review were the services and AFF sectors.

The services sector rose by 5.6 percent during the quarter, higher than the 5.0 percent growth recorded during the same quarter in 2002. This sector, which accounted for 43 percent of GDP, contributed the largest share of 2.6 percentage points of the GDP growth. The sustained output in
transportation, communication and storage (TCS), financial services, government services, trade, private services and ownership of dwellings and real estate (ODRE) subsectors drove this sector up. Services in the TCS subsector expanded by 7.9 percent in the third quarter of the year from 7.4 percent registered in the same period last year. Strong consumer demand for wireless communication services sustained the growth in communications, notwithstanding the already huge subscriber base of telecommunication firms. Land transport expanded at a faster pace of 6.1 percent during the review period from last year’s 3.0 percent, despite the slowdown in water and air transport subsectors. Likewise, financial services continued to gain strength, posting a 6.5 percent growth compared to only 4.4 percent a year ago. This was attributed to the higher revenues from fee-based activities, securities trading and bank lending. Government services expanded by 5.8 percent in the third quarter compared to 5.3 percent a year ago, even as the government reined in the budget deficit during the first semester of the year. The increase was due to the rise in the number of teachers, soldiers and police, and the salary adjustments given to the Armed Forces of the Philippines (AFP) and the Philippine National Police (PNP). Meanwhile, trade services rose by 5.0 percent in the third quarter from 4.6 percent in the previous year, as both wholesale and retail trade posted gains during the period. Private services continued to grow, albeit at a slower pace of 4.9 percent, during the period under review vis-à-vis the prior year’s 5.6 percent. The ODRE subsector started to pick up recording a 4.0 percent growth in the third quarter against 2.1 percent a year ago. This was brought about by the favorable performance in real estate, which surged by 9.7 percent from a minimal growth of 0.3 percent in 2002. Strong sales in both high-end and secondary residential markets, as well as increased revenues from rental and leasing operations contributed to the growth.

Similarly, output in the AFF sector rose by 5.5 percent, a significant recovery from the previous year’s contraction of 0.4 percent. The AFF sector comprised about 16.2 percent of total GDP and contributed 0.96 percentage point to the total growth. Palay recorded the highest growth of 20.4 percent in the last sixteen quarters, which could be attributed to the various government programs to increase agricultural activity such as encouraging farmers to immediately plant after harvest, the intensive distribution of subsidized high-yielding seeds, and the provision of adequate water for irrigation. The fishery sector recorded a growth of 4.7 percent during the third quarter, albeit a deceleration from the 5.4 percent growth in 2002. Meanwhile, forestry production surged by 313.3 percent during the quarter after contracting by 43.7 percent in the previous year. This was due to the renewed harvest from the plantation forests of Paper Industry Corporation of the Philippines (PICOP) in the CARAGA region.

The industry sector, which accounted for 33.2 percent of GDP contributed 0.8 percentage point to the total GDP growth. Major contributors
to growth were the manufacturing and mining and quarrying subsectors. Manufacturing recorded an expansion of 4.4 percent during the third quarter of 2003 against 2.7 percent in the same period in 2002, owing to increased production of petroleum and coal products, basic metal industries, food manufactures and machinery except electrical. Mining and quarrying exhibited double-digit growth of 17.8 percent while electricity, gas and water subsector showed a decelerated growth of 3.0 percent. Meanwhile, the construction subsector continued to contract.

### Aggregate Demand

On the demand side, personal consumption expenditure (PCE), contributed 3.6 percentage points to the growth of GDP. PCE rose by 4.9 percent during the third quarter in 2003 compared to 4.3 percent in 2002. The continued consumer price stability, implementation of the amended taxes on motor vehicles and increased remittances of OFWs bolstered the increase. Expenditures for food, which accounted for 2.4 percentage points to the growth in total PCE, expanded by 4.6 percent from 3.6 percent a year ago. Expenditures for transportation/communication posted a continuous expansion, albeit modestly from 13.2 percent during the third quarter in 2002 to 13.3 percent in the same period in 2003. Behind this continuous rise were the sales of passenger cars and motor vehicles parts and accessories, tires, and batteries as well as the surge in text messages sent and in subscribers’ base of wire line and wireless communication.

Expenditures on fixed capital formation exhibited a 1.3 percent growth in the third quarter, slower than its 5.9 percent increase a year ago. This was due to weak construction (down by 11.7 percent) even as the durable equipment and breeding stocks showed substantial gains during the quarter. Durable equipment posted the highest growth since the fourth quarter of 1993 on account of the surge in expenditures on office machines and data processing. Durable equipment expenditures registered a 52.2 percent growth for the third quarter of 2003 against 7.9 percent a year ago. Changes in stocks reversed from a net withdrawal of PHP 2,391 million in the third quarter of 2002 to a net inflow of PHP 977 million during the review quarter.
Exports in real terms showed zero growth during the third quarter in 2003 compared to the year-ago performance of 8.1 percent. Total merchandise exports dropped by 0.6 percent due to weak performance of principal merchandise exports, which declined by 10.9 percent during the review quarter. Behind the decrease was the lower value of the country’s top exports, such as semiconductors, consigned finished electrical machinery and garments. Meanwhile, exports of non-factor services recorded a 5.3 percent growth in 2003, a reversal from the 4.8 percent decline in 2002. The growth in non-factor services was bolstered by the remarkable gains in miscellaneous services. Behind the strong gains were the escalating needs in communication services in the country arising from the boom in the services of call centers.

During the third quarter of 2003, the growth of total imports slowed down to 2.6 percent from 5.0 percent in the comparable period last year. This was due to the deceleration in the merchandise imports to 2.9 percent during the third quarter compared to the previous year’s growth of 5.7 percent. There was a surge in imports of electrical machinery, machinery other than electrical and transport equipment. However, imports of non-factor services fell by 2.1 percent during the quarter on account of the substantial contraction in imports of travel services. This was largely fueled by the SARS outbreak, the US-Iraq war and security concerns, which reduced foreign travel. The country recorded a trade deficit equivalent to 1.6 percent of GNP. But this deficit was lower than the 2.2 percent of GDP registered last year.

B.2. Stock Market Developments

The local stock market continued to track an upbeat mood with positive developments in the domestic and external fronts in the third quarter. The PHISIX rose by 10.9 percent to average 1,243.6 index points in the third quarter from 1,121.5 index points in the previous quarter. On an annual basis, the average PHISIX was higher by 11.2 percent than that registered during the same period. This is a significant improvement in the benchmark index compared to the
The rise in the 30-company stock index reflects positive market sentiment, particularly due to the release of lower-than-programmed budget deficit figures for the first half of 2003, the 25 basis-point cut in the BSP's policy rates, as well as the lifting of the President of the state of rebellion on account of the failed mutiny in July. These developments triggered investors’ accumulation of major blue chips, such as PLDT shares. Improving US economic outlook and gains in the Wall Street also contributed to the rise in the PHISIX during the quarter in review. For some parts of the third quarter, the local stock market trading was sidelined by the weakening of the local currency combined with domestic political and security concerns due to persistent coup rumors as well as regional security concerns following the bombing incident in Indonesia in August.

During the period, the aggregate volume turnover expanded by 45.7 percent to 29,542 million shares compared to the second quarter of 2003. Except for mining and Small and Medium Enterprises (SMEs), volume turnover in most sectors increased as follows: commercial and industrial by 93.6 percent to 15,867 million shares, oil by 47.9 percent to 4,897 million shares, property by 13.7 percent to 2,433 million shares, banking and financial services by 58.2 percent to 261 million shares. Mining issues slid by 5.8 percent to 6,084 million shares, while no SME issues were recorded for the quarter.

In terms of value, total issues improved significantly by 47.2 percent to P36,064 million during the quarter compared to the second quarter of 2003. Except for SME issues, all other issues increased as follows: commercial and industrial issues by 50.9 percent to P23,119 million; property by 27.0 percent to P6,451 million; banking and financial services by 58.8 percent to P6,416 million; mining by 26.2 percent to P53 million; and oil by 62.5 percent to P26 million.

**B.3. Labor, Employment, and Wages**

Based on the results of the Labor Force Survey (LFS) of July 2003, the employment situation deteriorated slightly during the third quarter of 2003 as the unemployment rate rose to 12.7 percent from 11.2 percent in the same period last year (Table 3). The increase in unemployment was due mainly to the jobs lost in the agriculture sector as a result of the series of typhoons that hit the country in May, June and July 2003. Thus, the employment rate declined to 87.3 percent from 88.8 percent in same period last year. The increase in unemployment rate could also be attributed to the
0.8 percent rise in the number of people seeking for work which exerted pressure on the labor market. The rate of unemployment in the third quarter of 2003 was slightly higher than the 12.2 percent registered in the second quarter of 2003 based on the LFS of April 2003.

In the agriculture sector, employment contracted by 6.8 percent (760,000 jobs) in the third quarter of 2003 from the same period last year resulting in a decline in the share of agriculture employment to total employment to 34.8 percent (10.4 million jobs) from 37.0 percent. The decline in employment in the agriculture sector was partly offset by the pick-up in the growth of employment in the industry sector after slowing down in the past two years. Employment in the industry sector posted a 5.5 percent year-on-year growth or an increase of 259,000 jobs resulting in the sector’s higher share to total employment at 16.6 percent (4.9 million jobs) from 15.6 percent in the third quarter of 2002. New jobs in the industry sector were recorded in the manufacturing, construction and mining subsectors. Likewise, employment in the services sector increased by 1.8 percent during the quarter in review from last year. The services sector generated 254,000 jobs to reach a share to total employment of 48.6 percent (14.5 million jobs) from 47.4 percent a year ago. The increase in employment in the services sector came from real estate, renting and business activities, transport, storage, and communication, hotel and restaurants and health and social work.

During the second quarter of 2003, nominal wages in agricultural and non-agricultural enterprises located in the National Capital Region (NCR) were kept at the second quarter 2002 rates of ₱263.25 and ₱303.33, respectively. For the second quarter of 2003, real wages in the agricultural and non-agricultural enterprises in the NCR declined to ₱149.66 and ₱172.45, respectively, from ₱156.32 and ₱180.34 in the same quarter last year.
C. MONETARY SECTOR

C.1. Reserve Money and Base Money

The level of reserve money (RM) as of end-September 2003 declined by P27.2 billion or 8.1 percent to P308.6 billion from the end-June 2003 level of P335.8 billion (Table 4). The lower level of RM was due mainly to the P53.5 billion decline in the BSP’s net domestic assets (NDAs) which more than offset the P26.3 billion improvement in the BSP’s net foreign assets (NFA).

The contraction in the NDA of the BSP was due mainly to higher BSP borrowings under the reverse repurchase (RRP) facility and decline in BSP holdings of Treasury bills. Meanwhile, the improvement in the BSP’s NFA was traced mainly to the higher level of gross international reserves resulting from the increase in BSP’s income from investments abroad and proceeds of NG bond flotations.

The level of base money  as of end-September 2003 at P432.1 billion, declined by P15.1 billion or by 3.4 percent relative to the end-June 2003 level due mainly to the lower reserve money level. Compared to the year-ago level, base money increased by P33.0 billion or by 8.3 percent owing to the increase in liquidity reserves.

C.2. Domestic Liquidity

As of end-September 2003, the growth of domestic liquidity (M3) slowed down to 0.4 percent from 0.8 percent in the previous quarter and the 2.1 percent quarter-on-quarter growth registered to the comparable period in 2002 (Table 5). On an annual basis, M3 grew by 3.4 percent to reach P1.6 trillion, a deceleration from the 9.0 percent year-on-year rise posted during the same period a year ago. The slowdown in M3 growth was attributed to the deceleration in NFA of the monetary system from 57 percent as end-September 2002 to 18 percent as of end-September 2003. This more

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2 Defined as the sum of reserve money, reserve-eligible government securities, liquidity reserves and reserve deficiency of banks, if any.
than offset the improvements in net domestic credits (NDC) to the public sector during the period. The expansion in NFA may be traced to the continued increase in deposit money banks’ (DMBs) investments in foreign currency-denominated assets coupled with the decline in their foreign liabilities.

A major portion (around 88.7 percent) of domestic liquidity consisted of peso demand, savings and time deposits and deposit substitutes. This portion declined slightly by 0.5 percent relative to the previous quarter’s level. Currency in circulation—which accounted for the remaining 11.0 percent of M3—rose slightly by 0.6 percent from the previous quarter’s level but was 10.6 percent higher than the level registered for the same period last year.

During the third quarter, NDC of the monetary system grew by 3.2 percent, a reversal from the 1.7 percent decline in the second quarter and an improvement from the 2.5 percent growth during the third quarter of 2002. The expansion in NDC was fueled mainly by increased credits to the public sector as demand for government securities remained strong. Credits to the public sector grew by 10.5 percent during the review quarter following a 1.7 percent decline in the second quarter of 2003. Meanwhile, credits to the private sector declined slightly by 0.5 percent, indicating an improvement as against the 1.7 percent decline registered in the previous quarter. On an annual basis, NDCs grew by 7.7 percent as of end-September 2003, as net credits to the public sector and the private sector rose by 18.7 percent and 2.6 percent, respectively.

Meanwhile, growth in M4—a broader concept of domestic liquidity defined as the sum of M3 and the foreign currency deposits (FCDs) of non-bank residents—was almost unchanged at 0.44 percent quarter-on-quarter, to settle at P2.3 trillion due to a moderate quarterly rise in the FCD holdings of non-bank residents. On an annual basis, M4 rose by 6.4 percent.

The financial deepening ratio (M3 as a percentage of GNP) which reflects the level of domestic mobilization of financial resources in the economy stood at 35.8 percent as of end-September 2003, lower than the year-ago ratio of 38.3 percent. The September 2003 level of financial
C.3. Prices

Headline inflation averaged 3.1 percent in the third quarter of 2003, slightly higher than the 3.0 percent average posted in the previous quarter and the 2.8 percent average registered in the same quarter a year ago (Table 6). Nevertheless, the average inflation rate for the first ten months of the year at 3.0 percent was still significantly below the Government’s full-year target of 4.5-5.5 percent for 2003.

The uptick in the average headline inflation for the quarter in review was driven mainly by relative price changes rather than broad-based pressures on consumer prices. In particular, the increase was traced mainly to higher energy prices brought about by the increase in the international price of crude oil. This, however, was offset partly by lower food inflation.

The inflation rate for food, beverage and tobacco (FBT) eased to 1.7 percent in the third quarter of 2003 from 2.1 percent in the previous quarter and from the 2.0 percent recorded for the comparable quarter in the previous year, traceable to the slower inflation rates for rice, cereals, and fruits and vegetables.

The inflation rate for non-food items inched up to 4.5 percent for the quarter in review from 3.9 percent in the second quarter and 3.7 percent in the third quarter of 2002. Compared to the previous quarter, the higher non-food prices in the third quarter was due to the higher inflation rates for clothing (2.4 percent from 2.1 percent), housing and repairs (3.0 percent from 2.7 percent) fuel, light and water (9.6 percent from 5.2 percent) and miscellaneous items (1.9 percent from 1.7 percent). Meanwhile, services registered a lower inflation rate of 6.0 percent in the third quarter from 6.3 percent in the last quarter.

In terms of geographical location, average inflation for Metro Manila rose to 4.1 percent in the third quarter from 3.3 percent in the previous
quarter owing to the acceleration in non-food inflation, particularly for fuel, light and water (Table 6a). It was also higher compared to the 2.9 percent posted in the same quarter a year ago. The average inflation rate for areas outside Metro Manila slowed down to 2.7 percent for review period from 2.9 percent in the second quarter as the lower FBT inflation offset the marginal increase in non-food inflation. Meanwhile, the third quarter inflation for areas outside Metro Manila was unchanged from the level registered in the comparable quarter a year ago (Table 6b).

Going forward, the outlook for food prices remain generally favorable given normalizing weather conditions and government measures to boost agricultural production. Meanwhile, the influence of demand-side factors on prices is likely to remain limited given moderate improvements in domestic demand. Thus, the current subdued inflation environment is expected to continue over the BSP’s policy horizon.

C.4. Domestic Interest Rates

Domestic interest rates eased in the third quarter of the year, a reversal of the increase registered in the previous quarter, as benchmark 91-day Treasury bill rates dipped by 136.2 basis point to 5.3 percent. This developed largely as a result of a benign inflation environment, the favorable fiscal performance in the first half of the year, and the BSP’s move to ease its policy rates in July. The Bureau of the Treasury’s (BTr) continued rejection of high bid rates and the reduction in the volume of Treasury bill offerings (in July) also contributed to the downtrend.

The monetary policy stance of the BSP in the third quarter of 2003 may be generally described as cautious but supportive of the economy’s growth objectives. On 2 July 2003, the Monetary Board eased its policy rates by 25 basis points to 6.75 percent for overnight borrowing and 9.0 percent for overnight lending, representing the lowest levels recorded since May 1992. The move was prompted by low inflation, a firming in the peso-dollar rate

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3 The policy interest rates was also lowered by 25 basis points on 15 March 2002.
and continued ample liquidity in the system. In August, however, amidst renewed financial market volatility, the Monetary Board removed anew the tiering scheme on deposits placed by domestic banks in the BSP (effective August 2003), while keeping policy rates steady. The move was intended as a pre-emptive measure to prevent an increase in inflationary expectations due to the recent depreciation of the peso following security jitters arising from persistent coup rumors. Amid moderate improvements in aggregate domestic demand conditions, manageable pressures from the supply side and downside risks to global recovery, the BSP kept its monetary stance unchanged in September.

Following the downward movement in BSP policy rates, the release of better-than-expected budget deficit figures in June, the BTr’s move to reduce the volume of its Treasury bill offerings in July as well as its rejection of high bids, interest rates on government debt papers dipped substantially in the third quarter of 2003. The bellwether 91-day T-bill rate went down by 136.2 basis points to 5.3 percent, the 181-day tenor by 91.7 basis points to 6.4 percent, and the 364-day tenor by 82.8 basis points to 6.9 percent. (Table 7)

Mirroring the movement in the yields on government securities, bank lending rates (all maturities) softened by 65.3 basis points to 9.4 percent in the third quarter. Interbank call loan rates declined by 31.2 basis points to 6.8 percent during the quarter. Similarly, yields on bank savings, time deposits and short-term promissory notes (Manila Reference Rates) across all maturities dipped by 101.6 basis points, 4.8 basis points and 108.8 basis points, respectively, to average 4.0 percent, 6.4 percent and 7.0 percent during the period.

Interest rate differentials between Philippine Treasury instruments and that of the US continued to narrow in the third quarter of 2003, on account of the larger decline in RP yields relative to that of foreign interest rates. Average monthly differentials between the 91-day Treasury bill rate and the 90-day LIBOR fell from 528.2 basis points in June to 413.4 basis points in September 2003. Meanwhile, real interest rates trended downwards

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4 This three-tiered interest rate scheme on banks’ overnight RRP placements with the BSP was initially removed on 20 March 2003 and then restored effective 5 June 2003 to free more funds into the system. Before August, bank placements under the scheme were subject to the following interest rates: (a) 6.75 percent for the first 5.0 billion placement; (b) 3.75 percent for placements in excess of 5.0 billion but not more than 10.0 billion; and (c) 0.75 percent for placements in excess of 10.0 billion.

5 The removal of the scheme kept interest rates on overnight RRP transactions with the BSP at a flat rate of 6.75 percent, regardless of the amount of the placement.

6 Month-on-month, however, while the yields on government securities moved downwards in July, it began showing a slight uptick beginning mid-August amid negative market sentiments following the failed mutiny in Oakwoods, Makati (on 27 July) and the renewed peso depreciation. Despite the BTr’s efforts to temper the rise in yields, rates on public debt papers rose anew in September.
C.5. Financial System

The country’s financial system maintained its stability during the third quarter of 2003 despite the still modest pace of economic activity, concerns over the sustainability of the country’s fiscal position and domestic security and political concerns. Key financial indicators continued to show improvement in banks’ resources, asset quality and capitalization. Behind this strength and resiliency was the BSP’s effort to implement measures to address critical concerns and spur growth in the banking system.

During the third quarter, the aggregate resources of the financial system increased to ₱4,443 billion, marginally higher than the previous quarter’s ₱4,421 billion. Commercial banks (KBs) accounted for almost 75 percent of the system’s total resources, followed by thrift banks (TBs) with close to 6 percent, and rural banks (RBs) with 2 percent. Non-banks accounted for the remaining 17 percent of the financial system’s aggregate resources (Table 8).

Meanwhile, the operating network of the financial system, consisting of head offices and branches, increased anew, from 18,053 as of end-March 2003 to 18,182 as of end-June 2003 (Table 8a) due to the increase in the number of non-bank financial institutions, particularly pawnshops, private insurance companies and non-stock savings and loan associations (NSSLAs).

Performance of the Banking System

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7 Real interest rates refer to nominal interest rates less inflation.
2003 Third Quarter Report

**Total Resources.** The banking system’s total resources increased by 0.6 percent to ₱3,683 billion as of end-September 2003 compared to the ₱3,662 billion registered in June. The modest growth in the system’s resources may be traced to the continued expansion in investments as well as loans and discounts.

**Number of Banks.** The number of head offices of the banking institutions declined slightly to 906 as of end-June 2003 from 909 during the previous quarter. The total number of head offices consisted of 42 KBs, 771 RBs and 93 TBs. Of the 93 thrift banks, 32 are savings and mortgage banks, 29 are private development banks, 30 are stock savings and loan associations while the remaining two are microfinance banks.

During the period January-August 2003, four mergers took place, two conversions were implemented and four RBs were closed, consistent with the BSP’s commitment to consolidate the banking system.

**Asset Quality.** The third quarter of 2003 saw marked improvements in asset quality, with the ratio of the banking system’s non-performing loans (NPLs) to total loans declining further to 14.4 percent from 15.0 percent during the previous quarter. Foreclosure proceedings to settle delinquent accounts intensified, with the level of real and other properties owned and acquired (ROPOA) rising by 4.0 percent to ₱198.6 billion as of end-September 2003 from ₱190.9 billion last quarter. Meanwhile, restructuring efforts continued, with restructuring loans at ₱133.3 billion during the review quarter, lower by 1.95 percent compared to the ₱136.0 billion posted as of end-June 2003. Despite the decline in the NPL ratio, the banking system remains constrained by its substantial level of idle assets.

Meanwhile, the KBs’ NPL ratio declined to 14.5 percent during the review period from 15.2 percent last quarter. Compared to the NPL ratios of other Asian countries, the KBs’ NPL ratio is lower than Thailand’s 15.5 percent, but higher than Malaysia’s 8.3 percent, Korea’s 2.3 percent and Indonesia’s 8.3 percent. The lower NPL ratios in most countries in the

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8 Sources: ADB-Asia Recovery Information Center’s (ARIC) financial and corporate indicators. Thailand (September 2003, commercial banks); Malaysia (September 2003,
The legal and tax framework has been established to prod banks to offload their idle assets and pare down significantly their non-performing assets (NPAs). The BSP has issued Memorandum to all banks/non-banks with quasi-banking functions (NBQBs) dated 17 June 2003 which prescribes the procedures for banks/NBQBs that intend to transfer/sell their NPAs to a special purpose vehicle (SPV) or to an individual that involves a single family residential unit, or transactions involving dacion en pago by the borrower or third party of an NPL for the purpose of obtaining the Certificate of Eligibility (COE) which is required to avail of the incentives provided under the Act. As of 31 August 2003, eight banks have applied for a COE involving dacion en pago transactions amounting to ₱2.1 billion and sale of ROPOA to individuals amounting to ₱3.0 billion or a total of ₱5.1 billion.

**Loan-Loss Provisions.** The banking system’s loan loss provisions relative to total NPAs decreased slightly to 49.1 percent during the third quarter from 49.6 percent at end-June level.

**Capital Adequacy Ratio (CAR).** The banking system’s capitalization remained more than adequate relative to international norms and the statutory floor. Using the new risk-based capital adequacy framework, commercial banks’ CAR improved to 17.0 percent as of March 2003 from 16.6 percent in December 2002. This ratio remains well above the BSP’s 10.0 percent statutory floor and the Bank for International Settlements’ (BIS) 8.0 percent standard.

To date, the country’s CAR is one of the highest in the region, second only to Indonesia’s 24 percent. Other Asian countries posted CAR of 13.4 percent for Malaysia; 10.4 percent for Korea; and 13.6 percent for Thailand.\(^9\)

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\(^9\) NPL purchases by AMCS (as percent of total NPLs) were 90.05 percent for Indonesia (July 2003); 79.31 percent for Korea (December 2002); and 50.38 percent for Thailand (June 2003). Malaysia’s AMC called Danaharta reported a total rehabilitation of its NPLs as of September 2002.
Bank Lending. Posting its thirteenth consecutive month of growth since September 2002, commercial bank lending activity sustained its momentum to post a 1.8 percent increase to ₱1,469.91 billion as of end-September 2003 compared to the ₱1,443.52 billion as of end-June 2003. The sustained growth in KBs’ outstanding loans may be traced to the year-on-year rise in loans extended to the following sectors: agriculture, fisheries and forestry sector (9.6 percent); community, social and personal services (9.6 percent); and manufacturing sector (7.3 percent).

Real Estate Exposure of Banks. KBs’ outstanding loans to the real estate sector as a percent of total loans fell in the second quarter of 2003, registering 10.0 percent vis-à-vis the 10.5 percent recorded as of March 2003. The decrease was due to the drop in the growth in loans for the acquisition of residential and commercial properties, along with the loans for the development of subdivision for housing projects.

Banking Policies. 11 The rules and regulations issued by the BSP during the period July-September 2003 were aimed at enhancing further the BSP’s regulatory and supervisory functions to sustain the strength and the growth of the country’s banking system.

The policy amendments as well as new guidelines introduced by the BSP during the quarter govern the following: 1) delivery of securities and other documents of title which are the subject of quasi-banking functions; 2) imposition of loan limit to a single borrower; 3) adoption of the risk-based capital adequacy framework by banks and quasi-banks; 4) conduct of securities lending activities; 5) issuance of redeemable preferred shares; 6) conduct of credit card operations of banks and their subsidiaries; 7) implementation of Tier 1 and Tier 2 capital as well as the coverage of on-balance sheet assets; 8) expansion of the market risk weight of on-balance sheet assets; 9) recognition and de-recognition of domestic credit rating agencies; and 10) imposition of minimum documentary requirements for foreign exchange forwards and swaps.

D. FISCAL SECTOR

10 Sources: ADB-ARIC financial and corporate indicators. Indonesia (September 2003, commercial banks); Malaysia (September 2003, commercial banks); Korea (June 2003, commercial banks); and Thailand (August 2003, commercial banks).

11 Please refer to Annex 1 for a detailed description of the banking policies issued during the third quarter of 2003.
D.1. National Government Cash Operations

During the third quarter of 2003, the NG cash operations showed a deficit of P63.1 billion (Table 9). This was P16.3 billion (34.8 percent) higher than the year-ago deficit of P46.8 billion. The P8.0 billion increase in revenues softened the impact of the P24.4 billion rise in expenditures. Compared to the program for the quarter, the deficit was also higher by P15.8 billion as expenditures exceeded the target by P21.6 billion (11.2 percent), which was tempered by the P5.7 billion above-program collections. Meanwhile, compared to the previous quarter, the third quarter deficit was higher by P42.4 billion due both to the decline in revenues of P18.1 billion and an increase in spending of P24.4 billion.

Total revenues during the quarter amounted to P151.1 billion, exceeding the target by 3.9 percent and the preceding year’s collections for the same period by 5.6 percent. The higher-than-programmed revenues generated by the BTr and other offices, which exceeded their respective targets by P7.5 billion and P2.0 billion, more than offset the shortfalls in the revenue collections of the Bureau of Internal Revenue (BIR) and the Bureau of Customs (BOC). The BIR failed to reach its target during the period due to the slowdown in revenues on excise taxes on motor vehicles in September pending the implementation of the new excise tax scheme on the automotive industry. The BOC, also missed its target by P1.2 billion as imports weakened due to the slight deterioration in the exchange rate. Compared to the previous quarter, revenues dropped by 10.7 percent due to the P19.6 billion decline in the aggregate revenue collections of the BIR, BOC, and other offices.

Meanwhile, total expenditures for the third quarter amounted to P214.3 billion, P21.6 billion higher than the P192.7 billion targeted for the quarter. It was also higher by P24.4 billion from the level posted during the third quarter of the previous year. The higher-than-programmed expenditures was largely accounted for by the disbursements for capital outlays which started in July as the government implemented a calibrated winding down of payables given the previously tight spending stance during the first semester. This was further augmented by the higher-than-
programmed allotment to local government units (LGUs) and in net lending mainly to settle the Casecnan-related accounts of the National Irrigation Administration (NIA) and National Power Corporation (NPC). Meanwhile, the ₱24.4 billion increase in expenditures from the same quarter a year ago was due to the increases in almost all of the expenditure items, except for maintenance and operating expenses and equity.

Net borrowings from domestic and external sources amounting to ₱82.3 billion and ₱30.6 billion, respectively, constituted the major source of financing during the third quarter. These were used to finance the deficits in the budgetary (₱63.1 billion) and non-budgetary (₱44.1 billion) and to augment the Government’s cash balance (₱5.7 billion).

E. EXTERNAL SECTOR

E.1. Balance of Payments

The balance of payments position posted a significantly lower deficit of US$167 million for the third quarter of 2003 compared to the US$978 million deficit recorded in the same period last year. This positive development was attributed primarily to the higher surplus in the current account coupled with the substantially lower net outflow in the capital and financial account as geopolitical uncertainties dissipated and the SARS outbreak was put under control (Table 10).

Current Account

Strengthened by the continuous net inflows from the income account and the lower deficit in both the trade-in-goods and services accounts, the current account registered a surplus of US$1,063 million in the third quarter of 2003, nearly twice the surplus recorded in the same period a year ago. Remittances from overseas Filipino workers (OFW) remained a major

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source of income at US$1,783 million during the quarter in review. Meanwhile, the trade-in-goods, while remaining in deficit posted a substantially lower shortfall owing to the greater decline in imports than exports. The services account also recorded a lower deficit due mainly to higher net receipts from travel as fears of the SARS epidemic subsided.

Merchandise Trade. For the third quarter of 2003, the deficit in the trade-in-goods balance declined significantly to US$66 million compared to the US$178 million deficit in the same quarter last year. Imports of goods posted a decline of 4.2 percent to reach US$9,018 million as companies drew from their inventories acquired in the first quarter. Bulk of raw materials and mineral fuel requirements was front-loaded in the first quarter in anticipation of supply disruption amid the war in Iraq. Oil import bill in the third quarter showed an improvement of 2.7 percent to reach US$916 million following the increase in the average price of petroleum crude from US$25.63 per barrel to US$27.22 per barrel even as the volume of petroleum crude declined. The volume of petroleum crude imports dropped by 9.8 percent to 24.0 million barrels in July-September 2003 from 26.62 million barrels in the comparable quarter last year reflecting inventory drawdown by oil companies of the oil supply stockpiled in the first semester. Meanwhile, exports registered a 3.1 percent drop on account primarily of lower exports of manufactured goods, particularly electronics, machinery and transport equipment and garments as demand from the country’s major trading partners remained sluggish (Tables 10a-b).

Services. The trade-in-services account for the quarter in review posted a net outflow of US$255 million, 36.9 percent lower compared to the level in the comparable period in 2002. The improvement was due mainly to the increase in net travel receipts and communication services. Net inflows from travel rebounded in the third quarter with a 25.4 percent increase after consecutive declines in the first two quarters, as concerns on geopolitical uncertainties and fears of SARS epidemic waned. The immediate resolution to the domestic security concerns fostered by the military mutiny in July this year helped curbed the extent of the adverse impact of this recent political noise to the tourist traffic in the country.

Income. The income account continued to post a higher surplus in the third quarter of 2003 on the back of inflows from OFW remittances. However, remittances from overseas workers at US$1,783 million were slightly lower in the third quarter of 2003 on account of the 15.0 percent decline in total OFW deployment with the bulk of the decline traceable to the decreased deployment of land-based workers. However, shift in the profile of land-based workers to professionals and service workers such as

12 Based on BPM5

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caretakers/caregivers, clerks, office managers, teachers and utility personnel with higher salaries, as well as the increase in the number of deployed sea-based workers partially cushioned the impact of the decline in the number of deployed land-based workers. Meanwhile, the bulk of OFW remittances, which comprised about 89 percent of gross income receipts in the third quarter, came from the U.S., Saudi Arabia, Japan, U.K., Hong Kong, United Arab Emirates and Singapore.\(^\text{13}\)

**Current Transfers.** Meanwhile, net inflows from current transfers increased to US$157 million from the year-ago level of US$131 million. The 19.8 percent improvement can be traced to higher transfers from migrant workers as well as receipts in the form of gifts, grants and donations to individuals and non-governmental institutions.

**Capital and Financial Account**

The net outflow in the capital and financial account was significantly reduced to US$1,237 million in the third quarter of the year compared to a net outflow of US$2,546 million in the same quarter a year ago. The 51.4 percent improvement was attributed to the marked declines in the net outflows of both portfolio and other investments combined with the net inflow posted by the direct investments account, due, in turn, to the improving outlook on the global economy in the second half of the year.

**Capital Account.** The capital account during the review quarter yielded a net inflow of US$4 million, a reversal from the net outflow of US$5 million last year due to lower disbursements of migrant transfers and the increase in receipts of capital transfers from other sectors.

**Direct Investment.** The direct investment account managed to turn in a net inflow of US$58 million in the third quarter of the year, although lower than the net inflow of US$174 million last year. Largely contributing to the weak performance was the combined effect of the more than threefold increase in residents’ investments abroad?mainly to affiliated enterprises?and the decline in net placements by non-residents in equity capital as investors postponed their investment plans, even as better economic prospects are expected to emerge in the last two quarters of the year. Also contributing to lower net direct investment inflows during the

\(^{13}\) Data may not reflect the actual country source of remittance or country of deployment of OFWs due to the practice of remittance centers in various cities abroad to course remittances through correspondent banks mostly located in the U.S. Since banks attribute the origin of funds to the most immediate source, the U.S., therefore, appears to be the main source of OFW remittances.
review quarter was the net outflow in other capital representing net repayment of intracompany loans.

**Portfolio Investment.** The net outflow in portfolio investments dropped significantly to US$232 million during the review quarter, down by 63.3 percent from the US$633 million net outflow last year. This was due mainly to the maturing placements in debt securities of resident banks in the third quarter of 2003. Moreover, proceeds from the National Government’s bond issues intended for budgetary support, helped reduced the net outflow in the portfolio investments account.

**Other Investment.** Similarly, the net outflow in the other investments account was cut down to a substantially lower net outflow of US$1,067 million from a net outflow of US$2,082 million in the third quarter of 2002 as non-residents’ investments expanded by almost 92 percent to US$2,157 million from last year’s level of US$1,125 million. The significant improvement was traceable to the turnaround from withdrawal to placement of deposits by non-residents in local banks.

**E.2. International Reserves**

The country’s GIR, including the reserve position in the IMF, climbed to US$16.2 billion as of 30 September 2003. This was $0.4 million or 2.5 percent higher compared to the end-June 2003 level of US$15.8 billion (Table 11). The end-September 2003 level of reserves was equivalent to 4.5 months’ worth of imports of goods and payment of services and income. Alternatively, the level of reserves is 2.5 times the amount of the country’s short-term foreign liabilities based on original maturity and 1.3 times based on residual maturity.14

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14 Refers to the adequacy of reserves to cover outstanding short-term external debt on original maturity basis plus principal payments on medium- and long-term loans of the public and private sectors falling due in the next 12 months.

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The GIR climbed during the third quarter of 2003. This was supported by the NG’s deposit of proceeds from its bond/loan issuances and BSP’s income from investments abroad. These inflows were, however, partly offset by the debt service requirements of both the NG and the BSP.

The reserve portfolio continued to consist mainly of foreign investments (76.6 percent), gold (20.1 percent), foreign exchange (2.5 percent) and in combined SDRs and reserve position in the Fund (0.8 percent). In terms of currency composition of reserves excluding gold, 84.1 percent were in US dollars, 9.1 percent in Euros, 3.9 percent in Japanese yen, 1.5 percent in pound sterling and the balance of 1.4 percent in other foreign currencies.

Net international reserves (NIR) similarly increased to US$12.6 billion as of end-September 2003 from the end-June 2003 level of US$12.3 billion.

E.3. Exchange Rate

Trends in the Peso-Dollar Rate

After appreciating in the second quarter, the peso weakened against the US dollar during the third quarter by 3.18 percent to average P54.58/US$1 (Tables 12 and 12a). The peso reached its lowest at P55.53/US$1 on 26 August 2003 from P53.41/US$1 at the beginning of the quarter. The peso’s weakness was due largely to seasonal factors, including the slowdown in remittances by Filipinos working abroad combined with higher demand for the dollar by corporates to cover import requirements and service end-quarter obligations. The peso’s movement was also partly sentiment-driven, reflecting the market’s reaction to the uncertainties in the domestic market following the failed mutiny in July.

<table>
<thead>
<tr>
<th>Peso-US Dollar Rate Monthly Average</th>
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</thead>
<tbody>
<tr>
<td>P/US$</td>
</tr>
<tr>
<td>54.58 56 58 60 62 64 66 68 70 72 74</td>
</tr>
</tbody>
</table>

Deposits by NG included proceeds from RP Global Bonds (US$742 million), RP Discounted Treasury Notes (US$167 million) and ADB Non-Bank Financial Program Loan II (US$74 million) while BSP’s investment income amounted to US$168 million for July-September 2003.
The peso was also more volatile during the quarter as indicated by the higher standard deviation of the daily exchange rate of P0.66 in the third quarter, from only P0.48 a quarter ago, reflecting heightened concerns on the country’s political and security conditions. However, the average trading range, another indicator of variability, narrowed to about P0.13 in the third quarter of 2003 compared with P0.18 a quarter ago.

As of end-September 2003, the peso depreciated by 3.1 percent relative to its level as of 2 January 2003. Other Asian currencies that depreciated against the US dollar during the same period include the Singapore dollar (1.0 percent) and the Hong Kong dollar (0.01 percent). Meanwhile, the following currencies appreciated vis-à-vis the US dollar: Japanese yen (1.5 percent), South Korean won (1.1 percent), New Taiwan dollar (1.6 percent), Thai baht (4.8 percent), and the Indonesia rupiah (5.4 percent).

Nominal and Real Effective Exchange Rates

In terms of the nominal effective exchange rate (NEER) index, the value of the peso depreciated by 2.9 percent during the third quarter vis-à-vis the currencies of the country’s major trading partner. Similarly, the NEER of the peso against the broad and narrow baskets of competitor countries depreciated by 4.1 percent and 3.8 percent, respectively. (Table 12b).¹⁶

¹⁶ 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 Euro and the British pound. Major trading partners include the US, Japan, European Monetary Union and the United Kingdom. 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 nominal depreciation of the peso was translated into real depreciation thus improving the peso’s external competitiveness. During the quarter in review, external competitiveness increased following the 2.2 percent depreciation of the real effective exchange rate (REER) index\(^{17}\) of the peso relative to the currencies of the country’s major trading partners. This development could be attributed to the nominal depreciation of the peso. The peso likewise posted real depreciations over the same period relative to the broad and narrow currency baskets of competitor countries, as reflected in the decline in the REER index by 2.0 percent and 1.8 percent, respectively.

### E.4. External Debt

The country’s total external debt increased to US$56.1 billion as of end-June 2003 from US$55.8 billion as of end-March 2003 (Table 13).

Accounting mainly for the expansion in external liabilities at the close of the second quarter of the year was the transfer/assignment of Philippine debt papers from residents to non-residents which increased the debt stock by US$580 million. Revaluation losses resulting largely from the weakening of the US dollar against most major currencies further brought up foreign liabilities by US$297 million.

Net repayments of loans and redemption of bonds, particularly by the public sector and commercial banks, caused a reduction of US$515 million

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\(^{17}\) The REER index represents the NEER index of the peso adjusted for inflation rate differentials with the countries whose currencies comprise the NEER index basket.
to total external debt. These, together with downward adjustments amounting to US$45 million to account for late reports and audit findings on prior periods’ transactions, tempered the rise in foreign debt.

The country’s external debt continued to be prudently managed as indicated by the high proportion of liabilities consisting of medium to long term tenors. Medium- and long-term (MLT) maturities accounted for 88.9 percent of total while short-term liabilities comprised the balance of 11.1 percent. The maturities of MLT obligations had an average maturity of 16.7 years, with the debt maturity for the public sector at 18.9 years and the private sector at 10.9 years. More than one half of the country’s MLT debt carried fixed rates while 39 percent had variable rates. The remaining 3 percent were non-interest bearing. Most of the outstanding obligations were owed to official creditors (multilateral and bilateral institutions) at 44.2 percent of total.

More than half of the country’s debt continued to be denominated in US dollar (55.4 percent) and more than a quarter in Japanese yen (26.4 percent). Multi-currency loans from the World Bank and the Asian Development Bank comprised 8.7 percent of total debt while the rest were Special Drawing Rights (4.4 percent), Euros (4.3 percent) and other currencies (0.8 percent).

Preliminary estimates for the third quarter of 2003 showed an increase in the ratio of debt service burden to exports of goods and receipts from services and income to 17.6 percent from 14.2 percent in the second quarter of the year. The quarter-on-quarter increase in the ratio stemmed from the significant increase in principal and interest maturities during the quarter in review (Table 14).

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18 Major outflows include: (a) the NG’s US$312 million regular loan payments; (b) the BSP’s US$200 million payment corresponding to the portion of its maturing US$500 million term loan facility that is owed to non-residents as well as US$99 million for the standby credit and extended fund facilities provided by the IMF; and (c) payments for build-operate-transfer (BOT)-related loans amounting to US$124 million. These outflows were offset, however, by the following major loan inflows and bond proceeds: (a) the BSP’s US$195 million loan from offshore banks, representing a portion of the US$585 million term loan facility which was availed of to refinance its maturing US$500 million term loan facility; (b) the NG’s US$148 million borrowings from multilateral and bilateral creditors; (c) a private corporation’s US$215 million loan from offshore banks to refinance its outstanding foreign obligations; and (d) a private bank’s US$200 million 10-year bond issue.

19 Of the US$49.9 billion MLT liabilities, 87.1 percent have maturities of more than five years.
E.5. Foreign Interest Rates

The major central banks maintained a generally accommodative monetary policy stance during the third quarter of 2003 in the face of a generally weak global economy but with signs of prospects for recovery.

The US Federal Open Market Committee (FOMC) decided to keep its target for the federal funds rate unchanged at 1.0 percent during the third quarter of 2003. The Fed noted that an accommodative monetary policy stance, coupled with robust underlying growth in productivity, are providing important ongoing support to economic activity. The US interest rates (based on the weighted average) were generally on a downtrend during the third quarter of 2003. The federal funds rate was lower by 22.95 basis points to average 1.0311 percent, while the prime rate was lower by 24.56 basis point to average 4.0000 percent (Table 15).

The Governing Council of European Central Banks (ECB) decided to maintain the minimum bid rate on the main refinancing operations and the interest rates on the marginal lending facility and the deposit facility at 2.0 percent, 3.0 percent and 1.0 percent, respectively.

Meanwhile, the Monetary Policy Committee of the Bank of England (BOE) voted on 10 July 2003 to reduce the Bank’s repo rate by 25 basis points to 3.5 percent. The Committee believed that the reduction was necessary in order to keep inflation on track to meet the target in the medium term, given the possibility of subdued economic activity continuing in the near term. The key repo rate was left unchanged during the Committee’s subsequent meetings on 7 August and 4 September 2003. Following the 10 July interest rates reduction, the 90-day London Interbank Offered Rate (LIBOR) shed 11.36 basis points to 1.1250 percent.

The Bank of Japan’s guidelines for money market operations were left unchanged during the quarter, with the conduct of money market operations aimed at an outstanding balance of current accounts held at the Bank of around 27 to 30 trillion yen. The previous change in the guidelines for money market operations was made on 20 May 2003, when the target

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21 The Federal funds rate refers to the interest rate at which depository institutions lend balances at the Federal Reserve to other depository institutions overnight. The discount rate refers to the rate charged by the Federal Reserve banks when they extend credit to depository institutions.
22 The prime rate refers to the interest rate banks charge their most creditworthy customers.
23 Bank of Japan, Monetary Policy Meetings held on 15 July, 8 August, and 12 September 2003, available online at http://www.boj.or.jp/en/seisaku/03/seisak_f.htm
balance of current accounts held at the Bank was raised from around 22 to 27 trillion yen to around 27 to 30 trillion yen. With its current monetary policy stance, the Bank has been providing ample liquidity to the system. Subsequently, the overnight call rates continued to move at about zero percent while interest rates on term instruments remained steady at low levels.

Following Asia’s 90-day Singapore Interbank Offered Rate (SIBOR) declined by 12.7 basis points to 1.1258 percent during the third quarter compared to the second quarter this year.

E.6. Other Major External Sector Developments

The period marked a strong global recovery led by robust growth in the US and modest expansion in the Euro-zone\(^{24}\) despite weak economic activity in Japan. The acceleration in real GDP growth in the industrialized economies initiated momentum for economic recovery in the major ASEAN economies and newly-industrialized Asian economies (NIEs).

The faster-than-expected 8.2 percent annualized growth in the US during the period was a historical high for the world’s largest economy in almost 20 years.\(^ {25}\) Solid growth was underpinned by an acceleration in consumer spending, an upturn in exports, and an increase in residential fixed investment, all of which more than offset the downturn in federal national defense spending, which accounted for most of the US economy’s expansion during the previous quarter. The pickup in consumer and business demand also reflected the effect of the first wave of tax cuts implemented by the Bush administration in May. Growth in the Euro-zone was more moderate at 0.3 percent year-on-year as the German, French, and Italian economies, which comprise more than 70 percent of the Euro-zone economy, posted mild expansions during the quarter, a turn-around from the recession experienced in Germany and Italy during the previous period. The recovery in exports and steady demand from the household sector contributed to the growth in the Euro-zone. Meanwhile, in Japan, the economy slowed down at an annual rate of 1.4 percent (compared with the 2.2 percent originally estimated) as capital spending remained weak.

\(^{24}\) The Member States participating in the euro-zone are Belgium, Germany, Greece, Spain, France, Ireland, Italy, Luxembourg, the Netherlands, Austria, Portugal and Finland.

\(^{25}\) Third quarter GDP growth was the fastest pace since the first quarter of 1984, when U.S. GDP posted 9.0 percent growth.
The overall favorable economic environment in industrialized countries during the period benefited the rest of Asia. This, coupled with the resurgence in investments, exports and spending in China after SARS was contained, led to the revival of economic activity in Asia. China led the expansion in the region as its economy grew by 9.1 percent, followed by Thailand with 6.5 percent, Malaysia with 5.1 percent, Hong Kong with 4.0 percent, Indonesia with 3.9 percent, Korea with 2.3 percent, and Singapore with 1.7 percent.

Subdued inflationary pressures in the US and the Euro-zone accompanied the expansion in growth. Similarly, China and most Asian economies except Indonesia, experienced a moderate uptick in inflation against a background of rising real incomes. Inflationary pressures in Indonesia was muted on account of the decline in food prices. Meanwhile, Japan continued to experience deflationary pressures as the supply and demand conditions in the macroeconomy remained volatile despite the recent gradual improvement. Hong Kong also experienced decline in prices arising from structural adjustments being implemented by authorities in view of he rapid pace of economic expansion in Mainland China.

Meanwhile, labor conditions eased but continued to remain sluggish in the US and Japan. Euro-zone unemployment rate remained severe, indicating dampened business sentiment. Elsewhere in Asia, employment conditions were mixed. In Hong Kong, China, and Singapore, unemployment rate worsened, in part due to the after-effects of the SARS epidemic. However, in Thailand robust economic growth improved employment conditions during the period.

<table>
<thead>
<tr>
<th>Country</th>
<th>Real GDP</th>
<th>Inflation</th>
<th>Unemployment</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>3Q</td>
<td>2Q</td>
<td>3Q</td>
</tr>
<tr>
<td>G3</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>U.S.</td>
<td>8.2</td>
<td>3.3</td>
<td>2.2</td>
</tr>
<tr>
<td>Japan</td>
<td>1.4</td>
<td>2.3</td>
<td>-0.2</td>
</tr>
<tr>
<td>Euro-zone</td>
<td>0.3</td>
<td>0.2</td>
<td>2.0</td>
</tr>
<tr>
<td>NIEs</td>
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<td>4.0</td>
<td>-0.5</td>
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<tr>
<td>Korea</td>
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<td>1.9</td>
<td>3.2</td>
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<tr>
<td>Thailand</td>
<td>6.5</td>
<td>5.8</td>
<td>1.9</td>
</tr>
</tbody>
</table>

Sources: Bloomberg, U.S. Bureau of Economic Analysis, Economic and Social Research Institute (Japan), Singapore Department of Statistics, National Statistics Office (Korea), Bank of Thailand.
F. Financial Condition Of The BSP

F.1. Balance Sheet

Preliminary and unaudited data indicated that in the third quarter of 2003, BSP assets expanded by ₱69.8 billion or 5.7 percent from the previous quarter. During the same period, its liabilities rose by ₱55.0 billion or 5.3 percent, resulting in an increase in BSP’s net worth by ₱14.8 billion or 7.9 percent. Compared to its year ago level, the BSP’s net worth expanded by 17.3 percent (Table 16).

The expansion in BSP assets during the quarter was due mainly to increases recorded in international reserves (₱38.3 billion); loans and advances (₱20.8 billion); other assets (₱13.2 billion); and the foreign exchange differential account (₱2.5 billion).

The 4.6 percent rise in international reserves from the previous quarter was attributed largely to the proceeds of NG’s foreign borrowings which were deposited with the BSP and the BSP’s income from its foreign investments. The ₱1.355 depreciation of the peso vis-à-vis the US dollar also resulted in higher international reserves in the third quarter. Loans and advances expanded mainly on account of the ₱22.6 billion additional loans to PDIC for liquidity support to banking institutions. The expansion in the other assets account was attributed to increases in due from foreign banks/special account which holds the account due from BSP’s clearing bank for its PDDTS transactions; the 25% subscription to the BSP’s 3,000 shares in the Bank for International Settlements (BIS); and, additional provisions to the fidelity insurance fund of the BSP. The increase in the foreign exchange differential account, on the other hand, stemmed from the revaluation loss incurred by the non-IR foreign accounts following the depreciation of the peso vis-à-vis the US dollar. Meanwhile, domestic securities declined on account of the net sales in BSP’s holdings of Treasury bills.

On the liabilities side, all major accounts, with the exception of deposits and currency issue (which declined by ₱17.6 billion and ₱0.7 billion respectively), showed expansions as follows: BSP debt instruments (₱28.3 billion), revaluation accounts (₱24.6 billion), foreign loans payable (₱15.4 billion), foreign bonds payable (₱2.5 billion), and other liabilities (₱2.5 billion).

BSP borrowings from the financial system through the reverse repurchase facility posted an increase as the lifting in late August of the tiering scheme on banks’ placements under the reverse repurchase facility with BSP encouraged banks to shift their excess reserve deposits with the BSP to the RRP facility. The revaluation of international reserves account...
(the contra-account in the BSP balance sheet where the valuation gains and losses due to foreign exchange fluctuations are booked) increased by ₱7.3 billion following the peso depreciation in the third quarter. Likewise, the increase in gold prices during the third quarter resulted in ₱17.3 billion valuation gains booked in the revaluation of gold holdings account. BSP’s net foreign borrowings under the securities-backed loan facility and the gold repo facility largely accounted for the increase in foreign loans payable.

**F.2. Income Statement**

Based on preliminary and unaudited data, the BSP realized a net income of ₱2.8 billion during the third quarter of 2003. Revenues amounting to ₱14.6 billion (including gains on foreign exchange fluctuations of ₱0.6 billion) exceeded expenses of ₱11.8 billion (including provision for income taxes and licenses of ₱0.3 billion). Compared to the preceding quarter and previous year’s performance, this meant a 61.6 percent and 124.6 percent growth in its net profit, respectively (Table 17).

Total revenues at ₱13.9 billion expanded by ₱1.8 billion from the previous quarter due mainly to the 15.9 percent rise in interest income, the bulk of which came from the combined earnings from international reserves and domestic securities. The ₱1.7 billion increase in interest income from international reserves was generated largely from a higher income of ₱1.0 billion from the managed fund component of the bank’s foreign investments. Likewise, higher income from loans to PDIC (₱221.2 million), regular rediscount loans (₱96.3 million) and liquidity loans (₱33.7 million) resulted in a 51.8 percent rise in interest income from loans and advances. On an annual basis, revenues expanded by 77.0 percent as interest income and miscellaneous income rose by ₱4.4 billion and ₱1.7 billion, respectively.

Total expenditures at ₱11.5 billion contracted by ₱315 million or 2.7 percent compared to the previous quarter. Interest expense amounted to ₱6.6 billion or a decline of ₱771 million as interest payments on foreign loans payable, including the use of IMF credits, decreased. Taxes and licenses paid to the National Government during the quarter totaled ₱389 million. Other
expenses at ₩4.2 billion grew by ₩630 million due to higher outlays for fidelity and property insurance.

G. CONCLUSION: Challenges and Future Policy Directions

The strong performance of the Philippine economy in the third quarter amid challenging conditions in both the domestic and international fronts suggests better economic prospects for the remainder of 2003 and through the coming year. In particular, stronger output growth against a backdrop of subdued inflation, a supportive policy environment and improving economic activity overseas should lead to a favorable turnout for the Philippine economy in the near term.

It cannot be overemphasized that the Philippine authorities continue to face a number of challenges in order to ensure the sustainability of the country’s growth performance. The downside risks for the overall strength of economic activity—the recently observed slowdown in money and credit demand, the restrained pace of bank lending, and the generally uneven trends in economic data—pose a challenge to policymakers’ ability to preserve the ongoing stimulus to economic activity without any undue risk of demand-pull inflation. The inflation outlook is also clouded by risks stemming from financial market concerns over domestic political conditions in the run-up to the May 2004 elections. This could influence the direction and movement of the exchange rate and other financial variables. Additional risks may also come from planned adjustments in import tariff rates and utility charges.

Monetary authorities must therefore be careful in ensuring that the macroeconomic environment remains conducive to credit demand and investment activity while helping guard against potential risks to price stability. The monetary policy stance should continue to recognize the liquidity needs of economic growth while emphasizing the need for caution in order to keep in check any possible vulnerabilities in the system. The challenge is real in terms of addressing any renewed volatility in the foreign exchange market, excessive debt accumulation by both the private and public sectors and a possible build-up in asset price inflation.

More generally, the continuing priorities for the BSP in the near term include reinforcing the institutional framework for delivering price stability through inflation targeting and encouraging the flow of credit to the productive sectors of the economy. This implies a need to, among other
things, strengthen the banking system and spur lending activity among banks. Thus, the BSP’s policy initiatives going forward will include the following:

a) motivating banks to clean up their non-performing assets (NPAs);
b) enhancement to risk management practices in anticipation of Basle II;
c) strengthening corporate governance through public education campaigns and strengthening the role of external auditors; and
d) supporting the development of critical institutions such as an independent credit rating system and a modern payments infrastructure.

Concerns over the non-performing assets (NPAs) which could undermine the health of the banking system, reduce capital adequacy and constrain the flow of credit to the private sector, must be addressed. The legal and tax framework has already been established to encourage banks to dispose of their idle assets and pare down significantly their NPAs. The non-performing asset situation appears to have stabilized but improvement has been limited. The SPV law finally became operational with the promulgation of its implementing rules and regulations in April 2003 but it has yet to be a major factor in facilitating asset clean-up given the reluctance of banks to accept deep discounts being offered by potential wholesale buyers. Meanwhile, banks have forged ahead with smaller individual deals based on available opportunities to unload some non-performing assets.

Such efforts will be complemented by the BSP’s continuing work on other areas of concern, such as capital market development, which includes laying the foundation for an active secondary market for government securities through a fixed income exchange and cash-settled securities transactions (CSST), as well as initiatives to reform the managed fund business, particularly common trust funds (CTFs). Such moves will proceed alongside BSP efforts to combat money laundering and support credit at the micro-finance level. The recent amendments to the Anti-Money Laundering Law eliminated the deficiencies identified by the Financial Action Task Force (FATF). However, proper implementation will have to be demonstrated in order to remove the Philippines from the FATF list of non-cooperative countries. The Anti-Money Laundering Council is finalizing its Implementation Plan (IP) to be submitted to the FATF. The IP will serve as a basis of the FATF in determining how the Philippines will effectively implement the amended law, the Revised Implementing Rules and Regulations and all other relevant laws. Moreover, the IP sets forth the milestones to be achieved by the AMLC for a more resolute detection, investigation and prosecution of money laundering cases.

The BSP has taken initiatives to create an enabling policy and regulatory environment that would meet the new challenges posed by
greater economic and financial integration. To further enhance the effectiveness of monetary policy, the BSP is promoting regional advocacy to build-up a data base on significant economic activity, infrastructure support and security risks in the regions. The scope of the Business Expectations Survey has been widened nationwide to expand the coverage of market surveillance on advance indicators of production and investment plans of businesses.

The rapid adoption of financial innovation attendant to accelerated financial integration necessitates closer monitoring and careful assessment of its impact on monetary transmission channels and stability of the financial system. Functions of various departments are being reviewed to focus on core competencies to sharpen policy formulation and implementation. Meanwhile, improvement in supervision technology has been prioritized to channel resources on areas based on relative riskiness and impact on banking operations.

The BSP has likewise hosted and participated in regional and international conferences which provide a useful forum for the exchange of information and experiences to assist emerging market economies overcome their constraints and strengthen their economic fundamentals. These fora promote closer inter-regional financial cooperation and forge cooperative structures aimed at facilitating policy consultations.
MONETARY AND BANKING POLICIES

Monetary Policies

Reduction in BSP’s policy rates. The Monetary Board reduced the BSP’s policy interest rates by 25 basis points each to 6.75 percent for the overnight RRP rate and 9.0 percent for the overnight RP rate effective 2 July 2003. The rates remained unchanged for the rest of the quarter.

Lifting of the tiering scheme for banks’ placements. The Monetary Board lifted the tiering scheme for banks’ placements maintained with the BSP. Thus, effective 28 August 2003, overnight RRP transactions with the BSP were accepted at a flat rate of 6.75 percent.

Banking Policies

Guidelines governing the delivery of securities. Securities, warehouse receipts, quedans and other documents of title which are the subject of quasi-banking functions, such as repurchase agreements, shall be physically delivered to a BSP custodian, or by means of book-entry transfer to the appropriate securities account of the BSP accredited custodian in a registry for said documents. (Circular No. 392 dated 23 July 2003)

Rule imposing a loan limit to single borrower. The rule on single borrower’s limit was amended to exclude from the computation of total liabilities loans fully secured by US Treasury Notes and other securities issued by central bank governments and central banks of foreign countries with the highest credit quality given by any two internationally-accepted credit rating agencies. (Circular No. 393 dated 29 July 2003)

Guidelines on the adoption of the risk-based capital adequacy framework. The MB further amended the guidelines on the adoption of the risk-based capital adequacy framework to include the on-balance sheet assets which are assigned fifty percent (50%) risk weight of securities issued by special purpose vehicles against assignment of receivables arising from future payments of the NG. (Circular No. 394 dated 6 August 2003)

Amendments to the securities lending provisions. The MB approved the amendments to Securities Lending provisions under Circular No. 1389 and of the Manual of Accounts for Expanded Commercial Banks, Commercial Banks, and Thrift Banks regarding conditions governing securities lending activities. The conditions that were added include: 1)
loaned securities shall be limited to those lodged under the account “Trading Account Securities (TAS) – Investments” for universal and commercial banks and “Available for Sale (ASS) – Foreign; 2) BSP prior approval of the bank’s board of directors; 3) a reputable, internationally recognized third-party agent and regulated in its country of operation must conduct the securities lending; 4) written legal agreement between the lending bank and the lending agent; 5) fully-secured loaned securities by debt securities of countries or third parties with the highest credit quality, cash in currencies acceptable as part of international reserves, letters of credit and certificates of deposits issued by banks with highest credit rating agencies; and 6) daily marking-to-market on the loaned securities and on the securities where cash collateral is invested/reinvested. (Circular No. 395 dated 19 August 2003)

Amendments governing the issuance of redeemable preferred shares. The MB amended specific subsections of the Manual of Regulations for Banks, particularly on banks’ issuance of redeemable preferred shares that do not need to be replaced with at least an equivalent amount of newly paid-in shares upon redemption and the treatment thereof for purposes of capital adequacy ratio computation. (Circular No. 397 dated 19 August 2003)

Amendments prescribing new rules on credit card operations of banks and their subsidiaries. The MB approved the amendments to the Manual of Regulations for Banks and Non-Bank Financial Institutions and the Manual of Accounts for Universal, Commercial, and Thrift Banks, prescribing new rules and regulations that shall govern the credit card operations of banks and their subsidiaries. The issuance requires banks and their subsidiary credit card companies, among other things, 1) to establish an appropriate system for managing risk exposures; (2) to exercise proper diligence in ascertaining the credit standing and financial capability of prospective credit cardholders; (3) to disclose information such as method of computation of finance charges, effective interest rates and other fees and charges. (Circular No. 398 dated 21 August 2003)

Guidelines on the deductions from Tier 1 and Tier 2 capital and on the on-balance sheet assets. The deductions from the total Tier 1 and Tier 2 capital as well as the 100 percent risk-weighted on-balance sheet assets shall cover reciprocal investments in unsecured subordinated term debt instruments of other banks/quasi-banks in excess of the lower of: 1) an aggregate ceiling of 5 percent of total Tier 1 capital of the bank, or 2) 10 percent of the total outstanding unsecured subordinated term debt issuance of the other bank/quasi-bank. (Circular No. 399 dated 1 September 2003)

Guidelines on quasi-banks’ adoption of the risk-based capital adequacy framework. The guidelines, taking into consideration the
provisions of the General Banking Law of 2000 (GBL), shall initially cover only the capital requirements for credit risks pending the issuance of supplementary guidelines to incorporate risks.26 (Circular No. 400 dated 1 September 2003)

**Guidelines expanding the market risk weight of on-balance sheet assets.** The coverage of on-balance sheet assets was expanded, thus: 1) a 20-percent risk weight will be assigned to claims on Philippine incorporated banks, which obtain and maintain credit ratings of at least equal to that of the Philippine National Government from a BSP-recognized international credit rating agency; and 2) a 50-percent risk weight will be assigned to claims on Philippine incorporated banks, which obtain and maintain credit ratings of not more than one notch lower than that of the Philippine National Government from a BSP-recognized international credit rating agency. (Circular No. 403 dated 19 September 2003).

**Rules and regulations governing the recognition and derecognition of domestic credit rating agencies (CRAs) for bank supervisory purposes.** To ensure that the reliance on CRAs is not misplaced, the BSP prescribed the rules on regulations to govern domestic CRAs, enumerating the BSP's pre-qualification requirements and prescribing the requirements for the CRAs’ organizational structure, resources, objectivity, independence, transparency, disclosure practices, credibility, and internal compliance procedures. Only ratings issued by CRAs that are recognized by the BSP shall be considered for BSP bank supervisory purposes. The BSP will regularly circularize to all banks and non-bank financial institutions an updated list of recognized CRAs. Moreover, the BSP spelled out the grounds for derecognition, including: 1) failure to maintain compliance with all the requirements; 2) involvement in illegal activities such as ratings blackmail; creation of a false market or insider trading; and other related activities; and 3) any violation of applicable laws. (Circular No. 404 dated 19 September 2003)

**Minimum documentary requirements for foreign exchange (FX) forward and swap transactions.** To guard against the use of financial derivatives products for activities that would destabilize the foreign exchange (FX) market, the BSP issued the minimum documentary requirements for foreign exchange forward and swap transactions. (Circular No. 407 dated 30 September 2003).

26 The risk-based ratio of a quasi-bank, which is expressed as a percentage of qualifying capital to risk-weighted assets, shall not be less than 10 percent for both solo basis (i.e., head office plus branches) and consolidated basis (i.e., parent quasi-bank plus subsidiary financial allied undertakings, excluding insurance companies). The ratio shall be maintained daily.