

## **The Philippine Economy: The Continuing Challenge**

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Occasion: 57th Inaugural Meeting of the Management Association of the Philippines (MAP)

Speaker: Governor Amando M. Tetangco, Jr.

### Introduction

During the BSP's annual reception for the banking and business community last Tuesday, I had one principal appeal to our friends. To make the best of our circumstances, achieve progress in our own spheres, so that in the end, the whole nation will be better off.

Distinguished officers and members of the Management Association of the Philippines led by 2005 President Mon Paterno and 2006 President Evelyn Singson, colleagues from the BSP and the government, distinguished guests, friends, ladies and gentlemen, good evening.

MAP's theme for this year, "Call to action: Country above self", happens to be in accord with my Tuesday's appeal. We are all convinced that the must-do list for the Philippines is long, some of the items are structural while some would require streamlining of policies. Any and all efforts to address this must-do list are therefore quite crucial. The next best thing to do is precisely this - take action in your respective spheres of influence. As captains of industries - described by media as movers and shakers of our economy - you can truly generate tremendous benefits for our country and our people. Ladies and gentlemen, what you have selected as guiding theme for this year is exactly the mindset we want Filipinos to have: Country above self. If you can widen the reach of this message to cover as many Filipinos as possible, then you would be a part of a chain that seeks to improve the nation.

Now, let me share with you some positive news on the economic front which give us reason to be more confident about our future.

### 2005 a most challenging year

By most accounts, 2005 was a very challenging year for the Philippines. We had to contend with high oil prices, rising global interest rates, lower farm output, and non-economic tremors. Yet our economy, as measured by GDP, continued to expand. Sure, it wasn't at the pace we aimed for, but our economy proved its resilience once again.

The expansion in economic activity was achieved amid an easing inflation environment. Inflation has continued to ease since the second half of 2005, supported mainly by the softening prices of food and oil, and to some extent the stronger peso. Headline inflation has fallen to 7.0 percent in the second half of 2005. The average inflation rate for last year was 7.6 percent. More importantly, core inflation, which takes out the impact of volatile food and energy prices on the CPI, has steadily trended downwards. The decline in core inflation suggests that the inflationary pressures of the past year were not of a permanent, demand-driven nature. This fact supports the limited and selectively tightening bias of monetary policy.

Another source of optimism is the improving fiscal performance. Coming from a very difficult period of large and persistent fiscal overhang, the government embarked on and succeeded in its initial efforts towards fiscal consolidation, by way of intensified tax administration and vital new tax measures as well as expenditure control. The National Government budget deficit stood at P146.5 billion for 2005, well below the target for the period. This figure also represents the lowest budget shortfall since 2001. As revenue gains continue with the VAT implementation, we stand a good chance of seeing a balanced budget by 2008.

The positive investor sentiment over the progress made on the fiscal front as well as healthy inflows from remittances have also strengthened the external position. Latest estimates show that the overall balance of payments (BOP) position for 2005 stood at a surplus of US\$2.4 billion, which is a welcome turnaround from the previous year's shortfall.

The peso likewise ended stronger against the US dollar on the back of the positive market sentiment and strong inflows. The peso ended 2005 as the top performing currency in the Asian region.

This surge in dollar inflows also allowed the BSP to build up its dollar reserves. At US\$18.5 billion as at end-December 2005, the country's gross international reserves (GIR) is significantly higher than the US\$17 billion target for the year and is sufficient to cover about 4 months' worth of imports of goods and services.

Meanwhile, the country's external debt also narrowed to US\$55.5 billion by end-September 2005. This amount continued to be made up mostly of medium- and long-term liabilities, which ensures that our debt payments remain manageable and sustainable.

At the same time, the Philippine banking system continued to show improving soundness. As of November 2005, commercial banks' non-performing loans as a percentage to total loans registered a single digit level of 8.7 percent. Growth in bank lending, however, continues to be modest (2.1 percent Nov.), but we

expect it to rebound this year given the substantial progress achieved so far with sustained asset clean up.

Having said this, I have to admit, the Philippines is not yet totally out of the woods. There are risks that we have to face and manage in the years ahead. We are sure, however, to move forward if we persevere. For us at the bangko Sentral ng Pilipinas, we are aware of the risks attendant to our primary responsibility of keeping prices stable.

The Monetary Board had to respond promptly and carefully to these inflationary risks to the inflation target. In the course of 2005, we raised our policy interest rates by a total of 75 basis points and increased reserve requirements by 200 basis points. These were modest responses compared to other jurisdictions where their capacity is nearing to the brim and the labor market is stretched to the limit. Yet they were decisive, considering the demand pressures were limited and the second round impact was yet to emerge. By the second half of 2005, inflation had started to ease.

Improving fundamentals, optimism and 2006

What then do we see in 2006.

We continue to face uncertainties, but I believe the country's improving economic fundamentals should give us a reasonable degree of optimism about 2006.

Economic activity, for one thing, is likely to continue at a reasonable pace, driven mainly by the services and industry sectors. Nonetheless, the rise in oil prices over the past year is likely to take its toll on domestic demand, particularly on consumption spending. For this reason, the development budget coordinating committee is looking at real GDP growth in 2006 that is likely to be closer to the lower end of its target at 5.7 percent.

As for inflation, it is expected to be higher in 2006, given the continued upside risks. Oil prices, for example, are expected to remain high relative to their historical trend and the RVAT is likely to exert, at least a short-term, upward pressure on consumer prices. Taking into account the recent easing of oil prices, as well as the strengthening of the peso, inflation is expected to hover between 7.5 and 8.1 percent in 2006. Let me point out though that we do expect an easing of inflation in the second half of the year, as the impact of the RVAT diminishes.

Meanwhile, improvements in fiscal performance, ample liquidity in the financial system, and moderate credit growth are expected to mitigate the impact of inflationary pressures on market interest rates.

There is also good reason to expect a strong external position this year. Dollar inflows, primarily from OFW remittances and investments, are expected to continue to come in. With healthy inflows, the exchange rate is poised to remain broadly stable in the course of the year.

The continuing challenges to monetary and banking policies

While economic performance appears to be on track, we remain watchful of the potential risks and challenges to the economic outlook. These risks include the following: (1) volatility in world oil prices; (2) a build-up of excess liquidity in the financial system; (3) possible exchange rate volatility due to excess liquidity; and (4) adverse shifts in the public's inflation expectations.

In the face of these challenges, the public can count on the BSP to make sure that these risks do not endanger our path to economic progress. The BSP will stay committed to its mandate of promoting low and stable inflation.

The BSP is also committed to strengthening the financial sector through continued structural reforms. Foremost of these measures is the clean-up of banks' balance sheets of non-performing assets. The clean-up will help spur credit and investment activity and create the basis for more sustainable growth in the medium term.

Other key financial reforms will be focused on: (1) improving the BSP's supervision technology and capacity; (2) aligning prudential regulation of the banking system with international standards and best practices; (3) strengthening corporate governance standards and market discipline mechanisms; (4) further developing the domestic capital market; and (5) enhancing the payments system.

Efforts are also underway for the implementation of Basel II accord and adoption of international accounting standards by local banks. These initiatives are designed to bring local banking practices in line with internationally accepted standards.

In the area of capital market development, the BSP will continue its active collaboration with other government agencies and the private sector for the completion of much-needed market infrastructure to enhance system integrity and overall market confidence.

We will likewise pursue further enhancements in financial information to guide investor decisions. A key effort in this area is the establishment of credit rating agencies. We are also working closely with congress on the establishment of a centralized credit information system to help private enterprises secure better access to credit, reduce borrowing costs, as well as minimize the risk exposures of financial intermediaries.

The BSP also actively seeks to widen the investor base of the local financial markets through a number of new investment products which would better reflect market prices. These will help encourage more institutional investors such as insurance companies, mutual funds and pension funds to participate in the capital market. Future reform measures will eventually lead to the introduction of exchange-based products that can further stimulate market activity and deepen liquidity.

The continuing challenge

Let me sum up by saying that the near-term economic outlook suggests more vibrant economic activity, but there are potential obstacles on the way to sustainable growth. The critical task ahead is for us to focus, not just on macroeconomic stabilization in the short-term, but also on preserving the momentum for economic reforms to ensure sustained growth in the years to come. Consistent with map's marching order, we need to act outside of ourselves.

Most of the items on the must-do list will take time before these come into fruition. Reforming an economy is an enormous task, one that the government, even in theory, cannot do by itself. Governments govern, or better still, guide. But it is the economic and business community that creates commodities and services, builds the economy and competes in the global market.

I take heart in the fact that our business leaders in MAP remain a stalwart partner of the government in making economic progress possible. Personally, I am optimistic that our hard work and resourcefulness will allow us to overcome our remaining economic problems. As a people, they say Filipinos have a knack for turning adversity into opportunity. My caution is that we should not always welcome adversity to be able to turn it into opportunity. I believe that by responding to the challenges with a deeper sense of purpose, by adhering to "country above self" as a guiding principle, we can reach our full potential. By all means, we have what it takes to succeed. The outgoing officers and board members of the MAP, congratulations on a job well done, and to the new officers, I wish you all the best!

Thank you very much. Mabuhay tayong lahat.