

The Outlook for the Philippine Economy and Policy Directions in 2006

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Occasion: Regular Membership Meeting of the Rotary Club-Makati Central

Speaker: Governor Amando M. Tetangco, Jr.

Distinguished officers and members of the Rotary Club of Makati Central, friends, ladies and gentlemen, good afternoon.

It is a great pleasure to join your regular membership meeting today and speak on the Philippine economic outlook and its implications for the Bangko Sentral's monetary and banking policies. I know we share the same goal of economic prosperity for more of our people, but I also realize that we have different roles to play in meeting that goal. An instructive way to be on the same roadmap is for us to consider together the recent economic developments and prospects and anticipate potential challenges along the way.

Recent economic developments

There seems to be a general sense of renewed, although cautious, optimism about economic prospects for the Philippines at present?? I believe this is largely because last year, our economy continued to prove its resilience and fundamental strength. We had a respectable output growth of 5.1 percent. Although this magnitude compares favorably with what our neighbors in Asia recorded, I know that this has to be improved to make a dent in combating poverty in the Philippines.

Second, we achieved growth with a relatively subdued inflation rate. The emphasis is on subdued. Unlike the other countries, we have stopped subsidizing the oil industry since 1998.? Our consumer basket remains dominated by weather-sensitive food commodities. Yet, with real growth of over 5 percent, average inflation rate in the Philippines was kept at 7.6 percent in 2005. ? We can compare this with Indonesia (10.4 percent) and Thailand (4.5 percent).

Third, the government's overall fiscal consolidation efforts have already shown good results. The National Government budget deficit stood at P146.5 billion for 2005, well below the target for the period, and certainly lower compared to the year-ago level. The progress made in fiscal consolidation has continued this year as the government was able to curb the budget deficit for the first two months of the year.

Fourth, our external payments position achieved a big surplus in 2005.? This was made possible by the sustained dollar inflows from OFWs, foreign direct and portfolio investments, and export receipts.

The significant increase in remittances and investments allowed the BSP to build up its international reserves to a new record high level of US\$20.6 billion. At the same time, with all those big current and capital inflows, a stronger peso is another natural consequence.

Fifth, the economy continues to improve its external indebtedness picture. Medium- and long-term debt liabilities comprise the bulk of the country's external debt. Key debt service ratios have also continued to improve, indicating better manageability and sustainability of the country's external debt.

Finally, another welcome development is the sustained improvement in the soundness of our banking system. Asset quality of banks continued to improve. Bad loans ratio has declined to single-digit level and is at its lowest in eight years.

Outlook and challenges

Despite the recent gains in macroeconomic performance and economic reforms, we remain conscious of the risks and challenges to the economic outlook. On the part of the BSP, we will continue to address the challenges attendant to our twin responsibilities of conducting sound monetary policy and banking supervision. The BSP will continue to address the risks to inflation and inflation expectations; strengthen the external position, and sustain the pace of reforms in the financial sector.

The main challenge for us is to effectively manage inflation and inflation expectations. We see average inflation exceeding the government's inflation target of 4.0-5.0 percent this year given continued upside risks. Oil prices are expected to remain high relative to their historical trend while the implementation of the additional two percentage points in the vat rate is expected to have a one-off impact on prices. In the second half of 2006, we expect inflation to follow a decelerating trend as the short-lived impact of the EVAT on prices of goods and services tapers off. Easing food prices, given improving weather conditions, should also help tame non-food price pressures.

The sustained appreciation of the peso owing largely to strong dollar inflows should also help to keep the inflation path in check. The continued dollar inflows, however, also imply a risk of a renewed surge in liquidity growth as inflows are converted into pesos and absorbed by the banking system. We will need to monitor this closely, together with the expected narrowing of interest differentials, as they can adversely affect inflation.

All of these risks make monetary policy a difficult task. But we have done our homework much earlier. The BSP carefully calibrated monetary policy over the

past year to be able to establish a balance between price stability and economic growth. Policy rates were adjusted to guide inflation expectations downward.

We have also fine tuned our existing credit policies to ensure consistency of BSP credit with monetary policy. Towards this end, we issued new guidelines on the BSP's grant of rediscount and emergency loans and other advances to banking institutions. We likewise continue to improve our early warning systems to effectively manage risks and ensure macrostability.

Monetary policy going forward will proceed on a cautious footing. The BSP will keep a close eye on incipient inflationary pressures, especially those coming from the demand side, and stand ready to undertake the necessary monetary action in a timely manner. The public can expect us to be vigilant in ensuring that these risks do not undermine economic growth.

As a complement to monetary measures, direct action to address supply-side risks should remain a key policy priority. To this end, the BSP will intensify further representation with relevant government agencies in support of supply-side intervention measures to: (1) facilitate distribution of basic goods and services to final end-users; (2) promote energy conservation and efficiency; and (3) support exploration and use of alternative/indigenous energy sources.

Going forward, external sector policy will focus on further sustaining our strong external position. Specifically, the BSP will focus on maintaining a comfortable level of reserves and monitoring closely the country's foreign borrowings. Moreover, we will continue to support a market-determined exchange rate. We will not lean against the wind but will address short-term volatilities that will affect the decisions of economic agents.

With respect to the financial sector, we expect the banking industry to be more dynamic, competitive and stable. With the impending extension of the SPV Law, the BSP aims to further cut down the banks' non-performing loans by another P100 billion. Over the medium term, we expect the NPL ratio of banks to be further trimmed to the pre-Asian financial crisis level of 4 percent as we continue to foster an environment that will facilitate further disposal of banks' non-performing assets. Just this month, the Monetary Board approved the guidelines allowing banks to enter into Joint Venture Agreements (JVA) with real estate development companies for the disposition of the banks' foreclosed real estate property. The BSP hopes that this initiative will provide banks with effective means of reducing their NPA holdings. The asset clean-up of banks should spur credit and investments, thereby creating the basis for more sustainable growth in the medium term.

Beyond asset clean-up, financial sector reforms will be pursued. Reform efforts will focus on further strengthening corporate governance, risk

management and capital adequacy in our banks, aligning prudential regulation with international standards and best practices, and enhancing our payments system.?

With these reforms in place, we foresee further consolidation of banks. Eventually, we hope to see a banking landscape characterized by a handful of main banks complemented by many smaller banks with well-defined market niches. Recently, the Monetary Board decided to allow rural and cooperative banks to engage in FCDU operations. The decision was prompted by the board's desire to enhance RB's and CB's ability to compete in the remittance business and in the buying and selling of foreign exchange.

We will also continue to lobby for the passage of key legislations aimed at developing the local capital market. Specifically, we are working closely with Congress on the creation of a centralized credit information bureau system and the establishment of credit rating agencies. These should enhance the quality of financial information available to investors, enhance private sector access to credit, and minimize exposure to risks of financial intermediaries. Our goal for capital market development is to build an environment where, on the one hand, savers are provided with varied investment alternatives to meet their specific risk appetites, and on the other hand, borrowers are accorded choices for funding longer-term productive projects.

Concluding remarks

There is no doubt that the country has made solid economic gains. However, there is still much to be done to ensure sustainable growth for the long term. The economic indicators on the past year's performance give us reason to be upbeat about the year ahead. But we need to continue to work hard. Let me assure you that the Bangko Sentral remains committed to its strategic role of keeping inflation low, interest rates at reasonable levels, the peso broadly stable, and the banking system safe and sound.

However, appropriate policy reforms of government do not by themselves translate into the desired growth in output and incomes. Active participation of the private sector is equally important in the growth process. To this end, I would like to see that the partnership between industry groups like the rotary club and the Bangko Sentral ng Pilipinas continue to prosper. We go forward in 2006 with greater confidence that, with your continuing support and cooperation, we can achieve broad-based growth, with the fruits of development shared equitably among our people.

As one thinker once said, "All it takes to open a door of opportunities is to keep pushing". Let us continue to push until we are convinced all doors of opportunities are opened to us for the taking.

Thank you very much.