The Philippines: Ten Years After the Crisis

Margarita Debuque-Gonzales and Maria Socorro Gochoco-Bautista

The Philippines' economic situation in Asia has always been unique. Prior to the regional financial crisis in the late 1990s, the country had been the odd man out, constantly labelled as 'the sick man of Asia', with output never really growing as fast as that of its neighbours. During the crisis, it was again the East Asian exception, albeit in a more positive sense. The country suffered only a mild recession in 1997–8 and, primarily because previous capital inflows had not been very large in previous years, the country was relatively unscathed.

Ten years after the region-wide crisis, Asian economies – particularly the so-called economic tigers – are again moving into a position of strength. Their export levels have steadily risen, leading to strong output growth and trade surpluses. Consequently, and as part of a broad strategy to maintain competitiveness, they have accumulated substantial foreign exchange reserves and achieved robust savings rates.

The Philippines, meanwhile, assumes its familiar place as an outlier of the group. Economic growth, while respectable, has not been fast or vigorous enough for the country to play catch-up with the rest of East Asia. Up until recently, domestic banks had been saddled with non-performing loans, preventing credit growth from stimulating the economy. Foreign reserves, seen as 'self-insurance' against another crisis, have not been as large as in other countries in the region (although in some ways, this may not be much of a disadvantage), while debt levels remain consistently higher than those of its neighbours as a proportion of national income. (Another outlier in this sense is Indonesia.)

Yet financial fragility, the main concern of other crisis-afflicted Asian economies, is not the country's largest worry. Instead, the dilemma of economic leaders a decade after the regional downturn is – as it has always been – how to effectively leverage for long-term growth.

In this article, we describe how, despite the numerous changes that have taken place, especially in the financial sector, the story for the Philippine economy ten years after the crisis remains largely a story of the past. While the Philippines shares a number of economic vulnerabilities with other Asian nations, especially in the light of shared experiences and external conditions (e.g. dealing with global capital), its problems are unique and mostly concern issues related to governance and political legitimacy, weak institutions and structural limitations that hinder long-term prosperity.

The uniqueness of the country's situation and the inability of its leaders to sustain reforms has hindered the economy from progressing as rapidly as, say, even emerging economy Vietnam, the current darling of foreign investors and fast becoming an Asian success story. Its poor historical record for economic performance has led the international financial community to be largely intolerant of its financial and economic problems. Weak access to external credit and a seemingly unforgiving sentiment among international ratings agencies and investors have been partly responsible for preventing the country from recovering as well and as quickly as have other economies in the region.

Signs of life have lately breathed into the domestic economy with reported improvements in foreign investor outlook, but this is re-introducing the same set of problems the country had experienced a decade ago, which only delineates its old dilemmas in terms of monetary management. The stock market, for instance, is booming, direct investments are rising, the real estate sector has gradually recovered, and despite signs of demand growth and recent oil price shocks, inflation rates remain at safe levels. Once again, the signs of prosperity brought about by a new surge of capital inflows may simply be masking an impending collapse if economic fundamentals are not fully in place and excesses in spending show up as financial imbalances. As we have learned in the last crisis, this can have dire consequences for the entire region.

In the next section, we provide a brief background of the Philippines before the onset of the Asian financial crisis and the short period that followed to show the extent to which the country was affected by the regional downturn and to highlight the distinctiveness of the country's economic situation *vis-à-vis* the other affected economies in Asia. We then outline the domestic economy's strengths and vulnerabilities a decade later and focus on the special features of the country that may make it vulnerable to external shocks. Finally, we discuss the impending capital boom and the dilemmas for monetary policy. The article concludes by outlining the reforms that we believe can lessen the country's economic and financial vulnerabilities and help it achieve what could have been possible more than a decade ago – rapid East Asian growth.

1 Before and during the crisis – an East Asian exception

In the few years prior to the Asian financial crisis, economic leaders pursued the Philippines' goal to join the high growth club of East Asian economies. This ambition had been partly fuelled by memories of a time when domestic economic performance was still at par with that of other economies in the region. The country, for instance, had one of the highest *per capita* incomes in the immediate post-war era, ranking fifth in the entire set of Asian economies and above countries such as Taiwan and South Korea.

While the Philippines' economic performance did not deviate substantially from its neighbours in the 1960s and 1970s, a wide chasm developed in the 1980s, now known as the 'lost decade'. In 1984 and 1985, the country experienced its worst crisis, with negative real growth rates for the first time in its post-war history, from the political and economic turmoil that ensued after the assassination of Benigno Aquino. The country was bypassed by the Japanese wave that engulfed countries in Asia following the revaluation of the yen. Domestic output growth then averaged less than 2 per cent in contrast to the East Asian average of more than 6 per cent.[1] Observers attribute the poor growth to a combination of several factors – these ranged from unfavourable policy and endowment conditions, to institutional barriers to good policy, to a string of bad luck and bad politics (Balisacan and Hill 2003; De Dios and Hutchcroft 2003).

Because of economic reforms implemented in the late 1980s and early 1990s after the fall of the Marcos dictatorship, things began to visibly improve by the mid-1990s when the country experienced markedly better economic performance. It was also in this period that the Philippines again became an East Asian exception.

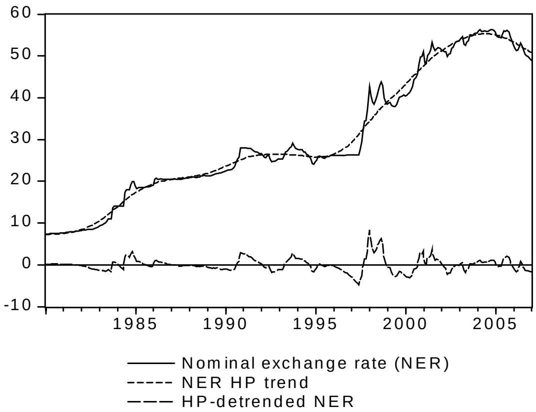
Among the major South-East Asian economies, the Philippines was arguably the least affected by the regional financial and currency crisis that struck in 1997. Unlike its neighbours, it did not undergo a major recession, with output contraction in 1998, partly due to a severe drought that brought down agricultural production.

Most notably, the country's banking system emerged from the crisis virtually intact. The ratio of non-performing loans of banks, for example, was less than 5 per cent in 1997 compared with a ratio of over 15 per cent in other crisis countries.

The resilience in part owes to the stronger prudential framework that the Philippine central bank had implemented beginning in 1996, which resulted in stronger bank capitalisation (Saldana 1999). By March 1998, for instance, capitalisation of the commercial banking sector was a hefty 17.3 per cent, high even by regional standards.

However, the financial system's insulation from the crisis also owes to the low level of financial intermediation (e.g. loans-to-GDP ratio of less than 65 per cent) and the fact that capital inflows arrived later and in smaller amounts than in other Asian countries (Gochoco-Bautista and Canlas 2003).

Figure 1 Nominal exchange rate – levels and deviations from HP trend†



† NER refers to the monthly peso–dollar rate. The series is detrended using the Hodrick-Prescott filter (λ=14,400).

The Philippines declared a moratorium on principal payments on its foreign debt following the Aquino assassination and was effectively excluded from foreign debt markets until 1992, when the capital account was liberalised. Even then, international investors remained wary about conducting their business in the country.

While the nation's woes during the mid-1990s were not primarily due to financial flows, of which there were relatively little, it is often noted that the Philippines might in time have suffered the same weakening of the financial sector had the regional crisis not interrupted the surge of capital to the country.

Clearly, some momentum was then already being gained when net capital and financial flows in the balance of payments grew from US$3.4 billion in 1995 to US$11.1 billion in 1996, or roughly 12.8 per cent of GNP. Portfolio inflows, which included financial derivative transactions, experienced an unusual surge in that single year, from US$248 million to US$2.2 billion. Medium- and long-term loans and short-term capital also all grew substantially.

There was also a significant decline in commercial banks' net foreign assets, reflected as a US$4.2 billion inflow in the country's financial account in 1996, indicating a growing amount of funds being sourced abroad then re-lent or invested locally. External borrowing by private banks had grown from US$533 million in 1993 to US$4.5 billion in 1996, while foreign borrowing by non-banks, mainly private corporations with access to international capital markets, had expanded from US$5.2 billion to US$8.4 billion during the period.

Symptoms of unsustainable monetary policies were visible, though not to the extent detectable in other affected economies. The Philippines had emulated its neighbours by running a quasi-fixed exchange rate while maintaining an independent monetary target. This resulted in an untenable situation as predicted by the Mundell-Fleming framework, where capital inflows led to an expansion of money, which then needed to be sterilised, precipitating higher interest rates and attracting even further inflows, in turn fueling currency appreciation and repeating the cycle.[2]

Banks and corporations also over-borrowed to take advantage of lower interest rates abroad and a virtually fixed nominal exchange rate, and failed to suitably hedge against currency risk. Hot money entered the country as investors took advantage of interest rate differentials and then speculated on peso depreciation, increasingly through novel financial instruments such as certain types of derivatives transacted through universal banks (specifically those with foreign affiliations), when a fall in the domestic currency became more likely because of contagion and herding effects.

Although the Philippines shared many of the economic conditions of crisis-afflicted Asian countries, it also dealt with its own set of problems – i.e. large real currency appreciation (the largest among the affected economies), chronic trade imbalances, high public debt and historically low growth and high inflation. With the devaluation of the baht, there was widespread speculation on the peso, largely because the country was seen to further lose competitiveness against its East Asian rivals (see, for instance, Intal 2005).[3]

The Philippines managed to achieve 5.2 per cent growth and export expansion of 23 per cent in 1997, but economic conditions deteriorated due to a severely depreciated peso coupled by liquidity tightening and resultant high interest rates.[4] Output contracted in 1998, and the worsening environment adversely affected the financial sector.

Bank profitability plunged in 1998, with return on equity falling from 16.3 per cent in 1996 to 6.6 per cent in 1998. The proportion of banks' non-performing loans (NPLs) to total loans meanwhile rose from 2.8 per cent to 10.37 per cent. This severely hampered the ability of monetary policy to stimulate growth, as banks burdened by bad loans became risk averse and reluctant to lend at a time when business activity was slack due to low demand and excess capacity in the economy.

While most of the other Asian economies started to recover at the beginning 1999–2000 because of rising global demand for their electronic products and domestic fiscal pump-priming efforts, the Philippines' growth continued to be restrained. Lack of stability in political institutions and leadership, which created uncertainty, played a role in dampening economic activity.

Heightened dissatisfaction with the administration of President Joseph Estrada beginning mid-2000 eventually led to its collapse in the early part of 2001, which unhappily coincided with the bursting of the US technology bubble that nipped Asia's recovery. Growth during these years of political crisis and a US slowdown averaged well below 4 per cent.

2 Ten years after – economic strengths and vulnerabilities

Asian economies have bounced back in recent years, with Asian governments for the most part succeeding in putting their economic houses in order. The Philippines has similarly improved overall – not only in terms of building stronger resistance to speculative attacks, but also through better economic fundamentals and greater financial strength.[5]

Studies have chronicled higher exchange rate flexibility in the region after the crisis, and basic measures clearly show this to be true for the Philippine currency. There has generally been greater monthly movement in the peso as well as larger annual changes in its value in the period after the regional crisis (Figure 1, Table 1).

The *Bangko Sentral ng Pilipinas* (BSP) apparently loosened its hold on the domestic currency (e.g. allowed the peso to depreciate during the political crisis of the Estrada government), with nominal exchange rate volatility generally higher and foreign reserve volatility generally lower than their pre-crisis levels. In this sense, the country has been less vulnerable to a speculative attack.[6]

Lately, monetary authorities have again tended to worry about the effects on the exchange rate of large capital surges, an inclination reflected by sharp increases in the level and variability of foreign reserves. This may be a danger signal of the return of a potentially unsustainable policy mix. What is apparent is that significant real appreciation hurts the competitiveness of the country's exports and makes necessary measures to cope with very large capital flows.

The country has also been able to accumulate international reserves above levels conventionally considered to be safe. Its import cover, which measures the number of months of average payments for goods, services and income that can be adequately covered by reserves, has grown from only 3.2 months in 1996 to 4.5 months a decade later. The benchmark level is about three months.

The country can now fund more than twice the amount of its short-term foreign obligations in a year – the rule-of-thumb measure is about one-to-one – or by about 235 per cent in 2006. Similarly, foreign reserves can now easily finance the Philippines' debt-service burden, which comprises the amount it must immediately pay to its creditors, as the reserves-to-debt service ratio has reached 291 per cent.

The proportion of broad money backed by reserves has lately been of interest to multilateral observers given the experience in the recent crisis when afflicted economies in East Asia suffered outflows of about 18–28 per cent of M2 (ADB 2006).[7] The Philippines' international reserves currently surpass that amount and can cover about a third of the country's money supply.

The country's 'foreign reserve fortress', currently at US$23 billion, has not been as high as that of other East Asian economies and numbers among the lowest in the region. Even so, monetary authorities seem to think that this level of reserves is high enough to discourage speculation and withstand capital flight. This situation can also be a plus in some ways, as a large stock of reserves entails opportunity costs and puts pressure on the central bank to innovate from traditional reserve management (e.g. by investing in riskier assets with higher return or in high-risk domestic investment ventures).

Table 1 **Indicators of economic and financial vulnerability of the Philippines**

	1991–5	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006
Exchange rate flexibility												
Nominal depreciation (appreciation)[1] (%)	(1.5)	2.0	12.4	38.8	(4.4)	13.1	15.4	1.2	5.0	3.4	(1.7)	(6.8)
Exchange rate volatility (std. dev.)[2]	2.7	1.9	6.7	16.1	13.3	7.4	12.7	9.6	4.3	4.8	2.5	5.2
Reserves volatility (std. dev.)[3]	12.1	10.9	12.1	7.7	13.1	15.7	5.8	5.6	5.2	4.0	7.3	18.0
Volatility ratio[4]	0.2	0.2	0.6	2.1	1.0	0.5	2.2	1.7	0.8	1.2	0.3	0.3
Foreign reserve adequacy												
Gross international reserves (billion US$)	6.14	11.77	8.80	10.84	15.06	15.06	15.69	16.37	17.06	16.23	18.49	22.97
Import cover (no. of months)[5]	3.1	3.2	2.0	3.1	3.7	3.5	4.0	4.0	4.0	3.6	3.8	4.5
GIR-to-short-term external debt[6] (%)	93.7	139.2	95.8	112.0	188.0	163.9	143.6	143.7	140.7	156.9	131.6	234.9
GIR-to-debt service burden (%)	170.0	234.2	157.2	212.8	228.9	240.4	240.3	210.8	214.7	224.9	242.6	290.7
GIR-to-M2 (%)	25.2	25.2	17.2	27.1	30.8	32.2	37.4	35.8	37.8	33.8	35.6	34.4
Total reserves less gold (billion US$)	4.95	10.06	7.30	9.27	13.27	13.09	13.48	13.33	13.65	13.12	15.93	20.03
Indicators of crisis due to:†												
Fiscal deficits, expansionary policy												
Fiscal surplus (deficit) (% of GDP)	(0.6)	0.3	0.1	(1.9)	(3.8)	(4.1)	(4.0)	(5.4)	(4.6)	(3.8)	(2.7)	(1.1)
Monetary authority claims on government.[7]												
% of GDP	8.6	6.2	6.2	5.2	5.5	3.2	2.1	3.2	2.4	2.0	0.7	2.6
Annual change (%)	(6.8)	(13.3)	11.6	(8.1)	18.7	(34.1)	(29.6)	65.3	(17.6)	(6.9)	(63.2)	332.9
M2 (% of GDP)	42.6	56.3	62.0	61.3	64.2	61.6	58.9	59.6	56.7	55.3	52.8	57.0
M2 growth (%)	19.7	21.3	20.8	8.2	15.6	7.8	3.5	9.9	3.5	9.5	6.2	17.9
Reserve money (% of GDP)	12.4	12.2	13.0	11.3	12.2	10.1	9.0	9.3	9.0	8.8	8.6	12.5
Reserve money growth	10.1	12.3	17.3	(4.7)	18.8	(7.0)	(3.5)	12.1	5.4	9.3	8.9	47.6
Sovereign debt												
External debt (billion US$)	34.1	39.9	43.0	46.1	51.0	51.2	51.9	53.6	57.4	54.8	54.2	53.4
% of GNP	58.3	46.2	50.1	67.3	63.6	63.5	68.3	65.6	67.2	58.7	50.8	41.7
of which:												
Short-term	7.2	6.3	7.4	8.5	6.2	6.8	7.9	6.8	7.2	5.4	6.0	3.9
Medium and long-term	51.1	39.9	42.7	58.8	57.4	56.6	60.4	58.8	59.9	53.3	44.8	37.8
of which:												
Public sector	47.5	31.2	31.1	43.7	42.8	42.3	43.9	43.5	46.2	40.6	34.2	29.0
Private sector	10.8	15.0	19.0	23.7	20.0	21.2	24.3	24.6	20.9	18.1	16.6	12.7

Table 1 (cont.) Indicators of economic and financial vulnerability of the Philippines

	1991–5	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006
% of foreign receipts[8]	168.6	100.8	89.4	106.3	113.4	105.9	124.9	118.0	121.9	104.9	96.0	80.9
Short-term external debt/reserves	1.1	0.7	1.0	0.9	0.5	0.6	0.7	0.7	0.7	0.6	0.8	0.4
Debt service burden												
% of GNP	6.1	5.8	6.5	7.4	8.2	7.8	8.6	9.5	9.3	7.7	7.2	6.2
% of foreign receipts	17.4	12.7	11.6	11.7	14.6	13.0	15.7	17.1	16.9	13.8	13.5	12.0
Current account imbalances, economic slowdown												
GDP growth (%)	2.2	5.8	5.2	(0.6)	3.4	4.0	3.4	5.5	4.9	5.0	4.8	5.3
Unemployment rate (%)	9.4	8.6	8.7	10.3	9.8	11.2	11.1	11.4	11.4	11.8	11.4	7.9
Current account (% of GDP)	(3.4)	(4.8)	(5.3)	2.4	(3.8)	(2.9)	(2.4)	(0.4)	0.4	1.9	2.0	4.3
Exports (% of GDP)	20.7	24.8	30.6	45.3	45.0	49.2	44.0	44.8	44.4	44.7	40.9	39.5
Export growth (%)	16.6	17.7	22.8	16.9	16.1	9.1	(16.2)	9.9	2.7	9.8	3.8	14.6
Imports (% of GDP)	31.0	38.5	44.2	45.3	52.8	57.1	52.8	52.0	51.7	51.3	48.6	45.4
Import growth (%)	17.1	20.8	14.0	(18.8)	36.2	7.7	(13.3)	6.3	3.1	8.0	8.0	10.6
RER deviation from trend[9]	4.5	20.9	14.0	(8.6)	4.8	(6.7)	(11.5)	(4.0)	(6.7)	(6.5)	(1.6)	9.3
Financial excess[10]												
Domestic credit												
% of GDP	38.0	67.9	78.5	70.1	64.2	62.3	58.7	56.7	55.6	53.8	46.2	43.7
of which, claims on:												
Government	10.3	15.9	18.6	17.2	17.4	17.3	18.4	19.4	20.7	21.4	17.6	16.3
Private sector	26.3	49.0	56.5	48.0	42.0	39.2	35.6	32.9	30.5	29.6	26.0	25.2
Other banks	1.4	3.1	3.5	4.9	4.9	5.7	4.6	4.5	4.4	2.8	2.7	2.2
Annual change (%)	40.1	38.9	29.2	(2.0)	2.3	9.3	2.0	5.5	6.9	8.9	(4.2)	4.8
of which, claims on:												
Government[7]	9.3	9.9	31.0	1.4	13.0	12.5	14.9	14.8	16.6	16.0	(8.4)	3.0
Private sector	28.8	48.7	28.8	(6.6)	(2.3)	5.4	(1.8)	0.8	1.1	9.3	(2.2)	7.4
Other banks	22.4	100.1	26.8	55.4	10.2	31.3	(11.4)	4.9	6.9	(27.5)	6.1	(8.5)
M2/reserves	4.0	4.0	5.8	3.7	3.2	3.1	2.7	2.8	2.6	3.0	2.8	3.1
Stock market indices												
Price index, annual change (%)	11.0	(2.6)	(12.9)	(33.5)	54.5	(6.3)	(35.6)	(24.9)	(15.6)	41.8	151.7	106.0
Volume index, annual change (%)	59.9	200.5	(22.5)	110.3	(40.3)	124.9	(80.0)	30.0	18.8	(22.0)	166.0	70.2
Inflation rate (%)	9.8	7.5	5.6	9.3	5.9	4.0	6.8	3.0	3.5	6.0	7.6	6.2

(cont.)

Table 1 (cont.) Indicators of economic and financial vulnerability of the Philippines

† Classifications are loosely based on Kaminsky (2003) as well as other empirical studies.
1 Annual percentage change in the peso–dollar rate. The figure in the first column refers to the average change within 1991–5.
2 Standard deviation of the monthly nominal peso-dollar rate in the preceding three-year period (inclusive of indicated date), except for 1991–5, where the figure refers to that period.
3 Standard deviation of the country's international reserves in the preceding three-year period (inclusive of indicated date), except for 1991–5, where the figure refers to that period.
4 Ratio of exchange rate volatility to reserves volatility.
5 Number of months of average import payments for goods, services and income that can be financed by the country's international reserves.
6 Refers to outstanding short-term external debt based on original maturity plus principal payments on medium- and long-term loans (private and public sector) due within 12 months.
7 The figures are net of central government deposits. The first column refers to the period 1994–5.
8 Foreign receipts correspond to exports of goods and payments from services and income.
9 Positive figures (without parentheses) indicate possible overvaluation (i.e. relative to HP trend).
10 Money and output growth figures are already shown in various groups of crisis indicators printed above.

Source IMF International Financial Statistics database; Bangko Sentral ng Pilipinas.

Table 2 Stability indicators of Philippine banks (billion pesos, end of period)

	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006
Total loans	1.222	1.573	1.542	1.583	1.628	1.625	1.639	1.747	1.784	1.873	2.081
Expanded commercial banks	0.882	1.112	1.080	1.086	1.025	0.992	1.042	1.119	1.143	1.194	1.320
Commercial banks	0.097	0.138	0.121	0.140	0.184	0.183	0.156	0.158	0.169	0.169	0.165
Government banks	0.135	0.166	0.186	0.201	0.222	0.200	0.193	0.215	0.232	0.269	0.297
Foreign banks	0.108	0.157	0.156	0.156	0.197	0.250	0.249	0.255	0.240	0.241	0.298
Non-performing loans	0.034	0.074	0.160	0.195	0.246	0.282	0.245	0.246	0.227	0.154	0.125
Expanded commercial banks	0.021	0.047	0.112	0.142	0.172	0.193	0.180	0.181	0.165	0.113	0.096
Commercial banks	0.004	0.010	0.016	0.023	0.032	0.042	0.027	0.029	0.030	0.018	0.015
Government banks	0.006	0.010	0.019	0.025	0.034	0.036	0.030	0.029	0.027	0.019	0.013
Foreign banks	0.004	0.007	0.012	0.005	0.007	0.012	0.008	0.006	0.005	0.004	0.002
Loan loss provision	0.015	0.035	0.061	0.091	0.107	0.127	0.125	0.130	0.137	0.119	0.100
Expanded commercial banks	0.010	0.023	0.042	0.063	0.071	0.081	0.084	0.085	0.092	0.075	0.065

Table 2 (cont.) Stability indicators of Philippine banks (billion pesos, end of period)

	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006
Commercial banks	0.001	0.002	0.003	0.006	0.010	0.014	0.013	0.014	0.015	0.011	0.008
Government banks	0.003	0.006	0.009	0.016	0.017	0.018	0.017	0.019	0.021	0.023	0.017
Foreign banks	0.001	0.004	0.007	0.006	0.009	0.014	0.012	0.011	0.009	0.009	0.008
Performance indicators:											
Asset quality											
NPL ratio (% of total loans)	2.8	4.7	10.4	12.3	15.1	17.4	15.0	14.1	12.7	8.2	6.0
Expanded commercial banks	2.4	4.2	10.4	13.0	16.8	19.4	17.3	16.2	14.4	9.5	7.2
Commercial banks	3.7	7.2	13.7	16.4	17.6	22.8	17.2	18.5	18.0	10.7	8.8
Government banks	4.4	6.2	10.1	12.6	15.1	17.8	15.7	13.3	11.8	6.9	4.2
Foreign banks	3.3	4.4	7.9	3.5	3.8	4.8	3.2	2.5	2.0	1.6	0.8
Distressed asset ratio[1]	–	–	–	21.4	25.1	28.4	27.7	27.0	25.3	19.7	15.8
Capital adequacy											
Net worth to risk assets[2] (%)	–	–	–	17.5	16.1	16.1	16.7	–	–	–	–
Capital adequacy ratio[3] (%)											
Solo basis	–	–	–	–	–	14.5	15.5	15.8	17.4	16.4	18.0†
Consolidated basis	–	–	–	–	–	15.6	16.9	17.3	18.4	17.6	19.4†
Total capital accounts to total assets (%)	–	–	–	14.5	13.6	13.6	13.4	13.1	12.6	11.8	11.7
Profitability											
Return on assets (%)	2.2	1.6	0.9	0.4	0.4	0.4	0.8	1.1	0.9	1.1	1.2
Return on equity (%)	16.3	12.4	6.6	2.9	2.6	3.2	5.8	8.5	7.1	8.8	10.6
Cost to income (%)	–	–	–	72.2	81.8	80.7	71.4	68.9	69.8	67.3	66.4

1 Ratio of to total loans NPL plus gross ROPOA (real and other properties owned and acquired) plus restructured loans.
2 Based on the old BSP framework.
3 CAR computations are based on the framework provided under BSP Circular 280 dated 29 March 2001, which implements Basel I capital standards. Solo basis refers to the head office plus branches, while consolidated basis refers to parent banks and subsidiary financial undertakings (but excluding insurance companies).
Source Bangko Sentral ng Pilipinas. †As of March 2006.

2.1 Economic fundamentals

Although fiscal imbalances were the sore point of the Philippine economy after the regional crisis, it has lately been declining. The national government's budget deficit as a proportion of GDP reached a peak of 5.4 per cent in 2002 but has lately dropped to about 1 per cent. With improvements in the country's fiscal position, public debt as a percentage of domestic output declined from 101 per cent in 2003 to 84 per cent in 2006.

The fiscal deficit had widened after the regional crisis as slow income growth impeded revenue collection, while ample fiscal spending had to be maintained to prevent a recession. The government was initially able to reduce the shortfall through 'spending compression' and subsequently through the implementation of tax reforms (i.e. an increase in the value-added tax and a lifting of VAT exemptions).[8]

Like fiscal deficits, the country's level of external borrowings remains a perennial concern as past crises had been invariably linked to the level of sovereign debt. However, the relevant indicators of a default crisis – one possibly created by a panic-driven withdrawal of foreign capital, specifically loans of short maturity – have lately been benign.

External debt, 70 per cent of which comprises public sector obligations, declined from 68 per cent of GNP in 2001, its highest point in the past decade, to 42 per cent in 2006, allowing foreign receipts (from goods, services and income payments) to cover a greater portion of the country's exposure. The share of short-term foreign debt from the total meanwhile declined from 13–15 per cent during the regional crisis to about 9 per cent in 2006.

The country achieved current account surpluses recently, but these were largely due to an influx of overseas workers' remittances. Large trade imbalances persist and exports have failed to respond as expected to the extended period of real exchange rate depreciation. Exports of other East Asian nations had picked up by 2003 after the bursting of the US technology bubble a couple of years earlier, but the Philippines' foreign sales continued to falter and appeared to recover only in 2006.

The domestic economy visibly started to progress at the beginning of 2002, with GDP expanding at about 5 per cent on average in the ensuing half-decade. Growth has evidently not been high enough or sustainable to achieve East Asian-style prosperity and poverty reduction. However, there is also not enough temptation to undertake extreme countercyclical policies that could spark a crisis (according to 'second-generation' crisis models).

From 2000 to 2005, the Philippines experienced what had been termed as 'jobless growth' with unemployment hovering about 11 per cent despite continuous output expansion. Such a phenomenon, if prolonged, would have compelled policymakers and politicians alike to push for much higher growth in order to make an impact on people's lives. Unemployment, however, has lately declined to 7.9 per cent, easing the pressure somewhat.

2.2 Financial stability

Bank performance in the Philippines deteriorated in the aftermath of the crisis with NPL ratios rising to a high of 17.4 per cent in 2001 (Table 2). The proportion of distressed assets, which additionally includes foreclosed real estate and restructured loans, correspondingly increased to 28.4 per cent that year. From being among Asia's best performers initially, the country's banks suddenly held among the worst portfolios in the region.

Monetary authorities viewed this weakness as rendering the system vulnerable to shocks and contagion effects in the event of major bank failures (Guinigundo 2005a).[9] With banks fearing further declines in asset quality, weak balance sheets were also identified as among the reasons for the observed slowdown in bank lending.

Banks shifted their assets to government securities (mainly Treasury bills and global debt papers) primarily to ensure profitability, an opportune development for the national government in the post-crisis period as it badly needed to finance its deficits. As a result, private banks have become widely exposed to corresponding market and liquidity risks where large and abrupt changes in bond prices potentially bring about excessive losses to the system.

The NPL ratio eventually fell to single digit levels (to 8.2 per cent in 2005 and further down to 6 per cent in 2006) owing to a more accommodative monetary environment and the passage of legislation that encouraged private asset management companies (i.e. special purpose vehicles or SPVs) to dispose of idle assets through special tax and other privileges.[10] These developments also significantly brought down the ratio of distressed assets to about 15.8 per cent.

Current figures, however, remain higher than pre-crisis levels. International rating agencies have in addition questioned the veracity of reported NPLs and shown concern about the quality of accounting in emerging markets, as bad loans are reportedly kept in bank books to avoid required provisioning. Possible lapses in reporting and provisioning for impaired loans and weaknesses of the supervisory and regulatory regime have already been noted in the country by such agencies, according to multilateral observers (ADB 2006).

Notwithstanding initially weak portfolios, banks in the Philippines were able to raise more than the required amount of capital. The capital adequacy ratio (CAR) calculated based on the Basel I formula rose from 14.5 per cent in 2001 to 18 per cent in 2006 on a solo basis and from 15.6 per cent to 19.4 per cent on a consolidated basis (Table 2). These are clearly above the benchmark levels of 10 per cent, as required by the BSP, and 8 per cent, as recommended under the Basel framework. These rates are also much higher than in other crisis countries save for Indonesia.

In contrast, bank profits now provide a smaller buffer to adverse developments since returns on assets and on equity weakened tremendously after the crisis. The decline was partly due to increased loan loss provisioning, which froze a large portion of banks' funds. Indicators have been gradually recovering, but remain well below their 1996 levels (Table 2). Profitability had improved substantially in 2003 as one major commercial bank unloaded a substantial portion of its NPLs (Guinigundo 2005b).

Excessive risk-taking in Philippine banks resulting from inherent moral hazard problems is being remedied through the introduction of reforms in prudential regulation and supervision. Standards were initially strengthened through the adoption of the Basel I framework, which entails risk-weighted measurement of regulatory capital that takes account of both credit risk, including those stemming from off-balance sheet exposures (implemented in 2001), and market risk arising from banks' open positions on bonds, equities, foreign exchange and derivatives (implemented in 2003). The BSP prescribed a minimum CAR that is higher than the Basel requirement in view of a delicate economy and possible weaknesses in loan provisioning and in anticipation of operational risk charges slated under the Basel II framework (Espenilla 2005).

Basel II is set to be implemented in its basic and standardised forms in 2007, with more advanced approaches scheduled to be adopted by 2010 at the earliest. Its three pillars deal with minimum regulatory capital (with weights now assigned to operational risk); an improved supervisory review process that encourages the establishment of sound internal processes within banks; and market discipline through enhanced bank disclosure

While the new regulatory regime creates incentives for banks to improve risk management, there are serious concerns with regard to its implementation. In particular, it may be infeasible in banking systems captured by political and business elites and family-dominated groups, and in countries with regulators lacking technical capacity and institutional independence (ASFRC 2005). Market discipline, for instance, may be difficult to achieve in light of underdeveloped capital markets, family-controlled or state-owned banks, shortsighted shareholders, unreliable accounting information, and the possibility of market analysts' assessments being manipulated.

Risk-sensitive measurement of regulatory capital may also give rise to problems of 'pro-cyclicality' as perception of risk tends to lower minimum capital requirements in a boom, further fuelling demand, and tighten capital standards in a bust, leading to a 'credit crunch' that can prolong a recession. This exaggerates the business cycle and potentially creates financial and economic instability (see the final article by Griffith-Jones and Gottschalk in this *IDS Bulletin*).

It bears noting that capital adequacy, bank profitability and bank loan performance are closely intertwined. NPLs, which have higher risk weights, tend to lower CARs, while also lowering profitability because of the need for increased provisioning. Nonetheless, Philippine banks have been able to achieve high CARs in the presence of weak asset quality and relatively low bank returns over the past several years. According to regulators themselves, the strong level of discipline had presented a 'formidable challenge' given the banking system's severely eroded capital base after the crisis (Espenilla 2005).

As mentioned above, the large amount of NPLs coupled with more stringent regulatory requirements partly explains banks' observed reluctance to intermediate, which in turn reveals why they have so far had significantly less exposure to risks emanating from consumer debt, compared with many of their counterparts in East Asia. Instead of lending out their funds to the private sector, banks operating in the country have chosen to place these in government securities, which have a capital charge of zero, to ensure returns.

But this practice is expected to end soon. Introduction of a capital charge on government securities under the Basel II framework will serve to dampen demand, while a more benign fiscal position will bring down the national government's funding needs.[11] Meanwhile, improved asset quality will allow banks to take on greater risk and seek other, more profitable uses of their funds.

Under the current institutional setup, an important source of regulatory weakness relates to the predominance of financial conglomerates, defined by local regulators as a group of companies under common ownership and control, providing services in at least two different financial sectors (i.e. banking, insurance and securities). The BSP states there are currently about nine universal banks and one commercial bank forming the core of these entities. These banks account for more than half (around 58 per cent) of the financial system's total assets.

Financial conglomerates with opaque ownership structures create vulnerabilities since banks from such networks might in fact be run by persons with conflicting interests (e.g. someone with greater stakes in a financial affiliate that issues and trades securities or in a non-financial and possibly unregulated subsidiary), thus endangering bank capital and deposits. Corporate governance issues especially abound in the Philippines' family-centered conglomerates as firms in such business groups can gain even easier access to credit from affiliated banks, leading to generally higher leverage and greater susceptibility to a downturn (Lim and Woodruff 1998).

These entities intensify the risk of contagion where financial difficulties in one company can trigger a run on an affiliated company. This may occur when not all members of the group have sufficient capital or when the capital of one is linked to the obligations of another (e.g. through complex corporate structures and extensive cross-shareholdings). Conglomerates may also succeed in regulatory arbitrage by transferring risk across asset classes (e.g. into deposits protected by insurance or by securitising assets to evade capital requirements) or by shifting certain activities of regulated firms to unregulated companies.

Some of these concerns are already being addressed under the current regulatory and supervision regime. In 2004, state agencies with regulatory powers (i.e. BSP, the Securities and Exchange Commission, the Insurance Commission and the Philippine Deposit Insurance Corporation) formed the Financial Sector Forum (FSF), a loose, interagency mechanism designed to coordinate supervision and regulation of the financial system and promote information exchange.

It is hoped that the FSF will be able to eliminate regulatory arbitrage and provide the various regulators enough information to effectively monitor intra-group exposures of conglomerates and 'look through' their corporate structures to see whether 'fit-and-proper' rules (for directors and officers) apply. However, whether or not such an arrangement can approximate the effectiveness of having a single, more focused regulatory body in terms of actually unmasking and disciplining erring business groups remains to be seen.

3 Other sources of weakness

The Philippines appears to have gained economic and financial strength over the past decade, but it remains by and large an outlier in the region. Economic growth never breached East Asia's pre-crisis benchmark of above 6 per cent; international reserves, initially built through debt rather than trade surpluses, are much lower than elsewhere in the region; and public sector debt, while declining, still numbers among the highest in Asia as a proportion of domestic output.

Rather than financial fragility *per se*, the country's biggest vulnerability relates to its historically low and erratic development and the failure to effectively leverage for long-term growth. These outcomes are offshoots of flaws in its economic structure and policies as well as its political institutions and governance. Such weaknesses also help explain why the international financial community has been less forgiving of lapses in the management of the domestic economy.

Output growth in the country has been mainly consumption-led, with relatively little set aside for the accumulation of capital needed to sustain growth. Savings as a proportion of GDP has risen from 14 per cent in 1997 to about 20 per cent almost a decade later, but the rate is still low compared with over 30 per cent elsewhere in the region. The failure to achieve high domestic savings, which is often attributed to chronic budget deficits and an inability to sustain economic development, effectively places a cap on domestic expansion, creating a vicious cycle of low, unstable growth.

The export sector remains susceptible to sudden downturns that are out of reach of monetary levers, given its heavy reliance on a few final markets (chiefly, the USA and Japan) and its lack of product diversification, with electronics and semiconductors accounting for about two-thirds of total sales. An import-dependent production structure meanwhile limits the sector's contributions to the domestic economy, preventing it from becoming a powerful engine of growth.

Exports grew rapidly from 1992 to 1999, climbing from less than 30 per cent of GDP to over 50 per cent, but it has underperformed in recent years. The inertia shown in the figures – i.e. the lag in response of foreign sales to a period of sustained real depreciation – suggests the presence of price rigidities and entrenched inefficiencies.[12] Weaknesses stem from past neglect of the sector under a system of high trade protection (i.e. from the 1950s up until the mid-1990s) that had a bias for capital-intensive industries and import-substituting consumer goods and a typically overvalued exchange rate.

With a sluggish domestic economy, there has been a growing reliance on overseas workers' incomes to support growth and stabilise consumption. Workers' remittances have consistently posted double-digit expansion rates since the early 1990s, ultimately allowing GNP to grow by over 6 per cent on average in the last four years (2002–6). Money sent home by the country's migrant workers currently amount to more than 9 per cent of national income and about one-quarter of foreign exchange earnings. Approximately 8.5 million Filipinos (one-quarter of the country's workforce) now work abroad.

Just like the country's exports, remittances are potentially at risk to sudden declines brought about by external disturbances as inflows tend to stream from a few major centres. The largest contributions come from Filipino workers in the Middle East (36 per cent of total remittances, of which 26 per cent originate in Saudi Arabia), North America (9 per cent) and Japan (8 per cent) (Burgess and Haksar 2005). In terms of actual number, around one-third of overseas workers are based in America alone, the largest group recorded, while about one-fifth reside in the Middle East (about 13 per cent in Saudi Arabia).[13]

The ever-increasing role of workers' remittances, while certainly serving as an important economic safety net, also comes at a price. The rising number of migrant workers, for instance, has substantial social costs (e.g. families and little children typically left behind, especially in the case of temporary workers) and also raises the possibility of a 'brain drain' and misallocation of human capital. In addition, the rapid growth of remittances, which substantially boosts national income, may lure the country's leaders and policymakers into complacency, reducing the pressure to tackle badly needed reforms that can improve the performance of the domestic economy.[14]

In this context, the emergence of enterprises based on back-office activities such as business process outsourcing (BPO), which also earn dollars while creating employment within the country's borders, has been viewed as a welcome development. These include call centres and companies engaged in software development, animation, medical transcription and other tasks that have been outsourced by foreign firms (e.g. accounting and human resource and claims processing). BPO export revenues have increased from less than half a billion in 2003 to more than US$2.5 billion in 2006; equivalent to about 2 per cent of GNP.

Electronics and semiconductors and BPOs now lead overall growth in the country's foreign exchange receipts. Even though BPOs earn less than one-tenth of what the electronics industry brings in (i.e. US$2.5 billion versus US$30 billion), it provides work for nearly a third in number, with total labour size exceeding 120,000. The consensus in the industry is that by the end of the decade, the sector will be able to generate around US$10 billion in export revenues and provide employment of approximately 1 million.

As is true for the country's other exports, BPOs cater to a predominantly American market. In

Table 3 Sovereign credit ratings in Asia (long-term foreign currency)

	Moody's			S&P		
Indonesia						
	11/2006	B1		11/2006	BB–	
	5/19/2006	B1	Upgrade	7/26/2006	BB–	Upgrade
	2/27/2006	B2		12/22/2004	B+	Upgrade
	9/30/2003	B2	Upgrade	10/8/2003	B	Upgrade
	6/26/2003	B3		5/12/2003	B–	Upgrade
	3/20/1998	B3	Downgrade	9/5/2002	CCC+	Upgrade
	1/9/1998	B2	Downgrade	4/23/2002	SD	
	12/21/1997	Ba1	Downgrade	11/2/2001	CCC	Downgrade
	3/14/1994	Baa3		5/21/2001	CCC+	Downgrade
				10/2/2000	B–	Upgrade
				4/17/2000	SD	
				9/12/1999	CCC+	
				3/30/1999	CCC+	
				3/29/1999	SD	
				5/15/1998	CCC+	Downgrade
				3/11/1998	B–	Downgrade
				1/27/1998	B	Downgrade
				1/9/1998	BB	Downgrade
				12/31/1997	BB+	Downgrade
				10/10/1997	BBB–	Downgrade
				4/18/1995	BBB	Upgrade
				12/7/1992	BBB–	
Malaysia						
	Moody's			**S&P**		
	12/6/2004	A3	Upgrade	9/2006	A–	
	9/29/2004	Baa1		10/8/2003	A–	Upgrade
	9/25/2002	Baa1	Upgrade	8/20/2002	BBB+	Upgrade
	6/24/2002	Baa2		11/10/1999	BBB	Upgrade
	10/17/2000	Baa2	Upgrade	9/15/1998	BBB–	Downgrade
	7/12/2000	Baa3		7/24/1998	BBB+	Downgrade
	12/3/1998	Baa3		4/17/1998	A–	Downgrade
	9/14/1998	Baa3	Downgrade	12/23/1997	A	Downgrade
	7/23/1998	Baa2	Downgrade	12/29/1994	A+	Upgrade
	6/4/1998	A2		9/13/1990	A–	
	12/21/1997	A2	Downgrade			
	3/15/1995	A1	Upgrade			
	1/20/1995	A2				
	3/15/1993	A2	Upgrade			
	3/12/1990	A3	Upgrade			
	11/18/1986	Baa1				
Philippines						
	Moody's			**S&P**		
	11/2006	B1		2/2006	BB–	
	2/16/2005	B1	Downgrade	1/17/2005	BB–	Downgrade
	11/9/2004	Ba2		4/24/2003	BB	Downgrade
	1/27/2004	Ba2	Downgrade	2/21/1997	BB+	Upgrade
	11/26/2003	Ba1		5/30/1995	BB	Upgrade

Table 3 (cont.) **Sovereign credit ratings in Asia (long-term foreign currency) – cont.**

Philippines (cont.)						
	Moody's			**S&P**		
	5/18/1997	Ba1	Upgrade	6/30/1993	BB–	
	1/23/1997	Ba2				
	5/12/1995	Ba2	Upgrade			
	7/1/1993	Ba3				
Korea						
	Moody's			**S&P**		
	11/2006	A3		7/27/2005	A	Upgrade
	3/28/2002	A3	Upgrade	7/24/2002	A–	Upgrade
	2/6/2002	Baa2		11/13/2001	BBB+	Upgrade
	12/16/1999	Baa2	Upgrade	11/11/1999	BBB	Upgrade
	8/23/1999	Baa3		1/25/1999	BBB–	Upgrade
	2/12/1999	Baa3	Upgrade	2/18/1998	BB+	Upgrade
	4/9/1998	Ba1		1/16/1998	B+	
				12/22/1997	B+	Downgrade
				12/11/1997	BBB–	Downgrade
				11/25/1997	A–	Downgrade
				10/24/1997	A+	Downgrade
				5/3/1995	AA–	Upgrade
				10/1/1988	A+	
Thailand						
	Moody's			**S&P**		
	11/26/2003	Baa1	Upgrade	10/31/2006	BBB+	
	10/2/2003	Baa3		9/19/2006	BBB+	
	6/21/2000	Baa3	Upgrade	8/26/2004	BBB+	Upgrade
	4/3/2000	Ba1		10/8/2003	BBB	Upgrade
	12/21/1997	Ba1	Downgrade	1/8/1998	BBB–	Downgrade
	12/1/1997	Baa3	Downgrade	10/24/1997	BBB	Downgrade
	11/27/1997	Baa2	Downgrade	9/3/1997	A–	Downgrade
	10/2/1997	Baa1	Downgrade	8/1/1997	A	
	4/8/1997	A3	Downgrade	12/29/1994	A	Upgrade
	8/1/1989	A2		6/14/1989	A–	

Note For Moody's, a rating of Baa indicates the presence of 'moderate credit risk'. The equivalent rating for Standard & Poor's (S&P) is BBB (i.e. the sovereign issue described as 'adequate').
Source AsiaBondsOnline, ADB (as of February 2007).

addition, the BPO industry, which is based primarily in the country's metropolitan areas, has been less able to mobilise the lower-skilled members of the workforce. The greater challenge for poverty reduction in the country is how to move the larger number of unemployed in the rural areas into labour-intensive sectors, such as manufacturing.[15] This divide is made evident by the growing scarcity of skilled, English-proficient workers, said to be the sector's biggest impediment to growth. While the IT-enabled sector certainly helps to generate much-needed foreign exchange and to stimulate economic activity, emerging bottlenecks highlight the need for reforms in other areas, such as education.

The episodic nature of growth in the Philippines up until the 1980s had been attributed to inward-looking policies and the inability to pursue reforms as well as an inauspicious macroeconomic environment resulting from highly politicised management of economic institutions. A period of change followed where key sectors of the economy were liberalised and key institutions reformed (e.g. creation of a 'new' and more independent central bank), and this

Table 4 Philippine balance of payments: net capital and financial flows and OFW remittances (US$ billion)

	1999	2000	2001	2002	2003	2004	2005	2006
Net capital and financial flows	4.185	3.363	0.911	1.056	0.726	–1.630	2.229	–1.722
Net capital flows	0.163	0.138	0.062	0.027	0.054	0.017	0.040	0.136
Net financial flows	4.022	3.225	0.849	1.029	0.672	–1.647	2.189	–1.858
Direct investment	1.114	2.115	0.335	1.477	0.188	0.109	1.665	2.242
Portfolio investment	3.315	–0.553	1.027	0.746	0.562	–1.713	3.475	2.744
Financial derivatives	0.008	0.044	–0.015	–0.021	–0.064	–0.027	–0.043	–0.138
Other investment	–0.415	1.619	–0.498	–1.173	–0.014	–0.016	–2.908	–6.706
Current account balance	–2.874	–2.225	–1.744	–0.279	0.288	1.628	1.984	5.022
Goods and services	–7.597	–7.841	–8.553	–7.532	–7.814	–7.461	–9.113	–7.624
Income	–1.061	–0.027	–0.051	–0.427	–0.284	–0.071	–0.294	–0.543
Current transfers:	5.784	5.643	6.860	7.680	8.386	9.160	11.391	13.189
of which workers' remittances	5.212	5.161	6.328	7.167	7.681	8.617	10.668	12.481
Overall BOP position	3.591	–0.509	–0.202	0.810	0.115	–0.280	2.410	3.769
(% of GDP)	4.7	–0.7	–0.3	1.1	0.1	–0.3	2.4	3.2
(% of GNP)	4.5	–0.6	–0.3	1.0	0.1	–0.3	2.3	2.9
Net unclassified items	2.280	–1.647	0.631	0.033	–0.899	–0.278	–1.803	0.469
Memo items:								
Change in commercial banks' net foreign assets	–1.835	0.891	–0.337	–0.604	–0.542	–0.152	–1.531	–4.656
OFW cash remittances	6.022	6.050	7.721	8.607	9.093	10.261	12.292	14.036
of which channelled through the banking system	†	†	6.031	6.886	7.579	8.551	10.689	12.762

† There is no differentiation made between total Overseas Filipino Workers (OFW) cash remittances and remittances channelled through the banking system during the years 1999 and 2000, which represents the transition years of the revised foreign exchange monitoring report form of the BSP.
Source Bangko Sentral ng Pilipinas (BSP).

succeeded in improving economic performance by the mid-1990s. However, the era of reform did not last long – a number of policies have either been stalled, undone or reversed since then – leading one to conclude that the root of the country's problems invariably stem from its poor governance and unstable personality-based politics.

Indeed, many problems related to the country's weak institutions survive in the present. Political legitimacy issues continue to hound the administration of President Gloria Macapagal-Arroyo, who had gained power through quasi-constitutional means in 2001, then was accused of vote-rigging in the 2004 presidential elections. This had made it extremely difficult for the Macapagal-Arroyo government to pursue economic reforms, especially if such were widely believed to be unpopular. Passage of a much-needed tax reform law to address rising fiscal deficits, for instance, was repeatedly delayed and almost appeared to have been shelved because of strong opposition shown by some sectors.

Gridlocks in the legislature have also created uncertainty, with detrimental effects on the economy. Widely seen as a ruse by the ruling party to stay in power, the recent attempt to change the country's Constitution and shift to a parliamentary system has created animosity between the two houses of Congress, as the desired shift to a parliamentary system pushed by the Lower House would in effect abolish the Senate. Mutual misgivings subsequently led to an impasse on budget-related legislation and for a time, restrained fiscal spending. Further standoffs on important laws are to be expected as the possibility of an opposition-dominated Senate after the elections in 2007 looms large.

The combination of weak institutions and decades of boom-and-bust growth (i.e. not managing growth for four consecutive years) helps explain why the international financial community has been reluctant to lay a wager on the prospects of the Philippine economy. This held true even after the country had performed outstandingly during the regional crisis.

Table 3 shows how the sovereign credit rating agencies have been much more forgiving of the other crisis-affected countries in the region after the crisis. Korea and Malaysia were able to merit an upgrade within 1–2 years and Thailand within about three years. Among the five affected economies, Indonesia and the Philippines have both yet to receive an investment grade rating. In contrast to its neighbours, however, the Philippines had been receiving downgrades beginning 2004, on account of its worsening fiscal position and political climate.

Hence, the country has had weak access to external credit, with repercussions on output as a country with low domestic savings and a lack of internal sources of funding for investments invariably necessitates seeking external sources.

4 Coping with a capital boom

The sentiment of foreign investors, however, appears to be shifting recently. Most investment banks are now issuing favourable reports regarding growth prospects in the country and there are growing signs of an impending capital boom.

The Philippines has been recording current account surpluses since 2003, owing largely to the growing amount of money being sent home by the country's migrant workers (Table 4). Net current transfers, the majority of which comprised workers' remittances, more than doubled from US$5.8 billion in 1999 to US$13.2 billion in 2006.

Substantial inflows have also begun to enter the country recently, in the form of financial investments. Direct investment inflows amounted to about US$1.7 billion net in 2005 and around US$2.2 billion in 2006, while net portfolio inflows came to around US$3.5 billion and US$2.7 billion, respectively. The latter followed the trend elsewhere in Asia, where high global liquidity streamed into emerging markets seeking higher returns and producing almost simultaneous currency appreciations and equity market booms.

Although the influx of capital is certainly welcome to help finance the country's growth, there is reason to be wary of a financial boom. Recent global crises were mainly brought about by fragilities created by financial excesses (Kaminsky 2003).

In a typical depiction (e.g. McKinnon and Pill 1994), capital injections into economies with weakly regulated financial sectors lead to over-lending by banks that in turn precipitate consumption booms and create asset price bubbles (e.g. in the stock and real estate markets). Over-extended banks thus become increasingly vulnerable to a recession –

Figure 2 HP-detrended CPI

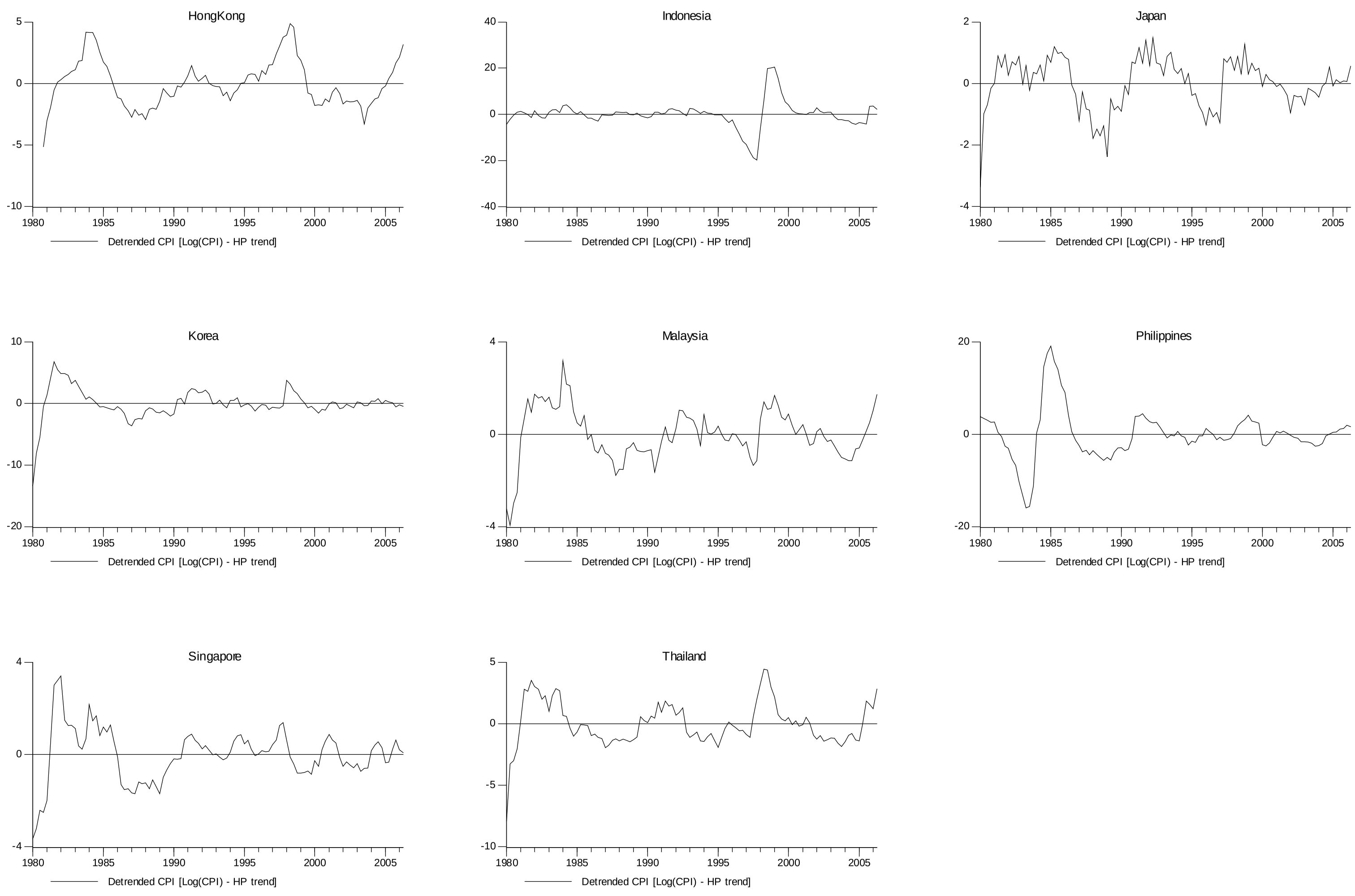


Figure 3 HP-detrended GDP

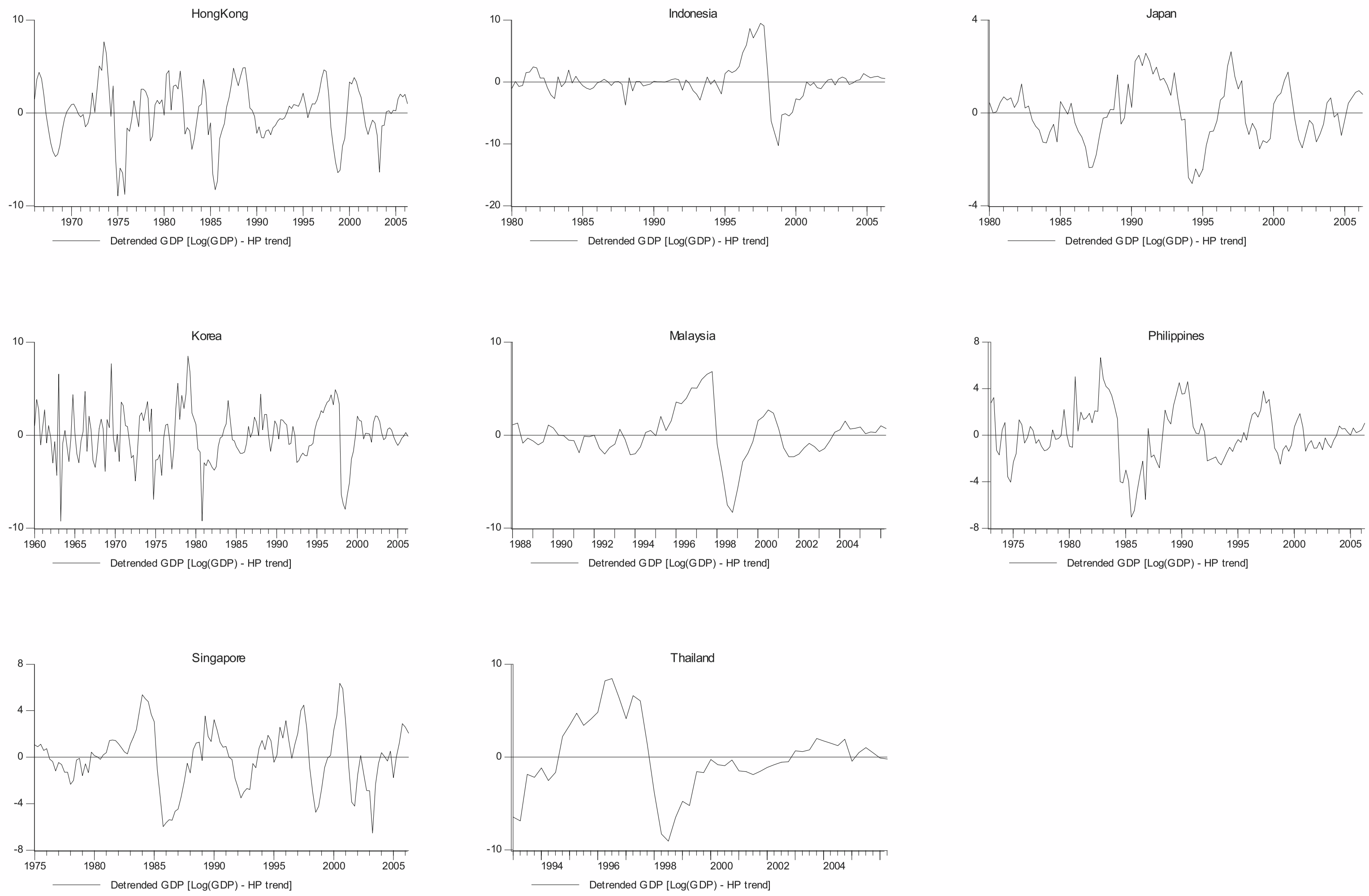


Figure 4 HP-detrended housing prices

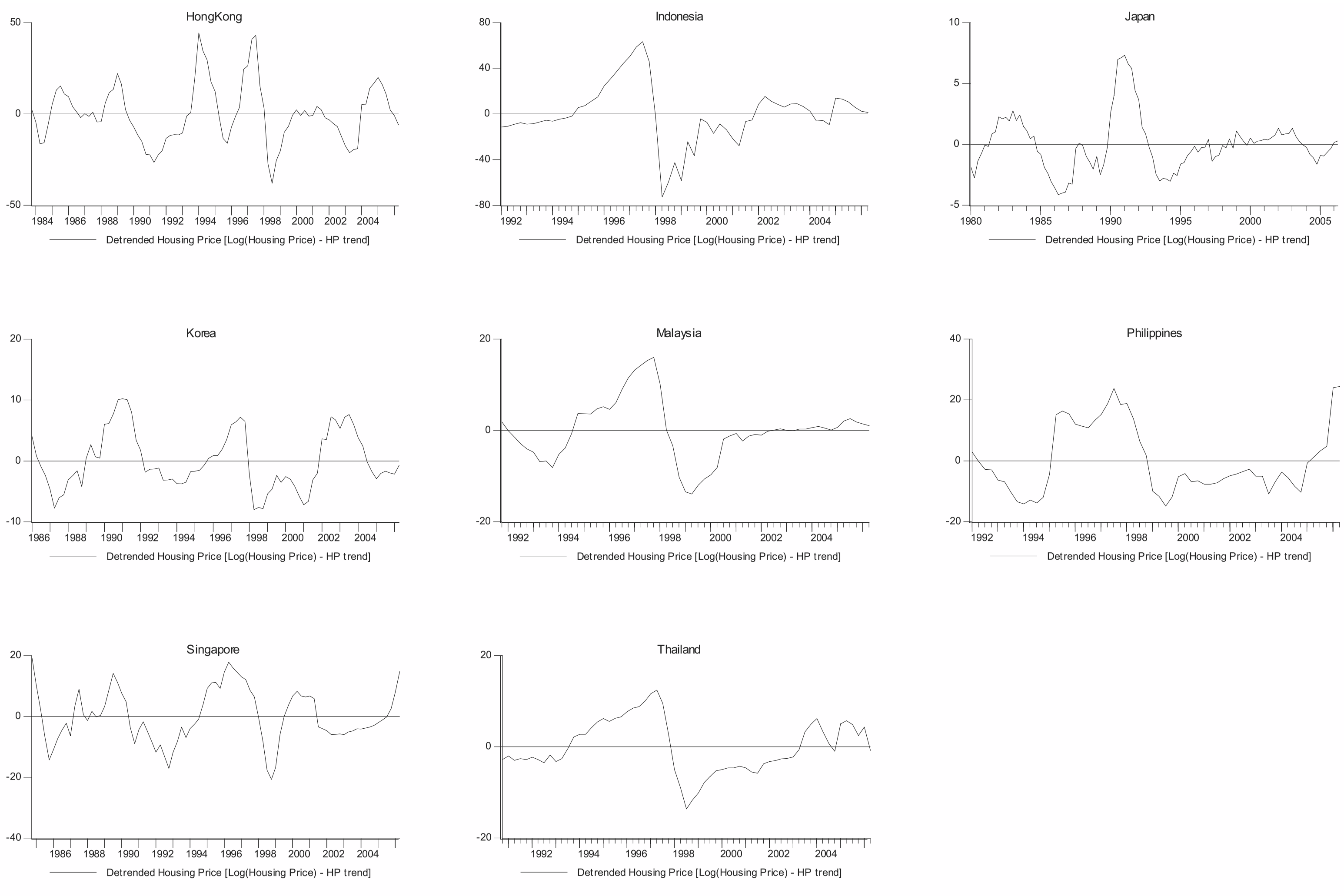
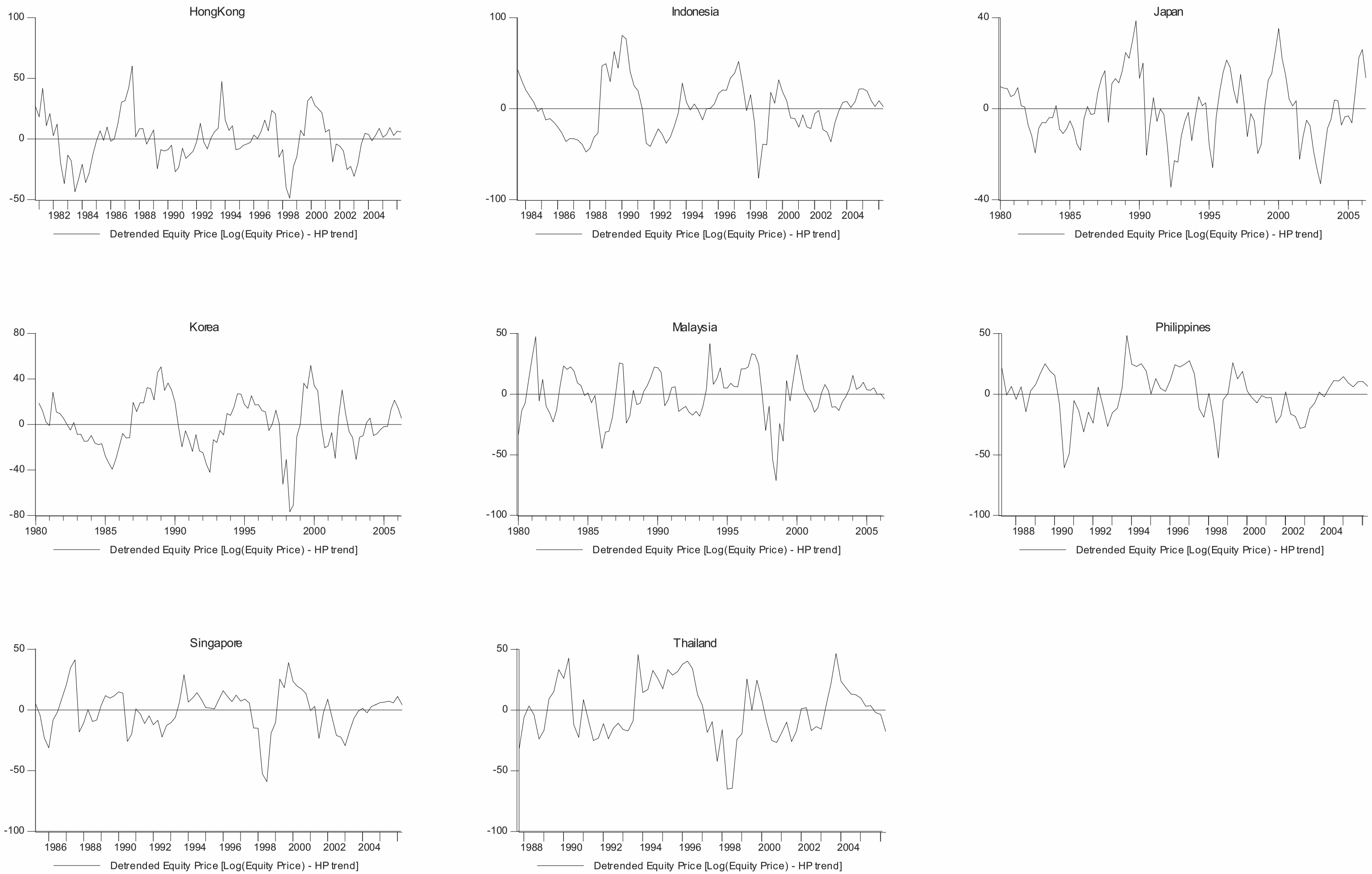


Figure 5 HP-detrended equity prices



possibly one brought about by real exchange rate appreciation and current account deterioration – and an eventual bursting of asset bubbles, to which they may have been widely exposed. The result is a currency crash, since a fragile financial sector makes the domestic currency exceedingly costly to defend.

Looking at relevant macroeconomic variables, a similar scenario played out in affected countries during the regional crisis (Figures 3–6). Focusing on the Philippines, one can see how the years preceding the period of sharp currency declines in the late 1990s had been characterised by booming asset prices (in equities and housing) that were clearly above the existing trend.

The same held true for output, albeit to a much lesser extent, but oddly not for consumer prices, which did not behave unusually prior to the unwinding of financial imbalances. Liquidity, however, had been high, with reserve money growing by over 10 per cent (to over 12 per cent of GDP), broad money by about 20 per cent, and domestic credit by nearly 40 per cent (Table 1).

There have been analogous signs of asset price booms recently, e.g. the peso has been strengthening, the equity market has been on a roll and property prices have been rising due to purchases by overseas workers (Table 1, Figures 5 and 6). Housing prices, in particular, have lately been far above trend and seem to be rising spectacularly. Meanwhile, output and inflation remain benign, masking potential risks should asset prices suddenly reverse course. Reserve money as a proportion of domestic output had been declining since 2003, but recently soared to its pre-crisis level.

Hence the old problems of monetary management are emerging, as the Mundell-Fleming dilemma remains intact. The central bank's decision to repay its foreign loans and accumulate reserves has helped keep the peso from drastically appreciating, but has also served to bloat domestic liquidity. Reserve money dramatically expanded by about 48 per cent in 2006 (to a level equivalent to about 12.5 per cent of GDP). The same is true of broad money, by some 18 per cent (to about 57 per cent of GDP). Monetary authorities, however, have visibly failed to sterilise inflows, at least in the traditional sense, with central bank domestic assets even expanding during the period.

Supposedly recognising the futility of trying to manage the exchange rate while attempting to control domestic liquidity, the Philippines along with several other crisis countries in Asia adopted an inflation targeting monetary regime. However, even in the literature, it is not very clear how such a framework can handle the dilemmas posed by large capital flows – especially given current realities in export-oriented economies with underdeveloped financial systems – without eventually bringing up some form of capital control.[16]

Moreover, looking solely at the inflation mean, which is the crux of pure inflation targeting, may miss out on possible signals of financial imbalances and future financial strains. As we have seen, capital surges hinder effective monetary management and can bring about boom-and-bust cycles in asset markets or even a currency crash. Philippine monetary authorities may thus fail to detect future crises (and even future sources of inflation) if they do not also consider the behaviour of other variables such as the level of household debt and asset prices when conducting monetary policy.

Fortunately, another crisis may yet be averted as asset market booms are still in their nascent stages. Easy money has not yet created the dreaded over-lending and over-borrowing cycles, with domestic credit indicators remaining at safe levels (Table 1). Credit extended to firms and households, in particular, has yet to regain its original pre-1998 pace, while broad money as a fraction of the country's reserves, the conventional 'credit boom' indicator, has not budged substantially from its 1999 position.

The rise in the stock market is likewise in its budding phase (and may have already dampened by the time this article is printed). Chinese equities have recently suffered a downturn (February 2007), sending stock markets around the world tumbling, but there are indications that investors may soon be clambering back to certain emerging markets in East Asia, where fundamentals are perceived to be firmly in place.

Moreover, looking at banks' balance sheets, one notices a sharp rise in net foreign assets (NFA) since 2004, which is the exact opposite of the steep fall into negative territory that had occurred just before the crisis. This trend is mirrored in the country's financial account as a net outflow of about US$1.5 billion in 2005, when commercial banks were able to build-up their foreign assets through currency and liquid deposits, and about US$4.7 billion in 2006, when they took advantage of cheap dollars to cut down their short-term foreign currency debt.

There has been, in short, no wide-scale foreign currency borrowing and re-lending similar to that which occurred previously. Inflows, which are largely comprised of overseas workers' remittances, allowed unabated accumulation of NFA by private banks, indicating some self-insurance at the micro-level and greater stability overall (albeit not necessarily greater bank efficiency).

5 Concluding remarks

There has been a marked improvement in the Philippine economy in terms of the indicators one typically looks at in assessing vulnerability to crisis. The exchange rate has been afforded some degree of flexibility, the country's fiscal position has improved after worsening radically and external debt levels have substantially declined. More recently, because of large inflows from its overseas workers, the country has been able to post current account surpluses and consequently build-up a robust level of international reserves. Banks likewise have healthier portfolios and higher capital adequacy ratios owing to a more disciplined regulatory environment.

But much still needs to be done in terms of improving the financial sector, as banks still carry the heavy burden of financing the needs of the economy. While tighter regulation has been able to buffer some of the currency mismatches of financial institutions, currency as well as maturity mismatches still remain, with the latter vulnerabilities more suitably addressed by developing the domestic capital market. This reform is crucial to lessening the risk and increasing the soundness of the entire financial system.

Also, as we have emphasised, old weaknesses remain in terms of the country's economic structure and political pre-conditions for prosperity. The fiscal picture, for instance, while it has significantly improved, remains a concern given the large temptation to backtrack on reforms and the unpopularity of any new tax measure. Improving the country's fiscal position and increasing national savings, however, are important ways, as investment bankers would put it, to boost the country's stock.

Because of its reliance on a few major markets for its exports of goods and services and arguably even remittances, the country remains highly vulnerable to slowdowns elsewhere in the world, especially a US slump. There is clearly a need to strengthen domestic drivers' growth, ideally one that is based on private investment. One thus sees a golden opportunity in the overflow of remittances that have yet to be leveraged in a manner that can support the country's long-term growth.

Given a possible capital boom, the immediate concern is resolving the dilemma the country's monetary managers face. What is clear, however, is that monetary authorities will need to look beyond the inflation rate and widen the variables it looks at, i.e. look more closely at other asset prices apart from the exchange rate, as such variables foretell a future bust.

In the final analysis, political legitimacy and governance issues remain the main reasons for the failure of government to institute and sustain reforms sufficient to effectively leverage for growth.

Notes

1 The Philippines was one of the few countries in the region that did not escape the 1980s debt crisis, earning it the much-abused moniker 'Latin American country in Asia'.

2 Capital inflows in the presence of currency overvaluation tend to favour non-tradable sectors such as real estate and construction. In the Philippines, the bias towards consumption over investment further increased the risk of asset bubbles developing in the non-traded goods sector (Gochoco-Bautista and Canlas 2003).

3 Crisis-afflicted countries such as Malaysia, Korea and Thailand shared the following conditions: benign fiscal positions, manageable real appreciation of domestic currencies and capital account surpluses that translated to current account imbalances (and not vice versa). Financial liberalisation that occurred earlier in the decade led to an accumulation of short-term private debt in foreign currency (and subsequent financial collapse) mainly because of lack of prudential regulation and supervision of financial intermediaries combined with implicit guarantees.

Ironically, these countries borrowed in foreign currency in exceedingly large proportions despite high domestic saving rates.

4 As in the other countries, local monetary authorities were torn between allowing the peso to fall, which could fuel inflation and increase the domestic value of foreign currency debt of banks and companies, pushing them to bankruptcy, or defending the domestic currency through high interest rates, which could generate a recession and cause certain banks to fail.

5 Unless otherwise indicated, all figures mentioned in this section are summarised in Table 1.

6 Most currency crisis models view an exchange peg as being central to the policy dilemma monetary authorities face (basically, the 'impossible trinity' of the Mundell-Fleming framework), which in turn serve as enticements for speculative play.

7 Its inverse, the ratio of M2 to reserves, is the typical 'credit boom' indicator and has served as a reliable leading indicator of currency crises in empirical studies (e.g. Kaminsky *et al.* 1998; Kaminsky 2003).

8 It is noted that such compression would not be necessary, if only the national government plugged its revenue leaks. Redundancy of fiscal incentives granted to certain firms and enterprises, for example, had been responsible for foregone income amounting to about P45.8 billion or 1 per cent of GDP in 2004 based on data from the Board of Investments (Reside 2006).

9 In the literature, bank sector weakness is dreaded for its potential effect on liquidity growth as monetary authorities might be forced to bail out troubled financial institutions; the end result being a balance-of-payments crisis and a currency crash (e.g. Diaz-Alejandro 1985).

10 By end-2005, around P97 billion worth of non-performing assets (which includes NPLs and certain types of real and other properties owned and acquired) were sold through the implementation of the SPV Act, reducing the existing stock by about 19 per cent. The law was extended for another two years in early 2006. The BSP has stated this would facilitate disposal of troubled assets worth about P100 billion in half a year.

11 Under the standardised approach of Basel II, national government securities will have a credit-risk weighting of 100 per cent as Philippine debt has an external credit rating of below investment grade. Moving up the ratings ladder will allow the risk weight to fall (e.g. to 0 per cent for triple-A credit).

12 One thread in the 'new open macroeconomics' literature, for instance, argues that depreciations may fail to have expenditure-switching effects if the market structure is such that exporters fix the price of their goods at the currency of the consumer (see Engel 2002 for a summary). This is an area of research that will surely require special attention.

13 Nearly half of the country's migrant workers are permanently based abroad (primarily in America, Canada and Australia) and thus have a weaker incentive to send money to relatives as they are able to eventually relocate their families (Tan 2006).

14 Pernia (2006), for instance, argues that the remittance bonanza has kept the government from pursuing 'real policy reforms' (e.g. a population policy) that can raise the performance of the domestic economy and reduce the need for overseas employment. Note though that the growth in numbers of dollar-earning Filipinos (estimated at about 10 per cent of the population), who are now also allowed to vote, serves to weaken the bias for exchange rate appreciation and hence prevent currency overvaluation, thereby addressing a crucial economic weakness.

15 It is hoped that the growth of BPOs will serve as a catalyst for growth in other sectors. The real estate market in Metro Manila, for example, has significantly tightened because of BPO activity, with positive implications for the banking system. Meanwhile, the industry's boom is also expected to encourage infrastructure development, thus generating more jobs.

16 Thus, in December 2006, in response to huge capital inflows that had appreciated the baht, inflation targeter Thailand imposed a tax on inward portfolio investment similar to that used in Chile. Equity prices fell by 15 per cent in just one day and controls were quickly removed from equities (but not for debt). It is for a similar reason – the ability to drive away investors – that the BSP is averse to imposing any form of capital control. This is apart from the Philippines' past experience with exchange controls (i.e. for most periods between the 1950s until 1992), which had been difficult to administer and prone to abuse.

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