**FOR AGENDA**

SM/02/266

CONTAINS CONFIDENTIAL INFORMATION

August 20, 2002

To: Members of the Executive Board

From: The Acting Secretary

Subject: **Philippines—Selected Issues**

This paper provides background information to the staff report on the 2002 Article IV consultation discussions with the Philippines and post-program monitoring discussions (EBS/02/148, 8/13/02), which is tentatively scheduled for discussion on **Wednesday, September 11, 2002**. At the time of circulation of this paper to the Board, the Secretary's Department has not received a communication from the authorities of the Philippines indicating whether or not they consent to the Fund's publication of this paper; such communication may be received after the authorities have had an opportunity to read the paper.

Questions may be referred to Mr. Felman (ext. 34138) and Mr. I. Lee (ext. 36763) in APD.

Unless the Documents Section (ext. 36760) is otherwise notified, the document will be transmitted, in accordance with the procedures approved by the Executive Board and with the appropriate deletions, to the WTO Secretariat on Wednesday, August 28, 2002; and to the Asian Development Bank, the European Investment Bank, the Food and Agriculture Organization, and the United Nations Development Programme, following its consideration by the Executive Board.

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INTERNATIONAL MONETARY FUND

PHILIPPINES

**Selected Issues**

Prepared by Il Houng Lee, C. Duenwald, B. Bakker, (all APD), G. Inchauste (FAD), B. Baldwin (MAE), I. Lukonga (PDR), and Jaewoo Lee (RES)

Approved by Asia and Pacific Department

August 19, 2002

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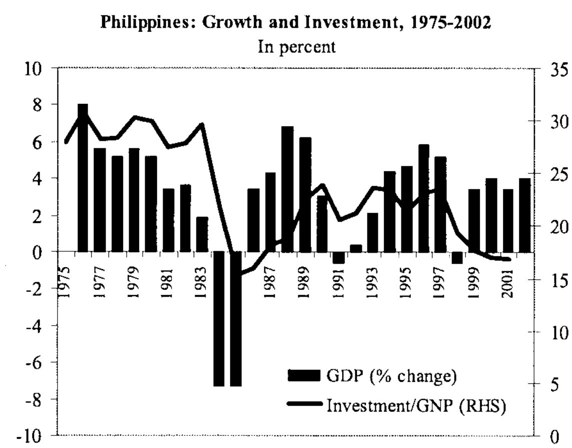
## I. Philippines: Economic Developments Since the Crisis of the 1980s and Remaining Agenda[1]

1. **The crisis of the early 1980s prompted a sharp reorientation of the government's policies, away from state direction and toward an open and competitive economy.** Nevertheless, developments in the 1990s revealed several weaknesses that still need to be addressed if the Philippines is to enter a sustainable growth trajectory. The historical experience, and the remaining agenda, is the subject of this chapter.

### A. The 1980s: Crisis and Response

2. **Economic policies in the 1970s encouraged import-substitution and capital-intensive industries.** Initially, this policy appeared to work as the economy grew by about 6 percent a year, supported by investment that hovered at about 30 percent of GNP. However, this investment boom was financed by large accumulation of debt, much of it external. Indeed, the external debt stock almost doubled in a mere three years to 54 percent of GNP during 1977-1980. Meanwhile, there was a similar expansion of domestic credit, much of it provided by government-owned banks that were involved in directed lending to "strategic" sectors.



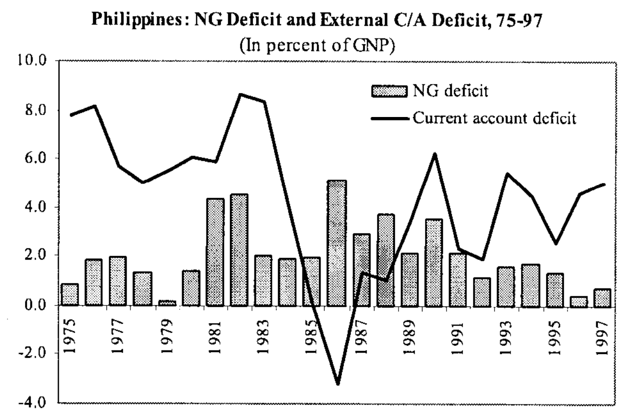

3. **Eventually, these debts began to strain the economy.** Nonperforming loans grew, creating balance sheet problems for the government-owned banks. In response, the central bank eased their liquidity problems to such an extent that it undermined its own balance sheet as well as the banks' incentive to properly assess credit risks. Meanwhile, on the fiscal front, various incentives provided to the industrial sector led not only to a misallocation of resources, but also to a severe loss of government revenue. With the fiscal balance deteriorating and investment remaining robust, the external current account widened to around 6 percent of GNP during the second half of the 1970s.

4. **In the early 1980s, the country suffered a foreign exchange crisis.** The current account deficit worsened further to 9 percent of GNP following the second oil shock. At the same time the debt service burden increased substantially as foreign interest rates rose to exceptionally high levels. Creditors consequently became cautious and foreign financing dried up; the level of official reserves fell from $3 billion in 1980 to less than $1 billion by

[1] Prepared by Il Houng Lee (APD).

1983. In the same year, the Philippines declared a debt service moratorium on a stock of external debt that by then had risen to 80 percent of GNP. The authorities were also forced to float the peso, whose value then plummeted by 80 percent during 1983-84 against the U.S. dollar. In the wake of these movements, the economy contracted by a cumulative 17 percent—still one of the largest output falls in modern times.

5. **The crisis prompted a wide-ranging reassessment of the economic strategy which had led to the disaster**. By 1986, President Aquino assumed office, determined to change the country's course and open up and liberalize the economy. However, the administration faced daunting challenges. Political instability, including six coup attempts, marked the first three years of the Aquino administration. In addition, a series of shocks, such as natural disasters and power shortages, complicated macroeconomic management.




6. **Nonetheless, much was accomplished (see Annex I)**. To strengthen the fiscal position, the tax system and public financial institutions were reformed and steps taken to privatize nonfinancial public enterprises. Quantitative restrictions were virtually eliminated, and average tariff rates were reduced from 28 percent in 1985 to 8 percent by the end of the 1990s. Other structural reforms included establishing a new and central bank (1993), opening up the banking system to new foreign banks (1994), opening the door to foreign investment (1991), and liberalizing the telecommunications (1993), aviation (1995), oil (1996), and electricity (2001) sectors. Moreover, a far-reaching contracting-out program was launched to encourage the private sector to build up the country's infrastructure, including encouraging independent power producers (1990), and what was at the time (1997) the world's largest water privatization—for Manila's water supply. Also, a Comprehensive Agrarian Reform Program (CARP) was launched in 1988.

## B. Performance From Aquino to the Asian Crisis

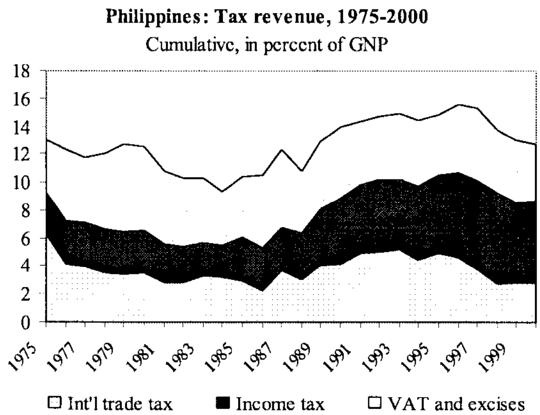
7. **As these policies began to take hold, economic performance improved**. The 1986-97 period witnessed a restoration of financial stability and a recovery in growth. In particular:

- **Fiscal revenue improved steadily through 1997**. Revenue rose from 11 percent of GNP in 1984 to 18 percent of GNP in 1997. Much of this increase stemmed from a steady improvement in tax administration. In

Fiscal Revenue (in percent of GNP)

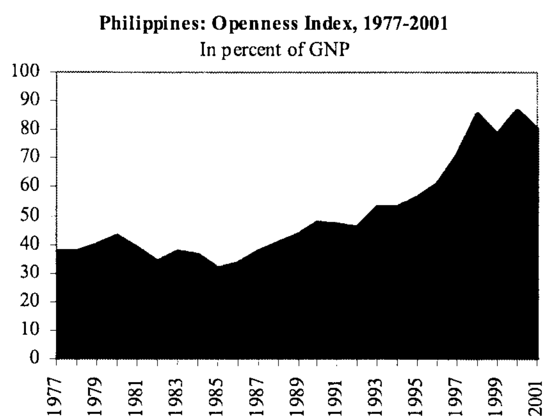
| | 1984 | 1997 | Diff |
|---|---|---|---|
| Current revenue | 10.8 | 18.0 | 7.2 |
| Tax revenue | 9.5 | 16.1 | 6.5 |
| Income tax | 2.3 | 6.4 | 4.1 |
| VAT and excises | 3.8 | 5.2 | 1.4 |
| Int'l trade tax | 3.2 | 3.7 | 0.5 |
| Other taxes | 0.2 | 0.8 | 0.5 |
| Nontax revenue | 1.2 | 1.9 | 0.7 |

Source: Government Finance Statistics and staff est.

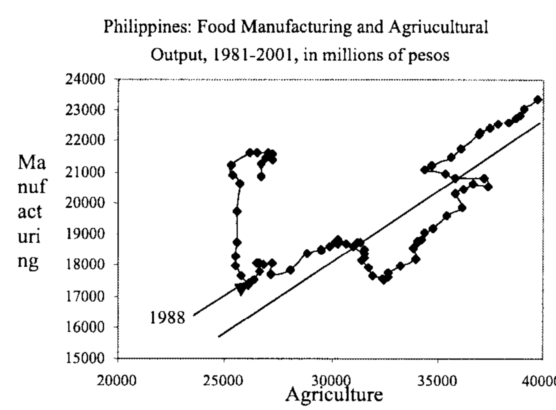



addition, the government enacted a major tax reform in 1986, which included changes in the individual and corporate income tax, the adoption of a VAT, and abolition of most export duties.[2] These efforts produced a large increase in income taxes, as well as higher receipts from VAT, excise taxes, and import duties—the latter in spite of sizable reductions in the effective tariff rate.

- The response to **trade liberalization** was also noteworthy. International trade, as measured by the openness index, almost doubled during the 1986-97 period. To a large extent, the increase is attributed to the electronics industry, whose share rose from 20 percent of total merchandise exports in 1991 to about 60 percent in 1998.




- **The impact of the agrarian reform** also became evident in 1988, when both agricultural as well as food manufacturing output (as measured in value-added terms) started to pick up—a marked contrast to the stagnation in agricultural output and the decline in food manufacturing, respectively, during the early to mid-1980s. The growth in food manufacturing became the main force behind the growth in the overall manufacturing sector.




- The strategy of inviting the private sector to participate in **build-operate-transfer** (BOT) and similar

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[2] There was also a second major reform in 1998, which expanded the VAT base, rationalized excise and oil product taxes, and amended to income tax legislation.

schemes has proved successful in building up the country's infrastructure. Since the BOT law was passed in 1990, the private sector has participated in 111 infrastructure projects, according to the World Bank (2002). More specifically, the authorities signed purchasing power agreements (PPA) with various independent power producers (IPPs) to address the power shortage of the early 1990s. In all, 36 power projects were signed under Executive Order 215, with an estimated total capital cost of US$26 billion.

**At the same time, important weaknesses remained.**

- **Despite the BOT schemes and some increase in public investment (during the mid-1990), infrastructure remained poor, discouraging private sector investment**. According to recent data from the World Bank, only about two third of households have access to power, which compares with 90 percent in Thailand and Malaysia. Furthermore, the amount of paved roads is comparable to Malaysia—a

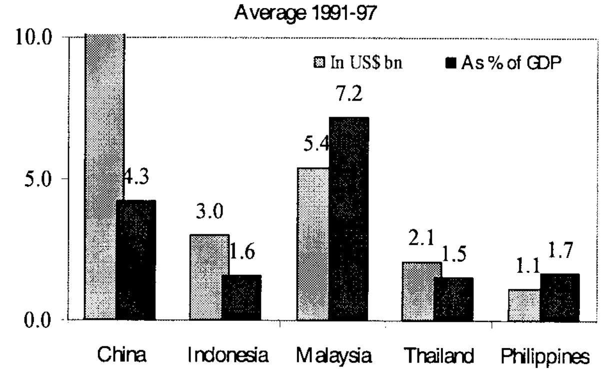
| | Philippines | Indonesia | Malaysia | Thailand | Korea | Middle income |
|---|---|---|---|---|---|---|
| Per capita power consumption | 451 | 320 | 2554 | 1345 | 4497 | 1367 |
| Access to power (% of households) | 65 | 39 | 92 | 87 | 97 | ... |
| Urban water access (% of population) | 92 | 91 | 95 | 89 | 97 | 93 |
| Rural water access (% of population) | 80 | 65 | 94 | 77 | 71 | 68 |
| Paved roads (%95-99) | 21 | 46 | 76 | 97 | 75 | 48 |
| Telephone mainlines per 1000 | 39 | 27 | 203 | 86 | 438 | 121 |

Source: World Development Report, 2000 (World Bank)

country with one-third the Philippines' population. Moreover, while the BOT initiatives have expanded the country's infrastructure at minimal initial cost to the budget, they have significantly increased the contingent liabilities of the government, and pushed the cost of power up to amongst the highest in Asia.

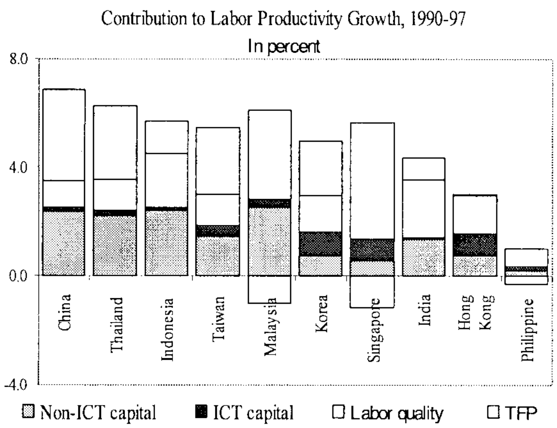
- **Even though the economy was liberalized and doors were opened to foreign investment, foreign direct investment to the Philippines**

Foreign Direct Investment
Average 1991-97

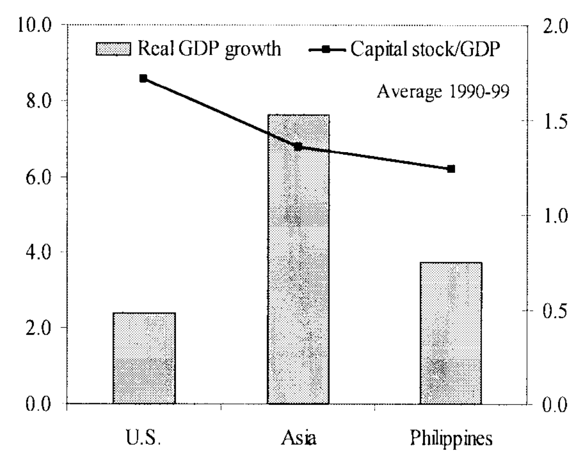



Source: World Economic Outlook and staff estimates.

**remained one of the lowest in the region in U.S. dollar terms**. FDI in the Philippines during 1991-97 was only half of that in Thailand and a third of that in Indonesia. Both the Economist Intelligence Unit Business Environment Rankings (on business environment) and the World Economic Forum Rankings (on overall competitiveness) placed the Philippines below Malaysia, Thailand, and Indonesia. Moreover, as discussed below, the positive spill over from FDI into the electronics sector to the rest of the economy has yet to be realized.




- **The productivity increase during the 1990s was poor.** Whereas other Asian economies (Korea, Indonesia, Taiwan POC, Hong Kong SAR, Thailand, China, India, Singapore, and Malaysia) on average achieved one sixth of their growth from total factor productivity (TFP), the Philippines actually recorded a small negative TFP growth during 1990-97.[3] Even the productivity gain from capital deepening in the Philippines' electronics sector was smaller than other countries. The problem was less with the level of the capital stock, which as a percent of GNP is broadly similar to other Asian countries. Rather it was with its efficiency. The large capital stock reflects investments in unproductive sectors during the 1970s and early 1980s that now weigh down average productivity. Also, a large proportion of new investments during the 1990s were channeled into construction and manufacturing, which did not yield returns because of the Asian crisis.

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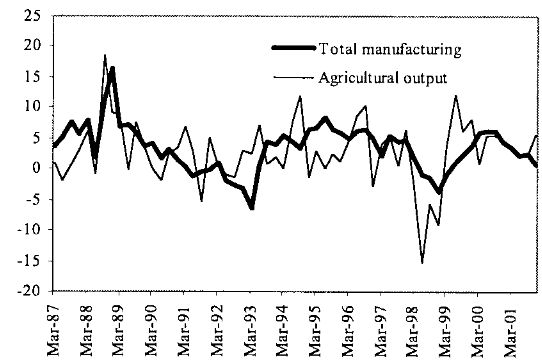
[3] Based on a production function Y = F(A, K, T, L), which can be parameterized as $\Delta \ln y = g + \alpha_K \Delta \ln k + \alpha_T \Delta t + \alpha_L \Delta \ln q$ where y=Y/L, k=K/L, t=T/L; q is labor quality index; and $\alpha_i$ are income shares. Further details can be found in Lee and Khatri (2001).

## C. Economic performance since the Asian crisis

**The Asian crisis exposed structural weaknesses and price misalignments.**

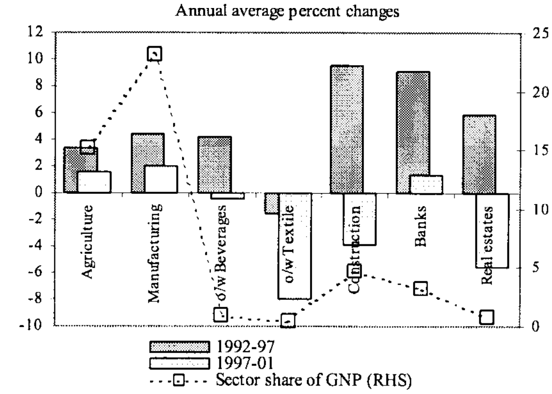
- **The impact from the Asian crisis on growth was relatively small, as the economy depended heavily on the agricultural sector, both directly and indirectly via the food manufacturing industry**. Indeed, the only reason growth turned negative in 1998 was because there was a severe drought, from which agriculture is still recovering (thereby boosting recent growth rates). Similarly, the limited impact of the 2001 global economic slowdown highlighted the relatively modest value added of the electronic sector. Unless the rest of the economy benefits from transfer of technology from the electronics sector, the net benefit from the electronics sector to the Philippines will remain small.

**Philippines: Manufacturing and Agricultural Output,**
1987-2000; Annual percent change




- **The impact was more severe on corporate balance sheets, where the Asian crisis resulted in a sharp realignment of asset prices as well as the real exchange rate**. The construction and real estate sectors were particularly hard hit, as were some manufacturing industries, especially in the traditional sectors (e.g., textile, beverages and heavy industries).

**Philippines: Value Added in Selected Sectors, 1992-01**
Annual average percent changes




- **Deteriorating corporate balance sheets in turn contributed to the weakening of the banking sector**. Nonperforming assets of the banking system increased to 28 percent by end-2001, making banks cautious in their lending operations, as indicated by the continuing stagnation of private sector credit during 2001.

- **As corporations and banks weakened, investment fell to low levels, of around 16½ percent of GNP in 2001**. Other factors have contributed to this decline, as well. Transportation and utility costs have been pushed up by poor infrastructure arising from low public capital investment and an inefficient energy sector. Labor cost relative to productivity is higher than in Thailand, Indonesia, China, and India. Also, security concerns have reduced the risk-adjusted profit margin of investment, discouraging in particular investments that require large amounts of capital or have long pay-back periods.

- **Of particular concern is the fall in fiscal revenue that undermines the painstaking gains of the last decade**. The fall in revenue reflects a reversal of a decade-long progress in tax administration, as well as government policies, such as the decision to avoid adjusting specific excise duties for inflation, and the failure to offset tariff reductions by raising collections. The fall in revenue has led to a renewed fiscal deficit, and again forced a reduction in public investment, reducing the prospects of upgrading infrastructure.

- **At the same time, some further progress has been made in structural reform**. For example, the economy has benefited from the Retail Trade Liberalization Act of 2000, following which retail trade picked up substantially attracting also foreign investors. The passage of an E-Commerce Law has put in place the framework for the development of the information and communication technology sector, including E-governance, which requires government agencies to computerize their operations. Also, the average tariff was further reduced to about 6 percent in 2002.

### D. Remaining Agenda

8. **In early 2001, the government new Arroyo government announced a far-reaching plan to address the remaining weaknesses**. Under this plan, the budget would be balanced over the medium term; the banking system cleaned up; and the economy further deregulated. This plan is analyzed at length in other chapters. But beyond these measures lie additional areas that need to be addressed before the economy can achieve a sustainable growth trajectory. In particular, the Philippines needs to:

- **raise the volume of investment**, by finding new ways to improve infrastructure, at minimal direct cost to the budget and without potentially costly guarantees. It must improve infrastructure and security, and lower production costs including through successful implementation of the energy sector restructuring plan.

- **improve productivity**, partly through liberalization of agricultural sector imports, which could facilitate further expansion of food processing industries.

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ANNEX I

## Philippines: Key Structural Reforms since the Mid-1980s

| Measure | Year |
|---|---|
| A schedule to reduce quantitative restrictions and tariffs on imports was put in place. Quantitative restrictions were reduced from 1,962 items in 1985 to 123 items in 1996 with the bulk of remaining items (69 items) retained because of health, safety and security considerations; and average tariff rates were cut from 28 percent in 1985 to 6 percent in 2002. | 1985 |
| A series of tax reform measures was put in place to make the tax structure more equitable and progressive. Most of these reforms were part of the 1986 Tax Reform Package. | 1986 |
| Comprehensive Agrarian Reform Program was introduced to enhance agricultural and rural development through improved land tenure and use. | 1988 |
| A comprehensive divestment program was identified involving 301 public corporations and 399 government assets. | 1986-87 |
| Executive Order No. 215 was issued inviting the private sector to participate in power generation. | 1987 |
| Build-Operate-Transfer Law (R.A. 6957) was passed opening infrastructure investment opportunity to the private sector. | 1990 |
| Foreign Investment Act of 1991 was approved, which liberalized entry barriers, clarified registration procedures, and allowed greater security of land tenure for foreign investors. | 1991 |
| Central Bank Act of 1993 was passed establishing an independent monetary authority. | 1993 |
| Telecommunication sector was deregulated. | 1993 |
| R.A. 7721 was passed, allowing new foreign banks to enter the Philippines. | 1994 |
| Aviation industry was opened to competition | 1995 |
| Negative list C, which restricts foreign entry in areas "adequately served" by domestic firms, was abolished. | 1996 |
| Importation of non-rice agricultural products was opened to the private sector. | 1996 |
| Oil sector was deregulated. Prices for petroleum products were allowed to move freely, and the Oil Price Stabilization Fund was discontinued. | 1996 |
| Manila water supply was privatized. | 1997 |
| New Tax Reform Act (RA 8424) was passed, which reinforced the 1986 Tax Reform Package, covering the income tax (e.g., changes in the rate structure and reducing the top marginal rate in line with corporate tax rate) as well as excise taxes (e.g., shift from ad valorem to specific taxes on alcohol and tobacco products), and overhauling the administration of the value-added tax. | 1998 |
| A new Anti-dumping Law (RA 8752) was passed, simplifying the former Anti-Dumping Act of 1994 (RA 7843). | 1999 |
| E-Commerce Act of 2000 (RA 8792) was passed to facilitate domestic and international dealings, and exchanges and storage of information through the utilization of electronic, optical and similar medium, mode and technology. | 1999 |
| Retail Trade Liberalization Act of 2000 was signed, liberalizing Philippine retail industry. Under this Act, foreigners may own up to 100% of enterprises engaged in retail trade, subject to minimum capital requirements and other restrictions. | 2000 |

| Measure | Year |
|---|---|
| A new Securities Regulation Code (RA 8799) was passed to provide greater protection to creditors and investors and to encourage faster capital market development. This Code updates the legal framework to modern standards, including tighter disclosure rules and regulatory oversight by the SEC. | 2000 |
| General Banking Law (RA 8791) was enacted, establishing a base for strengthening the banking system, improving transparency, putting in place internationally accepted standards, and enhancing BSP's capacity to take prompt corrective action in dealing with problem banks. | 2000 |
| Interim rules of Procedure on Corporate Rehabilitation was issued to transfer certain quasi-judicial powers of the Securities Regulation Commission (SEC) to the courts involving cases of corporate rehabilitation and suspension of payments. | 2000 |
| The Electric Power Industry Reform Act (RA 9136) was passed to privatize the National Power Corporation and establish a competitive electricity market. | 2001 |
| The Anti-Money Laundering Act (R.A. 9160) was passed defining the crime of money laundering and providing penalties. | 2001 |

# II. The Philippine Economy After the Asian Financial Crisis: A Closer Look at the Corporate Sector[1]

## A. Introduction

1. **Half a decade after the event, the impact of the Asian crisis on the Philippines is still not well understood**. Headline growth figures suggest that the Philippines was relatively unscathed by the crisis. In the four years prior to the crisis (1993-96), annual GDP growth in the Philippines averaged 4¼ percent, contracted by ½ percent in 1998, and recovered in the three years after the crisis (1999-2001) to an average growth rate of 3¾ percent. In contrast, growth in Indonesia, Korea, Malaysia, and Thailand—the comparator countries for this chapter—plummeted sharply in 1998.

2. **Yet Philippine corporate performance seems to have been severely affected**. Prior to the crisis, the profitability of the Philippine corporate sector compared well with other Asian countries. After the crisis, however, indirect indicators of corporate performance—including bank asset quality and equity prices—suggest a greater weakening in performance than elsewhere.

3. **This chapter attempts to shed light on Philippine corporate sector performance post-crisis, using a newly compiled data set on listed nonfinancial companies**. The data suggest that the ability of companies to service their debt—as summarized by the interest coverage ratio—weakened substantially post-crisis, reflecting both exchange rate depreciation and higher interest rates.[2]

4. **The remainder of this paper is organized as follows**. Section B begins with a brief assessment of the Philippine economy—especially the corporate sector—before the Asian crisis. Section C outlines the latter's financial and economic impact on the Philippines, in a regional setting. Section D begins by posing the main question of the paper: if the shock to Philippine financial markets from the Asian crisis was similar to that in the other countries, and the economy apparently escaped relatively unscathed, why was corporate distress so high? This section assesses the impact of the crisis on the corporate sector, while Section E examines the origin of corporate distress in the Philippines. Section F presents a brief discussion of the outlook for the Philippine corporates, followed by a concluding section.

## B. The Corporate Puzzle

### The Philippines Before the Crisis

5. **Before 1997, the Philippine economy—and by extension its corporate sector—seemed relatively robust to shocks**. The Philippine economy did not show the same imbalances as elsewhere, and its corporate sector seemed relatively healthy prior to the crisis.

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[1] Prepared by Christoph Duenwald (APD).

[2] The interest coverage ratio is defined as earnings before interest and taxes divided by total interest expenses.

6. **In the years prior to the crisis, the Philippines was not considered a "tiger."** While economic reforms contributed to a pickup in investment and growth in the early to mid-1990s, Philippines lagged far behind its more dynamic neighbors in terms of real GDP growth. Consequently, at the onset of the crisis, the Philippines presented a somewhat different pattern of strengths and vulnerabilities than the tigers most heavily affected by the crisis. As in other countries, current account deficits averaged 4-5 percent of GDP in the years before the crisis and private sector credit had been growing rapidly. However, by regional standards, external exposure, including short-term debt, was relatively small. Moreover, levels of corporate leverage were significantly lower (see below), major banks were well capitalized, and the reforms of the previous decade had created a reasonably robust economy.[3]

7. **The Philippine corporate sector was relatively healthy prior to the crisis** (Table 1). As reported in Claessens, Djankov, and Xu, 2000 (CDX), the average real return on assets—defined as the return on assets less the inflation rate—was about 8 percent during 1988-96 in the Philippines. Among the Asian comparator countries, only Thailand—at nearly 10 percent—surpassed the performance of the Philippine corporate sector over this period.[4] While in some countries—notably Indonesia and Thailand—corporate sector performance was already weakening before the crisis, this was not the case in the Philippines.

**Table 1. Return on Assets in Real Local Currency, Selected Asian Countries, 1988-96**

(In percent)

| | 1988 | 1989 | 1990 | 1991 | 1992 | 1993 | 1994 | 1995 | 1996 | 1988-96 |
|---|---|---|---|---|---|---|---|---|---|---|
| Philippines | ... | ... | ... | 7.1 | 6.4 | 8.1 | 8.5 | 6.8 | 8.4 | 7.9 |
| Indonesia | ... | ... | 9.4 | 9.1 | 8.6 | 7.9 | 7.4 | 6.2 | 6.5 | 7.1 |
| Korea | 4.4 | 3.9 | 4.1 | 4.0 | 3.9 | 3.6 | 3.4 | 3.6 | 3.1 | 3.7 |
| Malaysia | 5.4 | 5.6 | 5.4 | 6.2 | 6.0 | 6.5 | 6.3 | 6.1 | 5.6 | 6.3 |
| Thailand | 10.8 | 11.0 | 11.7 | 11.2 | 10.2 | 9.8 | 9.3 | 7.8 | 7.4 | 9.8 |

Source: Claessens, Djankov, and Xu (2000).

8. **The Philippine corporate sector also had a somewhat stronger financing structure than the crisis countries** (Table 2). The CDX study reports that leverage, as measured by total debt divided by equity (market value), was highest on average in Korea, Indonesia, and Thailand, while the countries less affected by the crisis—Philippines and Malaysia—had lower corporate leverage. In addition, with the exception of Indonesia, debt-equity ratios tended to rise in the years leading up to the crisis.

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[3] The crisis experienced by the Philippines in the early 1980s—characterized by default on external obligations, widespread failure of domestic banks and corporations, and a deep recession—had taught the country important policy lessons, and ushered in a period of reform. See Chapter on "Philippines: Economic Developments Since the Crisis of the 1980s—Remaining Agenda."

[4] Indeed, among the sample of 46 countries that report to Worldscope, Thailand, the Philippines, and Indonesia posted the highest returns.

**Table 2. Ratio of Debt to Equity, Selected Asian Countries, 1988-96**
(In percent)

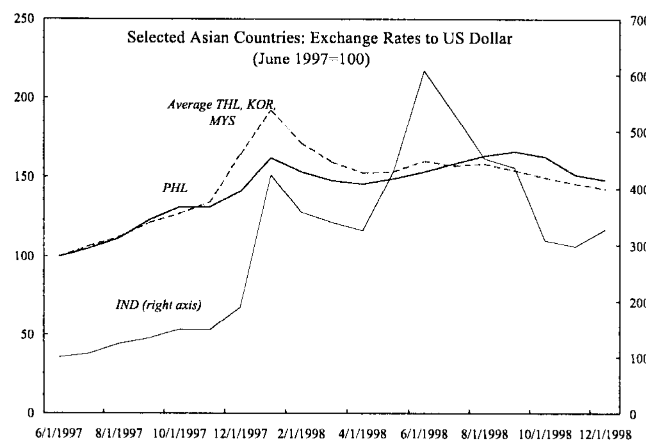
| | 1988 | 1989 | 1990 | 1991 | 1992 | 1993 | 1994 | 1995 | 1996 | 1988-96 |
|---|---|---|---|---|---|---|---|---|---|---|
| Philippines | ... | ... | ... | 0.8 | 1.2 | 1.2 | 1.1 | 1.2 | 1.3 | 1.1 |
| Indonesia | ... | ... | ... | 1.9 | 2.1 | 2.1 | 1.7 | 2.1 | 1.9 | 2 |
| Korea | 2.8 | 2.6 | 3.1 | 3.2 | 3.4 | 3.6 | 3.5 | 3.8 | 3.5 | 3.5 |
| Malaysia | 0.7 | 0.8 | 1 | 0.6 | 0.6 | 0.7 | 1 | 1.1 | 1.2 | 0.9 |
| Thailand | 1.6 | 1.9 | 2.2 | 2 | 1.8 | 1.9 | 2.1 | 2.2 | 2.4 | 2 |

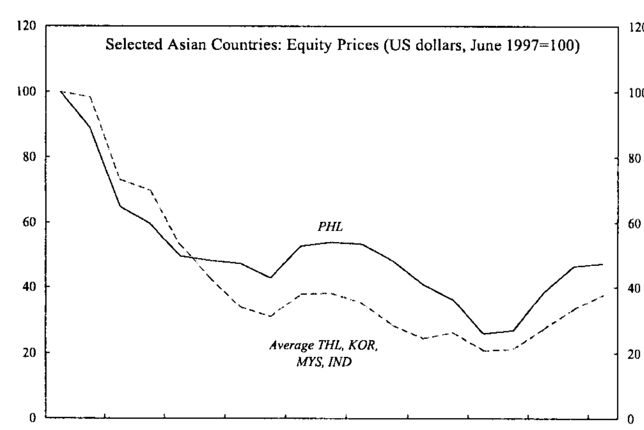
Source: Claessens, Djankov, and Xu (2000).

9. **The finding that the Philippine corporate sector was relatively healthy before the crisis is borne out by other studies**. In particular, Saldaña (2000) finds that profitability—measured by return on equity and return on assets—was strong in the Philippine corporate sector prior to the crisis, and that corporates had managed their borrowing risks relatively well.[5]

## C. Impact of the Crisis

10. **The financial market impact of the Asian crisis on the Philippines was broadly similar to other countries.** The peso depreciated substantially against the dollar between June 1997 and December 1998, as was the case in all of the countries affected by the crisis. The size of the depreciation in Indonesia was the largest by far, with the currencies of the Philippines and Malaysia initially depreciating somewhat less than Korea and Thailand. Similarly, the equity price drop in the Philippines post-June 1997 was slightly less than in the other countries, but nevertheless broadly comparable.

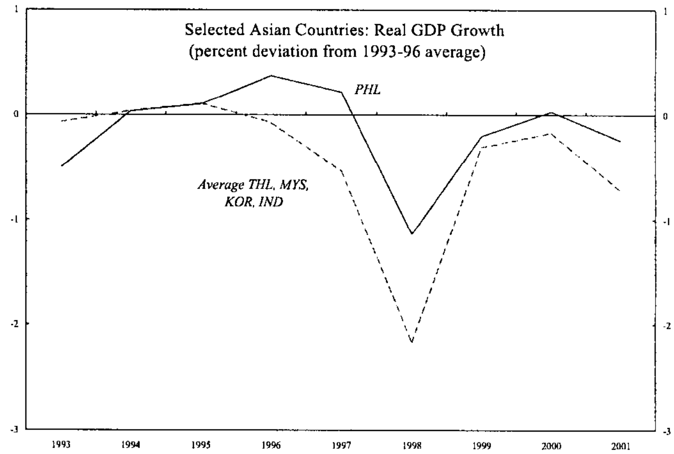



11. **Real activity in the Philippines, on the other hand, was less affected by the crisis than elsewhere**. The inevitable real sector impact of the financial pressures was relatively mild in the Philippines, compared with the other countries. In 1998, GDP growth in the

[5] Saldaña uses data from the SEC-*Business World* Annual Survey of the top 1000 Corporations.

Philippines fell only modestly below the average prior to the crisis (1993-96). In contrast, output growth declined much more in Korea, Indonesia, Malaysia, and Thailand. Moreover, the small drop in overall output in the Philippines was largely the result of adverse weather conditions, with agricultural output falling by over 6 percent, but nonagricultural output rising 1 percent in 1998.[6]




12. **In addition, corporate sector profitability in the Philippines was somewhat better than elsewhere** (Table 3). A regional comparison suggests that corporate profitability—as measured by the return on assets (ROA)—was relatively robust in the Philippines after the crisis, with only Malaysia recording higher ROA than the Philippines in 1999.[7] While the reduction in profitability in the Philippines after 1998 was severe, this came after several years of relatively strong performance.

**Table 3. Selected Asian Countries: Corporate Sector Profitability, 1996-2000**

(In percent)

| | 1996 | 1997 | 1998 | 1999 | 2000 |
|---|---|---|---|---|---|
| Return on assets | | | | | |
| Philippines | 8.6 | 5.7 | 2.4 | 1.2 | 1.9 |
| Malaysia | 4.6 | 2.9 | -1.7 | 2.5 | ... |
| Thailand | 0.9 | -2.1 | -2.0 | -0.7 | 0.1 |
| Korea | 0.5 | -0.6 | -3.8 | 0.3 | -1.5 |

Sources: Philippines: Worldscope database; Malaysia: 2000 Selected Issues, and KLSE; Thailand: SET and staff estimates; Korea: 2002 Selected Issues.

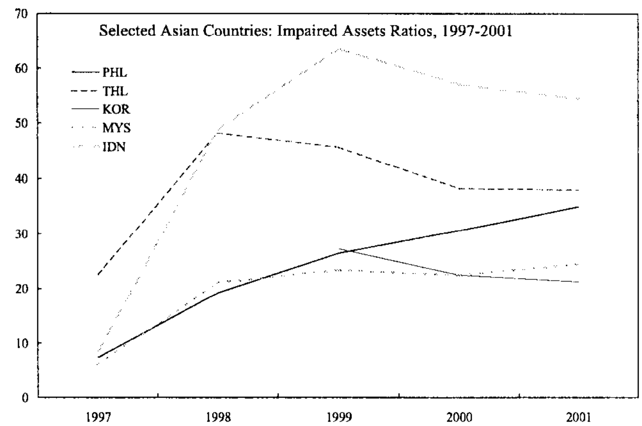
13. **While aggregate growth and corporate sector figures suggest that performance in the Philippines has been robust, indirect indicators point to great stress in the corporate sector**:

- **First, although the extent of the bad asset problem in the Philippines is less than in some of the other countries, bank asset quality has continued to deteriorate in the Philippines, in contrast to the other countries.** Since 1997, Philippine

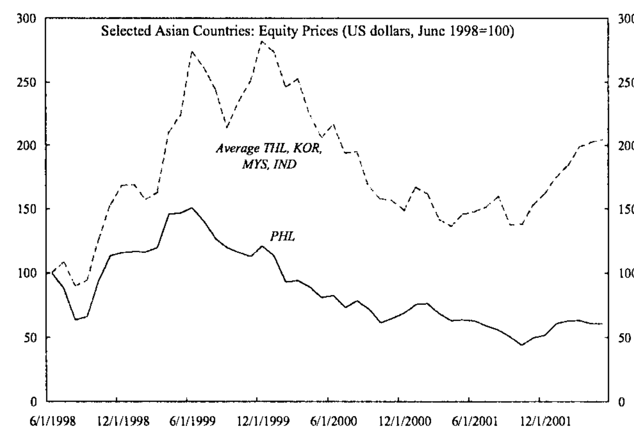
[6] The growth performance of the Philippine economy after the crisis will be examined in greater detail below.

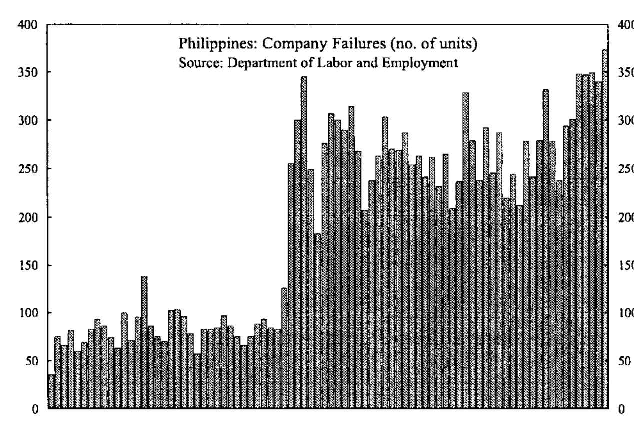
[7] Caution should be used when interpreting cross-country differences in corporate profitability owing to variation in accounting practices.

commercial banks' impaired asset ratio has quintupled to 35 percent at end-2001.[8] In contrast, the impaired assets ratios (NPLs plus loans transferred to AMCs as a percent of total assets) have stabilized in the countries most affected by the crisis (Indonesia, Korea, and Thailand), albeit at relatively high levels in Thailand and Indonesia.[9] In the Philippines, the level of impaired assets is relatively high and the upward trend shows no signs of tapering off.




- **Second, the Philippine stock market underperformed the other stock markets in the region, by a large margin.** Indeed, Philippine stocks are the only ones in the sample whose prices in U.S. dollars are below (by about 40 percent) June 1998 levels (the Asia crisis trough). The poor post-crisis performance of the Philippine stock market suggests financial markets have taken a dim view of future corporate earnings. It is worth noting that the weakness in Philippine stock prices may in part be structural, reflecting the characteristics of the local capital market and governance structures (see Boxes 1 and 2).



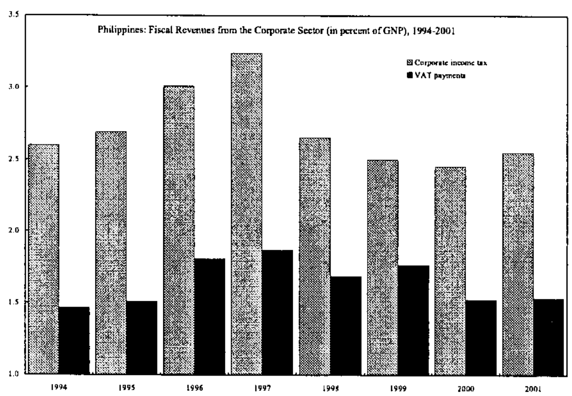

- **Third, company failures increased rapidly.** From an average of 80 per month during

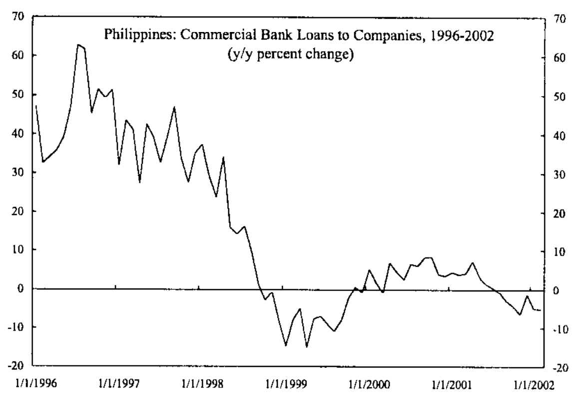
[8] Of course, part of the reason for the rise may be the tightening of classification standards. Note that impaired assets in the Philippines include NPLs, plus "real and other properties owned and acquired" (ROPOAs), and restructured loans. This sum is divided by the sum of total loans (net of interbank loans) and ROPOAs to obtain the ratio.

[9] Interestingly, another country seemingly less affected by the crisis—Malaysia—saw its bank asset quality continue to worsen in recent years. It thus appears that the crisis had a delayed impact on these countries.

1995/96, the average number of company failures more than doubled to 180 in 1997/98, highlighting the distress experienced by the Philippine corporate sector. The fact that company failures have remained at an elevated level since the Asian crisis is a source of concern.

- **Finally, deterioration in corporate performance is also suggested by the reduction in tax revenues from corporates, as well as in loans to the corporate sector**. While corporate income taxes were rising steadily as a percent of GNP ahead of the crisis, they have since declined to the same level as in 1994.[10] Similarly, VAT payments had also been rising in the years prior to 1997, but have since fallen off.[11] Moreover, to the extent that banks perceived corporates as becoming less creditworthy, the decline in the growth of bank loans to the corporate sector is also telling about corporate sector performance.[12] [13]




## D. Impact of the Crisis on the Corporate Sector

14. **The foregoing discussion raises the following puzzle**: if the shock to Philippine financial markets from the Asian crisis was similar to that in the other countries, and the aggregate economy apparently escaped relatively unscathed, why do indirect indicators suggest that corporate distress was so high? This section presents preliminary evidence from

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[10] A small reduction in corporate tax rates starting in 1998 (from 35 percent to 32 percent) was also a contributing factor.

[11] Note that VAT payments in the Philippines tend to be pro-cyclical.

[12] Of course, reduced demand for bank loans is also likely to have played an important role.

[13] Although not a point explored in any detail in this chapter, it may be that the weakness of the banking sector itself contributed to the downturn in corporate performance, with banks holding back credit to new companies and thus undermining financial intermediation. The weak relative performance of the banking/financial services sector is highlighted by the 50 percent decline in bank share prices since end-1999, whereas the overall market declined by only 10 percent.

a newly compiled database. These data tend to support the conclusions from the indirect indicators discussed earlier, namely, that the Philippine corporate was hard hit by the crisis.

15. **Evidence from listed corporates suggests corporate sector profitability was severely dented by the crisis.** Table 4 shows the results of aggregating firm-level data from the Worldscope database on 103 nonfinancial companies listed on the Philippine Stock Exchange, over the period 1995-2000.[14] The financial data are drawn from companies in the commercial/industrial, property, mining, and oil sectors, with the commercial sector accounting for the majority of sampled companies. As can be seen from the text table, the average company included in the dataset was quite large (2,700 employees).

| Summary Statistics of Worldscope Dataset | |
|---|---|
| (Millions of pesos; averages for 2000) | |
| Total Assets | 21,602 |
| Total Sales | 7,975 |
| Number of employees (thousands) | 2.7 |
| Number of companies included: 103 | |
| Sectors represented: Commercial, property, mining, and oil. | |
| Source: Worldscope database; staff estimates. | |

16. **The calculated indicators are categorized into estimates of leverage, profitability, cash flow adequacy, and liquidity.** Owing to variations in the number of companies reporting each year, as well as the high standard variation of the sample, medians were used to aggregate across companies. The following are the main findings:

- **Leverage indicators paint a rather rosy picture of corporate sector vulnerability**: regardless of how it is measured, leverage has remained at relatively low levels in the Philippines even after the crisis. However, there was a distinct upward shift in leverage between 1995 and 1998. Indeed, liabilities-to-equity rose from about 62 percent in 1995 to 87 percent in 1998. Nevertheless, the excessive leverage that plagued other Asian countries does not appear to be a problem among Philippine corporates (neither before nor after the crisis).

- **On the other hand, the profitability of the Philippine corporate sector was hard hit by the crisis**, with return on equity and return on assets more than halving in 1998 relative to 1997. The median profit margin also fell markedly in 1998. Profitability in 1999/2000 remained well below levels before the crisis; indeed, profitability in recent years has not been able to keep pace with inflation.

- **The financial difficulties facing Philippine enterprises are also highlighted by cash flow problems.**[15] The interest coverage ratio fell from a level of 2½ in 1997 to

[14] Note that this set of companies is only a small subset of the Philippine corporate sector. Of the 233,438 active stock corporations, only 233 are listed on the PSE (as of March 2002). The data set was then further reduced by taking out the financial companies, and those nonfinancial corporates for which only one year of data was available.

[15] Note that Table 4 uses EBIT for the interest coverage calculation, rather than the more common EBITDA. A recent study by Moody's concludes that the use of EBITDA interest

(continued)

well below 1 in 1998—meaning the median company was not able to generate enough cash to meet its debt servicing needs—although there has been some modest recovery since to around 1. The dramatic decline in interest coverage is consistent with the jump in impaired assets discussed earlier.

- **Liquidity in the Philippine corporate sector has been steady over time, but at a low level.** The low level of liquidity indicated by the quick ratio suggests that it may be difficult for corporates to carry out business without endangering credit quality, again consistent with the rise in impaired assets.

**Table 4. Philippines: Selected Corporate Indicators, 1995-2000**
(median, percent except where indicated)

| | 1995 | 1996 | 1997 | 1998 | 1999 | 2000 |
|---|---|---|---|---|---|---|
| Leverage | | | | | | |
| Total liabilities to equity | 61.5 | 69.1 | 80.9 | 87.4 | 83.3 | 79.9 |
| Total debt to equity | 31.0 | 38.2 | 47.2 | 46.2 | 47.8 | 44.1 |
| Total debt to total assets | 17.5 | 20.9 | 26.5 | 24.3 | 23.0 | 21.9 |
| Profitability | | | | | | |
| Return on equity | 11.6 | 10.3 | 5.6 | 1.0 | 1.4 | 1.2 |
| Return on assets | 7.8 | 8.5 | 5.5 | 2.4 | 1.2 | 1.9 |
| Operating profit margin | 15.1 | 14.3 | 14.2 | 8.0 | 5.2 | 5.8 |
| Cash flow adequacy | | | | | | |
| Interest coverage ratio 1/ | 6.3 | 4.1 | 2.5 | 0.6 | 1.1 | 1.1 |
| Liquidity | | | | | | |
| Current ratio 2/ | 1.5 | 1.5 | 1.1 | 1.1 | 1.2 | 1.2 |
| Quick ratio 2/ | 0.9 | 0.8 | 0.7 | 0.7 | 0.8 | 0.8 |
| Memo items: | | | | | | |
| Growth in median sales | ... | 36.4 | 11.2 | -10.4 | -5.3 | 15.3 |
| Growth in median net income | ... | -5.5 | -34.4 | -85.4 | -45.9 | 57.7 |
| Growth in median EBIT | ... | 4.6 | -20.3 | -59.1 | -51.1 | -14.2 |
| Growth in median operating expenses | ... | 22.6 | 36.8 | 6.3 | 3.3 | -14.5 |
| Growth in median interest expenses | ... | 168.1 | 77.4 | 85.7 | -18.7 | -1.2 |
| Growth in median total assets | ... | 27.8 | 36.6 | 7.9 | -5.3 | 5.8 |
| Growth in median total liabilities | ... | 49.6 | 65.3 | -2.9 | -14.3 | 13.3 |
| Growth in median total debt | ... | 60.7 | 68.2 | 12.0 | -16.7 | -4.2 |
| Growth in median long-term debt | ... | 38.6 | 75.8 | 11.7 | -3.1 | 16.2 |
| Growth in median retained earnings | ... | 30.2 | 13.2 | -23.3 | -73.3 | -10.5 |
| Growth in median total inventories | ... | -1.6 | 62.2 | 1.8 | -21.8 | -2.7 |

Sources: Worldscope and Staff estimates

1/ Defined as the ratio of EBIT to interest expenses.
2/ Current ratio=current assets/current liabilities; Quick ratio=(current assets-inventories)/current liabilities.

17. **A regional comparison of profitability and cash flow adequacy indicators suggests that the deterioration in Philippine corporates' financial performance was larger than elsewhere:**

- **Table 3 (Section C.) shows that, while the level of corporate profitability in the Philippines remained relatively high post-crisis, the extent of the deterioration was greater than elsewhere.** The median return on assets of Philippine corporates

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coverage ratios can be misleading, partly because they can be manipulated through aggressive accounting policies.

fell from 8½ percent in 1996 to just over 1 percent in 1999, recovering slightly in 2000. This worsening in performance was more pronounced than elsewhere.[16]

- **Similarly, the decline in Philippine corporates' interest coverage ratio (ICR) was especially pronounced relative to other countries (Table 5).** The ICR measures the capacity of enterprises to service their debt, thus linking corporate performance to banking system asset quality. While ICRs fell significantly in other Asian countries, the decline was more dramatic in the Philippines. For example, among Korean corporates, the ICR declined from 2.3 to 1.2 during 1996-1998, while Thai corporates saw their ICR drop from 4 to 1.2 over this period (and then to well below 1 in 1999). In the Philippines, the ICR dropped from over 4 to 0.6 during this period, implying a much larger deterioration in asset quality than elsewhere.

**Table 5. Selected Asian Countries: Corporate Sector Cash Flow Adequacy, 1996-2000**

| | 1996 | 1997 | 1998 | 1999 | 2000 |
|---|---|---|---|---|---|
| Interest coverage ratio | | | | | |
| Philippines | 4.2 | 2.5 | 0.6 | 1.1 | 1.1 |
| Malaysia | 5.7 | 3.8 | 0.9 | 2.3 | ... |
| Thailand | 4.0 | 1.6 | 1.2 | 0.3 | 0.9 |
| Korea | 2.3 | 1.9 | 1.2 | 2.2 | 2.1 |

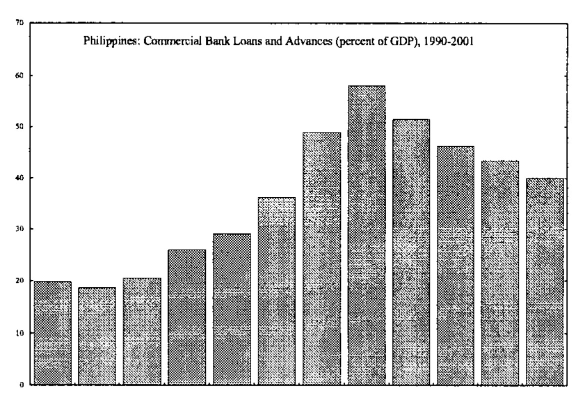
Sources: Philippines: Worldscope database; Malaysia: 2000 Selected Issues, and KLSE; Thailand: SET and staff estimates; Korea: 2002 Selected Issues.

## E. Solving the Puzzle

18. **To restate the puzzle posed earlier**: if the shocks hitting the Philippines were broadly the same as other countries, the Philippine economy—including its corporates—was in relatively good shape, and growth was robust after the crisis, why was corporate performance relatively poor post-crisis?

### The Lending Boom, Followed by Collapse

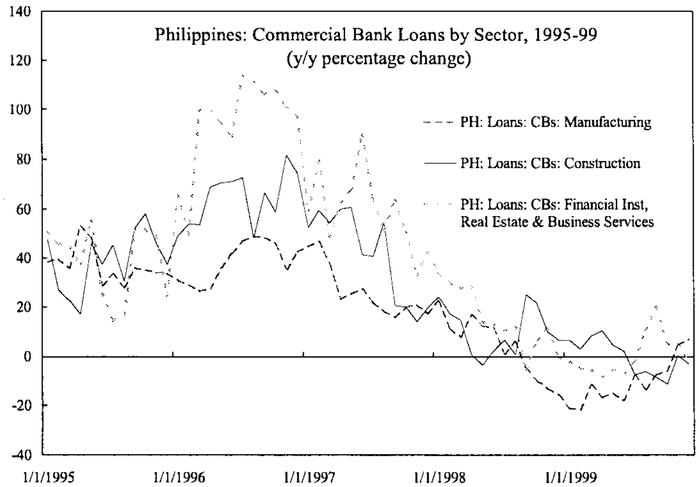
19. **Contrary to what is generally believed, the Philippines displayed some similarities to the countries most affected by the crisis.** In particular, during the first half of the 1990s, the Philippines experienced an asset price boom fueled by a rapid increase in private sector credit. The stock of commercial bank loans and advances tripled from about 19 percent of GDP at end-1991 to nearly 60 percent at end-1997. And between 1991 and 1996,



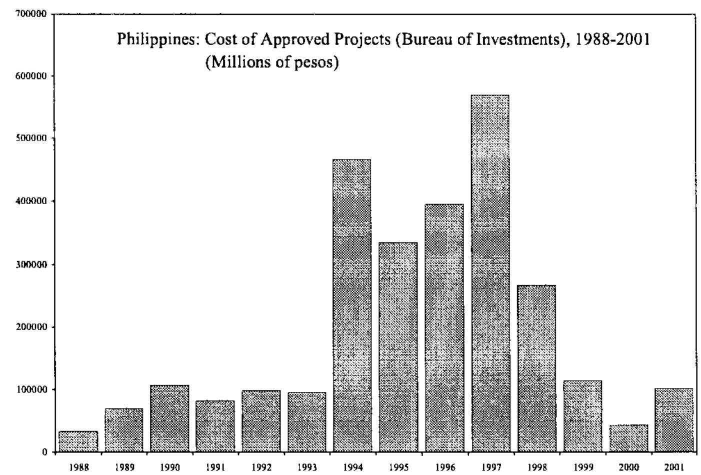

[16] Post-crisis corporate recovery in the countries most affected by the crisis may have been helped by public sector intervention to help clean up banks' balance sheets. Such intervention was absent in the Philippines.

commercial real estate prices quintupled, while residential real estate prices rose by 150 percent.

20. **Credit data show that lending to firms engaged in real estate rose particularly strongly before the crisis**. In addition, lending to manufacturers also rose substantially. In anticipation of a continuation of the boom, Philippine companies—particularly those in manufacturing and in real estate—borrowed heavily to expand capacity to meet the expected increase in demand.

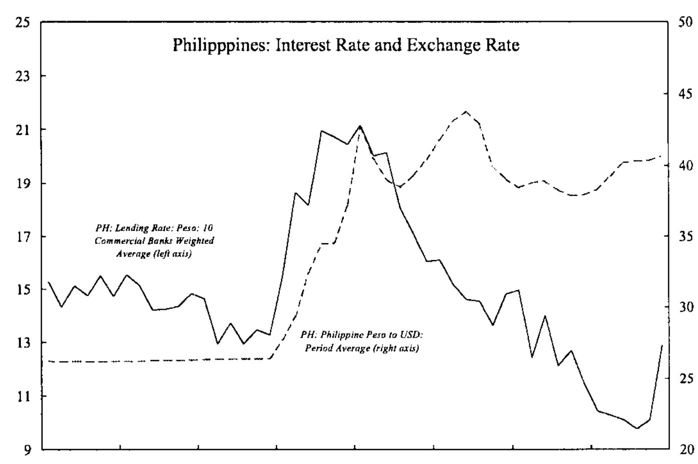



21. **This is consistent with data on the listed companies**. Median total debt rose by over 60 percent in both 1996 and in 1997, while median liabilities rose by well over 50 percent on average in those two years (Table 4).



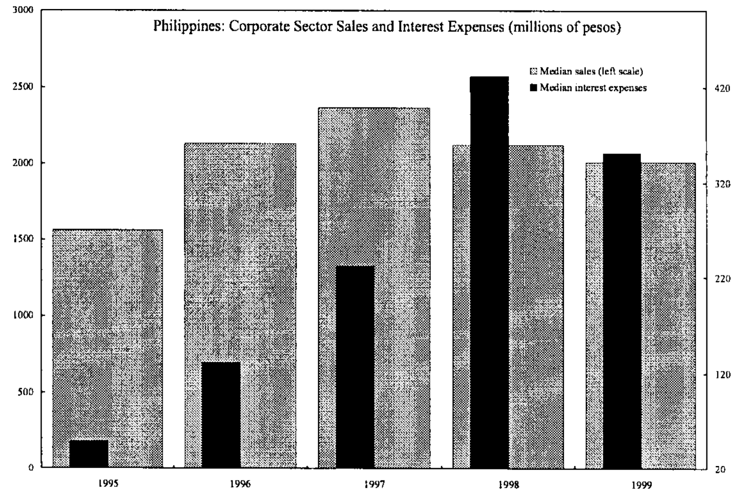

22. **As a result, investment began to rise**. In 1994, the cost of projects approved by the Bureau of Investments jumped to levels not seen before in the Philippines. Real fixed investment growth picked up, reaching double digit rates in 1996/97.

23. **The large expansion in debt left Philippine corporates vulnerable to financial market turbulence**. Indeed, the boom quickly ended with the onset of the Asian crisis. With asset prices tumbling, interest rates rose sharply, the peso depreciated, and firms found themselves with rising debt service burdens at the same time as revenues were collapsing.

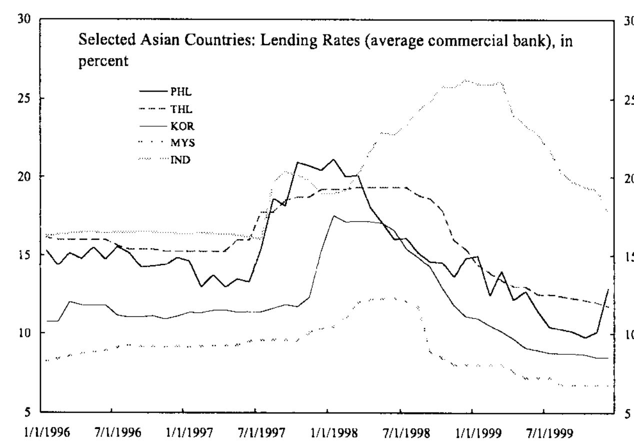



### The Transmission Channel

**Both higher interest rates and the weaker peso are likely to have been important channels for transmission of the Asian crisis to the Philippine corporates**. However, the available data do not allow firm conclusions about the relative importance of these two channels in causing corporate distress. Median interest expenses—which had already increased substantially in 1996/97 as companies took on more debt—rose another 85 percent in 1998 as lending rates rose sharply.[17] Indeed, commercial banks' weighted average lending rate spiked by up to 800 basis points between mid-1997 and early 1998. Moreover, to the extent that firms had unhedged foreign currency liabilities, the debt service burden rose sharply on account of the large depreciation of the peso, which fell by 63 percent against the dollar between June 1997 and August 1998.




24. **Compared with other Asian countries, lending rates in the Philippines rose earlier and by more.** As noted above, Philippine commercial bank lending rates rose sharply beginning in June 1997. With the exception of Indonesia, the rise in Philippine rates was greater than in other countries affected by the crisis. This helps explain the relatively sharper drop in the interest coverage ratio in the Philippines compared with other countries.




25. **At the same as the corporates were hit by an increased debt service burden, reduced demand cut into sales**. Median sales declined by over 10 percent in 1998, and by another 5 percent in 1999.

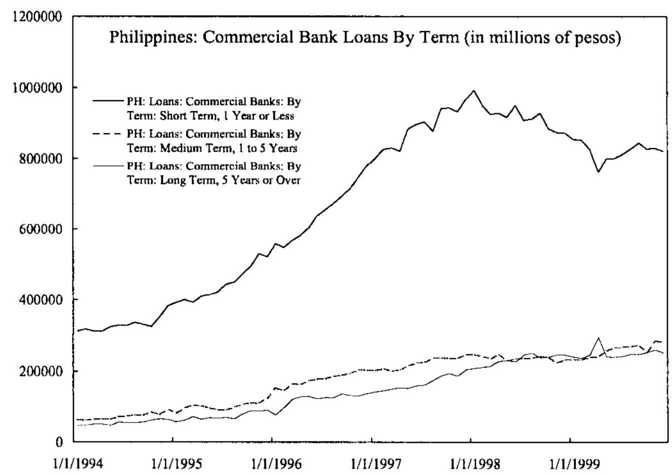
26. **Other evidence also supports the notion that exchange rate depreciation and higher interest rates had a debilitating impact on the corporates:**

- **First, survey data confirm the important role played by peso depreciation and higher interest rates in explaining corporate performance.** In a World Bank-commissioned study, Lamberte *et. al.* (2000) examine the impact of the Asian crisis

[17] This is consistent with the finding by Saldaña (2000) that debt—rather than equity or retained earnings—provided 93 percent of the financing requirements in 1997. Note moreover that, in Table 4, growth in retained earnings and in sales slowed drastically in 1997 while growth in total assets continued at a very high rate.

on the Philippine manufacturing sector, using survey data.[18] They find that surveyed firms' capacity utilization and output dropped significantly during the crisis. As for the perceived cause of the slowdown, the number one reason given by both exporters and nonexporters was the depreciation of the peso and associated jump in input costs. Exporters ranked higher interest rates as the second most important reason for the slowdown, while nonexporters blamed weak local demand, and ranked higher interest rates third. With regard to firms' structure of financing, Lamberte *et. al.* report that both before and during the crisis, firms financed themselves mainly through sales (i.e., internal cash generation) and local bank loans. Consistent with the figures in Table 4, they also suggest that firms attempted to reduce their debt in 1998 as they began to feel the effects of the crisis.

- **Second, short maturity loans had risen sharply before the crisis**. Prior to the crisis, the highest commercial bank loan growth was in loans with maturity of one year or less. Part of this may be accounted for by consumer loans, but the vast majority of the increase is likely accounted for by corporations borrowing short term, which subsequently increased their vulnerability to higher interest rates.




## Sectoral Evidence

27. **Available data suggest that the property/real estate sector contributed importantly to the post-crisis buildup of NPLs.** Direct data on the sectoral composition of NPLs are not available in a time series format, but the BSP has made available some data on past due loans by industry (Table 6). This suggests:

- **In absolute terms, the manufacturing sector is the main source of past due loans.** At end-2000, loans to manufacturing enterprises accounted for over 35 percent of the total loans extended to the top 200 borrowers.

- **Real estate accounts for a large proportion of past due loans.** Among the large borrowing groups, past due loans to the real estate sector are the highest at nearly 22 percent. Past dues were also very high in the "other" category, notably in the

[18] This study was one chapter in a book reporting survey results from five countries, including the Philippines.

construction sector. Moreover, the past due portion of real estate loans rose further last year, to over 25 percent at end-2001.

**Table 6. Philippines: Past Due Loans Among the Top 200 Borrowers**
As of December 31, 2000, in percent

| Industry | Loans as a Percent of total loans | Past due loans as a percent of total |
|---|---|---|
| Manufacturing | 35.3 | 17.6 |
| Non-Bank Financial Intermediation | 12.6 | 13 |
| Real Estate Activities | 11.5 | 21.7 |
| Electricity, Gas, Steam & Water Supply | 8.0 | 0.3 |
| Banking Institution | 7.1 | 0.2 |
| Postal & Telecom Services | 6.7 | 15.8 |
| Other | 18.8 | 31.4 |
| o/w construction | 1.0 | 32.5 |

Source: Response to FSAP Questionnaire, October 2001; staff estimates.

- **Data on the listed property companies appear to confirm this result** (Table 7). Data on 11 listed property companies show that the interest coverage ratio fell dramatically between 1996-98, from about 8½ to just under 1. This indicates a substantial reduction in property companies' ability to service their debts, consistent with the rise in the proportion of past due loans discussed earlier. In addition, interest coverage fell to 0.2 in 2000, which is consistent with the further substantial increase in past due loans in real estate in 2001.

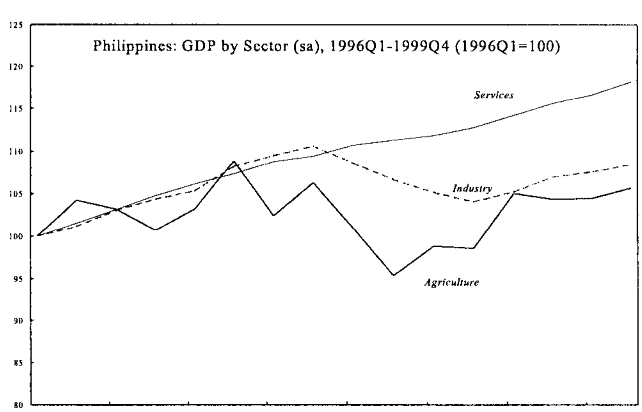
**Table 7. Philippines: Financial Performance of Listed Property Companies, 1995-2000**
(median; in percent)

| | 1995 | 1996 | 1997 | 1998 | 1999 | 2000 |
|---|---|---|---|---|---|---|
| Interest coverage (ratio) | 13.6 | 8.4 | 6.3 | 0.9 | 1.1 | 0.2 |
| Liabilities/equity | 36.0 | 54.4 | 70.3 | 55.8 | 48.7 | 71.9 |
| Return on assets | 8.5 | 10.3 | 7.5 | 2.7 | 2.4 | 1.3 |

Source: Worldscope and Staff estimates.

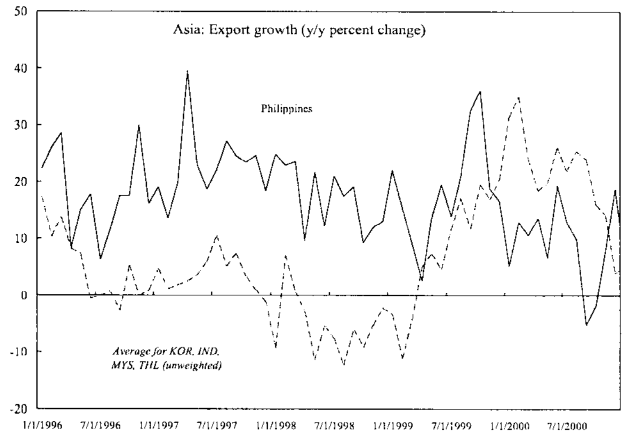
## What can be Gleaned From Macroeconomic Indicators?

28. **Why then did the Philippine economy continue to grow relatively rapidly?** Two main factors played an important role in dampening the real sector impact of the crisis on the Philippines:

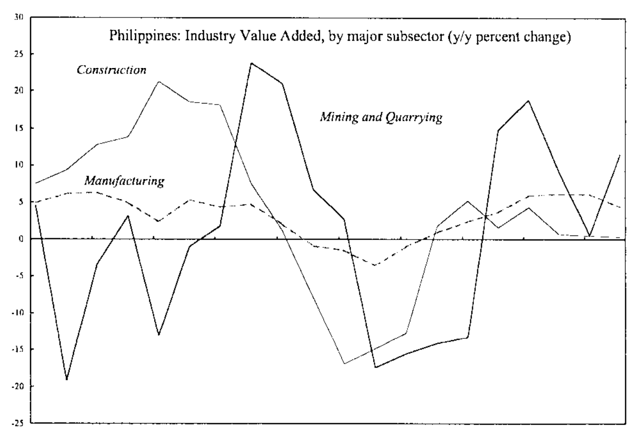



- **Sustained growth in the services sector**. Services continued to grow strongly, with positive contributions from all major subsectors, especially transport, storage and communications, as well as private services. Industrial and agricultural output, on the other hand, dropped considerably.

- **A more resilient external sector, helped by the growth of electronics**. In contrast to its neighbors, the Philippines benefited from strong export growth even during the crisis, with export growth averaging 20 percent in 1997/98. This reflected the fact that Philippine exports go disproportionately to the United States—which continued to grow quickly while Asian growth slumped—while there were also strong gains in market shares arising mainly from investments in the electronics sector.[19] In addition, while there was a sharp reversal of capital flows in 1997, foreign direct investment rebounded strongly in 1998 reflecting large foreign investment in the electronics sector.




29. **Industry output was substantially weakened by the Asian crisis**. While manufacturing output was relatively robust—helped by sustained growth in food manufacturing and electronics—mining and quarrying as well as construction suffered large declines. However, even within manufacturing, there were pockets of weakness: traditional industries, many focused on import substitution and previously protected by high tariffs, such as metals, chemicals, minerals, and transportation, suffered large output declines after the crisis. These sectors were partly responsible for the large run up in nonperforming loans, although their demise might simply have been accelerated by the crisis.




30. **Following the crisis, growth in the countries affected by the crisis recovered strongly**. Economic activity began to bottom out in the second half of 1998, and by the fall of 1999, was well on the way to recovery in most countries, particularly Korea (see Chart in Section C.). In the Philippines, post-1998 growth rates were relatively modest: during 1999

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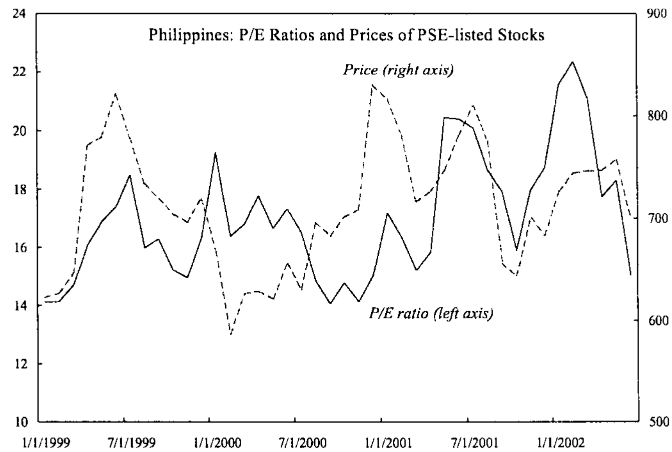
[19] While the sustained growth in electronics exports during the crisis helped mitigate its effects, the impact of this factor is likely to be relatively small due to the small value added of electronics.

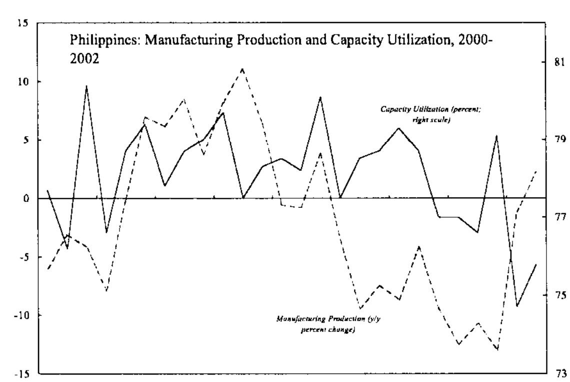
through 2001, growth averaged only 3¾ percent in the Philippines, below the nearly 5 percent average in Korea, Indonesia, Malaysia, and Thailand. The significant decline in U.S. economic activity beginning in 2000 dampened economic performance in the countries surveyed. The Philippine economy, however, was fairly robust to the global downturn and—powered by strong services and agricultural output—turned in a solid performance in 2001.

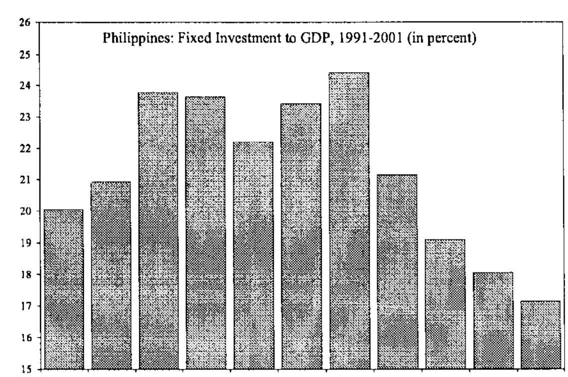
### F. The Outlook for the Corporate Sector

31. **The outlook for the corporate sector as a whole is very difficult to assess because aggregate data for 2001 are not yet available.** However, the indirect indicators of corporate performance discussed earlier—banking system asset quality and stock prices—suggest that the corporate sector has remained under considerable stress. Thus, the impaired assets ratio rose from about 30 percent at end-2000 to 35 percent by end-2001. Over the same period, stock prices declined by 22 percent between end-2000 and end-2001, suggesting that financial markets were expecting corporate earnings to weaken further. Stocks rallied sharply between October 2001 and February 2002, taking market valuation—as measured by the price-earnings ratio of listed stocks—to levels not seen since before the Asian crisis. But this runup in prices has corrected in the last few months, pointing once again to a less sanguine outlook for corporate earnings. The market's P/E ratio has returned to slightly below its historical (1996-2002) average.




32. **Since the Asian crisis, two shocks—one political in origin, the other economic—may have had a significant impact on the Philippine corporate sector**. In October 2000, a political crisis arising from allegations of corruption against President Estrada triggered turmoil in financial markets, with interest rates rising substantially and the peso coming under pressure. In addition, with the U.S. economy slowing significantly in 2000/2001, global growth weakened, leading to a sharp drop in Philippine exports in 2001. Partly as a result of these shocks, manufacturing output and capacity utilization in the manufacturing sector was depressed last year. Moreover, fixed investment as a percent of GDP has fallen continuously since the Asian crisis, while business confidence has been weak recently.



33. **While the effects of these shocks still need to work their way through the system fully, improvements in the macroeconomic and financial environment during the first half of 2002 bode well for the corporate sector**:

- **The debt service burden of corporates has likely fallen significantly**. Short-term interest rates have dropped substantially, with the primary market 91-day T-bill rate falling to a record low of 4.4 percent in mid-May, and lending rates also declining sharply. Borrowing abroad has also become less expensive, with spreads on Philippine 10-year dollar bonds falling by about 275 basis points between October 2001 and June 2002. In addition, the peso has been relatively stable.

- **Sales growth is likely to pick up**. With the global economy, led by the United States, apparently recovering—though at a more modest pace than previously expected—foreign demand should pick up.

- **Capital market conditions have eased**. In particular, capital markets have reopened to corporate borrowers. For example, telecom company PLDT has issued $350 million in five- and ten-year bonds for its refinancing needs. However, domestic credit remains stagnant and the stock market depressed.

## G. Conclusion

34. **The Asian crisis had a strongly negative impact on the Philippine corporate sector**. Indirect indicators—such as bank asset quality and stock prices—suggest a significant increase in corporate distress post-crisis, both in absolute terms and relative to other Asian countries. This is borne out by newly compiled data on listed companies from the Worldscope database, which suggest that both profitability and firms' ability to service their debt weakened substantially after the crisis.

35. **The Asian crisis exposed vulnerabilities that were built up prior to the crisis**. In particular, a lending boom had increased the debt burden among corporates, which, with the onset of the crisis, became difficult to service as interest rates rose, the exchange rate depreciated, and demand dropped. As a result, bank asset quality deteriorated rapidly, especially in the real estate sector.

36. **The aggregate GDP statistics mask some important weaknesses within manufacturing**. Traditional heavy industries that were severely burdened by debt saw their interest expenses jump, while simultaneously facing greater foreign competition as tariffs were cut. These industries are likely to have been important sources of NPAs.

37. **The outlook for the Philippine corporates is difficult to assess**. On the one hand, previous shocks still need to work their way through the system; on the other hand, the recent improvement in the macro environment—especially lower interest rates—has created better conditions in which to prosper.

**Box 1. Key Features of the Philippine Capital Market**

**The Philippine capital market is characterized by a number of features that set it apart from other countries in the region, and could account for its relative underperformance in recent years** (Figure 1):

- **Turnover is relatively low**. The low turnover on the Philippine stock exchange is generally linked to the high concentration of stock ownership, with many major firms closely held by only a few individuals. The Philippine stock exchange is generally considered a fringe market due to the scarcity of sufficiently liquid issues. This is highlighted by Philippine's low weight in the MSCI Emerging Market Free Index—0.8 percent—and in the MSCI Asia ex-Japan (4.7 percent).

- **Small number of listed companies**. The number of listed companies on the Philippine stock exchange was 232 in 2001, far below other countries, but significantly higher than in the early 1990s. Given that capitalization was relatively high, this implies that the average corporation listed on the Philippine Stock Exchange is relatively large, but its stock is infrequently traded.

- **The increase in market capitalization prior to the crisis was almost entirely driven by higher stock prices**. In the period 1988-96, Philippine stock prices (in U.S. dollars) increased by a factor of three—more than any of the other countries surveyed with the exception of Malaysia—while funds raised through new equity was relatively small, with Philippine companies relying heavily on bank loans for financing.[1]

- **Market capitalization is relatively high**. Averaging about one-half of GDP during 1988-2001, the capitalization of the Philippine stock market is above that of Indonesia, Korea, and Thailand, but significantly below that of Malaysia (almost 200 percent of GDP). Stock market capitalization in 2001 was far above that in the early 1990s, but only 60 percent of the 1996 peak of almost 100 percent.

[1] Thus, Unite and Sullivan (2000) note that, of the companies listed on the PSE, less than half are actively traded, the ten largest stocks make up 60 percent of market capitalization, and less than ½ percent of the Philippine population own publicly-traded equity.

## Box 2. Corporate Governance in the Philippines

**The governance structure of the Philippine corporate sector in many respects typifies the "Asian model."** The Philippine system of corporate governance falls into the "insider" category: there is a high concentration of ownership[1]; the number of listed companies is relatively small; the capital market is illiquid because controlling blocks are held by a few major shareholders, and these are held rather than traded; and there are a large number of holding or interlocked companies acting to deter outsiders from acquiring control. This system of governance raises an agency conflict, namely, between insiders (major shareholders) and outsiders (small shareholders), with the major shareholders being potentially able to expropriate minority shareholders' interests.

**Two features of the ownership structure of Philippine corporations are especially noteworthy:**

- **The dominance of a few families and the prevalence of group affiliation.** While large family control of corporations is common in Asia, as well as in some other parts of the world, the dominance of a few families in the Philippines is particularly striking: 17 percent of total market capitalization can be traced to the ultimate control of a single family (the Ayalas), and the top five families control 43 percent of stock market capitalization. [2] Moreover, in a wide-ranging study of the Philippine corporate sector, Saldaña (2000) notes that three quarters of the respondents to an AsDB survey were either a parent or subsidiary, suggesting that most publicly listed companies are parts of business groups.

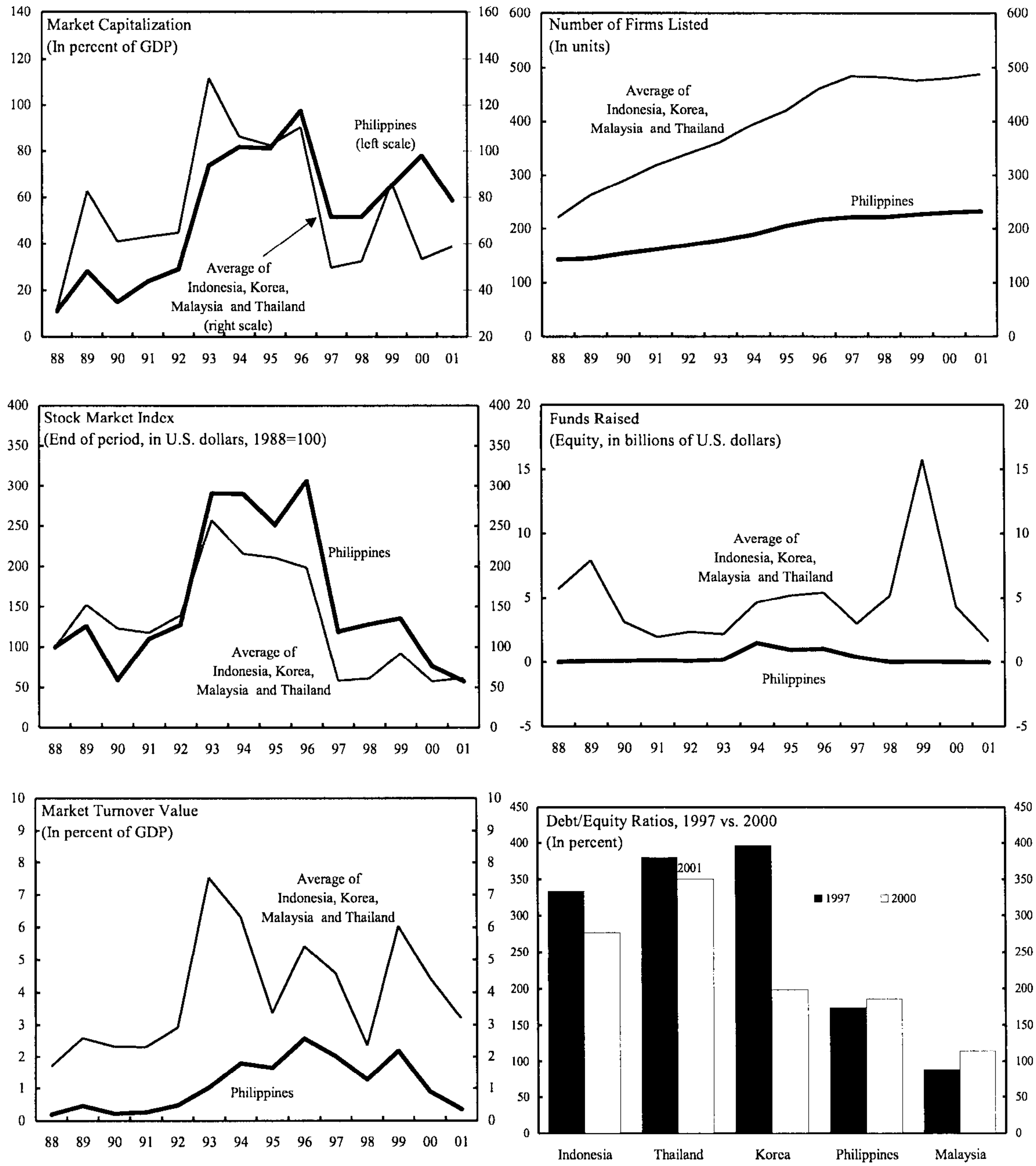
- **The tight linkages between the corporate and banking sectors**. Commercial banks are often affiliated with a particular business group. Thus, the top families also control most of the major banks in the country, and this has led to a significant concentration of loans outstanding. For instance, the top 100 corporate borrowers account for 30 percent of the loans outstanding in the banking system.

**The government has begun to address corporate governance issues**. Earlier this year, the Securities and Exchange Commission approved the Code of Corporate Governance, which applies to all registered and listed corporations, including public companies. The Code covers key areas of corporate governance, including accountability and audit, stockholder rights, and transparency. It also provides for stronger auditor independence, and requires that the external auditor be rotated at least every five years.

[1] Unite and Sullivan (2000) find that, for PSE-listed companies, the largest five stockholders have, on average, an almost 65 percent ownership interest. Note that concentrated ownership in itself does not necessarily result in weak governance; the question is whether there are sufficient safeguards to prevent large shareholders from expropriating the wealth of minority shareholders.

[2] Among Asian countries, only Indonesia has similarly high concentrations of ownership. See Claessens, Djankov, and Lang (1999).

Figure 1. Selected Asian Countries: Capital Market Overview, 1988-2001




Source: IMF, WEO; Bloomberg; and APD core database and CEIC database.

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# III. Issues in Fiscal Sustainability[1]

## A. Introduction

1. **Issues of fiscal sustainability lie at the heart of the Philippines' economic agenda.** The government of the Philippines publicly committed to eliminating the budget deficit by 2006 as a way of ensuring macroeconomic stability, and thereby spurring growth. At the same time, the authorities' 2001-2006 Medium-Term Economic Plan highlights the need to raise tax revenues to support spending priorities, including basic education, health, agricultural modernization and targeted poverty alleviation.

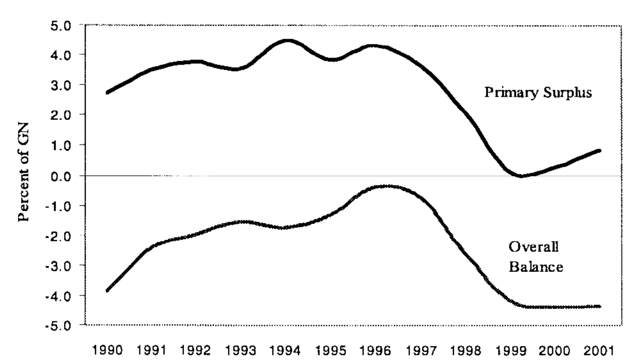
2. **Although the government essentially met its deficit target in 2001 for the first time since 1997, large challenges remain for the medium term.** The deficit remains large and yields from ongoing revenue raising efforts have so far been disappointing. Meanwhile, there are problems of allocative efficiency, since spending on infrastructure, operations and maintenance has been severely curtailed in a way that may not be optimal for growth and poverty reduction. Moreover, national government debt is now close to 60 percent of GNP, to which may be added large contingent liabilities. This paper aims to explore how, in these circumstances, the authorities can reach a sustainable fiscal stance.

3. **The rest of the paper is structured as follows: Section B analyses recent fiscal trends. Section C describes the authorities' plans for fiscal consolidation and discusses the importance of achieving these targets.** Section D assesses the difficulty in achieving these targets, lays out a framework for assessing fiscal sustainability, and determines the necessary adjustments from a baseline scenario. Section E describes the authorities' envisioned measures and proposes additional policy measures that could be taken to ensure that the deficit reduction targets are met. Finally, Section F summarizes and concludes.

## B. Recent Fiscal Trends

4. **The fiscal position of the national government deteriorated significantly over the last five years, as the deficit increased from 0.7 percent of GNP in 1997 to 4.3 percent of GNP in 2001 (Figure 1).**[2] As a result, the

Figure 1. Philippines, National Government Balances, 1990-2001




[1] Prepared by Gabriela Inchauste (FAD).

[2] IMF definition for overall deficit – includes the operations of the Central Bank-Board of Liquidators and accounts for privatization as a financing item.

primary surplus[3] declined from 3.6 percent of GNP in 1997 to balance in 1999. In 2001, the new administration succeeded in restoring primary surplus, of 0.9 percent of GNP, but the overall deficit merely remained stable, around 4 percent of GNP.

**Revenue**

5. **Underlying this deteriorating deficit was a dramatic decline in revenue over the last four years.** Tax revenues have fallen from a peak of 16.3 percent of GNP in 1997 to 12.7 percent of GNP in 2001. The outturn in 2001 represented the lowest collection ratio since 1988 and is substantially below collections in all other countries in the region, including Thailand, which had been performing below the Philippines until 2001 (Table 1).

Table 1. Asia: Central Government Tax Revenue

| | 1995 | 1996 | 1997 | 1998 | 1999 | 2000 | 2001 |
|---|---|---|---|---|---|---|---|
| | (percent of GDP) | | | | | | |
| Indonesia 1/ | 14.0 | 13.9 | 14.5 | 13.9 | 15.3 | 18.5 | 17.9 |
| Korea | 15.0 | 15.5 | 15.4 | 15.1 | 15.7 | 18.0 | 16.9 |
| Malaysia | ... | 19.4 | 19.8 | 16.7 | 16.0 | 14.3 | ... |
| **Philippines** | **16.4** | **16.9** | **17.0** | **15.6** | **14.5** | **13.9** | **13.4** |
| Singapore 2/ | ... | ... | 16.1 | 15.8 | 15.5 | 16.1 | 17.2 |
| Thailand 3/ | 17.5 | 17.6 | 16.5 | 14.3 | 13.5 | 13.7 | 13.5 |
| **Philippines (percent of GNP)** | **15.9** | **16.2** | **16.3** | **14.9** | **13.8** | **13.2** | **12.7** |

Source: Country authorities and IMF staff estimates.
1/ Includes oil revenue.
2/ Fiscal year runs April 1 through March 31.
3/ Fiscal year runs October to September. For years 2001 and 2002, the transfer of VAT on account of the Decentralization Act is not booked as a central government revenue (0.3 percent of GDP in each year). For 1997/98 and earlier the revenue of the extrabudgetary funds (social security) is consolidated in the above-the-line data.

6. **Table 2 quantifies changes that can be explained by either lower rates or declines in the tax base**. Part of the decline can be explained by tax policy changes, including lower tariffs and a loss in the real value of excises. However, this decline is offset partly by greater economic activity, as the tax base increased during 1997 to 2001. As a result, the bulk of the decline remains unexplained, implying that there must have been a deterioration in tax administration. In particular, the decline in Value Added Tax (VAT) collections appears to reflect administrative problems, as the sectors subject to VAT grew.

Table 2. Philippines: Explaining the Tax Revenue Decline

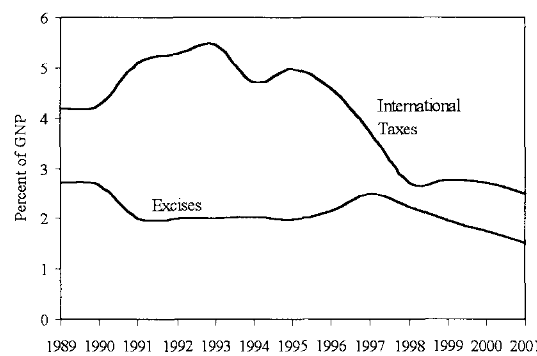
| | 1997 | 2001 | Difference | Explained | | | Tax Administration 1/ |
|---|---|---|---|---|---|---|---|
| | | | | Total | Tax Base | Policy Changes | |
| | (Percent of GNP) | | | | | | |
| Income and Profits | 6.5 | 5.8 | -0.7 | -0.6 | -0.4 | -0.3 | -0.1 |
| Corporate Income Tax 2/ | 3.2 | 2.6 | -0.7 | -0.6 | -0.4 | -0.2 | 0.0 |
| Personal Income Tax | 2.4 | 2.1 | -0.3 | -0.3 | -0.2 | -0.1 | 0.0 |
| Other | 0.9 | 1.2 | 0.3 | 0.3 | 0.3 | 0.0 | 0.0 |
| Excise Taxes | 2.5 | 1.5 | -1.0 | -0.3 | 0.4 | -0.7 | -0.7 |
| Value Added Tax | 1.9 | 1.5 | -0.3 | 0.6 | 0.6 | 0.0 | -0.9 |
| Other indirect taxes | 0.8 | 0.7 | -0.1 | -0.1 | -0.1 | 0.0 | 0.0 |
| Other domestic (DST) | 0.8 | 0.5 | -0.3 | -0.1 | -0.1 | 0.0 | -0.2 |
| International Trade | 3.9 | 2.6 | -1.2 | -0.6 | 0.4 | -1.0 | -0.6 |
| Non-oil tariffs | 2.4 | 0.9 | -1.5 | -0.9 | 0.2 | -1.0 | -0.6 |
| Oil tariffs | 0.1 | 0.1 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 |
| Import VAT | 1.3 | 1.4 | 0.1 | 0.1 | 0.1 | 0.0 | 0.0 |
| Other | 0.1 | 0.2 | 0.1 | 0.1 | 0.1 | 0.0 | 0.0 |
| **TOTAL** | **16.3** | **12.7** | **-3.6** | **-1.1** | **0.9** | **-2.0** | **-2.5** |

1/ This is calculated as a residual.
2/ Data limitations do not allow for an explicit accounting of the impact of tax incentives.

[3] Overall balance excluding interest payments.

7. **Over a longer time horizon, customs revenue has fallen by three percentage points of GNP between 1993 and 2001, largely because tariff rates have been reduced significantly (Figure 2)**. Following the Asian crisis, however, the decline due to tariff policy was partly offset by higher import values due to the exchange rate depreciation. Thus, as Table 2 shows, about half of the post-1997 decline is attributable to weaknesses in customs administration.

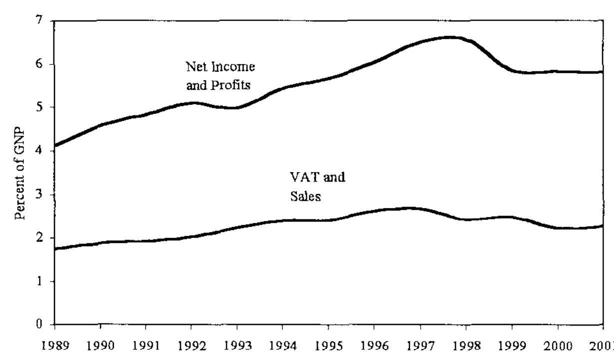
Figure 2. Philippines: Excise Tax and Customs Revenue, 1989-2001




8. **Excise tax collections have also fallen dramatically, by one percent of GNP between 1997 and 2001**. Much of this decline stems from the erosion in the real value of specific duties, since over this period there was only a one-time adjustment alcohol and tobacco duties in 2000, and no increase in specific rates for petroleum. The loss in real value of excises, however, was largely offset by increases in the tax base as consumption of excisable products increased. Consequently on balance the decline is largely unexplained, again pointing to problems in tax administration.

9. **Income and profit tax collections have declined less sharply (Figure 3). Evaluating these trends is difficult**. For example, after a sharp decline in 1997, personal income taxes have subsequently increased as a share of the wage bill and corporate tax collections have increased as a share of gross profits. However, when measured against growth in the economy, both taxes have not increased as vigorously as they should. For corporate taxes, this could be attributable partly to the tax holidays and exemptions that are in place precisely in the sectors that have grown most rapidly in the past four years.[4]

Figure 3. Philippines: Income and Value Added Tax Collections, 1989-2001

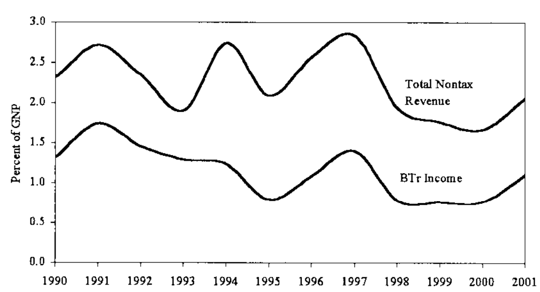



10. **Finally, nontax revenues have averaged about 2.2 percent of GNP over the last ten years, with sudden increases in certain years on account of high returns on**

[4] These include 6 year tax holidays for industries granted pioneer status, such as electronics. For a more detailed description of existing tax incentives in the Philippines and the regional context, see Chalk (2001).

**investments made by the Bureau of Treasury (BTr), and large government guarantee fees (Figure 4)**. Although it is difficult to predict, some of these non-tax resources are likely to be non-recurrent.[5]

Figure 4. Philippines: Nontax Revenue Collections, 1990-2001




## Expenditure

11. **Given the large decline in revenues, total expenditures and net lending was reduced from 19.9 percent of GNP in 1997 to 19.1 percent of GNP in 2001**. Within these overall totals, interest spending and transfers to local government actually increased. Accordingly, discretionary expenditure was squeezed considerably, with personnel services and capital bearing most of the brunt.

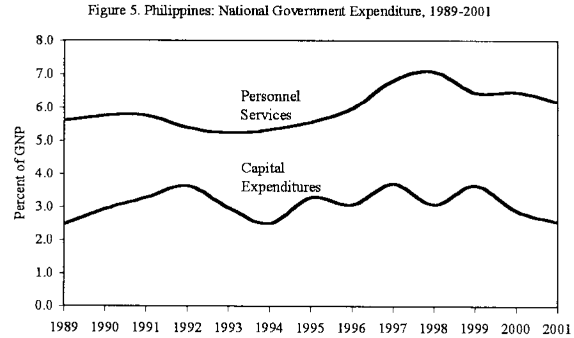
Table 3. Asia: Expenditures on Wages and Salaries

| | 1995 | 1996 | 1997 | 1998 | 1999 | 2000 | 1990's Average |
|---|---|---|---|---|---|---|---|
| | | | (percent of GDP) | | | | |
| Indonesia | 2.8 | 2.8 | 2.6 | 2.2 | 2.9 | 3.0 | 2.7 |
| Korea | 4.6 | 4.6 | 4.7 | 4.9 | ... | ... | 3.4 |
| Malaysia | 5.8 | 5.6 | 4.7 | 4.9 | 4.8 | 4.8 | 6.0 |
| **Philippines** | **5.7** | **6.2** | **7.1** | **7.4** | **6.8** | **6.9** | **6.2** |
| Singapore | 4.9 | 5.0 | 4.9 | 5.0 | 4.9 | 4.8 | 5.1 |
| Thailand | 5.3 | 5.2 | 5.5 | 6.1 | 6.3 | 6.0 | 5.4 |
| | | | (percent of Total Expenditures) | | | | |
| Indonesia | 19.9 | 20.1 | 17.2 | 12.8 | 15.6 | 13.8 | 16.2 |
| Korea | 27.8 | 26.4 | 25.9 | 23.5 | ... | ... | 18.8 |
| Malaysia | 25.9 | 25.4 | 22.4 | 22.9 | 20.2 | 21.3 | 24.6 |
| **Philippines** | **28.8** | **31.2** | **34.4** | **36.5** | **32.8** | **33.8** | **30.7** |
| Singapore | 22.4 | 17.7 | 18.6 | 18.0 | 20.6 | 23.6 | 22.3 |
| Thailand | 33.8 | 31.5 | 27.0 | 25.2 | 23.6 | 31.5 | 30.4 |

Source: IMF Government Finance Statistics (GFS), country authorities and staff estimates.

12. **Judged by regional standards, the weight of personnel services continues to be large, reaching 6 percent of GDP in the 1990's compared to an average of 4½ percent of GDP for the rest of the region (Table 3)**. Although the wage bill has started to decline as a share of GNP, it still accounts for about one-third of total expenditures.

Figure 5. Philippines: National Government Expenditure, 1989-2001




13. **Although there has been some decline in personnel services since 1998, this has been achieved by compressing wages, particularly at the management levels (Figure 5)**.[6] With salaries of senior executives and professionals lagging well behind their private sector counterparts, the government has had severe problems

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[5] In this vein, a detailed cost benefit analysis of BTr's investments against the interest payments it pays on government securities it issues to finance the deficit would be useful.

[6] Asiaweek 2000 Salary Survey found that salaries and regular allowances of senior executives and professionals amount to 20 percent of their private sector counterparts, while salaries in the lower pay groups are comparable to the private sector.

in attracting and retaining qualified staff, with vacancies emerging in a number of key positions. Meanwhile, the number of filled positions in the national government increased by 5 percent between 1997 and 2001. Moreover, the number of filled positions is expected to increase further in 2002, even when taking into account the recent abolition of certain agencies.

Table 4. Asia: Capital Expenditures

| | 1995 | 1996 | 1997 | 1998 | 1999 | 2000 | 1990's Average |
|---|---|---|---|---|---|---|---|
| | (percent of GDP) | | | | | | |
| Indonesia 1/ | 5.8 | 5.6 | 5.0 | 5.3 | 4.5 | 3.7 | 6.4 |
| Korea | 3.5 | 4.1 | 4.1 | 4.5 | 5.1 | 5.1 | 3.5 |
| Malaysia | 5.0 | 4.1 | 4.5 | 5.4 | 6.4 | 7.3 | 5.4 |
| **Philippines** | **3.4** | **3.2** | **3.9** | **3.2** | **3.9** | **3.1** | **3.3** |
| Singapore | 3.7 | 6.3 | 5.1 | 7.4 | 6.0 | 5.1 | 5.0 |
| Thailand | 5.4 | 5.9 | 9.0 | 11.2 | 12.2 | 4.7 | 6.2 |
| Average | 4.5 | 4.9 | 5.3 | 6.2 | 6.3 | ... | 5.0 |
| | (percent of Total Expenditures) | | | | | | |
| Indonesia 1/ | 41.4 | 40.6 | 33.1 | 30.7 | 24.4 | 17.5 | 38.5 |
| Korea | 18.2 | 20.0 | 18.6 | 17.6 | 18.6 | 20.6 | 16.5 |
| Malaysia | 22.5 | 19.1 | 21.6 | 24.9 | 26.8 | 32.6 | 22.5 |
| **Philippines** | **17.0** | **16.0** | **18.6** | **15.9** | **18.6** | **15.1** | 16.3 |
| Singapore | 17.1 | 22.3 | 19.1 | 26.7 | 25.0 | 25.1 | 21.5 |
| Thailand | 34.6 | 35.5 | 44.0 | 46.6 | 46.0 | 24.2 | 32.5 |
| Average | 25.1 | 25.6 | 25.8 | 27.1 | 26.6 | ... | 25.0 |

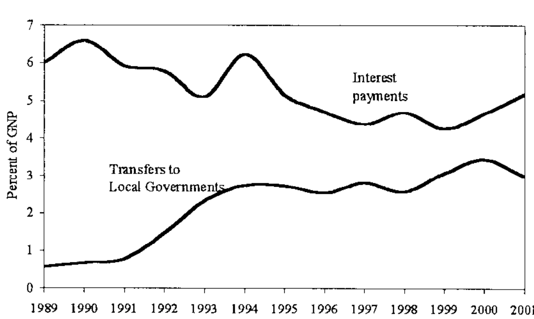
Source: IMF Government Finance Statistics (GFS), country authorities and staff estimates.
1/ Refers to Development Expenditure.

14. **Another area that has shouldered much of the expenditure restraint is capital expenditures, which have fallen by over 1 percentage point of GNP between 1997 and 2001 to around 3 percent of GDP, the lowest level in the region (Table 4).** This is reflected in fewer paved roads and telephone lines, and a lower consumption of electricity relative to other countries in the region.

15. **Operations and maintenance expenditures were kept around 2.2 percent of GNP between 1997 and 2001.** However, there have been recent cuts in this area, as the budget projects a decline of about 0.6 percentage points of GNP in 2002.

16. **Interest rate outlays, on the other hand, have increased by about 0.8 percentage points of GNP between 1997 and 2001 (Figure 6).** The upturn mirrors the increase in the stock of government debt, which grew from P 1.3 trillion at the end of 1997 (51 percent of GNP) to P 2.3 trillion at the end of 2001 (60 percent of GNP), a growth of 79 percent over five years.

Figure 6. Philippines: National Government Expenditure, 1989-2001



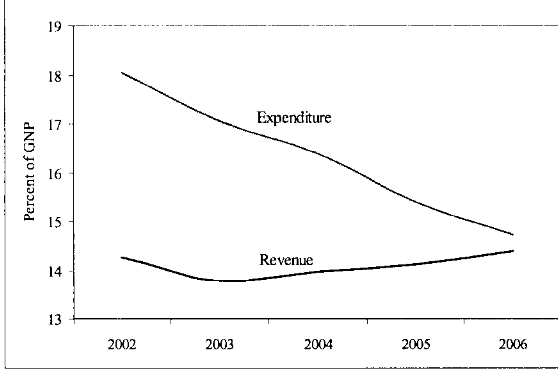

17. **Similarly, transfers to local governments have grown—and very substantially when measured over a longer time horizon.** The Local Government Code of 1991 established responsibilities for the three layers of local governments to which it devolved important responsibilities in agriculture, environment, natural resource management, health, public works, and highways. Devolution of these responsibilities was accompanied by a provision granting local governments an internal revenue allotment (IRA) equivalent to 40 percent of national internal revenue taxes based on the collection of the third preceding

fiscal year.[7] In addition, local government units are entitled to 40 percent of the proceeds from the development and utilization of the mineral, forest, and aquatic wealth in their jurisdictions in the preceding year. Until 2000, local governments had benefited from changes in the sharing formula, as the decline in tax collections had not yet been reflected into lower internal revenue allotments (Figure 6). The result has been an increase in transfers to local governments of 0.6 percentage points of GNP between 1997 and 2000.[8]

## C. Fiscal Sustainability

18. **The authorities have given heavy emphasis to placing the public finances on a sound footing to ensure that the Philippine economy weathers future shocks.** In particular, they have committed to bringing the budget back to balance by 2006, and targeting the limited public spending toward poverty reduction objectives. Under the 2001 Medium-Term Development Plan, the authorities will reduce spending dramatically, from 18.1 percent of GNP in 2002 to 14.7 percent in 2006 while revenues are projected to increase from 14.3 percent of GNP in 2002 to 14.4 percent of GNP in 2006 (Figure 7).[9]

Figure 7. Philippines: The Medium Term Plan




19. **The section below explains why it is important to adhere to the fiscal consolidation plan**. A framework for assessing the sustainability of the fiscal stance is presented, and it is shown that in the absence of fiscal consolidation the situation could quickly become unsustainable.

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[7] In the event that the National Government incurs an unmanageable public sector deficit, the President – in consultation with Congress – is authorized to make adjustments to this sharing agreement. However, a minimum of 30 percent of internal tax collections in the preceding third fiscal year is required (1991 Local Government Code, Section 284). Allocations between 1995 and 2000 have averaged 38 percent of internal revenue collections of the third preceding fiscal year.

[8] Transfers to local governments in 2001 were constrained to 3.0 percent of GNP, despite entitlements amounting to 3.5 percent of GNP according to the transfer formula. The government has negotiated with local governments to partly make up for this in 2002 with the remainder being paid out over the medium term.

[9] Note that the Medium Term plan has been recently redefined. The numbers illustrated here are based on the latest available plan.

**Assessing Sustainability**

20. **From an analytical point of view, fiscal sustainability requires that today's government debt is matched by an excess of future primary surpluses over primary deficits in present value terms**.[10] In order to assess whether the economy is in a fiscally sustainable path, economists typically look for a declining trend in the overall fiscal deficit-to-GNP ratio, the debt-to-GNP ratio or the debt-to-revenue ratio. One common measure is the primary gap indicator, which is based on the permanent primary deficit necessary to stabilize the debt ratio. Specifically, fiscal sustainability (FS) is measured by comparing the actual primary deficit ($pd^a$) with the sustainable primary deficit ($pd^s$).

(1) $$FS = pd^a - pd^s = pd^a - (n - r)d - (n - r^* - c)d^*$$

where n is real GNP growth, r and r* are the domestic and foreign interest rates respectively, d and d* are the domestic and foreign debt to GNP ratios, and c is the real exchange rate growth. If FS is less than or equal to zero, then the government is fiscally sustainable.[11]

21. **Note that this indicator is based on the notion of a stable debt-to-output ratio. For countries that are heavily indebted like the Philippines–sustainable fiscal policy necessitates a reduction in debt relative to output**. Nonetheless, this definition is useful because it serves as a first approximation to sustainability, since if it points to an unsustainable fiscal situation, then any other more stringent definition will not hold. This approach is complemented by comparing the gross financing requirements as a share of GNP relative to the average in previous periods.

**Why Does the Deficit Need to be Reduced?**

22. **What does equation (1) tell us about fiscal sustainability in the Philippines**? Assuming a constant primary surplus at the 2002 budgeted level, and interest rates and growth around historical levels, the stock of debt would remain stable as a share of GNP. Therefore, according to equation (1) the situation is "sustainable". However, the national government debt stock would remain at about 60 percent of GNP, far above desirable levels.

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[10] See Chalk and Hemming (2000) for an overview of approaches to assessing fiscal sustainability.

[11] Gerson and Nellor (1997) have defined an even stricter definition of fiscal sustainability for the Philippines by looking at the adjustment required to maintain overall fiscal balance and at the same time to ensure constant expenditure on public infrastructure investment. Sustainability defined in terms of the overall fiscal balance is a stronger requirement, as it implies a declining rather than a constant debt ratio.

Indeed, it would do nothing to improve the Philippines' fiscal vulnerability indicators, which at the end of 2001 were among the weakest in the region, and worse than some Latin American crisis cases. (Table 5). Such debt indicators leave the Philippines highly exposed to changes in financial market sentiment. What would be a safer level for the stock of government debt? Although there is no rule for this, some governments, such as New Zealand, have gone as far as setting a fiscal responsibility law stating public debt should not exceed 30 percent of GDP.

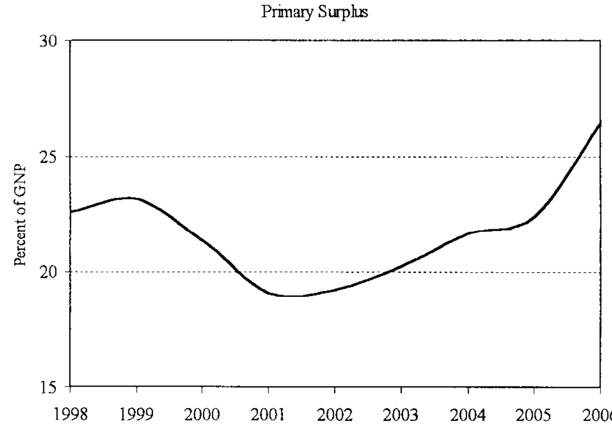
Table 5. Comparative Fiscal Vulnerability Indicators, end 2001
(in percent)

| | Nonfinancial Public Sector Debt/ GDP | Central Government Debt/ Revenue | Central Government Revenue / GDP | Debt service/ Revenue 1/ |
|---|---|---|---|---|
| Philippines | 97.1 | 404.6 | 15.6 | 50.8 |
| Other Asian countries | | | | |
| Thailand 2/ | 57.8 | 164.3 | 15.2 | 11.0 |
| Malaysia | 70.5 | 183.1 | 23.8 | 12.1 |
| Indonesia | ... | 451.7 | 20.1 | 53.7 |
| Latin American Countries | | | | |
| Argentina | 64.1 | 285.4 | 18.8 | 59.7 |
| Brazil 3/ | 55.8 | 154.0 | 23.0 | ... |
| Uruguay | 54.8 | 212.2 | 19.7 | 38.8 |

1/ Defined as total interest payments plus amortization payments on loans with maturities of one or more years.
2/ Debt service for Thailand includes total annual amortization payments.
3/ For Brazil, government debt is reported in net terms. Nonfinancial government debt includes central government, regional governments, public enterprises (all levels of government), central bank, and social security system. Revenue and grants includes the social security system.

23. **With a stable primary surplus, overall financing requirements would increase with scheduled amortization payments coming due and as new borrowing would be required every year to finance the deficit**. As shown in Figure 8, gross financing requirements would increase from an average of 22 percent of GNP in the last four years to over 26 percent of GNP by 2006, a level that domestic and international markets may not be willing to sustain at the interest rates that have prevailed in the past.[12] Indeed, financing requirements of this size (and growing) could precipitate exchange rate depreciation and increasing interest rates. In this case, the result would be a vicious cycle of higher financing needs, higher borrowing, and higher interest and amortization costs.

Figure 8. Philippines: Gross Financing Requirements Under Constant Primary Surplus




## D. How Difficult Are The Medium-Term Targets?

24. **As demonstrated above, it is not enough to maintain a constant primary surplus**. There needs to be some adjustment and the government has decided that the goal should be to balance the budget by 2006. At first glance this may seem a worthy goal, but perhaps

[12] Gross financing requirements are defined as the sum of the deficit, medium- and long-term amortizations and the stock of short term debt.

unambitious in its timetable. In fact, as demonstrated below, this target is more difficult to achieve than may seem, for on existing trends, the deficit is only likely to widen over time.

**Revenue**

25. **Three scenarios were constructed to assess possible revenue performance**. The baseline projection (Table 6) holds corporate and income tax buoyancy constant at the average for 2000-01, while assuming VAT is at least unitary elastic. In addition, import tariffs were assumed to decline gradually in line with trade commitments, while excise collections continue to decline in real terms. An optimistic scenario was then constructed with higher economic growth and tax buoyancy projections, while a pessimistic scenario was constructed assuming lower growth and no improvement in buoyancy. All scenarios show an improvement in 2006 on account of expected royalties and profit taxes from the Malampaya gas project.

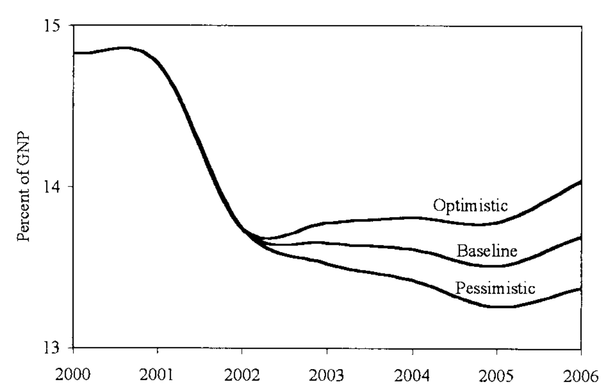
Table 6. Philippines: National Government Revenues, Baseline
(percent of GNP)

| | 2000 | 2001 | 2002 | 2003 | 2004 | 2005 | 2006 |
|---|---|---|---|---|---|---|---|
| Total Revenue | 14.8 | 14.8 | 13.7 | 13.7 | 13.6 | 13.5 | 13.7 |
| *of which:* Tax revenue | 13.2 | 12.7 | 12.0 | 11.9 | 11.8 | 11.7 | 11.9 |
| Net Income and Profits | 5.8 | 5.8 | 5.3 | 5.5 | 5.6 | 5.6 | 5.9 |
| Corporate income tax | 2.4 | 2.6 | 2.1 | 2.1 | 2.1 | 2.1 | 2.1 |
| Personal income tax | 2.3 | 2.1 | 2.2 | 2.2 | 2.3 | 2.3 | 2.3 |
| Other 1/ | 1.0 | 1.2 | 1.1 | 1.2 | 1.2 | 1.2 | 1.4 |
| Excises | 1.8 | 1.5 | 1.3 | 1.0 | 1.0 | 0.9 | 0.9 |
| Sales Taxes, VAT & Licenses | 2.2 | 2.3 | 2.3 | 2.3 | 2.3 | 2.3 | 2.3 |
| VAT | 1.5 | 1.5 | 1.6 | 1.6 | 1.6 | 1.6 | 1.6 |
| Other indirect tax | 0.7 | 0.7 | 0.6 | 0.6 | 0.6 | 0.6 | 0.6 |
| Other domestic | 1.5 | 1.7 | 1.6 | 1.6 | 1.6 | 1.6 | 1.6 |
| International taxes | 2.7 | 2.5 | 2.5 | 2.5 | 2.4 | 2.3 | 2.3 |
| Tariffs | 1.3 | 1.0 | 1.1 | 1.1 | 1.0 | 0.9 | 0.9 |
| Import VAT | 1.3 | 1.4 | 1.1 | 1.1 | 1.1 | 1.1 | 1.2 |
| Other | 0.2 | 0.2 | 0.4 | 0.4 | 0.4 | 0.4 | 0.4 |
| Non tax revenues | 1.7 | 2.1 | 1.8 | 1.8 | 1.8 | 1.8 | 1.8 |

Source: Authorities; and staff projections.
1/ Includes Malampaya royalty and income taxes.

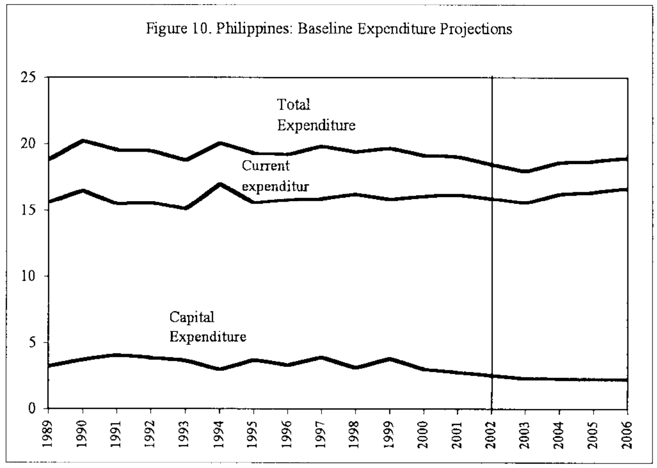
26. **Under the baseline scenario, revenues are expected to decline by around 1 percentage point to about 13.7 percent of GNP in 2002 (based on the performance in the first half of the year), and then remain around this level throughout the medium term (Figure 9)**. The optimistic scenario is not much better, with revenues expected to recover over the medium term, but only to 14 percent of GNP in 2006. In the pessimistic scenario, revenue would deteriorate further to 13.4 percent of GNP by 2006.

Figure 9. Philippines Revenue Projections



## Expenditure

27. **On the expenditure side, the baseline scenario adjusts 2002 budgeted outlays downward to ensure that the deficit target is met given lower revenue collections (Figure 10).** For the medium term the baseline projections assume:




- Continued growth in employment and some real increase in supervisory staff wages, in line with government policy to make wages competitive given their unsustainably low levels;

- Constant allocations for operations, maintenance, and infrastructure as a share of GNP.

- An additional ½ percent of GNP in interest costs, arising from the assumption of P200 billion of debt from the National Power Corporation (NPC) in 2003.[13] As a result the expenditure/GNP ratio will rise by about ½ percentage point over the medium term, to around 19 percent.

Table 7. Contingent Liabilities - Potential Budget Support Requirements

| | 2003 | 2004 | 2005 | 2006 |
|---|---|---|---|---|
| **Likely requirements** | (billions of Pesos) | | | |
| National Power Corporation | | | | |
| Assumed Debt | 200.0 | | | |
| Interest cost | 20.9 | 20.6 | 20.4 | 20.3 |
| Other GOCC loans | 9.1 | 9.8 | 10.6 | 11.5 |
| Forward Cover on Foreign Exchange Risk | ... | ... | ... | ... |
| BOT contract guarantees | ... | ... | ... | ... |
| Umbrella guarantees - housing | ... | ... | ... | ... |
| Tax Credit Certificates | 6.0 | 6.0 | 6.0 | 6.0 |
| **Requirement under pessimistic scenario** | | | | |
| Pensions | | | | |
| Social Security System 1/ | 2.2 | 7.8 | 13.4 | 19.0 |
| Government Service Insurance System | 0.0 | 0.0 | 0.0 | 0.0 |
| Deposit Insurance | | | | |
| Assumed Debt | 100.0 | | | |
| Interest cost | 10.4 | 11.4 | 12.4 | 13.6 |
| **Total** | 48.6 | 55.6 | 62.9 | 70.4 |
| Percent of GNP | 1.2 | 1.2 | 1.3 | 1.5 |
| Memo items: | | | | |
| Average domestic interest rate | 10.4 | 10.3 | 10.2 | 10.1 |

Source: IMF staff projections.
1/ Linear extrapolation of World Bank PROST estimates.

28. **There are other contingent liabilities that pose a threat to the budget**. These include pension liabilities, foreign exchange cover for loans, Build-Operate-Transfer (BOT) contract guarantees outside the power sector, potential costs of bank restructuring, and umbrella guarantees for various types of loans in agriculture, micro-enterprise and housing. Beyond guaranteed

[13] Under the recent power reform bill, the government is to assume up to P 200 billion of NPC debt after it is privatized.

Government-Owned and Controlled Corporations (GOCC) loans, contingent liabilities are largely unmonitored, leading to difficulties in adequately provisioning for them in the budget. However, Table 7 presents a preliminary assessment of the potential size of budgetary costs over the medium term.

## Quantifying the Degree of Reform Needed

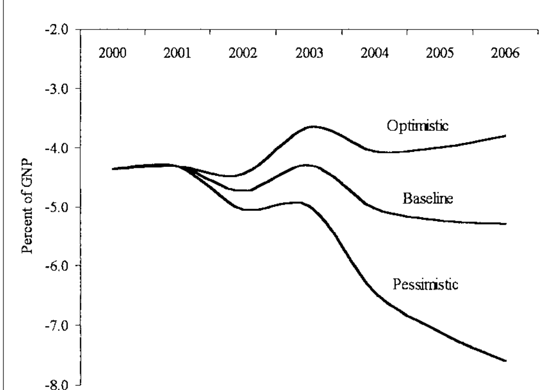
29. **The scenarios described above allow for a preliminary assessment of the fiscal position in the absence of measures, and allows for a quantification of the needed adjustments**. The baseline scenario is based on the baseline tax scenario and only the most likely contingent liabilities coming due, namely the assumption of NPC debt, continued subsidies to GOCCs and declining tax credit certificates. The result is an overall deficit that is expected to deteriorate by one percentage point of GNP between 2001 and 2006, while the National Government debt-to-GNP ratio increases (Table 8). Under these circumstances, the conditions for fiscal sustainability are not met and the gross financing need reaches nearly 30 percent of GNP (Figure 11).

Table 8. Philippines - Medium Term

| | 2001 | 2002 | 2003 | 2004 | 2005 | 2006 |
|---|---|---|---|---|---|---|
| Assumptions | | | | | | |
| Real GNP growth (percent change) | 3.4 | 4.3 | 3.9 | 3.6 | 3.5 | 3.5 |
| Domestic interest rates (percent) | 11.0 | 8.6 | 10.3 | 11.2 | 11.6 | 11.8 |
| External interest rates (percent) | 5.9 | 6.2 | 6.0 | 6.0 | 6.0 | 6.0 |
| Average exchange rate (Pesos/US$) | 51.0 | 51.0 | 51.0 | 53.3 | 55.1 | 56.9 |
| | (percent of GNP) | | | | | |
| Overall balance | -4.3 | -4.7 | -4.3 | -5.0 | -5.2 | -5.3 |
| Primary balance | 0.9 | 0.1 | 0.9 | 0.8 | 0.9 | 1.0 |
| Gross financing needs | 19.1 | 20.2 | 20.8 | 22.8 | 24.3 | 29.1 |
| National Government Debt 1/ | 59.7 | 59.5 | 63.9 | 64.6 | 65.4 | 66.2 |
| Difference Medium Term Plan | | 1.0 | 1.0 | 2.6 | 3.9 | 4.9 |

Source: IMF staff projections.
1/ Excludes onlent and guaranteed debt.

Figure 11. Philippines: Overall Deficit




30. **As can be expected, the optimistic scenario the outcome is better than under the baseline**. However, the deficit remains large and debt increases substantially—rather than falling--while gross financing needs are over 25 percent of GNP (Table 9).

31. **A pessimistic scenario was also constructed, based on the pessimistic revenue scenario and a number of contingent liabilities materializing, including 2 percent of GNP in bank restructuring costs in 2003 and subsidies to the Social Security System (SSS) over the medium term**. On the financing side, the pessimistic scenario assumes

Table 9. Philippines - Medium Term

| | OPTIMISTIC | | | | | |
|---|---|---|---|---|---|---|
| | 2001 | 2002 | 2003 | 2004 | 2005 | 2006 |
| Assumptions | | | | | | |
| Real GNP growth (percent change) | 3.4 | 4.3 | 4.2 | 3.9 | 3.8 | 3.8 |
| Domestic interest rates (percent) | 11.0 | 7.6 | 8.8 | 9.4 | 9.7 | 9.9 |
| External interest rates (percent) | 5.9 | 6.2 | 6.0 | 6.0 | 6.0 | 6.0 |
| Average exchange rate (Pesos/US$) | 51.0 | 51.0 | 51.0 | 53.3 | 55.1 | 56.9 |
| | (percent of GNP) | | | | | |
| Overall balance | -4.3 | -4.4 | -3.7 | -4.1 | -4.0 | -3.8 |
| Primary balance | 0.9 | 0.1 | 1.0 | 1.1 | 1.2 | 1.4 |
| Gross financing needs | 19.1 | 19.9 | 19.8 | 21.2 | 21.9 | 25.9 |
| National Government Debt 1/ | 59.7 | 59.2 | 62.8 | 62.5 | 62.1 | 61.4 |
| Difference Medium Term Plan | | 0.7 | 0.4 | 1.6 | 2.7 | 3.5 |

Source: IMF staff projections.
1/ Excludes onlent and guaranteed debt.

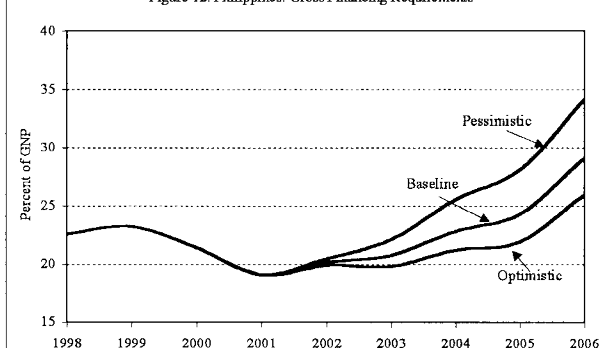
US$1 billion lower in foreign financing than assumed by the authorities and a concomitant shortening of the maturity structure. In this case, the overall deficit would worsen from 4.3 percent of GNP in 2001 to 7.6 percent of GNP in 2006 (Table 10). This scenario is not sustainable, while gross financing needs would exceed 30 percent of GNP.

| Table 10. Philippines - Medium Term | PESSIMISTIC | | | | | |
|---|---|---|---|---|---|---|
| | 2001 | 2002 | 2003 | 2004 | 2005 | 2006 |
| Assumptions | | | | | | |
| Real GNP growth (percent change) | 3.4 | 4.3 | 3.6 | 3.3 | 3.2 | 3.2 |
| Domestic interest rates (percent) | 11.0 | 9.6 | 11.8 | 12.9 | 13.5 | 13.7 |
| External interest rates (percent) | 5.9 | 6.2 | 6.0 | 6.0 | 6.0 | 6.0 |
| Average exchange rate (Pesos/US$) | 51.0 | 51.0 | 51.0 | 53.3 | 55.1 | 56.9 |
| | (percent of GNP) | | | | | |
| Overall balance | -4.3 | -5.0 | -5.0 | -6.4 | -7.1 | -7.6 |
| Primary balance | 0.9 | 0.1 | 0.7 | 0.4 | 0.3 | 0.3 |
| Gross financing needs | 19.1 | 20.5 | 22.1 | 25.5 | 28.1 | 34.1 |
| National Government Debt 1/ | 59.7 | 59.8 | 67.2 | 69.3 | 71.8 | 74.5 |
| Difference Medium Term Plan | | 1.3 | 1.7 | 4.0 | 5.8 | 7.2 |

Source: IMF staff projections.
1/ Excludes onlent and guaranteed debt.

32. **The result from this analysis is that the medium term targets laid out by the authorities are not easily attained**. The adjustment necessary to achieve the deficit targets amount to 3½ percentage points of GNP by 2006 in the optimistic scenario, and 7 percentage points of GNP in the pessimistic scenario. Moreover, note that all the scenarios discussed above do not take into account "confidence effects". In most cases, high fiscal deficits could lead to a loss in investor confidence, resulting in higher interest and exchange rates that would further damage the fiscal profile.

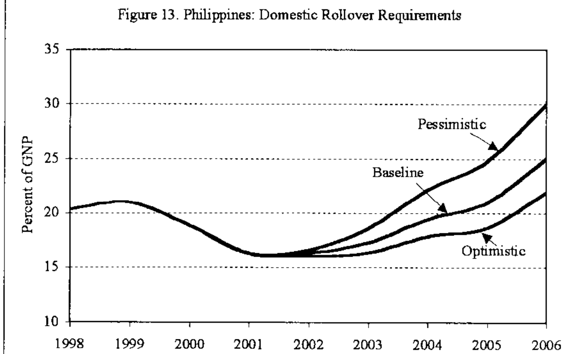
Figure 12. Philippines: Gross Financing Requirements




## Financing requirements and potential risks

33. **Gross financing requirements are projected to be much larger by 2006 than in the past four years, even under the optimistic scenario**. Specifically, gross financing requirements are projected to rise from 19 percent of GNP in 2001 to between 26 and 34 percent of GNP by 2006 (Figure 12).[14] Assuming the authorities' projections for foreign financing and calculating the domestic financing requirement as a residual, it is clear that such requirements will be **difficult to finance**. In particular, domestic roll-over requirements would increase beyond 20 percent of GNP under all of the scenarios, crowding out the private sector (Figure 13).

Figure 13. Philippines: Domestic Rollover Requirements




[14] Gross financing requirements rise in 2006 on account of large amortization payments due that year for previously undertaken project loans.

## E. Adjustments Required to Achieve the Government's Fiscal Targets

34. **The Philippine medium-term plan stresses the importance of eliminating the deficit**. However, on existing trends the deficit is likely to rise; according to the analysis in Section D, adjustments of about 5 percent of GNP would be required by 2006 under the baseline. To assess the adjustments needed to achieve the authorities' objective, an active policy scenario is constructed in the following order. First the scope for reducing "flexible" spending is estimated. Then, the possibility of civil service reform is discussed, and preliminary savings estimated. Finally, the need for revenue measures is discussed

### Can adjustment be done through expenditure compression alone?

35. **The 2002 Medium Term Plan envisages that the budget will be balanced mainly by reducing spending**. Under the plan, the expenditure/GNP ratio will fall by about 3½ percentage points relative to the 2001 outturn, of which 1 percent of GNP will come from interest savings. To do this, the government: (i) has put in place a medium-term expenditure framework to link planning and budgeting in a three-year rolling budget; (ii) is pursuing Sector Effectiveness and Efficiency Reviews (SEERs) to assess the effectiveness of agency programs, and (iii) has begun putting in place a framework to reorient budgeting towards outcomes. In addition, the government hopes that procurement reform will help contain costs and has envisaged a strategy for reengineering the public service. Procurement reform has begun with the introduction of an electronic system, which has already resulted in some savings in the education sector.

36. **These measures, however, will not be sufficient to reduce spending by 3½ percent of GNP**. One reason is that the bulk of the Philippine budget consists of "inflexible" expenditures which can not be easily cut, including interest payments, transfers to local governments, and the wage bill. The residual (flexible) budget would only average 3.6 percent of GNP between 2003 and 2006 (Table 11).

Table 11. Philippines: Size of the Budget

| | 1999 | 2000 | 2001 | 2002 | 2003 | 2004 | 2005 | 2006 |
|---|---|---|---|---|---|---|---|---|
| | | | | (percent of GNP) | | | | |
| Total Expenditure & Net Lending 1/ | 19.7 | 19.2 | 19.1 | 18.5 | 17.9 | 18.6 | 18.7 | 19.0 |
| Inflexible expenditures | 13.8 | 14.6 | 14.4 | 14.6 | 14.4 | 15.1 | 15.2 | 15.4 |
| Interest | 4.3 | 4.7 | 5.2 | 4.9 | 5.2 | 5.8 | 6.1 | 6.3 |
| Transfers to local governments | 3.1 | 3.4 | 3.0 | 3.4 | 3.2 | 3.2 | 2.9 | 2.9 |
| Personnel services | 6.5 | 6.5 | 6.2 | 6.3 | 6.0 | 6.0 | 6.1 | 6.2 |
| **Flexible expenditures** | **5.9** | **4.6** | **4.7** | **3.9** | **3.6** | **3.6** | **3.6** | **3.6** |
| Current | | | | | | | | |
| Operations & Maintenance | 2.3 | 1.9 | 2.3 | 2.0 | 1.6 | 1.6 | 1.6 | 1.7 |
| Subsidies | 0.2 | 0.3 | 0.2 | 0.1 | 0.2 | 0.2 | 0.2 | 0.2 |
| Tax expenditures | 0.2 | 0.1 | 0.0 | 0.0 | 0.1 | 0.1 | 0.1 | 0.1 |
| Capital 2/ | | | | | | | | |
| Infrastructure | 3.1 | 2.2 | 2.0 | 1.6 | 1.3 | 1.3 | 1.3 | 1.4 |
| Equity | 0.0 | 0.1 | 0.2 | 0.1 | 0.2 | 0.2 | 0.2 | 0.2 |
| Net lending | 0.1 | 0.1 | 0.1 | 0.1 | 0.1 | 0.1 | 0.1 | 0.1 |
| **Adjustment required** | | | | **1.0** | **1.0** | **2.6** | **3.9** | **4.9** |

1/ IMF definition; includes interest expenditures for CB-BOL.
2/ Excludes transfers to LGUs.

## The Need for Civil Service Reform

37. **Accordingly, the main scope for significant expenditure savings would come from civil service reform.**[15] To achieve the medium term budget targets, the government will need to implement a far-reaching reform program, including a reduction in the number of government workers, an improvement in the skills mix, an increase in compensation for supervisory staff, and an examination of the generous and poorly targeted nonwage benefits given to government employees (both past and present) that are contained in the budget.

38. **In line with these objectives, the active policy scenario assumes that expenditures on personnel services in 2002 are slightly above budget given the overruns in the first semester.** For the medium term, a hiring freeze is assumed until a detailed strategy can be put together, followed by a 20 percent retrenchment with offsetting severance payments in 2004. As a result, the budgetary savings would not be observed until 2005. This could be followed by a further 5 percent retrenchment in 2005 (Table 12). Meanwhile, wages are expected to increase with inflation, except for supervisory staff, who would receive an annual 18 percent wage increase over the medium term. By 2006, the resulting wage bill scenario is about 1¾ percentage points of GNP lower than in the baseline scenario.

Table 12. Philippines: Wage Bill Projections - Active Scenario

| | 2002 | 2003 | 2004 | 2005 | 2006 |
|---|---|---|---|---|---|
| | (percent increase) | | | | |
| Filled positions (percent increase) | 1.8 | 0.0 | 0.0 | -20.0 | -5.0 |
| Average wages | | | | | |
| Professional Non-Supervisory | 5.0 | 5.0 | 5.0 | 5.0 | 5.0 |
| Professional Supervisory | 5.0 | 18.0 | 18.0 | 18.0 | 18.0 |
| Sub-Professional Non-Supervisory | 5.0 | 5.0 | 5.0 | 5.0 | 5.0 |
| Sub-Professional Supervisory | 5.0 | 18.0 | 18.0 | 18.0 | 18.0 |
| Uniformed Personnel | 5.0 | 5.0 | 5.0 | 5.0 | 5.0 |
| | (percent of GNP) | | | | |
| Wage bill | 6.0 | 5.9 | 5.8 | 4.6 | 4.3 |

Source: IMF staff projections.

## Contingent Liabilities and Other Risks

39. **Another key component of an active policy scenario would need to be strong reform efforts in pensions and better monitoring systems for other contingent liabilities.** Subsidies for the social security institutions are not included in the active projections. But this would only be possible if the serious problems of these institutions are addressed. Social Security benefits are too generous and only weakly linked to contributions, while contribution rates are too low, and asset management practices are poor. To deal with these problems, the Presidential Retirement Income Commission recommended: (i) increasing

[15] Such a program could be part of the more general program to strengthen public administration, as outlined by the recent World Bank Public Expenditure, Procurement and Financial Management Review.

contribution rates for the SSS along with the minimum number of contribution years; (ii) increasing the retirement age from 60 to 65; (iii) introducing safeguards to ensure prudent, apolitical, asset management; (iv) improving the administration of contributions in order to reduce nonreporting and noncompliance; (v) calculating benefits on a career average salary (rather than average of the last five years of service); and (vi) encouraging the development of private pension plans.

40. **In addition, an explicit action plan must be adopted to better monitor and prevent a further build up of other contingent liabilities.** In the short-run the following steps could be taken: (i) conduct benchmark audits of the main institutions where there are large contingent liabilities; (ii) establish a separate accounting and provisioning system for foreign exchange cover and automatic guarantees; and (iii) ensure any future guarantees are covered under the ceiling set by the Foreign Borrowing Act. In the medium term, the government could set an annual limit on commitments to contingent liabilities and require all government agencies to submit periodic reports on the nature, risks and magnitude of their liabilities. Moreover, the government should start provisioning for these liabilities, build up capability to do risk assessment of projects, charge risk-based guarantee premiums, and disclose their magnitude in budget documents.

**Impact on Total Expenditure**

41. **Fiscal adjustment would generate a virtuous circle**. Lower expenditures would lead to lower deficits, which would in turn lead to lower interest rate costs, thus reducing the deficit even further. Interest payments would decline from 6.3 percent of GNP under the baseline to 5.2 percent of GNP in 2006. If in addition, revenue measures are taken as described below, then interest payments could fall further to 4.7 percent of GNP by 2006. Total expenditure and net lending under the active policy scenario would consequently be 2 percentage points of GNP lower than the baseline scenario by 2006—higher, nonetheless, than the authorities' medium term plan (Figure 14). The remaining adjustments required to reach the medium term deficit targets would consequently amount to 3 percent of GNP by 2006 (Table 13). These additional adjustments will necessarily have to come from increased revenue collections.

Figure 14. Philippines: Total Expenditure Projections

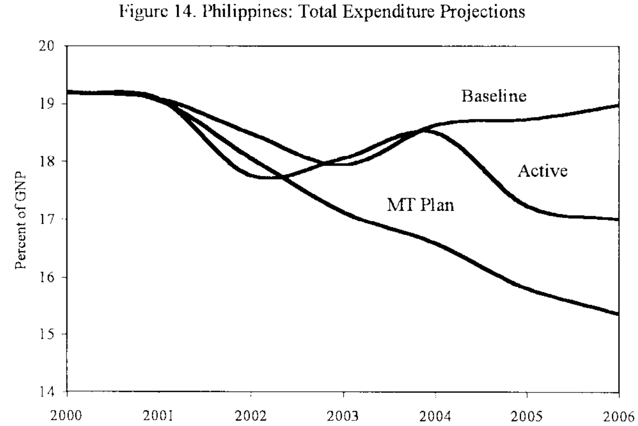


Table 13. Philippines: Budget Expenditure

| | 2001 | 2002 | 2003 | 2004 | 2005 | 2006 |
|---|---|---|---|---|---|---|
| | | | (percent of GNP) | | | |
| Total Expenditure & Net Lending 1/ | 19.1 | 17.8 | 18.1 | 18.6 | 17.4 | 17.2 |
| Inflexible expenditures | 14.4 | 14.3 | 13.8 | 14.1 | 12.7 | 12.3 |
| Interest | 5.2 | 4.6 | 4.7 | 5.1 | 5.2 | 5.2 |
| Transfers to local governments | 3.0 | 3.4 | 3.2 | 3.1 | 2.9 | 2.8 |
| Personnel services | 6.2 | 6.3 | 5.9 | 5.8 | 4.6 | 4.3 |
| Flexible expenditures | 4.7 | 3.4 | 4.3 | 4.5 | 4.7 | 4.9 |
| Current | 2.5 | 1.7 | 2.2 | 2.3 | 2.4 | 2.5 |
| Operations & Maintenance | 2.3 | 1.6 | 1.9 | 2.0 | 2.1 | 2.2 |
| Subsidies | 0.2 | 0.1 | 0.2 | 0.2 | 0.2 | 0.2 |
| Tax expenditures | 0.0 | 0.0 | 0.1 | 0.1 | 0.1 | 0.1 |
| Capital 2/ | 2.2 | 1.7 | 2.1 | 2.2 | 2.3 | 2.4 |
| Infrastructure | 2.0 | 1.5 | 1.8 | 1.9 | 2.0 | 2.1 |
| Equity | 0.2 | 0.1 | 0.2 | 0.2 | 0.2 | 0.2 |
| Net lending | 0.1 | 0.1 | 0.1 | 0.1 | 0.1 | 0.1 |
| **Remaining adjustment (after expenditure cuts)** | | | **1.0** | **2.5** | **2.5** | **3.0** |

1/ IMF definition; includes interest expenditures for CB-BOL.
2/ Excludes transfers to LGUs.

## Implications for Revenue

42. **As noted above, even if expenditures are compressed to the maximum extent feasible, additional measures amounting to 3 percent of GNP by 2006 would still be required—much more than projected in the Medium-Term Plan**.

## Tax administration

43. **The government expects to improve collections substantially over the medium term on the basis of administrative measures**. Plans for the Bureau of Internal Revenue (BIR) include: (i) an intensive audit program; (ii) full introduction of documentary stamp tax (DST) machines; (iii) improving withholding taxes; (iv) redefining gross income for special economic zones; (v) improving fuel excise administration, (vi) enforcing tighter ceilings on representation, advertising, transportation and promotional expenses; and (vii) expansion of the large taxpayer service. For the Bureau of Customs, collections are estimated to increase through the implementation of post-entry audits, collection of bonds used to guarantee customs payments on goods to be re-exported, sale of forfeited cargo, fines/penalties levied on seized shipments, and penalties for late remittances and importers for violations of customs laws. The authorities expect that these measures would amount to P 16 billion, or 0.4 percent of GNP in 2002.

44. **For the medium term, further tax administration improvements would be needed**. Taxpayers need to be convinced that there will be consequences for failing to pay taxes by prosecuting large and visibly delinquent taxpayers, auditing those whose monthly payments fall significantly below industry-wide benchmarks, and taking action against those who have stopped paying any tax at all. Also, tax collectors would need to be shown that there is a penalty for diverting funds from the national treasury, by prosecuting errant

officers, establishing an audit committee to ensure that audits are conducted properly, and publishing information about regional revenue collection, so that the public can assess how district offices are performing relative to their targets. Most importantly, the authorities need to follow through on their plans to transform the BIR, starting with overhauling its personnel.

Table 14. Philippines: Adjustment Required to Get to a Balanced Budget by 2006 1/

| | 2001 | 2002 | 2003 | 2004 | 2005 | 2006 |
|---|---|---|---|---|---|---|
| | (percent of GNP) | | | | | |
| Baseline Deficit (A) | -3.8 | -4.1 | -3.6 | -4.6 | -4.8 | -4.9 |
| Medium Term Target (B) | -3.8 | -3.1 | -2.6 | -2.9 | -1.1 | 0.0 |
| Adjustment Required (C=B-A) | 0.0 | 1.0 | 1.0 | 1.7 | 3.7 | 4.9 |
| Expenditure | | 0.7 | 0.0 | 0.1 | 1.5 | 1.9 |
| Civil service reform | | 0.0 | 0.1 | 0.1 | 1.4 | 1.7 |
| Expenditure compression | | 0.7 | -0.1 | 0.0 | 0.1 | 0.2 |
| Revenue Measures | | 0.2 | 1.0 | 1.6 | 2.3 | 3.0 |
| Tax administration measures | | 0.2 | 0.1 | 0.4 | 0.8 | 1.3 |
| Tax policy measures | | 0.0 | 0.9 | 1.2 | 1.5 | 1.7 |
| *Memo:* | | | | | | |
| Medium Term Target IMF definition | -4.3 | -3.8 | -3.3 | -3.3 | -1.5 | -0.3 |

1/ Authorities definition: excludes CB-BOL, includes privatization

45. **It is difficult to predict the outturn of such measures. However, it seems reasonable to expect tax buoyancy to increase somewhat, potentially bringing a revenue gain of 1.3 percent of GNP by 2006 (Table 14).**

46. **Even with these gains, tax policy measures would be necessary to fill the remaining gap**. In fact, the authorities plan to increase revenue through: the indexation of alcohol and tobacco excises to inflation and their restoration to 1997 real values; and the introduction of excise taxes for Asian utility vehicles. These measures, if implemented in 2002 could yield an additional 0.2 percent of GNP by 2006, but this would be far from being sufficient to close the gap. Additional measures would be needed to close the remaining gap of about 1.5 percent of GNP.

*Excises*

47. **Although the authorities are planning some measures to raise "sin taxes" on alcohol and tobacco, they will leave untouched petroleum excises, which made up 42 percent of total excise collections in 2001**. If the decline in excise collections is to be reversed, they will need to increase the specific rates for petroleum products, possibly by restoring them to their January 1, 1997 real value (a 48 percent increase) and indexing these rates semi-annually. Although an increase in petroleum excises will be politically difficult, this change would merely make up for the loss in real value over the past five years and bring taxes closer to levels prevailing the rest of the region. In addition, the authorities could abolish the price bands for alcoholic beverages and tobacco products; and increase the low excise rate for nipa/coconut-distilled spirits (with a five to ten year transition period) to the rate on other distilled spirits. The active policy scenario assumes these changes take place in 2003, with a yield of 0.2 percent of GNP beginning in 2003 relative to the baseline scenario.

**Tax Incentives**

48. **The authorities have organized an Inter-Agency Task Force to rationalize fiscal incentives with the aim of arresting the revenue decline and improving the transparency of tax incentives**. This task force has agreed to eliminate some incentives,

including provisions for reduced income taxes following income tax holidays, and double deductions for training, research and development. However, no decision has been reached on whether to scale back tax holidays, tax and duty exemptions on raw materials and capital, and on the practice of "picking winners" as part of the annual Investment Priorities Plan.

49. **Tax holidays, the centerpiece of the Philippine tax incentive structure, imply a structural downward path for the ratio of corporate tax revenues to GNP, especially if incentives continue to flow to the most dynamic sectors (e.g., telecommunications).** To address this revenue threat, under an active scenario, the authorities could:

- cease providing income tax holidays, exemptions or other rate preferences and replace them with across-the-board business tax relief in the form of a general reduction in the corporate income tax rate;
- simplify the incentive regime by consolidating all the various tax abatement provisions into one piece of legislation and reduce the number of agencies involved in the process of granting exemptions;
- replace the annual Investment Priorities Program with investment-based tax incentives such as accelerated depreciation;
- ensure that Philippine Special Economic Zones are strictly ring–fenced so that all sales to the domestic market or to residents of these zones are subject to normal customs duties and domestic taxes; and
- present the costs of these incentives to Congress in the context of the budget, as well as information on who receives them, and the trade-offs between offering these incentives and providing other public services. This information should also be available to the general public.

50. **The active scenario models the impact of the first measure, resulting in an additional 0.2 percent of GNP by 2006 compared to the baseline (See Table A2 for details).**

**VAT**

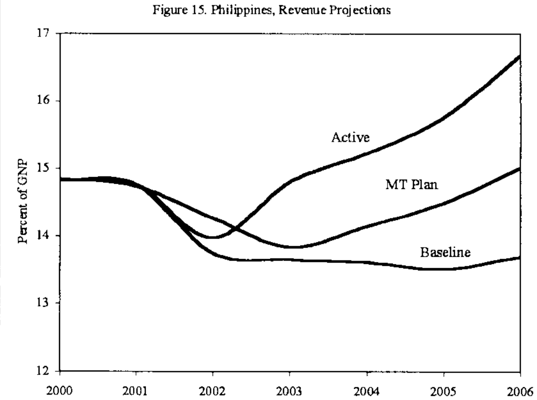
51. **The efficiency rate[16] of VAT is substantially lower than other Asian countries.** For the most part, this reflects administrative problems, but it also reflects exemptions from the VAT base, notably the exemption of the agricultural sector. In addition, there are several other goods that are VAT exempt, including petroleum products, but also power generated by cooperatives, coal, natural gas, and vessels of more than 5,000 tons. Others are zero-rated

[16] The efficiency rate is also referred to as the "productivity ratio" and is defined as the ratio of VAT revenues to GDP divided by the standard rate.

including services paid in foreign currency and the supply of goods and services to exporters. Although some of these exemptions are in line with other countries in the region, petroleum products are not typically exempt.

52. Under an active scenario the authorities could: (i) repeal zero-rating for goods and services paid in foreign currency or supplied to exporters; (ii) repeal several of the existing exemptions,[17] and (iii) repeal the transitional input credit and (iv) increase the VAT rate to 12 percent after administration is improved. The estimated impact of the measures would amount to 1 percent of GNP by 2006 over the baseline projection.

Figure 15. Philippines, Revenue Projections




53. The tax policy measures under the active policy scenario described above would improve total revenue collections by 3 percent of GNP by 2006 relative to the baseline (Figure 15). Deficits and Financing

54. **With the active expenditure and revenue measures described above, the fiscal position would become sustainable (Table 15).** National government public debt would decline from 59 percent of GNP in 2002 to 53 percent of GNP in 2006 despite the assumption of NPC debt in 2003. Moreover, gross financing requirements would be in line with the average for the last few years, and it could be

Table 15. Philippines - Medium Term - Active

| | 2001 | 2002 | 2003 | 2004 | 2005 | 2006 |
|---|---|---|---|---|---|---|
| Assumptions | | | | | | |
| Real GNP growth (percent change | 3.4 | 4.3 | 4.3 | 4.5 | 4.9 | 5.2 |
| Domestic interest rates (percent) | 11.0 | 7.8 | 8.9 | 9.5 | 9.7 | 9.9 |
| External interest rates (percent) | 5.9 | 6.2 | 6.0 | 6.0 | 6.0 | 6.0 |
| Average exchange rate (Pesos/US | 51.0 | 51.0 | 51.7 | 53.3 | 55.1 | 56.9 |
| | | | (percent of GNP) | | | |
| Overall balance | -4.3 | -3.8 | -3.3 | -3.3 | -1.5 | -0.3 |
| Primary balance | 0.9 | 0.8 | 1.4 | 1.8 | 3.5 | 4.4 |
| Gross financing needs | 19.1 | 19.2 | 19.4 | 20.1 | 17.7 | 19.3 |
| National Government Debt 1/ | 59.7 | 58.6 | 61.8 | 60.4 | 57.1 | 52.7 |
| Difference Medium Term Plan | | 0.0 | 0.0 | 0.9 | 0.2 | 0.0 |

Source: IMF staff projections.
1/ Excludes onlent and guaranteed debt.

[17] The following items should be subject to VAT at the standard rate: coal, natural gas, and petroleum products; raw materials to be used for manufacturing petroleum products; vessels of more than 5,000 tons including engines and spare parts; sales by artists of their works; power generated by electric cooperatives; and sales by cooperatives other than agriculture, electric, or credit cooperatives.

expected that interest rates could continue to fall as market sentiment improves in light of the reforms.

## F. Conclusion

55. **The government of the Philippines has rightly committed to balancing the budget by 2006 as a way of ensuring macroeconomic stability and growth**. This target, however, will not be easy to achieve given the downward trend in revenue collection, the limited scope for expenditure cuts, and the large debt from the National Power Corporation that will be assumed by the government. Tough policy decisions are required for the government to reach the intended deficit targets while ensuring priority spending is protected.

56. **In particular, the scope for expenditure compression is much more limited than the medium-term development plan seems to assume**. In order to ensure adequate spending on capital, and operations and maintenance related to poverty and growth related expenditures, the government will need to move ahead with the long-planned but never-implemented civil service reform, by streamlining the bureaucracy and improving the compensation package of senior government employees.

57. **There is also need for strong administrative and policy actions on the revenue front—much more than envisaged in the 2002 medium-term plan**. Critical administrative measures include demonstrating to tax payers that there is a consequence for failing to pay taxes, demonstrating to tax officials that there is a price for diverting funds from the national treasury, and overhauling the main tax collection agency, the BIR. On the tax policy side, measures could include the elimination of tax holidays and a simultaneous reduction in the corporate income tax, an increase in the petroleum excise tax to its 1997 real value, the elimination of VAT exemptions, and an increase in the VAT rate.

58. **Finally, there is need to improve the transparency of the policies being taken**. Information and trade-offs on tax incentives, government guarantees and other contingent liabilities should be clearly presented to Congress during budget discussions, as well as made available to the general public.

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# IV. Policy Issues in the Banking Sector[1]

## A. Introduction

1. **Since the Asian crisis, serious banking sector problems have emerged in the Philippines:**

- Nonperforming loans have been rising to alarming levels. The NPL ratio[2] of commercial banks, at end 2001 amounted to almost 20 percent, up from only 3 percent in 1996.
- In addition, there is a substantial portfolio of foreclosed assets. The NPA ratio[3] at end 2001 was almost 28 percent, up from 4 percent in 1996.
- The distressed asset ratio,[4] which also includes restructured loans,[5] is even higher. At end 2001, the distressed asset ratio amounted to a sizeable 35 percent.
- The capital adequacy ratio of several banks has fallen below the regulatory threshold of 10 percent. At end 2001, 8 of the 44 commercial banks, including systemically important ones, had a capital asset ratio below the regulatory minimum of 10 percent. Moreover, the reported capital asset ratio may overstate banks' ability to withstand financial shocks and absorb unforeseen losses, as reserve coverage of nonperforming loans is low across the industry, at an average level of 44 percent.

2. **From an international and historical perspective this level of problems is significant**. While it is less than the levels experienced in some other countries during the Asian crisis (NPLs in Thailand, for instance, increased to 48 percent), it is higher than during

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[1] Prepared by Bas Bakker (APD).

[2] The NPL ratio is defined as the ratio of nonperforming loans to total loans. Total loans here include both performing and nonperforming loans, but exclude interbank loans.

[3] The NPA ratio is defined as the ratio of (nonperforming loans+foreclosed assets) to (total loans+foreclosed assets).

[4] The distressed asset ratio is defined as the ratio of (nonperforming loans+foreclosed assets+restructured performing loans) to (total loans+foreclosed assets).

[5] A restructured loan is considered distressed, because the restructuring typically occurs when a loan has become nonperforming. Banks often restructure nonperforming loans to avoid the lengthy process of litigation.

other well-known banking crises. During the Nordic banking crisis in the early 1990s, for instance, NPLs peaked at around 10 percent—well below the current level in the Philippines (Hawkins and Turner, 1999).[6] Moreover, the fact that only a few, short-lived, bank runs have taken place should not be interpreted as a sign that bank problems are not serious: according to Demirgüç-Kunt, Detragiache, and Gupta (2000), during the majority of banking crises there are in fact no bank runs.[7]

3. **The sharp increase in NPAs has caused two main problems for banks: low profitability and low capital**. The increase in NPAs reduced the amount of interest-earning assets and thereby reduced profitability; the provisioning for (and write-off of) NPAs reduced capital. These problems have now led to a vicious circle: the lack of capital makes it difficult for banks to increase their lending and thereby to increase profits; while the lack of profits makes it hard for banks to increase their capital through an accumulation of profits.[8]

4. **It is likely that these problems can only be solved by an injection of new capital**. Such an increase would not only solve the capital problem, but would also improve profitability by enabling banks to increase lending.

5. **This chapter discusses several aspects of the banking problems and related policies in greater detail**. In particular, it will discuss the following questions:

- First, what is behind the banking sector problems? Why have NPAs gone up so rapidly?

- Second, can banks grow out of their problems without an injection of new capital?

- Third, will the establishment of private sector AMCs help solve the banking problems? Will it work without an injection of new capital by banks?

- Fourth, does waiting until banks increase their capital and applying forbearance in the meantime work?

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[6] For a more detailed discussion of the Nordic banking crisis, see Drees and Pazarbasioglu (1998).

[7] To quote Demirgüç-Kunt, Detragiache, and Gupta (page 19): "Perhaps the most interesting empirical regularity uncovered in this study is that contemporary banking crises are not accompanied by substantial declines in bank deposits. Thus while deposit runs have played a central role in the theoretical literature on banking crises, in practice they seem to be a sideshow at best."

[8] Of course, the increase in NPAs in itself makes banks more reluctant to lend, for it signals that risks have increased, especially to the extent that the increase in NPAs reflects a deterioration in future prospects or in the willingness to pay.

- Fifth, what are the macroeconomic costs of unaddressed banking sector problems?

## B. Background

6. **The banking sector problems in the Philippines originated in the asset price and credit boom of 1993-97**. During these years, there was a tremendous real estate boom, a sharp increase in stock prices and a surge in bank lending, driven in part by large capital inflows:

- **Real estate boomed**. Between 1992 and 1996, commercial real estate price quintupled, while residential real estate prices rose by 113 percent (Figure 1, top panel). Building activity expanded at a sizzling space, and in the first quarter of 1997, construction of commercial real estate was five times higher than three years earlier (Figure 1, middle panel).

- **The stock market went up sharply**. Between January 1995 and January 1997, stock market capitalization went up from US$50 billion to US$90 billion—an increase of almost 50 percent of 1997 GNP (Figure 2, top panel).

- **Loans increased very rapidly**. Between January 1994 and June 1997, the stock of commercial bank loans tripled, and rose from 30 percent of GDP to 60 percent (Figure 2, bottom panel). In absolute amounts, the largest increases were in loans to the manufacturing sector, and to real estate, financial institutions, and business services (Figure 3). In percentage terms, loans to the real estate sector increased particularly quickly: in June 1997, loans to construction companies were four times as high as 3½ years earlier; and loans to real estate, financial institutions and business services five times.

- **This boom was in part fueled by large capital inflows**. After the Philippines regained market access in 1992, and the capital account was liberalized, capital flows picked up strongly, and, as the exchange rate was kept stable through 1996, real interest rates dropped sharply (Figure 4).

7. **Following the Asian crisis, asset prices collapsed and growth slowed sharply**. By 1999, commercial real estate prices were 42 percent below their peak; and by 2001 two thirds. Stock market capitalization went down very sharply: by August 1998, stock market capitalization was only US$20 billion, US$70 billion down from its previous peak. GDP growth, which had averaged 4.3 percent between 1993 and 1996, slowed to minus 0.6 percent in 1998.

8. **This had a dramatic impact on profitability of firms**. As asset prices plunged and debt servicing costs increased, income of manufacturing, real estate, and commercial companies dropped significantly. According to data of the Philippine stock exchange, net income of stock exchange listed companies fell by half between mid-1997 and mid-1999, and halved again between mid-1999 and mid-2001, and the median interest coverage ratio of listed

companies fell below one. Real estate companies were hit very hard by the decline in asset prices, but profitability of commercial and industrial companies declined as well.

9. **Lower profits and asset prices led to a steady increase of NPAs**. The NPA ratio (which includes repossessed assets as well as NPLs) increased from 4.1 percent at end-1996 to 27.8 percent at end-2001 (Figure 5; top panel). Economically, the amount of NPAs became very significant: NPAs rose from 2 percent of GDP at end-1996 to 11 percent at end-2001.

10. **Nonperforming assets became a major problem on the banks' balance sheets.** The ratio of nonperforming assets to "broad" capital (capital proper and loan loss reserves;[9] i.e., the total reserves that banks have available to pay for assets that have gone sour[10]) increased from 20 percent in 1995 and 1996 to 93 percent in 2001; in the same year the ratio of distressed assets (which also includes restructured loans) to broad capital reached 118 percent.

11. **Bank profitability was severely hit**. Performing assets, and interest margins were compressed, profit declined, and the growth of bank capital, which had amounted to 60 billion pesos annually during 1996 and 1997, dropped to 28 billion on average during 1998 and 1999, and zero during 2000 and 2001. Part of the drop was the result of an increase in loan loss reserves, but the growth of "broad" capital dropped also very sharply—from 83 billion in 1997 to 11 billion in 2001.

12. **Credit stagnated, and the share of bank credit in GDP dropped very sharply**. By end 2001, the stock of outstanding commercial bank loans (excluding interbank loans) was virtually unchanged from end 1997; the stock of *performing* loans was 16 percent lower. The ratio of outstanding commercial bank loans to GDP, which had increased from 30 percent of GDP in 1993 to 60 percent in 1997, fell back to 40 percent in 2001.

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[9] Banks in general have only very small provisions for ROPOA (real and other properties owned or acquired). ROPOA are appraised at the time of foreclosure, when a one-off gain/loss is recognized on the income statement. Banks are not required to set up loss reserves against ROPOA, unless a new assessment shows that the market value of the assets has deteriorated. Given the sharp decline of real estate prices in recent years, it is likely that the book value of ROPOA is substantially higher than the market value. In January 2002, the BSP introduced the requirement that an in-house appraisal of ROPOA would need to be made at least every other year; it is not yet clear what the impact of this regulation will be in practice.

[10] Banks can pay for nonperforming assets from either their loan loss reserves, or their capital. Taking the two together gives a better picture of the financial buffer that banks have to pay for NPAs, than looking at the components individually; in addition, looking at the two together has the advantage that it does not require any judgment on whether the degree of loan provisioning is adequate.

## C. Can Banks Grow Out of Their Problems Without an Injection of New Capital?

13. **Would it be possible for banks to grow out of their problems?** To answer this question several scenarios were constructed. In the scenarios a wide range of assumptions for bank loan growth, the rate at which performing bank loans turn into distressed assets, and the interest rate margin on new bank loans was used. To put these assumptions in perspective: in 2001, bank loans fell by 2 percent; 7 percent of performing loans turned into distressed assets, while the interest rate margin on performing assets was 3.0 percent. The scenarios start with the actual position in 2001, and look at how the banks' situation could evolve by 2006.

14. **In the scenarios we in particular look at two indicators:**

- **Distressed asset ratio**, defined as the ratio of distressed assets to loans and repossessed assets. For these scenarios, this indicator has the advantage over the nonperforming loan or nonperforming asset ratio in that it does not require any assumption on the rate at which bank loans are restructured, or assets are repossessed.

- **Distressed asset to broad capital ratio.** This ratio gives an indication of the extent to which distressed assets threaten to erode bank capital. As broad capital includes both bank capital and loan loss provisions, it includes the entire financial reserves banks have to pay for nonperforming assets; for these scenarios, using broad capital rather than capital proper has the additional advantage that it does not necessitate a judgment on the proper degree of loan provisioning.

15. **The growth of broad capital depends on "broad" profitability,[11] which in turn depends on both the change in performing loans and the interest margin on new loans**. We assume that broad profits (as measured by the annual change in broad capital) will remain the same as during 2000-01, plus any change in interest income, with the latter calculated as the interest margin on new loans times the increase in performing loans. This implies that, if performing loans increase, interest income and thus profits will go up, and capital will thus increase at a faster rate; but if performing loans decline further (because of a large inflow in distressed assets and few new loans), the growth of capital will slow down further.[12]

16. **The scenarios show that if current trends continue, banking sector problems will become much worse**. If bank loans would remain stagnant, the inflow ratio of bank loans into distressed assets would remain at 7 percent, and the interest rate margin on new loans at

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[11] Defined as profits before provisioning.

[12] Note that provisioning for nonperforming loans does not affect the *amount* of broad capital, but only its composition (capital versus provisions).

3 percent, the distressed asset ratio would increase from 35 percent in 2001, to 70 percent in 2006 (Scenario 1). Meanwhile, the ratio of distressed assets to broad capital would rise from 118 percent in 2001 to 216 percent in 2006.

17. **The scenarios also show that strong loan growth alone is insufficient to bring the distressed asset ratio down; the inflow in distressed assets will also need to go down**. If the inflow ratio of bank loans into distressed assets would remain at 7 percent, then loans would have to grow by 20 percent a year, just to keep the distressed asset ratio constant. From an historical perspective, such a loan growth rate is very high, it has only been exceeded during the asset price/lending boom of the mid-1990s. To significantly reduce the distressed asset ratio, the inflow ratio will have to decline. If, with the same loan growth, the inflow ratio would drop to 3 percent, then the distressed asset ratio would fall to 23 percent.

18. **The ratio of distressed assets to broad capital will only improve substantially if the interest margin goes up as well**. If bank loans would grow by 20 percent and the inflow ratio would drop to 3 percent, the distressed asset to broad capital ratio would increase from 118 percent to 126 percent. If in addition the interest margin on new loans would double to 6 percent, the distressed asset to broad capital would drop to 103 percent (Scenario 2). From a historical perspective, this would be a very high margin; in 1998, at the previous peak, the interest rate margin was only 5.0 percent.

19. **Overall, these scenarios cast doubt on whether banks can grow out of their problems without an injection of new capital**. Only if loan growth is very strong, the inflow in distressed assets falls significantly, and the interest margin on new loans rises significantly will the situation of the banking sector improve. If one of these conditions does not hold, the situation will not improve, and under a wide range of plausible scenarios, the situation is likely to get significantly worse. Overall, these scenarios therefore suggest that the banks' capital position can only be improved sufficiently by an injection of new capital.

## D. Will the Transfer of NPLs to Private Sector AMCs Work without An Injection of new Capital?

20. **Many countries have used Asset Management Companies (AMCs) to address the overhang of bad debt in the financial system**. AMCs are generally founded on the supposition that by separating nonperforming from performing assets, they can help facilitate financial restructuring and maximize the recovery of nonperforming assets at the same time. The argument is several-fold:[13]

- Separation of NPAs allows a better a division of labor, as managers of banks can focus on lending, and managers of the AMCs on recovery of nonperforming assets;

[13] See Woo (2000).

- Separation facilitates valuation of banks. When bad assets are separated from the bank, it is easier for the market to correctly assets the value of the bank, which may be important if banks try to raise new capital;

- Separation may strengthen credit discipline by separating bad loans from their original credit officers;

- It might lead to economies of scale;

- It might lead to enhanced bargaining power for creditors.[14]

21. **Two main types of AMCs can be distinguished: a "centralized" model, in which bad debt is transferred to a centralized *publicly* owned asset management company, and a "decentralized" model, with *private* AMCs** (Klingebiel, 2000). Both models have advantages and disadvantages. While the economies of scale and enhanced bargaining power arguments favor the centralized approach, the decentralized approach allows AMCs to better tap into the knowledge base associated with the loans and assets transferred to them from the originating institutions. Another important tradeoff is that publicly owned AMCs often involve the use of public money, while privately owned AMCs are less likely to be a drain on the public finances. Both approaches have been used since the Asian crisis. Centralized AMCs were set up in Indonesia, Korea, Malaysia, and Thailand, while private sector AMCs were established in Thailand.

22. **In the Philippines, the government has rejected the idea of a centralized, publicly funded AMC**. However, it hopes that the establishment of private sector AMCs will facilitate a solution of the banking problems. To this end, it has sent a draft bill to Congress that would stimulate the establishment of private sector AMCs, including by reducing or eliminating taxes and fees on the transfer of nonperforming assets.

23. **To what extent will the transfer of NPAs to private sector Asset Management Companies (AMCs) help solve the banking problems?** The transfer of NPAs to private sector AMCs for cash or bonds would clean up bank balance sheets and give them fresh funds for lending. AMCs would, however, not solve the lack of capital.

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[14] There are also counter-arguments against the establishment of AMCs (see Woo, 2000). Transfer of nonperforming loans to AMCs may lead to a loss of institutional knowledge about these loans and thereby reduce the probability of recovery; it may weaken credit discipline because borrowers may be less likely to repay AMCs with which they do not have an ongoing relationship, and on which they cannot rely for new funding; it may be very difficult to price nonperforming assets; there may be political interference with AMCs; and AMCs may lack the expertise to recover nonperforming assets.

24. **The banks' *reported* capital may in fact even deteriorate by the transfer of NPLs to AMCs**. This is because for many banks, the book value of NPAs on their balance sheets exceeds their market value. This is especially the case for ROPOA. While real estate prices have declined sharply in recent years, banks have in general only very small provisions for ROPOA, which would suggest that it is very likely that the book value of ROPOA is substantially higher than the market value. Provisioning for NPLs is higher (about 45 percent), but total provisioning for NPAs is only about 30 percent of NPAs. The idea that the book value of NPAs exceeds their market value is further corroborated by the large difference between the price at which banks are willing to sell their NPAs and the price at which international investors are willing to buy them.

25. **This implies that if banks would sell their NPAs at market value, they would have to recognize a loss and accept a reduction of their reported capital**. Of course, such a reduction would only bring their reported capital in line with its underlying value. The loss would be even higher, if banks would only be able to sell NPAs at a discount to AMCs, which may well be the case if AMCs want to make a profit as well.

26. **Moreover, if banks are unwilling to increase their capital, private AMCs are unlikely to work**. If banks are not willing to recognize their losses on NPAs, banks will only be interested to transfer NPAs to AMCs if they can be sold at above market value. If this is not allowed, private AMCs may not be attractive.[15]

27. **This would suggest that AMCs can only be used as a complement to recapitalization, and not as a substitute**. This has been recognized also by the central bank, which in its most recent "Status Report on the Philippine Financial System" argued that "legislation that would allow the formation of asset management companies with well-defined and limited fiscal and other incentives would help reduce the expected cost to banks of the cleanup of the nonperforming assets and *facilitate their early recapitalization*" (italics added).

28. **Experience in other countries has shown that adequate supervision is crucial to prevent AMCs being used for window dressing**. If a bank owns an AMC and is not subject to consolidated supervision or consolidated reporting, it can transfer the problem assets at book value (rather than market value) and "hide" the losses. If a bank is subject to consolidated supervision, it may try to avoid consolidation at the bank level by taking a minority position and asking connected companies to put up the rest of the equity. If this "window-dressing" is not detected by regulators, banks may avoid restructuring, and banking

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[15] This would seem to be borne out be experiences in Thailand. In Thailand strict regulations were put in place that forbade banks to transfer nonperforming assets at above market value to AMCs. Subsequently, there was very little interest from private banks to use the AMCs.

problems may well get worse. The central bank has made it clear that it would not allow AMCs to be used as venue for window-dressing balance sheets. While it might tolerate a staggered booking over several years of losses resulting from transferring of NPLs to AMCs, instead of an immediate write-off, this would only be allowed if such staggering would be fully disclosed and closely tied up to a committed capital build-up process.

29. **Overall, private asset management companies do not alleviate the need to increase capital, and they are unlikely to work if banks do not want to increase their capital**. AMCs might be a very useful supplement if banks are willing to increase their capital, but they can not be an alternative for this increase.

## E. Why Not Wait? The Disadvantages of Forbearance

30. **So far we have concluded that banking sector problems can only be solved if new capital is injected into the banks**. The banking sector problems are too severe for banks to grow out of them; and private sector AMCs will not work either if banks are not prepared to recognize their losses and inject new capital. If banking sector problems can only be solved by new capital, and banks are not willing to inject new capital right now, why not wait until banks are willing to put in new capital, and use forbearance in the meantime?[16]

31. **The problem with waiting and forbearance is that such a policy is likely to *worsen* the banking problems**. Both theory and experience in other countries suggest that forbearance is not only unsuccessful in reducing the banking problems, but frequently also worsens them. This is mainly because forbearance gives the wrong incentives to bank owners: it increases moral hazard and risk taking, but puts little pressure for bank restructuring. These problems are discussed in greater detail in the next two subsections.

### Forbearance Does not Work in Theory

32. **Forbearance has often been used by central banks and other supervisory agencies with the aim of resolving banking problems with a minimum of publicity**. In these cases, supervisors intended to avoid an erosion of public confidence in a troubled bank by allowing it time in which to restore its capital adequacy (Taylor, 2000). Forbearance is usually based on the premise that banks can grow out of their problems by themselves, without further measures by supervisors. When supervisors exempt distressed banks from minimum capital adequacy requirements, they hope that improvements in the bank's operating environment will restore over time restore its capital adequacy.

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[16] The number of commercial banks in the Philippines with a capital-asset ratio below the regulatory minimum of 10 percent has been increasing steadily in recent years, from four in 1999 to eight in 2001, and includes systemically important banks. See BSP (2002).

33. **According to the academic literature, however, forbearance is generally unsuccessful, and in fact may well *worsen* bank problems**. This is because it gives banks wrong incentives, and also does not address the problems that caused the bank problems in the first place:

- **Forbearance increases moral hazard for weak banks**. Owners and managers who benefit from forbearance have a strong incentive to "gamble for resurrection". If a bank has negative net worth, the owners and managers, if allowed to continue in operation, have an incentive to take high risks. If they are successful, they will receive all the gains; if they are not, they will suffer no additional losses.

- **Forbearance encourages greater risk-taking by all banks**. If banks conclude from an episode of regulatory forbearance that unsuccessful risk taking will not be punished but forborne by regulators, the result may be a level of risk taking by all banks that is higher than socially optimal.

- **Forbearance may lengthen the life and thereby increase the total losses of loss making companies**. If loans are not performing, the borrowing company usually needs to be restructured. Under forbearance, this process is likely to be postponed, as banks have few incentives to recognize nonperforming assets. As a result, they may use forbearance to continue to capitalize interest on delinquent loans into new credit. This postponement of the necessary corporate restructuring is likely to extend losses, and thereby may contribute to an increase in the overall cost of the banking crisis.

34. **Thus would suggest that forbearance tends to increase the costs of resolving banking problems**. This is confirmed by Honohan and Klingebiel (2000), who examine to what extent fiscal outlays in resolving bank distresses are related to crisis management measures adopted by governments in the early years of a crisis. They find that regulatory forbearance, open-ended liquidity support, repeated recapitalizations, and debtor bail-outs add significantly and sizably to costs: if a country has *lax* policies in all of these areas, the predicted fiscal costs of a banking crisis are in excess of 60 percent of GDP, whereas if a country has *strict* policies in every area, the expected fiscal costs are only about 1 percent of GDP. Moreover, among the different policy tools, forbearance and liquidity support seem to be among the costliest measures; Honohan and Klingebiel predict that if forbearance (alone) is not employed, fiscal costs would be halved.

35. **The problems with forbearance would also seem to apply to other solutions that try to hide the seriousness of the banking problems**. If banking problems remain concealed, banks may lack incentives to address the problems; and if banks do not address the problems, these problems will only get worse. Thus, what may seem a good idea from a very short-term perspective (the desire to prevent the fiscal costs of a bank run), may backfire in the medium term, as it may substantially add to fiscal costs.

36. **Some authors have argued that capital ratios should be lowered temporarily during recessions, to offset the procyclical impact of fixed ratios**. These authors worry that the fixed minimum capital requirements that were introduced by the Basle accord tend to worsen recessions, because they force banks to cut back on lending during a downturn. This is because in a recession rising loan losses tend to erode banks' capital,[17] which may force banks to either raise new capital or reduce assets with high risk weights, especially loans. Because raising capital is difficult in a recession, banks tend to choose the second option and cut lending.[18]

37. **The problems in the Philippines, however, are not cyclical, but structural**. In the past three years, the NPA ratio has increased from 15 to 28 percent, while average GDP growth amounted to 3.7 percent—a far cry from a recession. This would suggest that the problems are structural rather than cyclical, and policy measures that treat the banking problems as a temporary, cyclical, problem may not be appropriate. Of course, even if the problems were indeed cyclical, this would not mean that lowering of capital ratios during a recession would be a good idea; a better idea might be to encourage banks to build up a buffer in their capital during good times.

38. **Other authors have made a case that in a situation of a sudden, systemic banking crisis, there may be a case for "gradualism", a temporary lowering of regulatory standards**[19] (Taylor 2000). If an economy suffers from a sudden, large, outflow of capital which leads to a surge of interest rates and a sharp increase in loan defaults, the entire banking system may be overwhelmed, which may lead to extreme market distress. In such a setting, it may simply not be feasible to recapitalize the undercapitalized banks overnight.

39. **Such a policy has successfully been applied in some countries that were hit by the Asian crisis**. In Thailand, for example, the authorities allowed financial institutions to phase in new, strengthened, rules for capital adequacy and loan provisioning over a 2½-year period, so

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[17] At least to the extent at they are not fully covered by loan provisions—which is often the case.

[18] See, for instance, the discussions in Jackson et. al. (1999).

[19] Taylor (2000) makes the following distinction between forbearance and "gradualism": "Forbearance engages in an unconditional relaxation of the capital standards applied to banks in the vague expectation that this will allow them to generate sufficient revenue to restore themselves to capital adequacy. By contrast, gradualism is connected with strict conditions and is adopted as part of a comprehensive restructuring strategy, which might include a strengthening of prudential norms together with a timetable for the forborne institutions to meet these new, higher standards."

as to avoid a credit squeeze and substantial nationalization of the banking system.[20] However, this forbearance came with strong strings attached: it forced banks to recognize all losses upfront, to ensure that even if their capital was below the regulatory minimum, it was not overstated as well, and included an explicit time table for raising additional capital.

40. **However, such a policy of gradualism should be reserved only for extreme situations, and accompanied by very strict conditions**. In adopting a policy of gradualism, it is important to ensure that it does not result in an indefinite commitment to relaxed supervisory norms, especially in an environment where tougher norms have traditionally been on the books but have been only weakly enforced. Thus, the exercise of gradualism should envisage from the outset a series of measures and a clear timetable according to which the institutions will be able to meet existing or enhanced prudential standards. The management of each institution should be required to formulate a detailed recovery plan, supervision should be intensified, a moratorium should be put on dividend payouts, and the exercise of gradualism should be transparent to the market (Taylor, 2000). If gradualism is applied, it is especially important that bank owners are forced to recognize their losses upfront. Such a recognition ends the artificial inflation of bank capital, makes it clear by how much bank capital will have to be increased over time, and takes away the incentive for banks to keep overvalued nonperforming assets in their portfolio so as to prevent their reported capital from going down.

41. **In the Philippines, the banking problems are not so extreme and acute that gradualism would be in order**. In Thailand, the NPL ratio jumped within a few quarters from very low levels to over 50 percent; whereas in the Philippines, the ratio is both lower and has gone up much more gradually. It should also be stressed that while in Thailand the new strengthened rules were phased in, they were not very lenient, but in fact stipulated a rapid increase of the capital asset ratio, as the ratio, which had dropped to around 3 percent by the end of 1998, had to be increased to 8 ½ percent by the end of 2000.[21]

## F. Forbearance Does not Work in Practice

42. **The theoretical objections to forbearance that were discussed in the previous section can be illustrated by some historical examples**. We will discuss two cases: the 1980s savings and loans crisis in the United States, and the problems in the banking sector in Japan in the 1990s. In both cases, the authorities' initial response to emerging problems was to relax rather than strengthen prudential standards. They anticipated that a less rigorous application of regulatory requirements would permit troubled banks to recover under their own

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[20] See Haksar (2000).

[21] In the event, the actual capital increase was much faster, and by the second quarter of 1999, the capital ratio of the commercial banks as a whole was already in accordance with the strengthened regulations.

initiative. However, in both cases, this optimism was not justified, and the problems only got worse, with the eventual costs far larger than they would have been without forbearance.

**Savings and Loans Crisis in the United States**[22]

43. **The Savings and Loans Institutions (S&Ls) came under serious pressure in the early 1980s when monetary policy was tightened and interest rates increased to historically high levels**. With their assets at long-term fixed rates, and their liabilities at short-term variable rates, the sharp rise in interest rates caused very serious problems for these institutions. By 1983, 10 percent of the industry was insolvent, and 35 percent of assets were nonperforming.

44. **The Federal Savings and Loan Insurance Corporation (FSLIC) reacted by using forbearance, rather than addressing the problem**. The prevailing view was that S&Ls should be granted forbearance until interest rates returned to normal levels, when thrifts would be able to restructure their portfolios. To forestall actual insolvency, capital requirements and provisioning rules were relaxed substantially. Capital requirements were reduced from 5 percent to 3 percent; S&Ls were allowed to use regulatory accounting principles (RAP) that were considerably more lax than generally accepted accounting principles(GAAP); and accounting rules for goodwill were relaxed considerably.

45. **This strategy failed, and problems worsened rather than improved**. The financial situation of S&Ls deteriorated further, and the number of S&Ls that went bankrupt increased sharply. In 1988 alone, 190 S&Ls failed, with total assets of $98 billion, which cost the FSLIC $47 billion.

46. **The use of forbearance is estimated to have augmented the total cost of the S&L debacle by $135 billion**. While the costs of the S&Ls crisis eventually amounted to $160 billion, it would, according to estimates by the National Commission on Financial Institutions Reform, Recovery and Enforcement, have cost only about $25 billion if insolvent S&Ls had been closed in 1983.

**The Japanese Banking Sector in the 1990s**[23]

47. **The Japanese banking crisis found its origin in the asset price/lending boom bubble in the second half of the 1980s**. Between 1985 and 1989, the Nikkei increased from 13,000 to 39,000; commercial land prices in the six largest cities quadrupled; and the private sector credit to GDP ratio increased by 25 percentage points (Figure 6).

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[22] This section is based on F.D.I.C. (1997).

[23] This section is based on Kanaya and Woo (2000).

48. **The subsequent asset price collapse led to a substantial deterioration of the health of banks and other financial institutions**. The fall in real estate prices led to a rapid deterioration of the quality of loans to the real estate industry and an erosion of the value of collateral; the drop in equity prices put pressure on the capital of banks; and the deceleration of growth reduced the ability of debtors to continue to service their debt.

49. **While some restructuring measures were taken, many banks relied on the assumption that stock and property prices would recover**. Instead, they reportedly restructured nonviable loans by reducing interest rates and extending their maturity. According to Kanaya and Woo (2000), some banks used their "related companies" to clean up their balance sheets by transferring nonperforming loans at above market value.[24] To protect their margins, banks began to take more risk by, for example, extending the maturity of their lending. To boost short-term profits they also relaxed credit conditions.

50. **The authorities' initial reaction was in part based on the hope that the economy would soon turn the corner** and that a full economic recovery would buoy the banks. After 1995, when it had become clear that the banking problems had worsened considerably and a more systematic public intervention would eventually become inevitable, they hesitated to take strong action because of their fear of triggering a public panic.

**By 1997, it was clear that the situation was deteriorating, which triggered corrective action—although not strong enough to solve the problem**. During that year, several large and high profile financial institutions went into effective bankruptcy. In reaction, a new Financial Supervisory Agency was established; the Diet set 60 trillion yen (12 percent of GDP) of government funds aside for the strengthening of the banking sector and full deposit protection. However, while this stabilized the problem, it was not sufficient to solve this problem; and despite some steps to tighten loan classification and provisioning practices, the problems in the banking sector continue to exert a drag on the Japanese economy.

### G. Why Not Wait? The Macroeconomic Costs of Unaddressed Banking Problems

51. **Letting banking problems linger on may have significant macroeconomic costs**. One problem, which was discussed in the previous section, is that if banking problems are allowed to linger, they tend to get worse. A second problem, which will be discussed in this section, is that banking problems may lead to a so called "credit crunch".

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[24] These "related companies" were jointly owned by the banks and the firms with which the banks had interlocking shares. Until December 1998, these related companies did not need to be consolidated in the financial reporting of the banks.

52. **Modern corporate finance theory suggests that the higher the leverage of a firm, the lower the riskiness of its assets has to be to attract investors.**[25] For equity owners, it is advantageous to put in little capital of their own, and to use debt financing instead, because a high degree of leverage will increase their expected return. Debt owners, are less enthusiastic about a high degree of leverage, and, will only be willing to issue debt to a firm if the firm has sufficient capital of its own. This is because if the firm has low capital they run the risk that they will not be repaid if the firm runs into trouble.[26] This suggests that the riskier the assets of the firm, the higher the firm's capital has to be to attract investors willing to buy its bonds.

53. **For a bank without deposit insurance the situation is very similar; the lower its capital-asset ratio, the lower the riskiness of its assets has to be to prevent deposit withdrawals or even bank runs.**[27] Deposit owners may not be very concerned about low capital of a bank if the bank's assets largely consist of government paper; but they may be much more worried if the bank's assets largely consist of real estate loans or loans to high-risk firms. If there is deposit insurance, the accompanying prudential regulation of banks will have the same impact. Under the Basle capital standards, there is a clear link between capital ratios and portfolio risks, and if banks' capital falls, they might to have to reduce the riskiness of their portfolio in order to keep meeting the capital standards.

54. **This suggests that if banks' capital falls, they will become more risk averse in their lending behavior.** Of course, banks cannot change the riskiness of their assets immediately, as they cannot simply liquefy their loans. Over time, however, banks can change the riskiness of their portfolio by, for example, lending less to higher-risk customers, and more to low-risk customers—including the government. If the banking system becomes very distressed, risk aversion by banks may become so severe that it leads to a so-called "credit crunch". Under a credit crunch, banks seem to be unwilling to lend to the *private* sector, while they are eager to buy lower-risk *government* assets.[28]

55. **Experience in other countries has shown that bank sector problems may have a very pronounced impact on lending to the private sector**. In Japan, credit to the private

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[25] See, for instance, the famous article by Jensen and Meckling (1976).

[26] A related risk is that low capital may provide an incentive for equity owners to engage in overly risky investments, as they will have little (the firm's equity) to lose, and a lot to gain (given the high leverage).

[27] See Calomiris and Wilson (1998).

[28] Under the Basle Capital accord, the risk-weight of government assets is either very low or zero, and thus substantially lower than that of private sector assets, so a shift from private sector assets to government bonds increases banks' capital-asset ratios.

sector has been stagnant in real terms since the early 1990s. In other countries the impact has been even more severe. In Sweden and Finland, for example, which experienced a banking crisis in the early 1990s, real credit dropped by 30-40 percent in a few years; in Mexico the decline was even sharper (Figure 7).

56. **Of course, it is very difficult to determine whether a country suffers from a credit crunch, as weak credit may also be the result of weak credit *demand*.** Indeed, in practice it is very difficult to determine which of the two factors is more important; and econometric techniques have not yielded conclusive results. Nevertheless, the distinction has some important policy implications. If weak credit growth is the result of demand constraints, then policies that increase aggregate demand, such as lowering interest rates, may be successful and increase bank lending. On the other hand, if weak credit is the result of supply constraints, then such a policy is unlikely to work. Moreover, in a setting of supply constraints, policies that will increase demand for credit, but reduce profit margins of banks may well worsen the banking problems (see Box 1).

57. **Experience in other countries would suggest a credit crunch may have a very negative impact on growth**. Countries with a distressed banking system often not only have a low growth of credit, but also a very low growth rate of GDP. The weak growth performance of Japan in the 1990s, for instance, is well known. Sweden and Finland experienced a severe contraction in GDP in the early 1990s; Swedish GDP regained its 1990 level only in 1995 (Figure 8). Of course, from a theoretical perspective, the causality from a distressed banking system to weak growth can run in both directions. In practice, however, a distressed banking system is often seen as an important factor in explaining low growth. In Japan, for instance, the distressed banking system is seen as a key factor behind the prolonged stagnation.

58. **Some countries with a distressed banking system have managed to escape slow growth, but in these countries strong export growth took over the role of domestic demand**. A distressed banking sector is likely to primarily affect domestic demand, and will likely have less impact on external demand. To the extent that strong export growth may be able to offset weak domestic demand, a country with a distressed banking system may be able to continue to grow. A good example of a country that managed to grow without a strong banking system was Mexico. After the 1994 devaluation its banking system became impaired, and in the following years private sector credit declined sharply. However, as a result of the North American Free Trade Agreement (NAFTA), exports grew very strongly, and FDI inflows picked up, strongly boosting growth (Figure 9).

59. **The Philippines has the typical signs of a credit crunch**. In recent years, bank lending to the private sector has not grown, while bank demand for low-risk government assets has been strong (Figure 10). At the same time, growth has not yet recovered to its pre-Asian crisis levels, while demand components that are most dependent on bank credit (investment) have been particularly weak. Of course, the fact that it has the typical signs of credit crunch does not prove that it has a credit crunch, and it is likely that weak credit growth can at least in part be attributed to weak credit demand as well. Nevertheless, it is very likely that the weak

situation of the banking sector will constrain strong credit growth to the private sector, which would suggest that even it does not constrain credit growth right now, it would very likely do this if the corporate sector were to recover.

60. **At the same time, it is not clear whether exports can take over the role of domestic demand in boosting growth**. Electronics exports currently suffer from weak global demand, and it is far from clear how strong electronics exports will grow in the years ahead. For other exports to pick up, competitiveness may have to improve, or Foreign Direct Investment (FDI) inflows to pick up. The exchange rate has depreciated after the Asian crisis, but since 1990, competitiveness vis-à-vis other Asian countries seems to have deteriorated (Figure 11). Moreover, FDI inflows have been tapering off.

61. **This would suggest that addressing the banking sector problems may be crucial for boosting growth**. Moreover, experience in other countries has shown that early addressing of banking sector problems does pay off. Australia, for instance, experienced banking problems in the early 1990s. It addressed these problems aggressively, and as a result, GDP growth during the 1990s was among the highest of industrial countries.

## H. Conclusion

62. **Serious banking problems have emerged in the Philippines**. At end-2001, the NPA ratio was almost 28 percent, up from 4 percent in 1996. These banking sector problems originate from an asset price and lending boom prior to the Asian crisis. During these years both asset prices and bank lending rose very sharply. When asset prices collapsed after the Asian crises, many loans started to go sour, and NPAs increased progressively.

63. **These problems have become so severe that they can likely only be solved by an injection of new capital**. Strong loan growth alone will not generate enough profits to restore capital; moreover, with the current low level of capital, it is very unlikely that loan growth could be strong in the first place. Thus, the stock problem has become too severe to be solved by a flow solution.

64. **Private sector AMCs cannot substitute for these needed capital injections; and in fact without an injection of new capital are unlikely to work**. Private sector AMCs may reduce the stock of nonperforming assets; but they do not restore capital of banks. Moreover, if banks are not willing to increase their capital, private sector AMCs are not likely to work, because NPAs will likely be transferred to AMCs only at below their current book value.

65. **Waiting for banks to inject new capital, and meanwhile applying forbearance is unlikely to work, and may have very negative side effects**. Both theory and practice in other countries suggest that forbearance significantly adds to the total costs of banking sector problems.

66. **Waiting to address banking sector problems has significant macroeconomic costs**. Countries with distressed banking sectors typically experience a credit crunch, in which the banking system no longer lends to the private sector. Such a credit growth often has a very negative impact on domestic demand and GDP growth—unless exports can take over.

67. **The Philippines has the typical signs of a credit crunch**. At the same time, it is unlikely that exports can take over the role of domestic demand. The exchange rate is not particularly competitive, and FDI inflows have been edging down. This would suggest that the current banking problems may have a very negative impact on growth prospects.

68. **This would suggest that addressing the banking sector problems is urgent**. Forbearance for banks with inadequate capital needs to be stopped, and banks' capital needs to be increased. The precise policy problems and prescriptions are dealt with in another chapter.

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**Box 1: Is Inducing Banks to Reduce Interest Margins and Lend more a Good Idea?**

In the past year, in their concern about the impact of stagnating bank credit on the economy, some observers have suggested putting pressure on banks to reduce their interest margins and increase their lending. These proposals intensified when observers noted that while policy interest rates had dropped sharply, lending rates were reduced less, and they worried that the loosening of monetary policy was insufficiently reflected in lower lending rates.

If increasing interest margins were the result of profit-maximizing behavior by oligopolistic banks, pressure to limit interest margins might be a good idea. If banks would use their power to generate excess profits, and keep interest rates higher than would be socially optimal, it would be desirable to intervene; and pressure on banks to reduce interest margins would in effect be a policy to encourage competition among banks.

However, it seems doubtful that banks are generating excess profits. Bank profitability dropped sharply after the Asian crisis, and is now at very low levels. Accordingly, the increase in interest margins is likely to reflect the desire of banks to stop the erosion of their profitability and allow them to restore their capital. The sharp increase in nonperforming assets in recent years has affected bank profitability in two ways: first, it has eroded the stock of performing assets, which has reduced their interest income; and second, it has led to a sharp increase in loan loss reserves, which reduced profits directly.

Seen in this way, pressure on banks to reduce interest margins may well make it more difficult for banks to recover from their problems. As was shown in the simulations, without an increase in interest margins it will be very difficult for banks to significantly increase their capital.

The same problem applies to inducing banks to lend more. To the extent that growth is constrained by a credit crunch, such pressure might well stimulate economic growth in the short run. However, if banks increase their credit to more risky customers, this may well lead to a further increase in nonperforming loans. As was shown in the simulations, the inflow of nonperforming assets must decline to resolve the distressed asset problem. Thus, to the extent that pressure to increase lending worsen banks' problems, it will actually undermine the economy in the longer run.

In sum, pressure to reduce interest margins and increase bank lending may be at odds with the desire to improve the banking sector situation.

**Box 2. The Benefits of Addressing Banking Sector Problems: The Case of Australia**

**In the early 1990s, the Australian banking industry experienced its worst losses in almost a century**. In the 1990-92 period, cumulative losses amounted to over 2¼ percent of GDP—one third of the aggregate level of shareholder's funds in the banking system in 1989. The largest losses were incurred by state government owned banks and foreign-owned banks; several foreign banks recorded losses that exceeded their shareholder's funds.

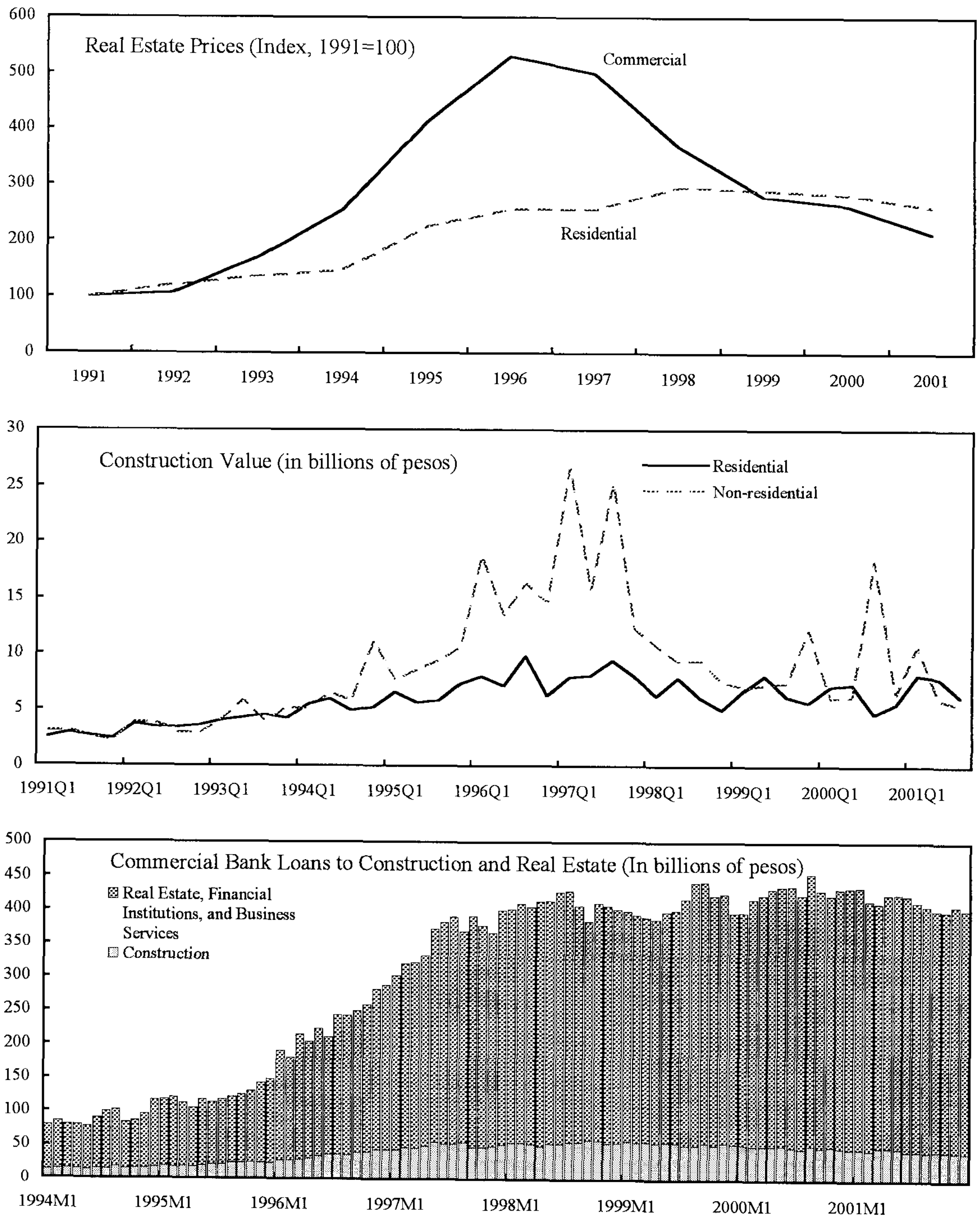
**These losses were the result of the collapse of an asset price/lending boom**. Deregulation in the mid 1989s intensified competition and the desire by banks to grow their balance sheets rapidly. This took place in an environment in which asset prices, particularly commercial property prices, were increasing quickly, and credit assessment procedures in many financial institutions had not adjusted to the new liberalized environment. The result was extremely strong credit growth secured against increasingly overvalued commercial property. In 1989, the combination of high interest rates and a softening of the commercial property market exposed the poor credit quality of some of the most risky loans. Then, as the economy went into recession and the decline in property prices accelerated, more broadly based credit quality problems became evident; by mid 1992, the ratio of nonperforming loans to total loans had increased to 6 percent.

**The banks made very serious efforts to address the problems** (public funds were only used to recapitalize government-run banks). Banks recognized their losses; state banks privatized, problem banks were recapitalized; some banks were merged; and several banks which had made losses but still had a capital ratio above the minimum made a concerted effort to increase their capital ratio in order to reduce investors' worries. Overall, the capital ratio of the banking system increased strongly, from 9 percent in 1989, to 12 percent in 1992.

**As a result, the banking problems were resolved relatively quickly**. The banking industry soon returned to strong profitability: the real return on shareholders' funds, which had fallen from 10 percent in 1989 to –4 percent, rose to 13 percent by 1995, and stayed around that level throughout the 1990s. By 1993, real credit was increasing again, and real credit growth remained strong throughout the 1990s.

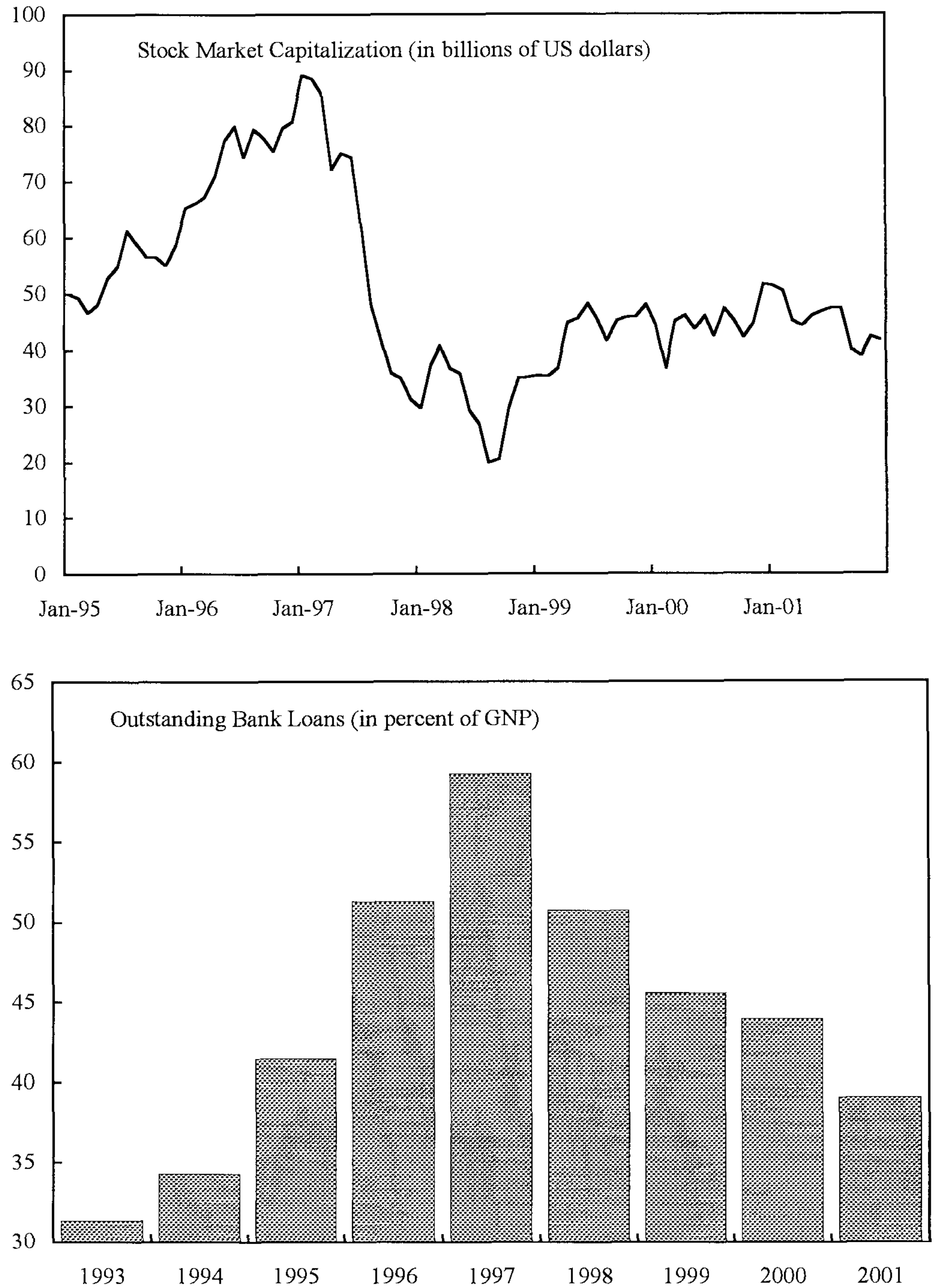
**Because of the quick resolution, the banking crisis had no long-lasting effects on economic growth**. Indeed, after the banking problems had been resolved, the Australian economy recovered strongly, and during the remainder of the 1990s it enjoyed one of the highest growth rates in the OECD.

Figure 1. Philippines: Real Estate Developments, 1991-2001



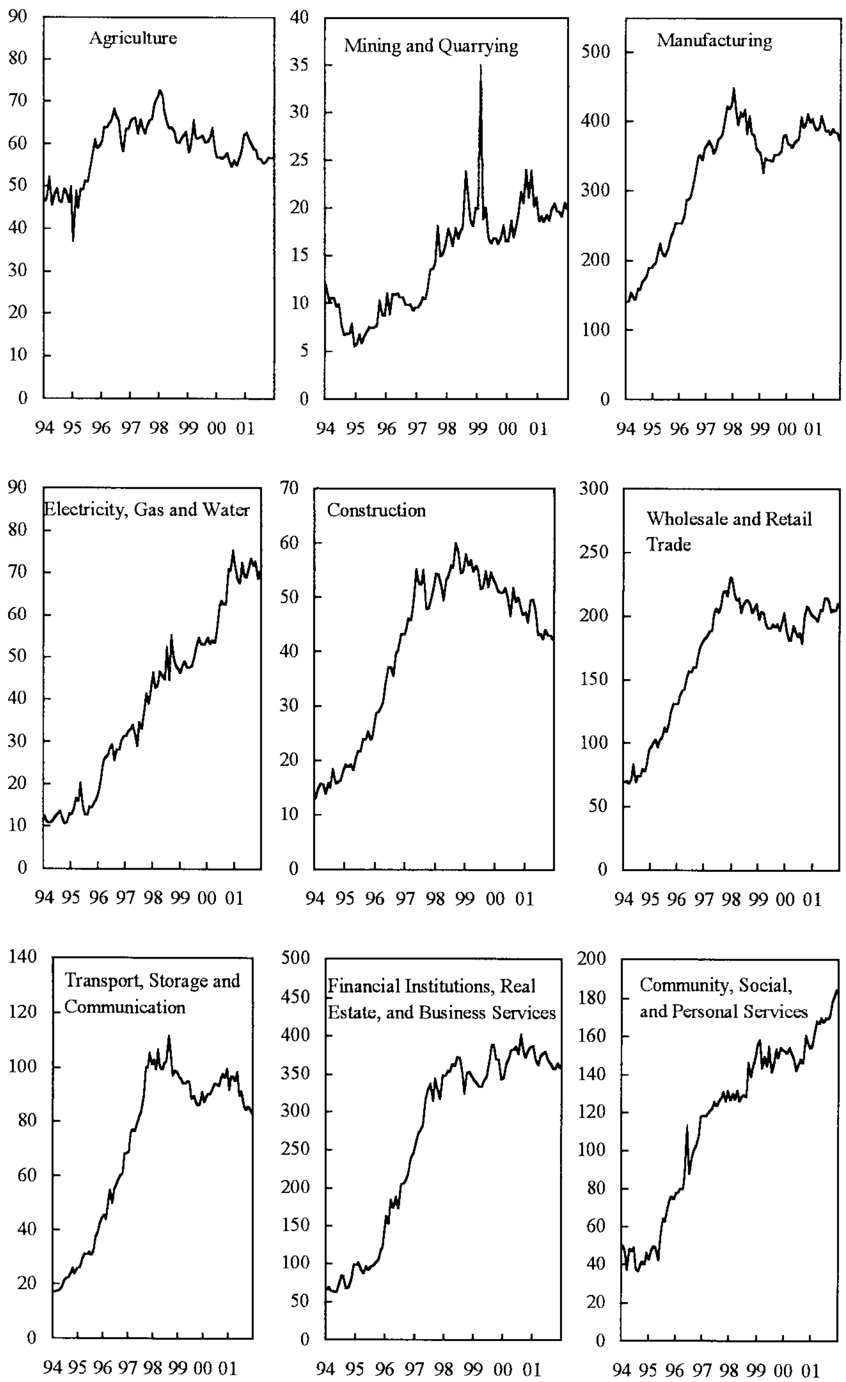

Source: CEIC database; and data provided by the authorities.

Figure 2. Philippines: The Asset Price and Lending Boom, 1993-2001



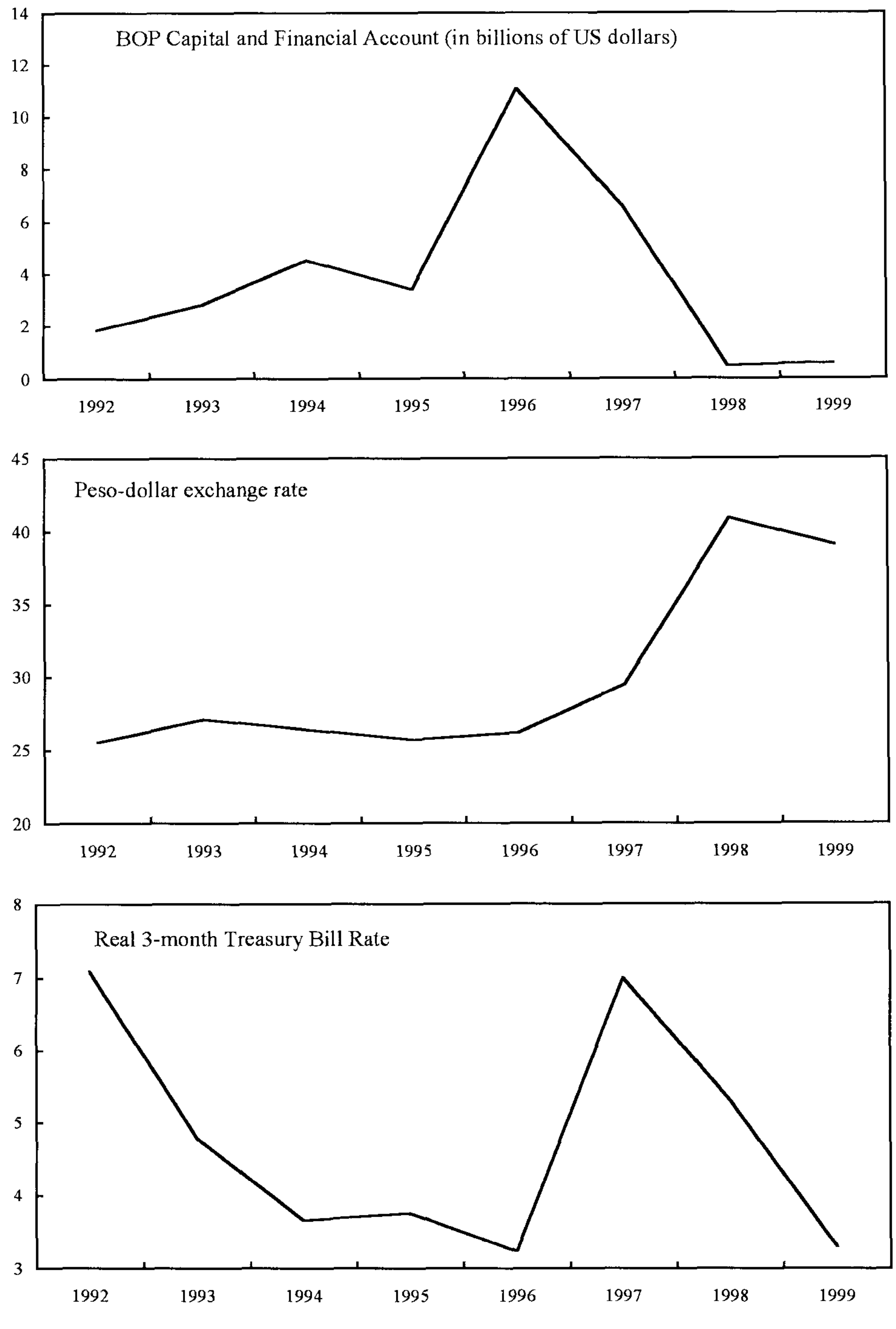

Source: CEIC Database

Figure 3. Philippines: Commercial Bank Loans, 1994-2001
(In billions of pesos)



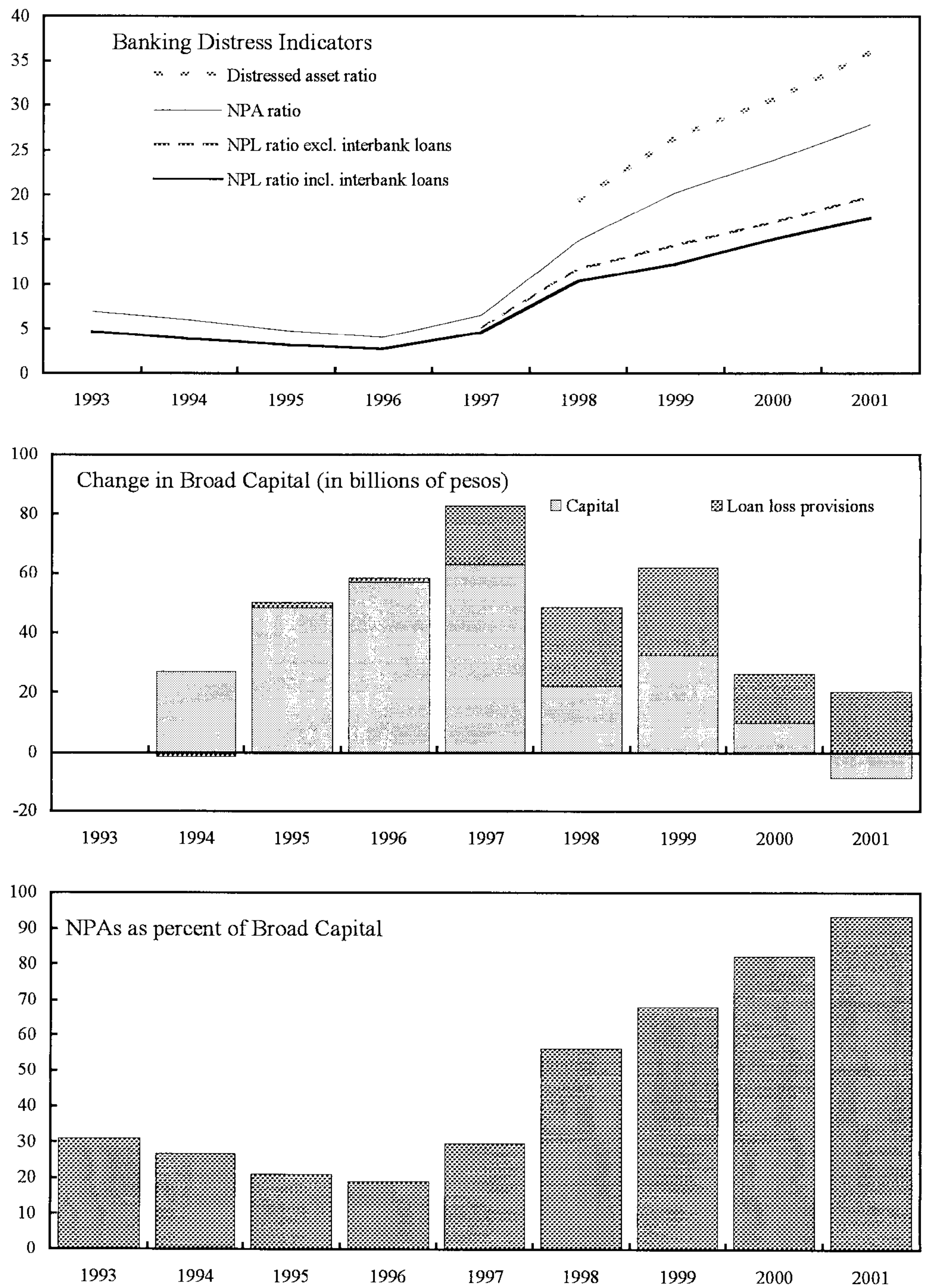

Source: CEIC Database

Figure 4. Philippines: Capital Inflows and Real Interest Rates, 1992-1999



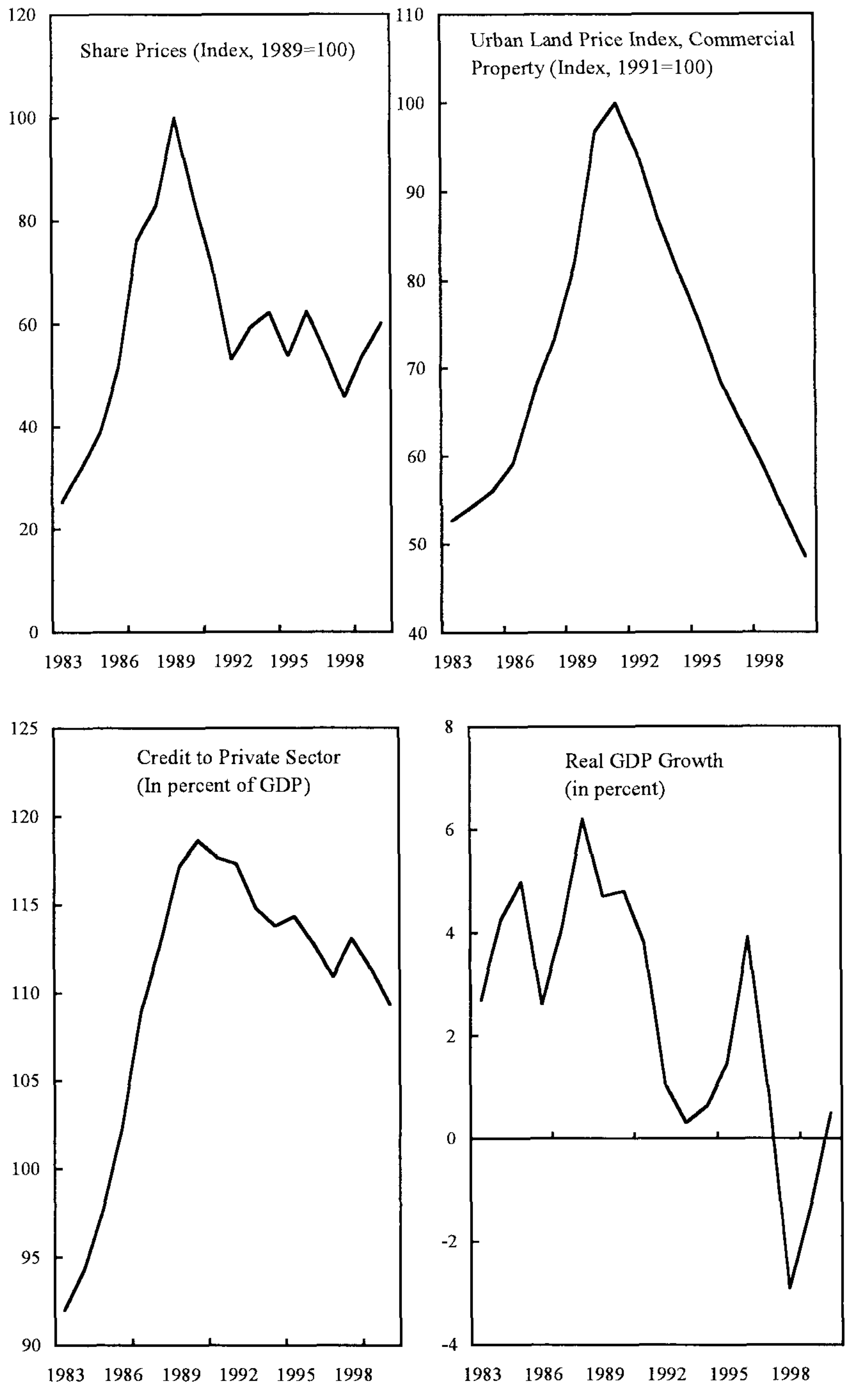

Source: CEIC Database

Figure 5. Philippines: Banking Sector Indicators, 1993-2001



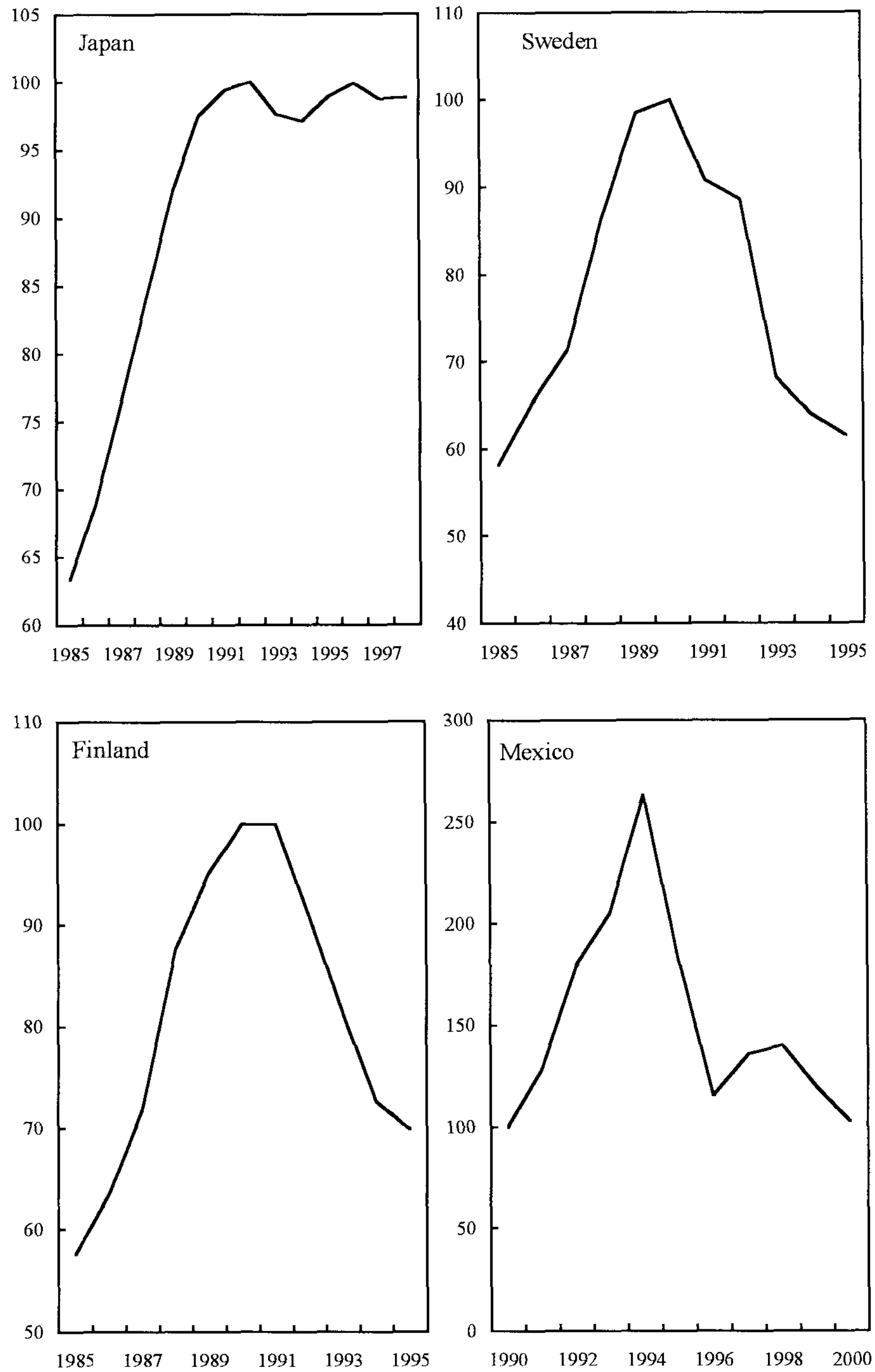

Source: Data provided by the authorities; and Fund staff calculations

Figure 6. Japan: Selected Indicators, 1983-2000



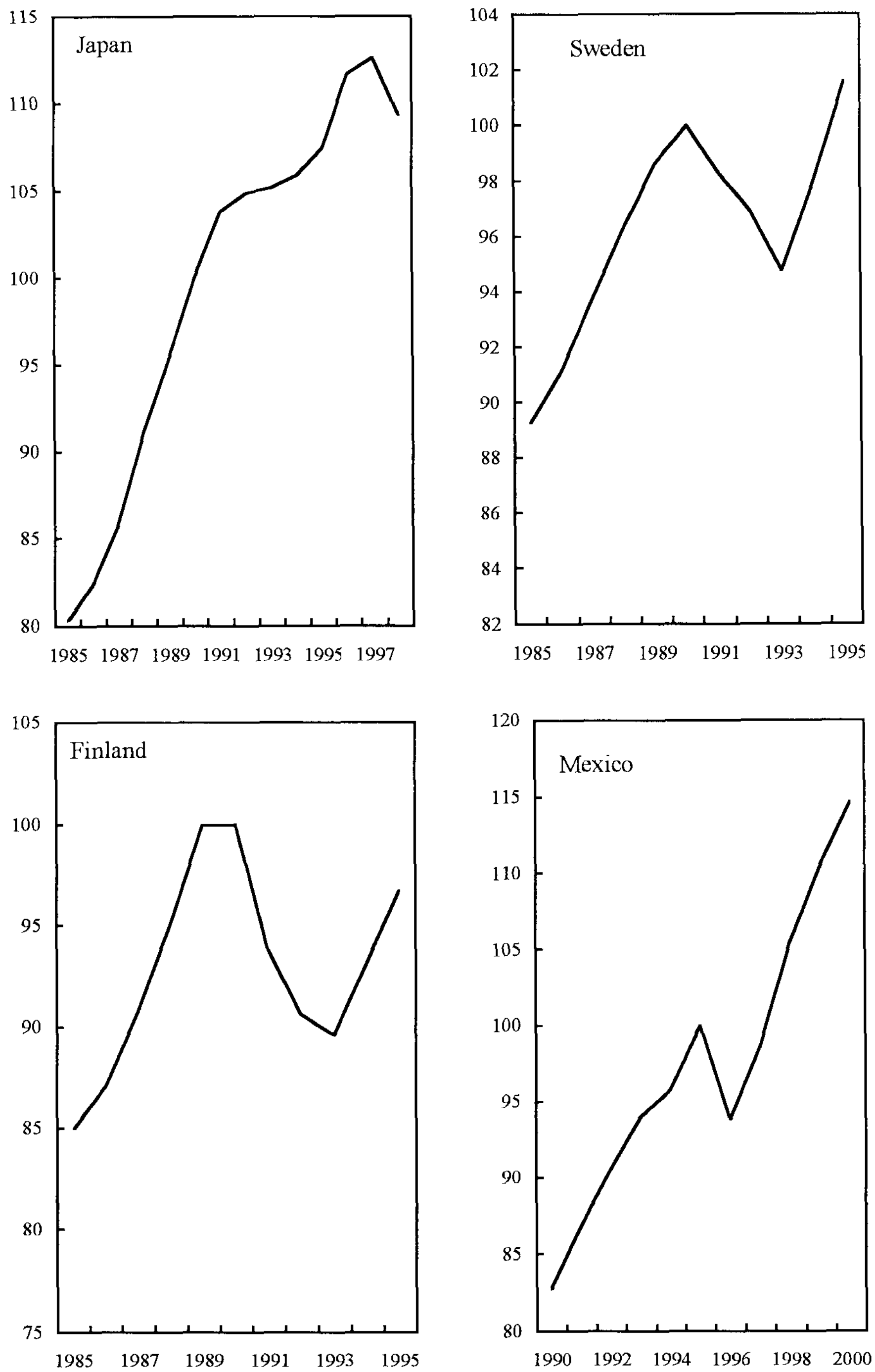

Source: IMF, IFS; and CEIC Database

Figure 7. Real Private Sector Credit in Selected Countries



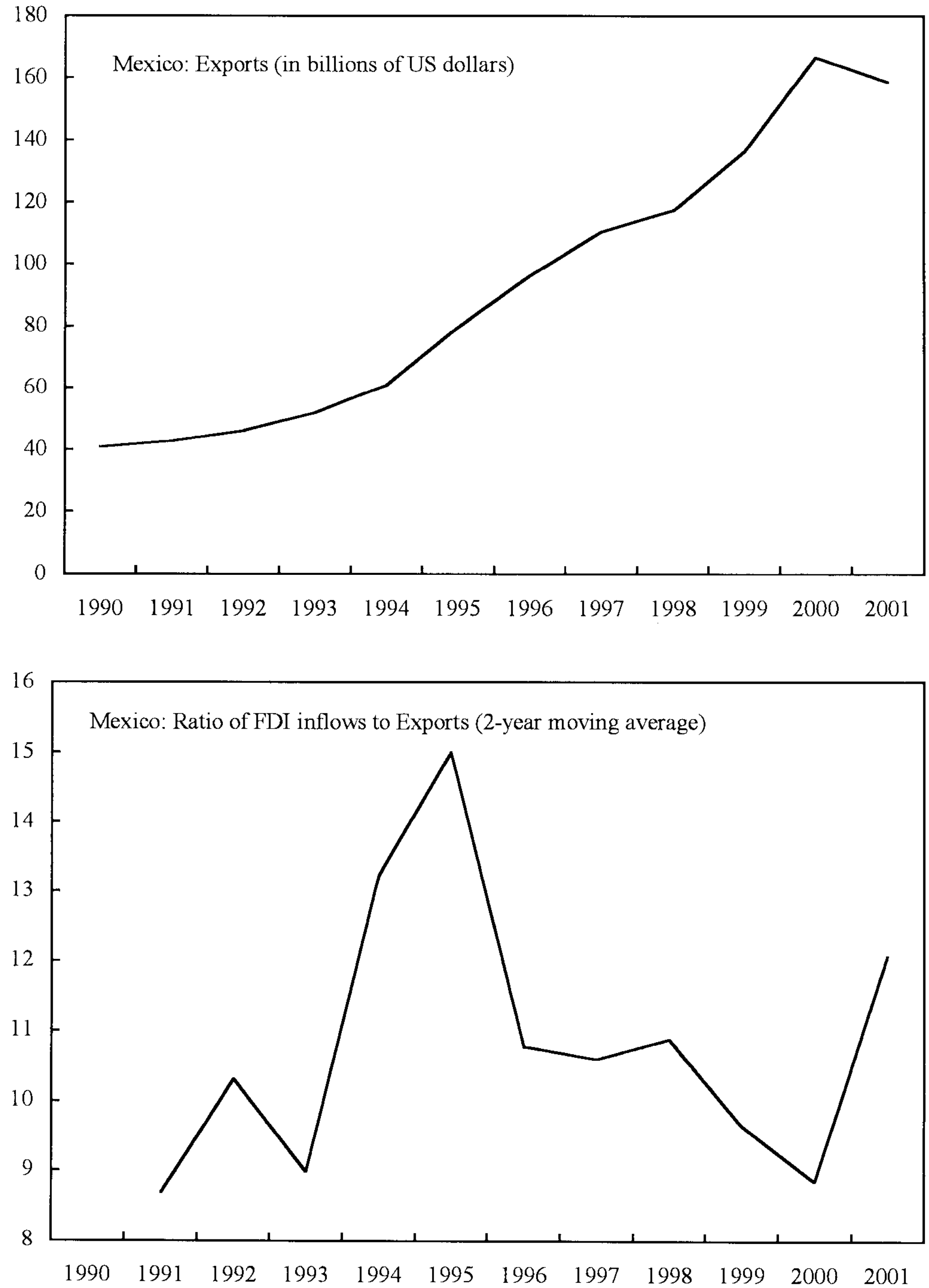

Source: IMF, IFS

Figure 8. Real GDP Level in Selected Countries



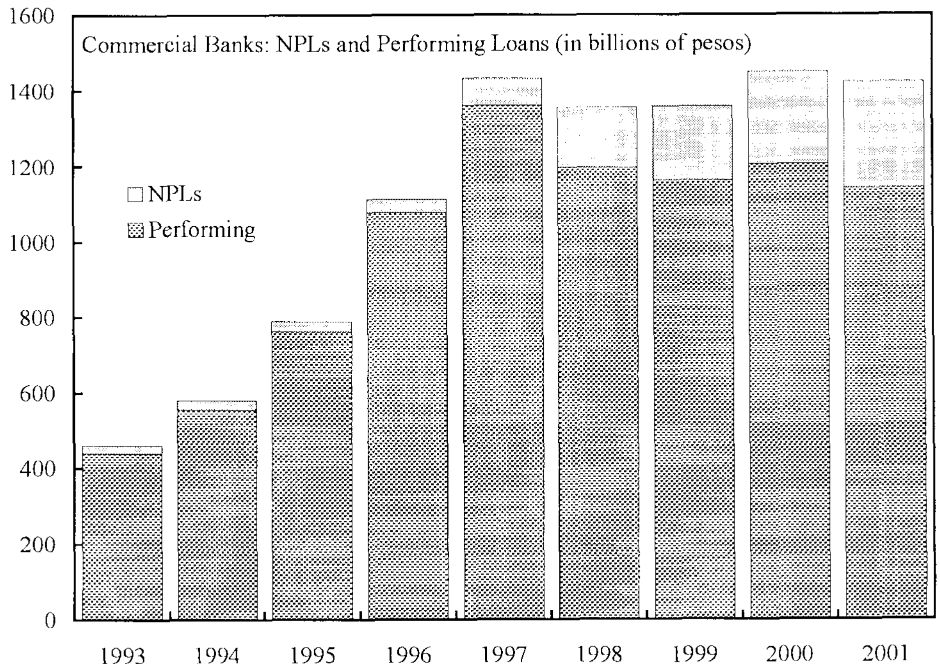

Source: IMF, IFS

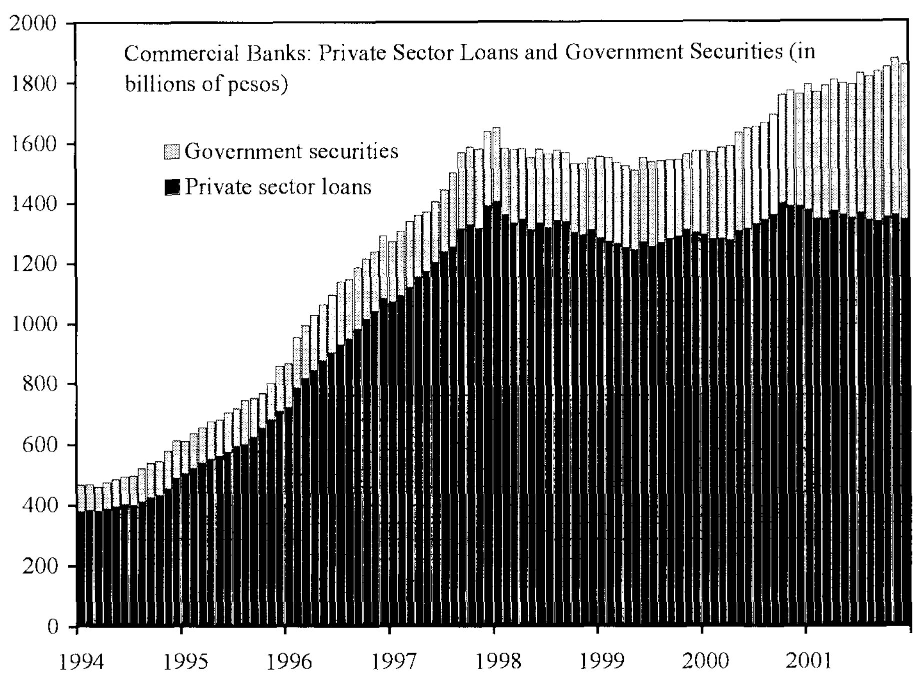
Figure 9. Mexico, Exports and FDI, 1990-2001




Source: IMF, IFS

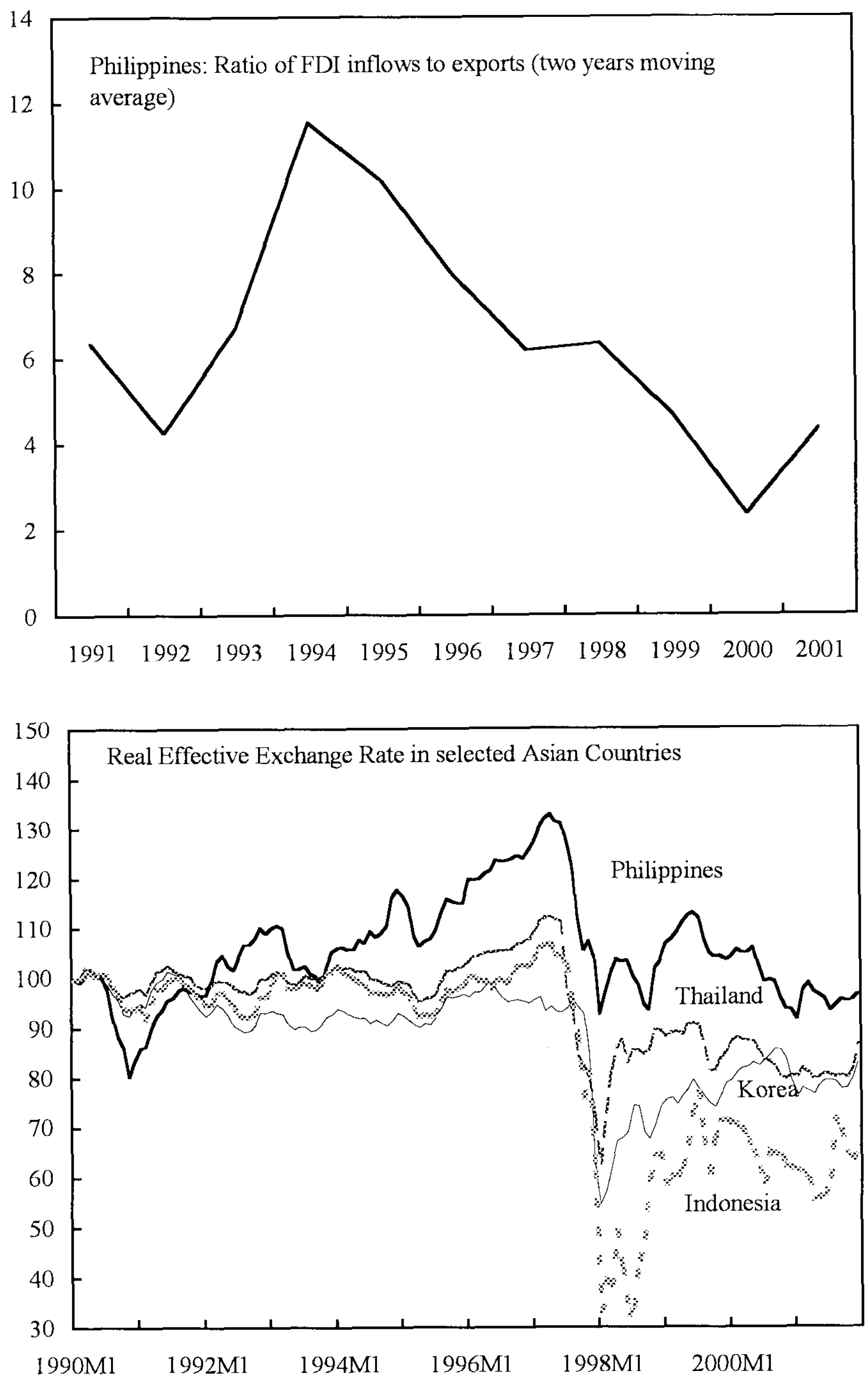
Figure 10. Philippines: Credit Cunch, 1993-2001




Source: CEIC Database

Figure 11. Philippines: Competitiveness and FDI, 1990-2001




Source: IMF, IFS; and Fund Staff Calculations.

### Scenario 1: Different Inflow Ratio and Loan Growth Assumptions

(Assumes interest margin of 3 percent on new loans)
(Shaded areas indicate improvement compared with 2001)

Distressed asset ratio in 2006 (2001: 35 percent)

| | | Distressed asset inflow ratio | | | | | | |
|---|---|---|---|---|---|---|---|---|
| | | 7 | 6 | 5 | 4 | 3 | 2 | 1 |
| | 0 | 70 | 65 | 60 | 55 | 50 | 45 | 40 |
| Loan growth | 5 | 58 | 53 | 49 | 45 | 40 | 36 | 32 |
| | 10 | 48 | 44 | 41 | 37 | 33 | 29 | 26 |
| | 15 | 41 | 37 | 34 | 31 | 27 | 24 | 21 |
| | 20 | 35 | 32 | 29 | 26 | 23 | 20 | 17 |

Distressed assets in percent of broad capital in 2006 (2001: 118 percent)

| | | Inflow ratio | | | | | | |
|---|---|---|---|---|---|---|---|---|
| | | 7 | 6 | 5 | 4 | 3 | 2 | 1 |
| | 0 | 216 | 198 | 180 | 163 | 146 | 130 | 114 |
| | 5 | 213 | 194 | 176 | 158 | 141 | 124 | 108 |
| Loan growth | 10 | 209 | 190 | 172 | 154 | 136 | 119 | 102 |
| | 15 | 205 | 186 | 167 | 149 | 131 | 113 | 96 |
| | 20 | 201 | 182 | 162 | 144 | 126 | 108 | 91 |

### Scenario 2: Different Interest Margin and Loan Growth Assumptions

(Assumes inflow ratio of 3 percent; shaded area indicates improvement compared with 2001)

Distressed assets in percent of broad capital in 2006 (2001: 118 percent)

| | | Interest margin on new loans | | | | | |
|---|---|---|---|---|---|---|---|
| | | 1% | 2% | 3% | 4% | 5% | 6% |
| | 5 | 144 | 142 | 141 | 140 | 139 | 137 |
| Loan growth | 10 | 145 | 140 | 136 | 132 | 128 | 124 |
| | 15 | 146 | 138 | 131 | 124 | 118 | 113 |
| | 20 | 147 | 136 | 126 | 117 | 110 | 103 |

## V. Enhancing the Framework for Bank Resolution in the Philippines[1]

1. **In 2000, the Philippine enacted a new General Banking Act (GBA), to complement the 1993 Central Bank Act**. This legislation tightened prudential regulations and strengthened the framework for bank resolution. However, the new framework still tightly circumscribes supervisors' ability to restructure or liquidate distressed banks, without shareholder interference. This chapter compares this framework with best practices in bank resolution, and analyzes recent proposals to narrow the gap between the two.

### A. Lessons from International Best Practices

2. **A comparison of bank resolution frameworks across several jurisdictions as well as results from a large number of Basel Core Principles assessments reveals the following broad lessons** (see Appendix I). Several of these are considered by the Basel Committee as key preconditions for effective supervision.

- **Powers to intervene.** *Critical to the efficient resolution of distressed banks is the need to provide the supervisory authorities with adequate powers to take full control of a bank, so they can supercede shareholder rights and restructure or liquidate the bank.*[2] In the absence of such powers, a Prompt Corrective Action (PCA) regime, however well designed, is unlikely to be effective.

- **Prompt corrective action.** *Supervisors must have sufficient powers to implement timely corrective action resolution measures.* In all jurisdictions reviewed, the law stipulates clear triggers (mainly solvency criteria) that empower the supervisor to promptly intervene a distressed bank and close it, if deemed necessary.

- **Finality of decisions.** *The law and/or judicial practice must typically ensure that supervisory decisions are treated as final, with well-circumscribed opportunities for aggrieved shareholders to challenge these decisions in court, thus minimizing the risk of delaying resolution because of frivolous and unjustified petitions.* In the United States, for example, while supervisory decisions (e.g., by the conservator and receiver) may be challenged, the judicial process ensures that the courts exercise strict discretion, and consider a challenge only if the decision is found to be arbitrary or capricious. In some countries (e.g., Canada and Poland) the law is even more forceful and prohibits challenges to supervisory decisions.

[1] Prepared by Barbara Baldwin (MAE).

[2] Restructuring methods used include the creation of a bridge bank, loss sharing arrangements, and purchase and assumption (P&A) transactions.

- **Legal protection.** *Equally, supervisory staff must be provided with sufficient legal protection.* Most jurisdictions reviewed provide strong legal immunity to supervisory officials, for actions taken in good faith. For example, under the U.S.C. Title 12 on Banks and Banking and the FDIC Act, supervisors are protected under legislation governing all government employees. Additionally, the law provides specific immunity for FDIC staff acting within the scope of their employment, and in good faith. Similar provisions are contained in the Canadian Bank and CDIC Acts, and the Czech Banking Act.

- **Creditor rights.** *The law and judicial practice should also be balanced in its protection of the rights of debtors and creditors.* A legal framework that overprotects either one of these parties to the detriment of the other can result in delays in bank resolution and problems with market discipline.

## B. The Philippine Framework for Bank Resolution

3. **There are three basic components of the Philippine framework for bank resolution**. There is an *early warning system* to detect emerging weaknesses in particular banks at an early stage. There is a *PCA procedure*, allowing regulators to address weaknesses promptly in order to minimize disruption to the banking system and preserve asset values. Then, there is *conservatorship/receivership*, for banks whose problems prove more intractable. A quick review of these components indicates that identification of weak banks is working relatively well; it is in the response to such developments that the majority of difficulties arise.

- **Early warning system.** The central bank's (BSP) early warning system is designed to forecast trends in nonperforming loans, highlighting those institutions which appear most vulnerable for further assessment by analysts. The Supervisory Reports and Studies Office (SRSO) has also developed a bank performance report that generates analytical ratios of financial performance which can be used in trend analysis and to benchmark a particular institution's performance against that of its peers. Other tools developed by the SRSO include a tracking system to follow the top 500 corporate borrowers, incorporating identification and monitoring of borrower groups in order to track large exposures in the banking system.

- **Prompt Corrective Action.** Under the PCA regime introduced in 1998, progressively more stringent corrective actions are prescribed in three distinct stages (Box 1). When a bank is undercapitalized, it must reach agreement with the BSP on a capital restoration plan. When the undercapitalization exceeds 20 percent, then the BSP will meet with the bank to decide on remedial measures. When under-capitalization exceeds 60 percent, the BSP will appoint an external auditor and may appoint a resident examiner or controller. If these measures fail to rehabilitate a bank *and* its capital base is deficient by more than 80 percent, the BSP is allowed to appoint a receiver.

- **Conservatorship.** The BSP's experience with conservatorship has not been encouraging. On occasions when it has appointed conservators to manage an intervened bank's affairs, it has been sued in court by shareholders, on grounds of mismanagement and abuse of power. Accordingly, this authority has rarely been invoked.

- **Receivership.** Under the Philippine system, an unsound bank is first closed, and then handed over to the Philippine Deposit Insurance Corporation (PDIC) as receiver. The PDIC is enjoined to find a least-cost resolution strategy, and is required to wait at least 90 days to consider rehabilitation plans proposed by the shareholders. If these plans are rejected, the PDIC normally tries to find another party willing to take over all or part of the bank, often providing it with financial inducements or regulatory forbearance to do so.

### C. Obstacles to Effective Bank Resolution

4. **The authorities have a good understanding of the problems in the financial sector and an appreciation of the measures that should be taken to resolve them**. Too often, however, their efforts to resolve banks are impeded by obstacles beyond their control. Most problematic, supervisory decisions often prove not to be final, as they are often challenged, delayed, and even overturned by shareholders in the courts. There are also weaknesses in the prompt corrective action program. (Bank secrecy is a further problem; see Appendix II.)

5. **The following limitations in the bank resolution framework are of particular concern, marking significant departures from international best practices**.

- **Powers to intervene**. The law does not explicitly empower the BSP/PDIC with adequate authority to intervene in, and restructure, a distressed bank—whether open or closed—or force its sale, merger, or liquidation, *without shareholder interference*. In order to initiate liquidation or other actions that would reduce shareholder equity, the law requires prior shareholder approval which, understandably, is not usually forthcoming. Owners can even invoke their rights *after* the bank has become insolvent, and the value of their investment becomes worthless. Because the BSP cannot effectively ensure that owners bear the costs associated with imprudent and unsound management of the bank, there is no incentive for shareholders to adequately direct, monitor and discipline management.

- **Application of prompt corrective actions**. The law, as implemented in practice, does not provide the BSP with sufficient powers to implement timely corrective action resolution measures. Indeed, under the GBA (section 53), banks can unilaterally suspend operations and declare a bank holiday without immediate intervention of the supervisory authorities; only very recently has the BSP tested its ability to take prompt action in these situations, and that decision is now being disputed in court.

- **Finality of decisions.** The sheer number of court cases, and especially those cases where supervisory decisions regarding bank resolution have been overturned, are indicative of a legal framework which in practice ascribes little ultimate responsibility and authority to the institution to which regulatory responsibility has been delegated. In too many cases, decisions are being rendered by parties who are not equally well-versed in bank resolution matters, undermining the credibility of the supervisory program.

- **Legal protection**. The law does not provide supervisory staff with adequate protection against litigation. Officers and staff regularly face lawsuits filed against them personally by aggrieved shareholders of banks subject to supervisory actions. The ill-defined and unreasonable standard of *"extraordinary diligence"* imposed on BSP staff in the enforcement of their authority, and a court system that does not evaluate at the outset a petition's merit or require that petitioners post a substantial bond upon filing, invite such legal challenges to the implementation of prompt enforcement actions. This weakens the authority of the BSP/PDIC, and can result in significant delays in the ultimate resolution of distressed banks, as in the case of Orient and Urban Banks.

- **Creditor rights**. As explained below, the law and judicial practice are not balanced in their protection of the rights of debtors and creditors.

6. **These weaknesses make it difficult for supervisors to implement tough measures for bank resolution**.

**Finality of Decisions**

7. **As indicated above, one of the most serious problems facing the supervisory authorities is that their decisions are frequently blocked by the courts**. Unlike in most countries where court intervention in regulatory decisions is kept to a minimum and occurs only in the presence of clear misconduct by regulators, the BSP's decisions on placing banks under receivership and the PDIC's decisions regarding resolution options can be challenged easily in the courts. Examples of this problem are numerous. The PDIC annual report for 2000, for example, discusses how shareholders have managed to hold the PDIC's decision to take over two rural banks in Batangas in abeyance, first by securing temporary restraining orders and then by a court injunction against the takeovers. The same report discussed the liquidation of the Pacific Banking Corporation, which started in 1985, but was still continuing as of end-2000.[3] In other cases, courts have reversed BSP closure decisions and ordered that banks be reopened, years after they were closed and liquidated (Box 2).[4]

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[3] Apparently, shareholders have been able to exploit the requirement that regional courts approve and supervise PDIC liquidation plans.

[4] Some of these issues are to be addressed in the pending amendments to the Central Bank Act, by leaving the power to suspend the BSP's decision only with the Supreme Court. It is

(continued)

8. **Easy access to the court system not only slows down the restructuring process, but it also tightly circumscribes the authorities' room for maneuver**. Convincing banks to implement corrective actions measures is difficult, because shareholders know that they can appeal to the courts if they are threatened with sanctions. Moreover, the current system can create opportunities for owners to "free ride" at the expense of the state, particularly where publicly-funded liquidity or capital support is involved (Box 3). It also gives owners and management the time and opportunity to strip assets from banks before they can be taken into active receivership and resolution measures are initiated. Finally, it inhibits supervisors from even attempting to impose sanctions on banks, especially because individual officials are required to exercise "extraordinary" diligence, raising the risk that they could be held legally liable for their regulatory decisions.[5] Even in cases where the charges are ultimately proven baseless, significant amounts of scarce supervisory resources need to be devoted to such suits.

9. **How has such a situation arisen?** One reason is that the judicial system is poorly equipped to handle the special considerations of bank insolvency cases. There is no commercial court with judges experienced in the relevant issues. Nor are there many judges familiar with the complexities of bank insolvency, including the implications of long delays in bank resolution for increased resolution costs at the government's expense.

10. **More fundamentally, the judicial culture gives little support to creditors' attempts to enforce their contractual rights**. Market participants have long complained of the inefficiency of the judiciary in enforcement of financial contracts. Actions can take many years to be resolved through the current legal processes; most lenders simply avoid the court system altogether when foreclosing on collateral, relying instead on the voluntary "dacion en pago" agreements under which property is given in a noncash settlement of outstanding debt. These problems are even worse when the creditor in question is the Philippine government, for the government itself is frequently at a disadvantage in the courts compared to the private sector.

**Weaknesses in the PCA Program**

11. **Several factors limit the effectiveness of the PCA program.** One is the supervisor's difficulty in taking control of banks, as discussed above. But beyond this, there are a number of problems that stem from the way the program is designed.

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not clear, however, whether a regional court will still be allowed the authority to suspend or override the PDIC's decision as a receiver.

[5] The pending amendment to the Central Bank Act would also improve upon this weakness to some extent.

12. **The conditions under which a bank can be placed in receivership have not proven sufficiently robust.**[6] The threshold of 80 percent undercapitalization for taking a bank into receivership is low in the Philippine context, because little salvageable capital will remain by that time.[7] But in any case, the provision against insolvency is rarely cited because such decisions are too easily challenged; bank owners can simply allege that the examiners underestimated the value of the bank's assets. And this, in turn, undermines the entire basis of the PCA program, since its triggers are based solely on insolvency.

13. **There are other grounds for sending a bank into receivership, but they too have proved vulnerable to court challenge**. There is a provision against violating a "cease and desist" order from the BSP, which should be relatively easy to substantiate, but the actions have seldom been used in practice given the difficulty faced by the central bank in enforcing its rules and regulations. Therefore, most recent closure decisions have been based on a provision citing a bank's inabilities to pay its liabilities as they fall due. However, that too is now facing a court challenge (see Box 4).

14. **Another problem is that parts of the circular are vaguely written**. For example, the recommended supervisory responses for undercapitalized and significantly undercapitalized banks are not substantially different. The same language (i.e., recommended supervisory actions) appears again for critically undercapitalized banks, suggesting that perhaps no forceful action can be taken until the bank has reached that stage. When banks become critically undercapitalized the framework suggests that a resident examiner or conservator be appointed "if legally feasible," suggesting that such a step might not be possible. In any case, it is unclear whether the supervisor actually is required to take any action at all. Nor is it clear how shareholders will be held to account if action is taken, but the measures are not successful.

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[6] The BSP can cite any of the following as a basis for closing an institution: (a) the bank is unable to pay its liabilities as they become due in the ordinary course of business: *Provided*, that this shall not include inability to pay caused by extraordinary demands induced by financial panic in the banking community; (b) the bank has insufficient realizable assets, as determined by the BSP, to meet its liabilities; (c) the bank cannot continue in business without involving probable losses to its depositors and creditors; or (d) the bank has willfully violated a cease and desist order under Section 37 that has become final, involving acts or transactions which amount to fraud or a dissipation of the assets of the institution; in which cases the Monetary Board may summarily and without need for prior hearing forbid the institution from doing business in the Philippines and designate the PDIC as receiver of the banking institution.

[7] Proposed amendments to the BSP Act stipulate that the CAR must fall below 2 percent for 90 continuous days before the BSP may close a bank or place it under receivership.

15. **Even when a bank is placed under receivership, problems remain**. For example, PDIC is not allowed to take any actions toward liquidation until 90 days after a bank is placed in receivership, in order to give owners yet another chance to come up with a viable resolution plan.

16. **As a result, the BSP has difficulty persuading distressed banks to agree to an MOU that includes necessary but painful recapitalization plans**. There have been particular difficulties in dealing with some of the larger, distressed banks such as the Philippine National Bank and Equitable. But there have also been long delays in the final resolution of a number of smaller banks placed under the receivership of PDIC (Box 5).

## D. Enhancing the Bank Resolution Framework

### Planned reforms

17. **The following (mostly legislative) changes have already been proposed by the BSP and PDIC, with bills currently pending before Congress**:

- **Powers to intervene**. Grant BSP and PDIC more effective powers over banks taken into receivership, including the authority to immediately intervene in any bank that unilaterally declares a bank holiday, without shareholder intervention.

- **Prompt corrective actions**. Provide BSP/PDIC powers to take control of a distressed bank, once capital adequacy (or some other trigger, such as asset quality) has fallen below a defined threshold, so as to implement its forced restructuring, sale, merger, or liquidation, without interference from shareholders.

- **Finality of decisions**. Circumscribe opportunities for banks and their shareholders to challenge supervisory orders in court, thereby minimizing the risk of delaying resolution because of frivolous and unjustified petitions. Also, an Action Program for Judicial Reform 2001–2006 has been introduced under the auspices of the Supreme Court to address concerns about the judicial system.

- **Legal protection.** Strengthen the protection of BSP/PDIC staff against litigation, and replace extraordinary diligence standards for BSP staff with appropriate standards, such as protection for actions undertaken in the normal course of duty, unless gross misconduct or negligence is evident.

- **Creditor rights.** Create a better balance between the rights of creditors and debtors, thereby providing for the orderly and efficient resolution of disputed claims during a liquidation and strengthening credit discipline.

18. **Opposition to these measures, however, has been significant**. These bills have made little progress in Congress, mainly because legislators are concerned that the proposed changes to the BSP and PDIC charters would grant the agencies too much power. From a

historical perspective, taking into account the practices that occurred during the Marcos era, this concern is understandable. However, a review of a regional sampling of bank rehabilitation and resolution frameworks reveals that the proposed legislative changes are far from radical, and would merely bring the Philippines in line with regional counterparts (see Appendix III).

19. **Indeed, counterparts in other countries face far fewer obstacles in carrying out their supervisory responsibilities**. Elsewhere in the region, regulatory decisions are considered as final, recognizing that this authority has been delegated to those who have been appointed to positions of responsibility in financial sector supervision. Mechanisms for formal challenges to supervisory decisions do exist, but are utilized in only the most egregious cases where malfeasance is evident. Furthermore, such actions do not delay necessary supervisory action to protect depositors and asset values. In the Philippines, virtually every commercial bank closure (as well as a number of rural bank and thrift bank cases) is challenged in court, and the use of temporary restraining orders results in the substantial delays in necessary supervisory measures.

**Other measures**

20. **Even if the legislative measures remain blocked, interim actions could still be taken to be strengthen the bank resolution regime.** To reduce "judicial dominance", it might be possible to create a bankruptcy court that would specialize in corporate recovery issues. Alternatively, the initial jurisdiction for bank resolution cases (and suits against BSP staff) could be shifted from regional courts to the Court of Appeals, where there would be fewer judges to equip with the necessary skills. Also, the rules governing the use of Temporary Restraining Orders could be applied more rigorously.

21. **At the same time, the prompt corrective action framework could be strengthened**. The language of the framework could be tightened to make the BSP's responsibilities at each stage more specific and binding. For example, deviations from a bank's capital restoration plan would advance the institution to the next level in the PCA framework, and would eventually lead to receivership unless promptly and proactively addressed. To make such a progression more binding, the authorities are planning to step up the use of cease and desist orders (CDOs). Given that violations of CDOs are included in the list of circumstances under which BSP can close a bank, regular use of such orders in the context of the PCA program should render the BSP's decisions less subject to legal challenge.

22. **Also, rather than relying strictly on capital ratios to determine steps to be applied under the PCA framework, triggers could be based on asset quality**. NPAs are more easily measured than CARs, which can be manipulated to make the capital buffer appear larger than it really is. Moreover, by the time a true CAR figure is calculated, reflecting all losses associated with the loan portfolio or other assets, there is often little left for the regulators to salvage. At present, the BSP is faced with the argument from banks that high levels of NPAs are not a violation of any prudential regulation, and therefore cannot be

subject to strict enforcement action by the BSP. Yet, carrying a high level of NPAs, especially if underprovisioned, is clearly an unsound banking practice.[8]

23. **In addition, more stringent restrictions could be placed on those banks accessing BSP emergency loans**. For instance, in exchange for receiving government assistance, bank owners could be required to assign voting rights over their common shares to the BSP, giving the regulators greater control over those banks in which government funds have been placed at risk. Liquidity support could also be made contingent on assignment of a conservator or agreement on a detailed CDO limiting bank activities and clarifying the graduated corrective actions available to supervisors.

## E. Conclusion: Will these Measures be Sufficient?

**It is not clear whether these measures will be sufficient to bring Philippine bank resolution practices in line with industry best practices**. To begin with, implementation of these measures is not within the authorities' control. Especially with respect to necessary legislative changes, it will be imperative to have the support of the Congress, which has proven reluctant to grant supervisors more authority. The BSP/PDIC would also need the support of the judiciary to ensure any new legal powers can actually be implemented. However, if all the measures discussed above were taken expeditiously and implemented effectively, it seems likely that the framework would compare favorably with regional and international counterparts.

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[8] The BSP has recently issued a circular outlining what activities or conditions would be considered "unsafe and unsound," in an effort to reduce legal challenges to its enforcement and resolution actions.

**Box 1. Prompt Correct Action Regime**

1. *Undercapitalized (up to 20 percent below requirement)*

- Require the bank to execute a Memorandum of Understanding (MOU) with the BSP, to implement a viable capital restoration plan within 30 days.
- Require intensified monitoring by BSP.
- BSP to conduct a special examination of the bank.

2. *Significantly Undercapitalized (up to 60 percent below requirement)*

- BSP to call a meeting with bank directors and principal officers to agree on remedial measures and a timetable for implementation
- Further intensify monitoring by BSP
- BSP to immediately conduct an extensive on-site examination
- Require an MOU with the BSP, which could include such options as disposition of a majority shareholder's interest; sale of assets; capital injection; and sale or merger of the bank
- Bank to create a separate unit for remedial asset management

3. *Critically Undercapitalized (more than 60 percent below requirement)*

In addition to all measures prescribed above for banks undercapitalized up to 60 percent:

- Assign the bank to the PCA Unit within SES[1] since this condition would require more than normal bank supervision
- BSP to call a meeting with principal shareholders and directors to agree on prospects for an immediate capital injection or other measure to restore bank's capital base
- BSP to conduct continuous, intensive monitoring of the bank's financial condition
- Create a BSP Ad Hoc Committee to oversee the implementation of the action plan
- Appoint an external auditor at the expense of the bank to perform financial and operational audit under the terms of reference of the BSP
- If bank's condition further deteriorates to the extent that depositors and creditors protection is at stake and its capital base is deficient by more than 80 percent, appoint/assign a resident examiner/comptroller or conservator, if legally feasible, to oversee/take over management of the bank.

If necessary, appoint a consultant specialist to diagnose the problem and to recommend appropriate remedial measures.

**Box 2: The Court System: An Effective Defense Against Bank Liquidation?**

BSP officials face significant difficulties in successfully closing banks, often because owners can impede supervisory actions simply by filing civil or criminal suits alleging misconduct by BSP and/or PDIC, and even against staff members individually. The relevant language in the legislation is sufficiently broad as to invite such suits. There is no upfront assessment of the validity of claims filed, so even those that are ultimately proven to be without merit can prevent a timely resolution.

The leading case in this area is the Supreme Court's 1991 decision in *Banco Filipino Savings* v. *Monetary Board, Central Bank of the Philippines* in which BSP's closing of a bank was overturned, the finding of insolvency ruled inadequate and the bank reopened after some five years of litigation. Although the operative language of Sec. 30(2) of the Central Bank Act has been changed since the *Banco Filipino* case, the BSP's ability to close a bank is still in doubt. Indeed, numerous similar petitions have since been filed, with many still pending after several years. Examples include:

1. *Orient Bank* - A commercial bank whose problems emanated from violations of DOSRI rules (covering loans to directors officers shareholders and their related interests). It was finally ordered into liquidation in November 1999, eighteen months after declaring a bank holiday and nearly a year after being placed under receivership. The Regional Trial Court supported the BSP's findings, but the decision was overturned by the Court of Appeals. The liquidation of the bank has been suspended while appeals continue.

2. *Rural Bank of San Miguel* - One of the biggest rural banks, closed in April 1999. The owner claimed grave abuse of discretion by the BSP on the closure, and numerous cases were filed against BSP and its officials. The lower court ruled in favor of the owner, and the BSP officials are to be penalized 6 months worth of salary for "acting unprofessionally". They have appealed the decision, and the case is still pending.

3. *Urban Bank* – Another commercial bank, closed in April 2000. Lawsuits lodged by the owners delayed its resolution. Even though it was eventually sold to another commercial bank, there have been ongoing court battles between the former owners and both BSP and PDIC. Many were found to be nuisance charges; in addition, PDIC officials who did not directly participate in the closure decision were included among those charged. Recent decisions on several of the pending suits are contradictory. On one hand, they clearly indicate that BSP was correct in closing the bank; however, four top BSP supervision officers were ordered suspended for "neglect of duty," apparently over an issue that isn't even relevant to the case.

4. *Rural Bank of Tayasan* - Closed after 1993, the owners petitioned in court for a "temporary" restraining order on the receivership. Owners have thus been left in control of bank documents and properties, jeopardizing their integrity and value.

5 & 6 *Rural Banks of Balayan and Tuy* – These two institutions were owned by the same family group. Closed in 2000, PDIC has not yet been able to take over control because of a court ruling which is still being appealed.

**Box 3. An Excess of Liquidity Support?**

Another concern raised regarding the bank resolution framework is the frequent recourse to BSP liquidity support. It has been difficult for BSP to declare that liquidity support is not warranted when a bank gets into difficulty. It is not clear that the BSP has been able to enforce a distinction between temporary illiquidity and illiquidity indicative of underlying solvency problems. In the latter case, liquidity support usually leads only to increased resolution costs.

Many central banks, including the US Federal Reserve, have tightened provisions for extending liquidity support following a period of significant banking distress. This recognizes the potential moral hazard associated with unbridled extension of liquidity support, especially in cases where viability of the bank is in question. Under revised regulations, the Federal Reserve is held liable for costs incurred in extending liquidity support to banks that later fail. It is not considered appropriate to pass the increased cost of resolution on to the Deposit Insurance Fund. It has been recommended that the BSP charter be amended to restrict the extension of liquidity support to true emergencies, and to tighten the accountability of the BSP in extensions of liquidity support.

The landmark Supreme Court ruling on the closure of Overseas Bank of Manila (OBM) demonstrates the difficulty faced by the BSP in withholding liquidity support. In effect, the ruling suggests that no matter how much the bank violated prudential regulations, the blame for the bank's weak condition was to be borne by the Central Bank because it had penalized the bank for violating regulations and had not provided unlimited funds toward the rehabilitation of the bank. This is another case where the liquidation was annulled, and the Central Bank foiled in enforcing its regulations by bank owners. Though the Central Bank Act has been amended since this ruling was issued, supervisors remain personally liable for acts undertaken in an official capacity.

**Box 4: What Constitutes an Inability to Service Liabilities?**

The General Banking Act (GBA) of 2000 permits banks the right to unilaterally declare a bank holiday. In most countries, only the authorities can make such a declaration, and that decision in itself is a taken because of severe illiquidity. This provision of the GBA authorizes the BSP to summarily close the institution if the "holiday" (or if the bank in any other way suspends payment of its liabilities) lasts for more than 30 days. One could perhaps interpret this as a fifth condition (in addition to the four cited in the text) under which the BSP can close a bank. It should be noted that Section 30 of the Central Bank Act does not require the BSP to wait for 30 days to declare a bank closed based on the inability to service liabilities. But this discrepancy has created yet another loophole for bankers to exploit in their efforts to delay closure.

The Urban Bank case was the first real test of the BSP's authority to promptly put a bank into receivership; it was closed on the day after declaring a bank holiday. Their decision was based on a ruling by the BSP's General Counsel that declaring a bank holiday was evidence of an inability to service its liabilities as they become due (Section 30, provision (a) of the BSP Charter). The former owners of Urban Bank are now suing the General Counsel personally for issuing an inappropriate legal opinion.

## Box 5: The Orient Bank Saga

Orient Bank was the first of two Philippine commercial banks to have been closed during the Asian crisis. It declared a bank holiday in February 1998 after suffering from heavy withdrawals. The bank was eventually placed under the receivership of the PDIC in October of that year, after an 8 month bank holiday, during which the owner submitted several rehabilitation plans which were deemed unsatisfactory. In a review of bank operations, investigators determined that P5.4 billion of the bank's P6.5 billion loan portfolio were DOSRI (related party) loans. The BSP ordered liquidation in October of 1999, on the conclusion that the bank was insolvent, as its liabilities exceeded its assets by over P1 billion. PDIC liquidated the bank's assets in late 1999 and sold its 52 branches to Allied Bank.

However, Orient's owner filed a series of petitions challenging the BSP's decision to close and liquidate the bank, which went up to the Appellate Court (CA). The CA ordered the BSP and PDIC to stop the liquidation and seriously evaluate and reconsider a January 1999 rehabilitation plan submitted by Orient Bank as a basis for reopening the bank. In the court's judgment, the Monetary Board had rejected the rehabilitation plan too hastily. The CA also raised questions about Orient Bank's "alleged" bankruptcy and the manner in which the bank was liquidated. The BSP and PDIC are ordered to refrain from enforcing mortgage foreclosures or writs of attachment against Orient Bank until final resolution of its application for rehabilitation.

BSP and PDIC have filed a motion for reconsideration before the CA and, if necessary, will appeal to the Supreme Court. They argue that an examination of the bank's books showed Orient Bank to be insolvent and revealed significant irregularities, mismanagement, and violations of BSP prudential regulations. They also note that Orient Bank was given sufficient opportunity to present a viable rehabilitation plan -- including searching for a "white knight"—during its long bank holiday. Also, much had already transpired since the BSP ordered Orient Bank's liquidation in October 1999, making a reopening impractical, if not impossible. Most of the bank's assets have already been sold. PDIC has settled claims of insured depositors. Allied Bank has since taken over the branches and shouldered some of Orient Bank's liabilities to uninsured depositors.

More than four years after Orient declared a bank holiday, this case is still languishing in the courts.

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Selected court records

## FRAMEWORK FOR DISTRESSED BANK RESOLUTION

| United States | Canada | Argentina | Brazil | Czech Republic | Malaysia | Poland |
|---|---|---|---|---|---|---|
| **Regulatory Authorities** | | | | | | |
| FDIC, OCC (OTS for thrifts), and state authorities | Superintendent of Bank Supervision, CDIC | Central Bank | Banco Central do Brasil | Czech National Bank | Bank Negara Malaysia | Commission for Banking Supervision (under the Central Bank) |
| **Relevant Laws** | | | | | | |
| U.S.C, Title 12 (Banks and Banking), FDIC Act | Bank Act (1991, updated 1999), CDIC Act (updated to 1999), Trust and Loan Companies Act, Winding-up and Restructuring Act | Law of Financial Institutions (LFI), Central Bank Law (CBL) | Law Nos. 2321 (1987), 4595 (1964, 6024(1974), 9477(1997) | Czech Banking Act (No. 21, 1992, as amended under Act No. 264, 1992) | Banking and Financial Institutions Act (BAFIA) (Act No. 372, 1989) | Banking Act |
| **Prompt Corrective Action** | | | | | | |
| **Is there a Prompt Corrective Action (PCA) regime?** | | | | | | |
| Yes. Progressive actions to restore capital base of a bank. | Yes. Progressive actions to restore capital base of a bank. | Yes. Regularization/ Rehabilitation Schedule. | Yes. Progressive actions to rehabilitate a bank. | Yes. Progressive actions for bank rehabilitation. | Yes. Progressive actions to resolve a bank. | Yes. Rehabilitation program. |
| **What are the triggers for enforcement of PCA?** | | | | | | |

## FRAMEWORK FOR DISTRESSED BANK RESOLUTION

| United States | Canada | Argentina | Brazil | Czech Republic | Malaysia | Poland |
|---|---|---|---|---|---|---|
| –Undercapitalized situation reported. | –Undercapitalized situation reported.<br>–Superintendent determines problems with viability of the bank.<br>–Violations of Bank Act. | –Problems with liquidity or insolvency observed.<br>–Repeated failure to comply with regulations. | –Bank's financial condition and activities threaten systemic stability. | –"Failure to comply with laws and regulations".<br>–Bank's activities threaten the stability of the banking system and the shareholders have not taken the necessary steps to remedy the shortcomings. | – Bank reports: insolvency or likely inability to meet its obligations.<br>–Supervisor determines any threat to the interests of depositors, creditors or the general public, or contraventions against provisions of the BAFIA or other relevant laws. | –Bank incurs a net loss that threatens its soundness/ solvency. |
| **Effect of PCA on shareholder rights** | | | | | | |
| –Suspension of dividend payout.<br>–Possible loss of the bank. | –Suspension of dividend payout.<br>–Possible termination of shareholder rights. | –Suspension of dividend payout. | –Suspension of dividend payout. | –Suspension of dividend payout. | –The supervisor may take full control of the bank. | –Suspension or restriction of dividend payout.<br>–Forced loss allocation to capital or forced capital increase. |
| **Conservatorship** | | | | | | |
| **Does the law allow appointment of a Conservator?** | | | | | | |
| Yes. FDIC may be appointed as Conservator. | Yes. CDIC may be appointed as Conservator. | Yes. Central bank may appoint an Inspector with powers to veto management action. | Yes. Appointed by the central bank, and vested with management powers, and the power to call a general meeting of shareholders. | Yes. Appointed by the central bank, taking into account the MoF's opinions, to perform "enforced administration". | Yes. Conservator (Manager) appointed by central bank, and may act as Receiver. | Yes. The central bank may appoint a Conservator. |
| **Triggers for conservatorship** | | | | | | |

## FRAMEWORK FOR DISTRESSED BANK RESOLUTION

| United States | Canada | Argentina | Brazil | Czech Republic | Malaysia | Poland |
|---|---|---|---|---|---|---|
| Insolvency (i.e., the bank has insufficient assets to meet its obligations).<br>–12 other requirements. | –Superintendent determines the bank is non-viable.<br>–Excessive dependence on loans, advances, guarantees, or other financial assistance to sustain its operations.<br>–Bank has lost confidence of the public.<br>–Regulatory capital about to become substantially deficient.<br>–Failure to pay any liability that has (or may) become due. | –Problems with liquidity or insolvency observed.<br>–Repeated failure to comply with regulations. | –Losses resulting from bad management, which expose the bank's creditors to risk.<br>–Repeated infractions of the terms of banking legislation that are not rectified through normal supervision.<br>–Facts justify an extra judicial liquidation, but the central bank believes that an intervention would possibly avoid that result. | –Bank's activities threaten the stability of the banking system; and –the shareholders have not taken the necessary steps to remedy the shortcomings. | If the bank reports insolvency and likely unable to meet its obligations.<br>Supervisor determines that: a bank is carrying out its business in a manner detrimental to the interests of depositors, creditors or the general public; and a bank has contravened any provisions of the BAFIA or other relevant laws. | –Bank incurs a net loss that threatens its soundness/ solvency.<br>–Does not submit an adequate rehabilitation program. |
| **Can a conservatorship takeover shareholders' rights** | | | | | | |
| Yes. Shareholders' rights may be taken over by the Conservator. | Yes. Superintendent may request the MoF to order that the shares and subordinated debt of the bank be vested in CDIC; CDIC may take over all powers, duties, functions, rights and privileges of the directors and officers of the distressed institution. | Yes. While conservatorship typically results in a suspension of dividend payout, the central bank may authorize the conservator to take over shareholder rights in the event of a forced restructuring. | Yes. The conservator can take over shareholders' rights, and may transfer rights, assets and liabilities of the bank or its businesses to other entities. | Yes. The Conservator may take over the rights of shareholders so that he can convene a general meeting. | Yes. The Conservator may takeover shareholders' rights. | Yes. While Conservatorship typically results in a suspension or restriction of dividend payout,<br>forced loss allocation to the capital;<br>forced capital increase, the conservator can takeover shareholders' rights in the event of a forced restructuring. |
| **Can the conservatorship be legally challenged?** | | | | | | |

## FRAMEWORK FOR DISTRESSED BANK RESOLUTION

| United States | Canada | Argentina | Brazil | Czech Republic | Malaysia | Poland |
|---|---|---|---|---|---|---|
| Yes, but very limited ("...only if the court finds such decision arbitrary, capricious..") | No. | Not specified by the law. | Yes, but in a limited way. | Not specified by the law. | Not specified by the law. | Prohibited under the law. |
| **Receivership/Liquidation** | | | | | | |
| **Appointment of Receiver/Liquidator** | | | | | | |
| FDIC must be appointed as receiver for federally chartered banks (States also typically use the FDIC). | CDIC may be appointed as receiver/liquidator. | The law does not distinguish between conservator and receiver, but states that in the event of liquidation proceedings, the central bank may authorize the conservator to perform the necessary functions. | The law does not distinguish between conservator and receiver, but states that if the conservator recommends initiation of liquidation proceedings, then the central bank may (i) authorize the conservator to proceed with extra judicial liquidation; | The law does not distinguish between conservator and receiver, but states that if the Conservator recommends initiation of liquidation proceedings, the central bank nominates a liquidator, and the court must rule on this within 24 hours. | The law does not distinguish between conservator and receiver, but states that if the conservator (manager) recommends the initiation of liquidation proceedings, the central bank may authorize him to proceed. | The law does not distinguish between conservator and receiver, but states that if the conservator recommends the initiation of liquidation proceedings, the central bank may authorize him to proceed. |
| | | | (ii) appoint a new liquidator; or (iii) require bankruptcy of the bank. | | | |
| **Can the receivership/liquidation orders be legally challenged?** | | | | | | |
| Title 12 does not mention this specifically. | No. Orders treated as final and conclusive, and may not be questioned or reviewed in any court. | Not Applicable. | Not specified by the law. | Not specified by the law. | Not specified by the law. | Prohibited under the law. |
| **Forced Restructuring and Liquidation** | | | | | | |
| **Can a forced restructuring be implemented?** | | | | | | |

## FRAMEWORK FOR DISTRESSED BANK RESOLUTION

| United States | Canada | Argentina | Brazil | Czech Republic | Malaysia | Poland |
|---|---|---|---|---|---|---|
| Yes. The FDIC has the authority to implement a (i) forced merger; (ii) forced P&A. | Yes. The CDIC has the authority to implement a (i) forced merger; (ii) forced P&A transaction; (iii) or any other transactions to restructure a substantial part of the business of the distressed bank. | Yes.<br>–A forced P&A is allowed, possibly supervised by a court-appointed supervisor.<br>The law does not specify forced mergers. | Yes. The Conservator can "transform, merge, consolidate, spin-off, or transfer the shareholding control of the bank.." and "propose the expropriation, by necessity or in the public interest, of the shares of the institution.." upon prior and express approval of the central bank. | Not specified by the law. | Not specified by the law. | Yes.<br>–A forced merger is allowed.<br>The Banking Act does not specifically mention P&A transactions. |
| **What are the requirements for a forced restructuring?** | | | | | | |
| –Title 12 does not specify requirements for a forced merger.<br>–A forced P&A requires prior approval of the OCC/OTS. | –CDIC given full powers to carry out a forced restructuring, once it has been appointed as conservator/receiver. | –Requires prior approval by the central bank on grounds that a bank's solvency or liquidity have been severely affected. | –A forced restructuring by the conservator requires the prior approval of the central bank. | Not specified by the law. | Not specified by the law. | A forced merger requires the approval of the central bank, provided: (i) the bank's loss exceeds half of its capital in 6 months; (ii) likely insolvency or capital drop under regulatory requirement. |
| **What are the effects of a forced restructuring on shareholders' rights?** | | | | | | |

## Framework for Distressed Bank Resolution

| United States | Canada | Argentina | Brazil | Czech Republic | Malaysia | Poland |
|---|---|---|---|---|---|---|
| Shareholders' rights superceded and subordinated to other claimants. | Shareholders' rights superceded and subordinated to other claimants. | Not specified by the law, but could require:<br>–forced loss allocation to capital<br>–forced increase/decrease in capital by shareholders. | Shareholders' rights expropriated and superceded by the central bank, or the conservator appointed on its behalf. | Not specified by the law. | Not specified by the law. | Shareholders' rights superceded to implement a forced merger, which results in a forced loss allocation to the capital, and a subordination of shareholders to other claimants. |
| **Can a forced restructuring order be challenged?** | | | | | | |
| No court action is allowed, in principle. | No court action is allowed, in principle. | No | Not specified by the law. | Not specified by the law. | Not specified by the law. | In the event of a forced merger, the law allows a Petition to be filed to the Chief Administrative Court. |
| **Can a forced liquidation be implemented?** | | | | | | |
| Yes. By the FDIC in its role as receiver. | Yes. By the CDIC in its role as Receiver. | Yes, subsequent to license revocation. | Yes. The Conservator or Liquidator appointed by the central bank can carry out a forced or extra judicial liquidation. | Possibly Yes. | Yes. By the receiver/manager. | Yes. By a liquidator appointed by the Commission. |
| **What are the prior requirements for a forced liquidation?** | | | | | | |

## FRAMEWORK FOR DISTRESSED BANK RESOLUTION

| United States | Canada | Argentina | Brazil | Czech Republic | Malaysia | Poland |
|---|---|---|---|---|---|---|
| Title 12 does not specify this. | –If restructuring by the receiver is not completed within the stipulated time, or the expiration of any extension to that period. | – If a bank's solvency or liquidity severely affected. | Financial institution fails to meet its commitments, thereby endangering the country's financial and economic situation. Laws and regulations are violated seriously. | Conservator establishes that the bank is overburdened with debts, he has the right, with the prior approval of the Czech National Bank, to wind-up the bank through liquidation. | Not specified by the law. | Same as for a forced merger. |
| | | | Institution incurs losses, exposing its non-privileged creditors to abnormal risk of loss. After closure, an institutions fails to commence ordinary liquidation process within 9 days, or when, upon starting such liquidation, the central bank determines that the a slow liquidation process may result in losses to creditors. | | | |
| **What are the effects of a forced liquidation on shareholders' rights?** | | | | | | |
| Shareholders' rights subordinated to other claimants. | Shareholders' rights subordinated to other claimants. | Not specified by the law | Shareholders' rights generally subordinat-ed to other claimants. | Not specified by the law. | Not specified by the law. | Shareholders subordinated to other claimants. |
| **Can a forced liquidation be challenged?** | | | | | | |
| Yes, but only after the receiver determines claims. | Likely not. | Shareholders may appeal to the National Appellate Court to contest a license revocation. | Not specified by the law. | Not specified by the law. | Not specified by the law. | Same as under forced merger. |

## FRAMEWORK FOR DISTRESSED BANK RESOLUTION

| United States | Canada | Argentina | Brazil | Czech Republic | Malaysia | Poland |
|---|---|---|---|---|---|---|
| **Is there legal protection for supervisory officials?** | | | | | | |
| Yes. Supervisors protected under legislation governing all government employees. Additionally, specific immunity for FDIC staff acting within the scope of their employment. | Yes. For all actions taken in good faith. | Information not available. | Information not available. | Yes. | Information not available. | Information not available. |

Sources: Based on laws accessed from the IMF-World Bank Global Banking Law Data Base; IMF's Banking Supervision Regulatory Database.

## Excessive Bank Secrecy

**Excessive bank secrecy also impedes bank resolution**. Though the Philippines has recently introduced Anti-Money Laundering (AML) legislation which allows limited exceptions to the strict secrecy rules governing access to bank deposit information, bank secrecy requirements continue to significantly impede the PDIC's ability to implement timely and efficient bank resolution measures. Current legislation places such a degree of secrecy on bank deposit records that the PDIC does not have access to deposit records until after the failure of a bank. Not only does this impact its ability to craft an effective resolution of the failing institution (given the inability to assess funding structure and whether deposit accounts have been split to protect large deposits), but it severely hampers the PDIC's ability to pay the insured deposits in a timely manner. The combination of deposit secrecy, the right of owners to submit a rehabilitation plan post-receivership (90 day waiting period), and the opportunity for owners to judicially challenge actions can significantly delay effective resolution.

**From a depositor's perspective, quick access to their accounts after a bank failure is the litmus test for the effectiveness of a deposit insurance scheme**. Many countries have adopted a resolution approach in which a bank is closed on a Friday and then "reopened" the following Monday. This reopening can take several forms. If the failing bank is being merged with a healthy bank, the most pressing administrative issues can be addressed during the weekend and the office opens as a branch of the acquiring bank on Monday, with insured depositors advised accordingly. It is much the same with a Purchase and Assumption transaction; another bank purchases selected assets and acquires the deposits of the failing institution. Depositors are advised accordingly and have access to their funds at the acquiring bank; the remaining assets and liabilities (including uninsured deposits) are left behind in the receivership to be dealt with separately. This practice reassures small depositors that they will be able to access their funds. Large deposits remain in the receivership and will be repaid from the proceeds of the liquidation. However, for this system to work in the Philippines, the PDIC would need access to deposit information significantly in advance of the bank being taken into receivership.

## FRAMEWORK FOR BANK RESTRUCTURING—REGIONAL COMPARISON

The following is a comparison of bank resolution frameworks in three Asian countries, focusing on two aspects of the framework for regulating banks under financial distress: (i) whether the banking supervisor can forcefully take over banks for restructuring, and (ii) whether the banking supervisor can close banks for liquidation if necessary. This overview (and the accompanying table) demonstrates that the powers envisioned in the charter amendments are standard for supervisors in the region (and globally as well). Essentially the BSP is simply requesting clarifications that will allow it to use the powers already granted more effectively.

### A. Indonesia

The Indonesia Bank Restructuring Agency (IBRA) plays a critical role in bank restructuring, deriving its power to assume control of insolvent banks from Regulation of the Government of Indonesia Number 17 of 1999.[1] Currently, the restructuring of distressed banks is governed by Regulation 2/11/PBI/2000.

A bank is placed under special surveillance when its condition deteriorates significantly, including when CAR is less than 4 percent and problem loans are greater than 35 percent.[2] The bank under special surveillance is required to remedy the deficiencies within six months if it is publicly traded, or three months if it is privately held.

When the bank under special surveillance does not take actions in time or when its prospects deteriorate further, Bank Indonesia can place the bank in receivership by IBRA, under the designation of either Bank Under Restructuring (BUR) and Bank Suspended from Operations (BSO). In principle (but not so far in practice), BUR status can be revoked when the restructuring has been completed to a satisfactory extent. BSO status, in contrast, is declared when the bank is to be liquidated according to the provisions governing the revocation of operating license, dissolution of legal entity, and liquidation of banks.

There is no explicitly stated route for challenging regulatory decisions legally, but they can be contested in a commercial court, in principle. While regulatory decisions have never been formally challenged, informal pressure has been exerted on Bank Indonesia and IBRA, thereby delaying bank closures.

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[1] Prior to two revisions of the legal framework for IBRA, Presidential Decree of 1998 and Regulation Number 17 of 1999, there were incidents that revealed the deficiency in the initial legal framework for IBRA (IMF OP 188).

[2] Bank Indonesia can order the bank, among other things, to increase capital; to merge with another bank; sell out to a buyer willing to take all liabilities; to entrust a third party with the management; and to sell part of assets/liabilities to another party.

After sending international auditors into all sizeable banks, the government announced in March 1999 the closure of thirty-eight banks—comprising 5 percent of the banking sector—and the takeover of seven banks—comprising 2 percent of the banking sector. Despite the resistance by some bank employees, IBRA gained access to all branches and carried out closure and takeover. In addition, nine banks were deemed eligible to receive public recapitalization funds, with eight subsequently participating. The shareholders of the ninth bank did not contribute as required to the joint recapitalization scheme, and this bank was taken over by IBRA.

On the other hand, there were incidents where bank restructuring did not proceed as stipulated in the law. In 2001, Unibank's deadline for remedial actions—to address its failure to settle its clearing obligations—expired in May, but it was transferred to IBRA only at end-October.

## B. Thailand

The weakest link in the financial sector of Thailand at the outbreak of the 1997 crisis was the finance companies, but it was inevitable that commercial banks were adversely affected as well. Banks' asset quality deteriorated rapidly, and all banks were found to have a capital shortfall in June 1997. The Commercial Banking Act was revised in October 1997, empowering the Bank of Thailand to write down capital or replace management, when the condition of commercial banks poses the risk of inflicting damage on public interest.

The authority to place banks under conservatorship or receivership, however, lies with the Minister of Finance. When the Minister is of the opinion that the condition or operation of a commercial bank is such that *serious* damage may be caused to the public interest, the Minister is authorized to order the bank to be placed under control or order the withdrawal of its license.

In taking over the control of a commercial bank, the Minister appoints a Control Committee, which has the power and duty of carrying on the management of the affairs of the commercial bank in every respect. When the withdrawal of license or the dissolution of a commercial bank is ordered, the Minister appoints a liquidator who will carry out liquidation under the relevant provisions of the Civil and Commercial Code, except that the power and duty of the general meeting devolves on the Minister.

There is no explicitly stated route for challenging regulatory decisions legally, but, in principle, all administrative decisions can be contested in the administrative court that was set up in 2001. In practice, no regulatory decisions have yet been contested.

Since 1997, several banks were taken over or intervened. Between December 1997 and January 1998, FIDF (Financial Institutions Development Fund) recapitalized three banks—accounting for about 10 percent of banking system deposit—by a debt-equity swap, after writing down the old capital and replacing the management. Thereafter, several more commercial banks were intervened, and the authorities in the end took over six commercial banks out of a total of fifteen in the banking system.

## C. Singapore

The legal framework for banking supervision leaves ample room for discretion to the supervisory authority, the Monetary Authority of Singapore (MAS). The regime has served Singapore well, and its banks have weathered the Asian crisis relatively smoothly. There have been no incidents of the MAS actually taking over or closing banks, but the MAS is well known for its unquestioned authority over commercial banks, domestic or foreign.

The banking system is currently undergoing significant restructuring, spurred by the government initiative to improve competitiveness of the overall financial sector. While individual banks remain profitable and well-capitalized at the moment, the MAS chairman has repeatedly remarked that the Singapore's banking sector should be consolidated to about 3 domestic banks down from the current 9 domestic banks, so that each of them attains the critical mass to stay competitive in the global financial market.

Some of these issues are to be addressed in the pending amendments to the Central Bank Act, by leaving the power to suspend the BSP's decision only with the Supreme Court. However, it is not clear whether a regional court will still be allowed the authority to suspend or override the PDIC's decision as a receiver.

**Abbreviations**

MB: Monetary Board
BSP: Bangko Sentral Ng Pilipinas
BI: Bank Indonesia
IBRA: Indonesia Bank Restructuring Agency
MAS: Monetary Authority of Singapore
MOF: Ministry of Finance

**Table 1. Legal Framework for Bank Rehabilitation in Selected ASEAN Countries**

| **Philippines** | **Indonesia** | **Singapore** | **Thailand** |
|---|---|---|---|
| **PROMPT CORRECTIVE ACTION** | | | |
| *Presence of Prompt Corrective Action regime* | | | |
| Has elements | Has elements | Not explicit | Has elements |
| *Triggers for Corrective Action* | | | |
| Undercapitalized | Progressively more stringent criteria on CAR and NPL | Judged necessary by MAS | Undercapitalized |
| *Possible Imposition on Shareholders* | | | |
| Disposition of majority shareholder's interest | Capital injection | Discretion by MAS | Capital injection |
| **CONSERVATORSHIP** | | | |
| *Appointment of a Conservator* | | | |
| By MB | IBRA, by BI | By MAS | By MOF |
| *Criteria* | | | |
| Unable to maintain adequate liquidity to serve depositors and creditors. | Protracted period with difficulty in operation, including: CAR < 4%, NPL > 35% | Judged necessary by MAS | Serious damage may be caused to public interest; Suspension of payments |
| *Forced Mergers, Purchase and Assumption Transactions* | | | |
| Not explicit | Yes | Yes | Not explicit |
| **RECEIVERSHIP AND LIQUIDATION** | | | |
| *Appointment of a Receiver* | | | |
| Yes, PDIC | Yes, IBRA | Yes, by MAS | Yes, by MOF |
| *Liquidation* | | | |
| Petition with regional court for liquidation | Bank of Indonesia revokes license; applies to a court to appoint a liquidation team | Apply to high court for such proceedings as viewed necessary | The MOF revokes license or orders dissolution. |
| *Supervision of Liquidation Procedure* | | | |
| Regional trial court | Bank of Indonesia | MAS | Civil court |
| **LEGAL CHALLENGE TO REGULATORY ACTIONS** | | | |
| To superior court, almost always | Not explicit (To commercial court, in principle, but no such case) | To high court, but no such case. | Not explicit (To administrative court, in principle, but no such case) |
| | | | |

# VI. FOREIGN CURRENCY RESERVE MANAGEMENT—AN EVALUATION[1]

## A. Introduction

1. **The Bangko Sentral ng Pilipinas (BSP) has raised its reserve holdings markedly in recent years, with much of the increase being funded by borrowing in international capital markets**. While this policy has minimized the need for the BSP to purchase foreign exchange from the domestic market during a period when the exchange rate has been weak, the reliance on external borrowing to fund reserves and to finance fiscal deficits on the other hand has increased debt service requirements to substantial levels. There are, therefore, emerging concerns that the large financing requirements increase the Philippines' vulnerability to an adverse shift in market sentiment and that the BSP should preferably meet its reserve targets by purchasing foreign exchange in the domestic market. However, other contending views note that it is preferable for the BSP to build up reserves by issuing long-term bonds on the grounds that an increase in reserves resulting from monetary policy action tends to basically build up short term interest sensitive capital.

2. **This paper weighs the merits and de-merits of the competing arguments, identifies the risks associated with the authorities' current strategy and discusses options to mitigate the identified risks**.

3. **The rest of the paper is organized as follows: Section B discusses the principles and best practices in reserve management and the necessary conditions for a country to fund its reserves by borrowing**. Section C reviews the BSP's reserve management policy and practices. Section D identifies the risks arising from the authorities current strategy. The conclusions of the paper are summarized in Section E.

## B. Issues in Reserve Management

### Objectives and Methods of Funding Reserves

4. **Foreign currency reserves are both a national asset and a tool for monetary and exchange rate policy**. Poor management of the reserves may put at risk other elements of national policy and can cause severe economic damage out of proportion to the financial loss suffered on the assets themselves.

5. **Reserves are held for a variety of purposes, including as a formal backing for the currency, a tool for exchange rate or monetary policy, as an investment fund and/or for servicing foreign currency liabilities and debt obligations**. The choice of whether to fund reserves by borrowing in international markets or by purchasing foreign exchange in the domestic market depends on the country's ability to raise external loans, the state of the domestic foreign exchange market and perceptions about the appropriate exchange rate level.

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[1] Prepared by Inutu Lukonga (PDR).

The purposes for which the reserves are held and the cost of funding the reserves more or less determine the optimum level, but in general most countries tend to hold a "comfort margin" above the minimum they identify. Of particular importance is that the method by which the reserves are funded will have different consequences for how the reserves should be managed.

6. **Purchasing foreign exchange in the domestic market has a direct impact on the foreign exchange market and the exchange rate**. Depending on the supply and demand conditions this could lead to exchange rate volatility and the liquidity that is injected could fuel inflation. Alternatively, the purchases could be sterilized, but this would also increase the costs for the central bank. Countries that rely on purchasing foreign exchange in the domestic market could raise interest rates to attract capital flows but this has the risk of attracting short-term interest sensitive capital and the high interest rates could also hurt the corporate sector. There is, therefore, a need to reconcile reserve management with monetary policy objectives and the costs of sterilization.

7. **The domestic foreign exchange market and the exchange rate are not directly affected when the reserves are borrowed and invested abroad as reserves, and the resulting higher level of reserves may provide greater confidence**. But this policy may facilitate a more appreciated exchange rate than is warranted by domestic economic fundamentals. Besides the potential for exchange rate misalignment, relying on external borrowing to fund reserves entails additional risks, including the rollover risk on account of the increase in debt service requirements; the interest rate and currency risks associated with the composition of liabilities relative to the assets; and the quasi fiscal costs that could arise because of the differential between the cost of borrowing and returns on the investment of reserves. Consequently, countries that rely on external borrowing to raise reserves need to manage the reserves in a comprehensive portfolio framework that matches assets and liabilities to enable the authorities to focus on their net position and net risk. There is also need to recognize the cost of carrying reserves.

8. **Therefore, a principal objective of reserve management for countries that rely on external borrowing to fund their reserves should be to achieve the lowest possible funding cost subject to prudent liability management considerations**. These considerations include ensuring continued access to capital markets so that bond issues are not perceived as an indicator of pending economic difficulties; diversifying sources of funding in order to achieve risk diversification and optimal maturity structure and ultimately the costs; and putting in place backstop facilities for falling back on in cases of market stress. Given the constantly changing financial landscape, the scope and sophistication of the institution's management of foreign currency reserves has also to keep pace with developments and innovations in financial markets.

**IMF Policy and Practices**

9. **The Fund has worked to assist its members in the assessment of reserve adequacy and management, with a view to help increase countries' resilience to shocks**

**that may originate from global financial markets or within the domestic financial system**. However, because of concerns that no unique set of reserve management practices or institutional arrangement is best for all countries or situations, the guidelines are cast as high level principles and are not prescriptive. Thus, the Fund has not taken a position on the appropriate method for funding reserves.

10. **The Fund advocates that countries should seek to ensure that**: (i) adequate foreign exchange reserves are available for meeting a defined range of objectives; (ii) liquidity, market and credit risks are controlled in a prudent manner; and (iii) subject to liquidity and other risk constraints, reasonable earnings are generated over the medium to long term on the funds invested.

11. **The ratio of international reserves to short-term external debt by remaining maturity is considered the most relevant indicator of reserve adequacy for emerging market countries with significant but uncertain access to capital markets, although traditional reserve related indicators, such as the ratios of reserves to imports and to broad money also convey useful information**. The level of reserves should at a minimum cover short-term debt, measured by remaining maturity and covering both public and private sector debt and all debt instruments to nonresidents, regardless of the currency of denomination. A much higher level is recommended for countries with problematic characteristics such as large external current account deficits that raise financing needs; overvalued exchange rates that can lead to capital outflows; high levels of short term public domestic debt especially where there are no effective capital controls or other mechanisms that create captive markets, derivative position of the public sector and weak banking systems that can contribute to capital flight.

## C. The Philippines' Management of Foreign Currency Reserves

### Policy Objectives

12. **The BSP maintains a flexible exchange rate policy. Thus, intervention is aimed primarily at promoting orderly conditions in the foreign exchange market and to achieve specified targets for net international reserves**. Foreign currency reserves are also maintained to meet payments of principal and interest payments on maturing foreign currency denominated loans and bonds of the BSP, the National Government (NG) and CB-BOL.[2] Given the liberal capital account regime, reserves also serve to enhance investor

[2] The CB-BOL (Central Bank-Board of Liquidators) is tasted with paying off the obligations of the pre-1993 central bank. So far debt service payments accounted for the bulk of the foreign exchange uses, while sales to the markets have been relatively small. In 2001, debt service requirements for the NG, the BSP and other public enterprises amounted to about 50 percent of total foreign exchange uses of the BSP. Added to this is the rollover of the collateralized debt, including the securities and gold backed loans which raise the proportion of funds spent on debt service close to 80 percent.

confidence to the extent that they ensure the government is always ready to meet its international obligations.

13. **Since the 1997 Asian crisis, the BSP has targeted a gross international reserves (GIR) level of at least $14 billion, a ratio of one for reserves to short-term debt , and a five-month import cover**. A reserve level exceeding these benchmarks is considered sufficient for the financial markets to have confidence in the BSP's ability to meet its dollar requirements and as buffer against speculative attacks on the peso.

14. **The method of funding reserves depends primarily on market conditions**. When there is limited offer available from the dollar-peso market, the BSP taps international loan and bond markets, as well as the swap market, taking into consideration the maturity profile of existing obligations, the timing of the NG's foreign exchange (FX) funding activities and the all-in cost of the funding structure.

## D. Policy Implementation and Practices

### International Reserve Level and Sources

15. **The BSP has rebuilt its foreign currency reserves and improved the reserve adequacy measures substantially since 1997**. Gross international reserves have doubled since 1998, funded mainly by external borrowing from international capital markets. Concurrently, the ratio of reserves to short term debt increased from 60 percent to over 100 percent while the ratio of reserves to imports of goods and services increased from two to over five months of imports.

16. **After a complete absence in international markets, the BSP issued over US$6 billion in loans and bonds from international capital markets between 1997 and mid 2002**.[3] The BSP also borrowed a total of SDR1.6 billion from the IMF between 1997 and 2000 while short-term borrowing collateralized by gold and securities was stepped up from US$1.2 billion in 1997 to US$2.25 billion by end 2001. Meanwhile, net purchases from the domestic market have continued to decline even after the effects of the Asian crisis had dissipated, turning negative in 2000 and only picking up modestly thereafter.

17. **The reliance on external borrowing during this period is more pronounced than is suggested by the BSP's direct borrowing, because the government also increased its reliance on external borrowing to finance fiscal deficits, in an effort to avoid fueling inflation, crowding out the private sector or putting pressure on domestic interest rate**. Proceeds from the government's borrowing together with those of other government

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[3]Of the total external borrowing, 60 percent was in the form of bonds and the remainder through loans. All the bond issues were placed in the US dollar market, and 46 percent was issued at floating rate.

controlled corporations, particularly NPC, provided an additional source of foreign exchange inflows to BSP accounts.

18. **The Philippines is a small open economy with relatively high foreign exchange exposure and reliance on imported inputs, thus the BSP has been particularly sensitive to peso depreciation and volatilities in the exchange rate**. The Philippines pays particular attention to exchange rate stability, thus in the face of a declining supply of foreign exchange the BSP has increased its reliance on foreign borrowing to fund reserves. In particular, following the Asian crisis, the supply of foreign exchange declined considerably on account of declines in portfolio flows, foreign direct investment, and more recently from exports and remittances from Overseas Filipino Workers (OFWs). In an effort to stabilize the movements of the peso and to meet their reserve target, the authorities tapped international capital markets and also introduced several measures to reduce domestic demand for foreign exchange. These measures included the expansion of the coverage of the Currency Risk Protection Program –a hedging facility established in 1997; reducing the ceiling for undocumented over the counter purchases of dollars; imposing higher monetary and non monetary penalties on banks violating foreign exchange regulations and increasing liquidity reserve requirements of commercial banks.

Table 1. Philippines: Share of Central Bank Debt in Foreign Currency Reserves, 2001

(In millions of US dollars)

| | GIR | Central Bank Debt | | | Ratio to GIR | | |
|---|---|---|---|---|---|---|---|
| | | Total | IMF | Other | Total | IMF | Other |
| **Philippines** | 15,658 | 5,878 | 1,951 | 3,927 | 37.5 | 12.5 | 25.1 |
| **Other Asian Countries** | | | | | | | |
| Thailand | 33,048 | 8,325 | 1,679 | 6,646 | 25.2 | 5.1 | 20.1 |
| Korea | 102,821 | 10,720 | 0 | 10,720 | 10.4 | 0.0 | 10.4 |
| Malaysia | 29,896 | 1 | 0 | 1 | 0.0 | 0.0 | 0.0 |
| Indonesia | 28,016 | 11,441 | 9,209 | 2,232 | 40.8 | 32.9 | 8.0 |

Source: International Financial Statistics and Country Authorities

19. **The increasing reliance on borrowing in international capital markets to fund reserves has raised the BSP's share of external debt to reserves**. IMF loans and other external loans as a proportion of reserves is high relative to other Asian countries and is exceeded only by Indonesia.

Table 2. Philippines: Sources of Foreign Currency, 1994-2001

(In millions of US dollars)

| | 1994-1996 | 1997-1999 | 2000-2001 | 1994-1996 | 1997-1999 | 2000-2001 |
|---|---|---|---|---|---|---|
| | | Total | | | Share | |
| TOTAL | 26,562 | 31,343 | 21,155 | 100.0 | 100.0 | 100.0 |
| Net Domestic Purchases of FX | 10,357 | *365* | -957 | 39.0 | 1.2 | -4.5 |
| FX Purchases from AABs | 13,361 | 7,167 | 2,707 | 50.3 | 22.9 | 12.8 |
| FX Sales to AABs 1/ | 3,004 | 6,802 | 3,664 | 11.3 | 21.7 | 17.3 |
| Inflows from External Borrowing | 3,466 | 16,289 | 11,083 | 13.0 | 52.0 | 52.4 |
| Direct External Borrowing | 53 | 5236 | 3727 | 0.2 | *16.7* | *17.6* |
| Other External Loan Proceeds | 8,965 | 14,903 | 11,556 | 33.8 | 47.5 | 54.6 |
| Repayments of collateralised loans(minus) | 5,552 | 3,850 | 4,200 | 20.9 | 12.3 | 19.9 |
| Memorandum Item: | | | | | | |
| Debt service of NG, CB-BOL and BSP | 9,341 | 9,413 | 7,419 | 35.2 | 30.0 | 35.1 |

Source: Bangko Sentral Pilipinas, Foreign Exchange Budget.

1/ Percentage shares are as a proportion of total foreign exchange inflows.

**Framework to match assets and liabilities**

20. **To promote effective risk management of foreign exchange positions, the Philippine constitution requires prior concurrence of the Monetary Board of BSP for all foreign loans to be contracted or guaranteed by the Republic of the Philippines and provides that foreign loans may only be incurred in accordance with law and the regulation of the monetary authority.**[4] The same is the case for private borrowing in foreign currency, unless the borrower has access to foreign currency from outside the banking system. There is a ceiling for guarantees regarding foreign borrowing by government owned and controlled corporations (GOCCS), but a number of institutions are not included in this ceiling. The BSP and the Department of Finance imposes standard procedures and requirements for the issuance of government guarantees. The BSP also keeps a comprehensive record or outstanding guarantees for monitoring purposes.

21. **The BSP takes into account the external debt profile when determining the borrowing requirements for foreign currency reserves, specifically to avoid the bunching up of maturities of the public sector debt**. Sufficient liquid assets are also maintained to satisfy debt service requirements of the NG and if necessary to provide liquidity in the dollar-peso market to meet private sector external debt payments. Regarding BSP foreign obligations, which include foreign currency deposits accepted as a result of foreign borrowing of the NG and GOCCs, the treasury department matches these with reserve assets that have similar maturity and currency profile.

**Portfolio management**

22. **The Philippines guiding principle in managing the reserves is to combine and optimize the competing demands for liquidity, return, capital preservation, while minimizing credit and market risks**.

23. **For the management of credit risk, the BSP limits its investment to the upper investment grade vehicles--double A rating for government and supranational issues and single A to accredited deposit banks**. Furthermore, deposit banks as well as other counterparties have to be first accredited by the BSP, with deposit limits taking into consideration their credit rating by Moody's or S&P's and their financial strength and stability as measured by its total assets and tier 1 capital, among others. To manage derivative credit risk, the BSP has increasingly used the international Swap and Dealers Association (ISDA) Master Agreement with its counterparties.

24. **Interest rate risk is controlled by limiting average portfolio maturity or placing limits on weighted average duration**. The BSP reduces its portfolio's downside price risks by maintaining a short average duration/maturity for its internally managed portfolio. Foreign exchange and interest rate risk is controlled by maintaining asset/liability matching.

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[4] The BSP is represented in the Developmental Budget Coordination committee (DBCC) that decides the annual financing needs for the central government and decides on the distribution of domestic and foreign borrowing as well as the distribution between official Development Assistance and borrowing in the foreign capital markets by issuing securities.

25. **The use of the traditional cashflow forecasting and liquidity blotter continues to be the most essential part in managing liquidity risk**. Also an important part of liquidity management is the separator of the trading portfolio from the investment portfolio. The trading portfolio of the BSP is a small portion of the reserves actively managed by Treasury to keep the dealers abreast with market developments. The investment portfolio includes investments that are used to match liabilities and other assets that will be used to meet current and future liquidity requirements.

26. **The government has also entered into an arrangement to augment its dollar buffer against potential future financial market shocks under the Chiang Mai initiative**. In this regard, the government negotiated a $3 billion bilateral swap arrangement with Japan in July of 2001. On July 18, 2002 the BSP Monetary Board gave its approval for the BSP to enter into a swap arrangement with Korea and these negotiations are now in the final stage while negotiations with China have already been initiated. Financial assistance under the bilateral swap arrangements could be disbursed when an IMF facility is activated or will be activated in the very near future. This, notwithstanding, up to 10 percent of the maximum amount of drawing, could be provided without linkage with the IMF facilities for up to 180 days."

## E. The Risks of the Strategy

27. **The increasing reliance on borrowing to fund foreign currency reserves entails a number of risks, including difficulties in refinancing or rolling over the maturities under adverse market conditions, misalignment of the exchange rate and potential quasi fiscal costs**.

### Refinancing and Rollover Risk

28. **The external debt of the public sector and financing requirements to service the debt have increased significantly on account of borrowing, thereby rendering the Philippines vulnerable to a shift in market sentiment**. Public sector external debt and associated debt service requirements increased substantially after 1997. The increase in the public sector external debt after 1997 has also been accompanied by a corresponding increase in commercial debt.[5]

29. Scheduled debt service for the national government, the BSP and NPC is estimated to exceed $4 billion dollars annually through 2006. Thus, while the central bank has taken care to spread out maturities and total reserves exceed short term debt, debt service obligations and intervention to support the currency could deplete reserves rapidly if market access was limited, setting off a negative spiral of peso depreciation, higher interest rates and growing budget deficits.

[5]The foreign securities are typically long term and are contracted at fixed rates.

30. **Sentiment toward the Philippines sovereign remains guarded on concerns over the government's fiscal position**. A generalized shift in market sentiment could also affect the Philippines disproportionately, because external vulnerability indicators compare unfavorably with other Asian countries. The ratio of external debt to GDP, the ratio of debt service to exports and non-financial public sector debt to GDP are all higher than other Asian countries, while the ratio of gross reserves to short-term external debt is generally lower. The continued erosion of tax revenues coupled with the peso depreciation has boosted non financial public sector debt to almost 90 percent of GNP, which is much higher than comparable emerging market countries. The Development Budge Coordination Committee's efforts to ensure that economic policies are consistent and supportive of the macro-economic targets (especially to balance the budget by 2006 are therefore critically important.

Table 3. Selected Indicators for Comparative Countries, end 2001
(In percent)

| | Foreign currency LT rating (Moodys/S&P) | Total external debt/GDP | Total external debt/exports | Debt service/ exports | Gross reserves short term/ external debt | Nonfinancial public sector debt/GDP |
|---|---|---|---|---|---|---|
| **Philippines 1/** | **Bal/BB+** | **73.4** | **167.8** | **21.9** | **108.0** | **90.3** |
| **Other Asian countries** | | | | | | |
| Thailand | Baa3/BBB- | 58.7 | 88.5 | 20.4 | 126.7 | 57.8 |
| Korea | A3/BBB+ | 27.9 | 70.0 | 12.7 | 263.0 | 34.1 |
| Malaysia 1/ | Baa2/BBB | 51.5 | 44.0 | 6.3 | 265.6 | 66.8 |
| Indonesia | B3/CCC | 95.8 | 227.5 | 19.0 | 92.3 | 90.9 |
| **Latin America countries** | | | | | | |
| Argentina (end-2000) | B1/ | 51.5 | 472.8 | 105.8 | 81.1 | 50.8 |
| Brazil | B1/BBB- | 41.3 | 310.9 | 80.2 | 76.8 | 53.3 |

1/ As a percent of GNP

## Misalignment of the Exchange Rate

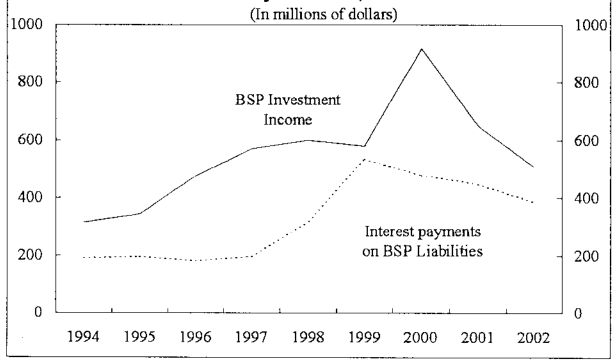
31. **The reliance on borrowing in international markets to meet the reserve target has potential to mask long-term deterioration in economic fundamentals that would otherwise require a real depreciation**. More specifically, this could facilitate a more exchange rate than would otherwise obtain, with adverse consequences for export competitiveness. Indeed, during 2001, the decline in the supply of foreign exchange was broad based across major categories of foreign exchange earnings. Although much of the decline in exports is clearly cyclical, there is a risk that the factors contributing to the decline in the supply of foreign exchange may persist for a prolonged period.

32. **First, the slowdown in the US and Japanese economies coupled with the global slump in the information technology (IT) or computer industry has reduced the demand for semiconductors and other electronics products resulting in a significant decline in the Philippine exports**. The decline is expected to reverse with the recovery in the US market, and although there are already signs of an upturn, there is still a lingering risk that the recovery may not materialize at the expected pace and even worse the downturn may not be a temporary event but rather a post-boom adjustment to a lower level of IT output, and perhaps a slower rate of growth. Second, after a rapid rise during the 1990s, OFW remittances declined beginning in 2000, reflecting declines in remittances from the US and some European countries.[6] Third, foreign exchange receipts from tourism have declined due to the series of kidnappings by the Abu Sayyaf and the lingering effect of the September 11 attacks in the United States. These security concerns could linger for some time to come. Finally, foreign investments coming into the Philippines has declined and the prospects are rendered uncertain by the competition that China poses following its accession to the WTO.

**Potential Quasi-Fiscal Costs**

33. **The Philippines is currently rated "Ba1" by Moody's Investors Service--that is one notch below an investment grade rating and 10 notches below the top investment grade ratings of Aaa**. Since 1997, when the BSP started to borrow in international capital markets, the average spread at issue on its bonds has remained above 200 basis points, even in the face of a generalized global decline in risk aversion. This differential in the cost of borrowing relative to the investment opportunities increases the potential for incurring a net interest cost on international reserves if reserves are funded by external borrowing. There is also a gap in yields to the extent that the BSP borrows long term and invests at relatively short term.

**Figure 4. Philippines: Net Interest Costs of Foreign Currency Reserves, 1994-2002**
(In millions of dollars)




34. **As a matter of policy the BSP consistently matches maturities of assets and liabilities**. This policy, together with benefits from the lower than market interest payments on the statutory reserves of the commercial banks, has been successful in ensuring a positive

[6] The increase in remittances from OFWs reported in 2001 is attributed to the expanded coverage of the monitoring system, which aside from commercial banks, now includ foreign exchange corporations and thrift banks. Without this improvement in coverage, receipts from OFWs dropped by 8.1 percent in 2001 on account of a decline in the deployment of Filipinos working abroad.

net interest income on the BSP's income and loss account. Nevertheless, interest cost on the BSP liabilities increased rapidly after 1997 as the BSP increased its reliance on external borrowing. Further, despite a general effort to match maturities of assets and liabilities, sometimes exceptions are made. For example, if the BSP expects a tightening of interest rates, funds may be placed in shorter-term investments, but the expected increase may not materialize.

## F. Conclusions

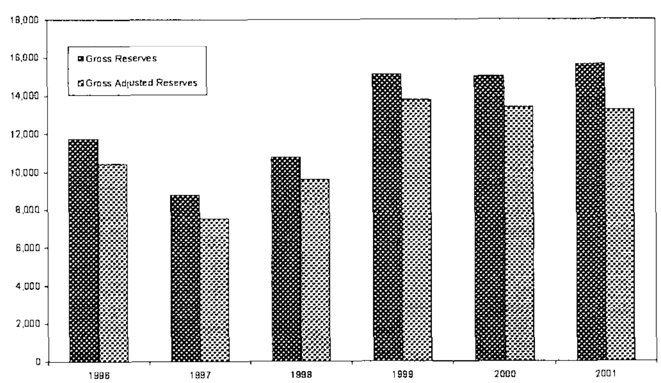
35. **Foreign currency reserves have a critical role to play in the Philippines.** As an emerging market country, the Philippines generally faces uncertainties in accessing international capital markets. Thus, foreign exchange reserves and reserve policy has an important role to play in reducing the costs of financial turbulence. The vulnerability to changing market sentiment is particularly heightened by concerns about the public sector fiscal deficit and debt dynamics. Also, the Philippine's vulnerability indicators compare unfavorably with other Asian countries. Thus, a generalized shift in market sentiment could affect the country disproportionately relative to other countries in the region.

36. **External borrowing to meet reserve targets entail risks that argue for a reorientation of strategy toward greater reliance on purchases of foreign exchange domestically.** In the event of an adverse shift in market sentiment, the large public sector financing requirement to service external debt could render it difficult to roll-over maturities falling due, and this could erode investor confidence. Furthermore, external borrowing could facilitate a more appreciated exchange rate than supported by domestic economic fundamentals, and the adverse impact on competitiveness of an appreciated exchange rate could impart a downward bias to FDI flows and export growth, thus further constricting the supply of foreign exchange and leading to greater dependence on external borrowing. In the event, external borrowing to fund reserves which was intended to be undertaken on a temporal basis to allow time for policies to take effect, could in the end impede the realization of the policy objectives. Moreover, external borrowing could generate quasi-fiscal costs, especially if the alternative is unsterilized intervention.

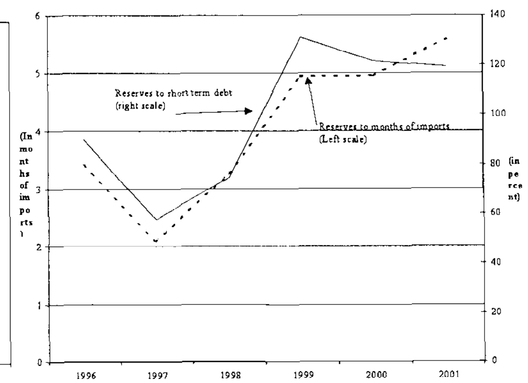
37. **Finally, the Philippines face important challenges in meeting competing policy objectives which call for a broad based and balanced policy response.** The need to augment reserves with borrowing suggests that the current supply of foreign exchange is insufficient to meet the competing needs of the public sector and the private sector. The resolution would require addressing the fundamental causes, including the large fiscal deficits as well as the causes of the declines in foreign investments and the overall supply of foreign exchange.

# Figure 1: Philippines: Foreign Currency Reserves and External Borrowing

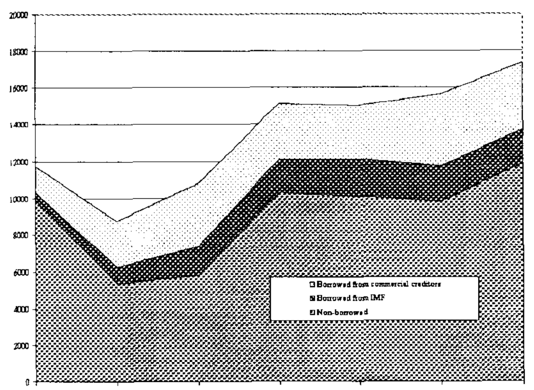
***The Philippines has substantially rebuilt its international reserves.***



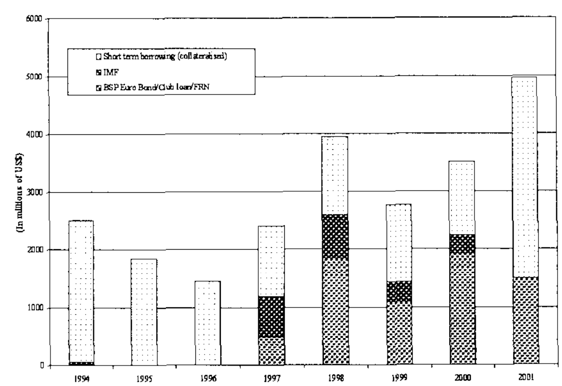

***....and improved the reserve adequacy measures***



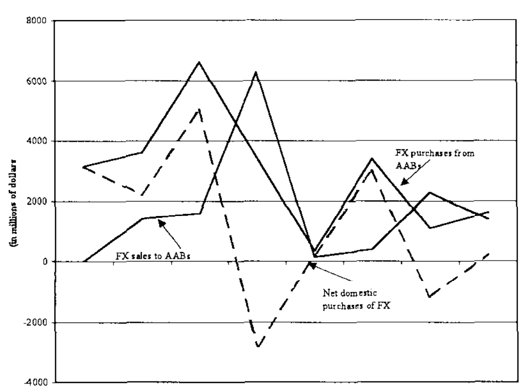

***...but much of the increase in reserves was funded by external borrowing***



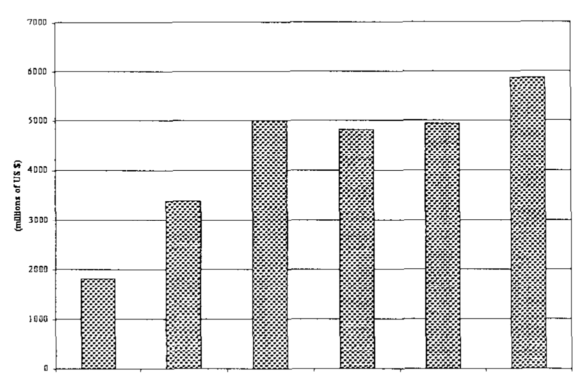

***...as the BSP stepped up its external borrowing of both short and long term loans.***




***Meanwhile, net domestic purchases of foreign exchange declined considerably.***

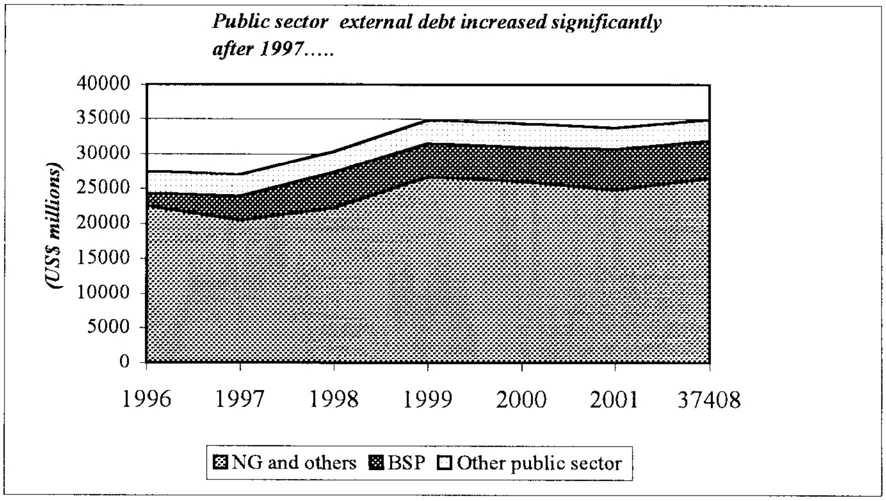


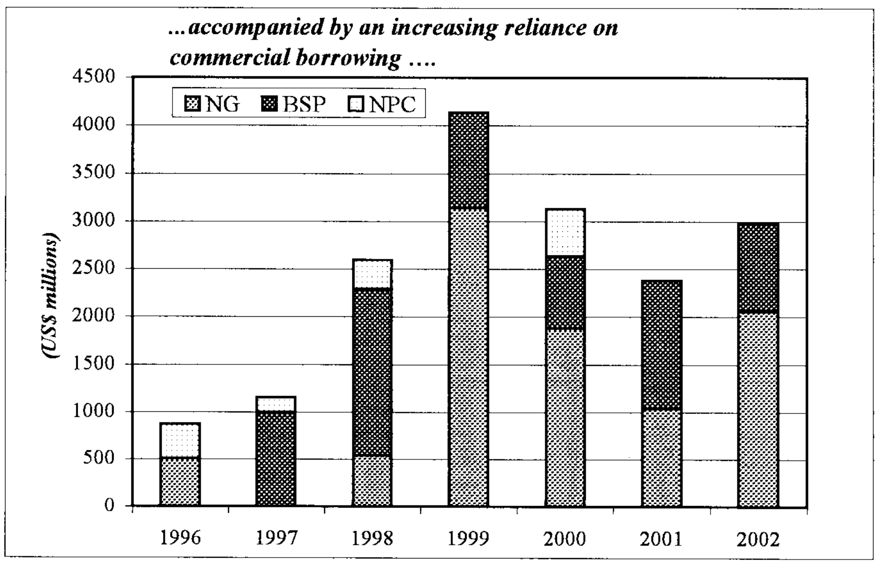

***...and the BSP's stock of external debt increased three fold between 1996 and 2001.***




Sources: Data provided by the Philippine authorities.

Figure 2. Philippines: Public Sector External Debt and Debt Service



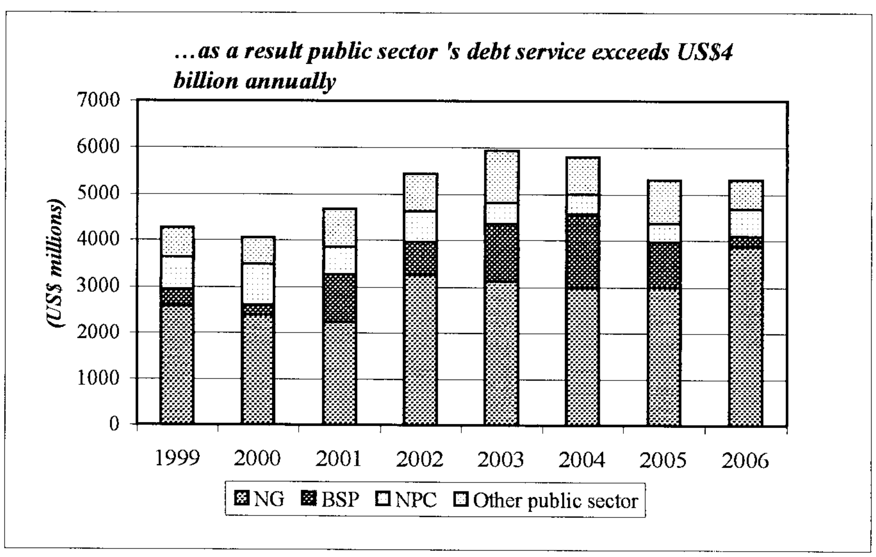
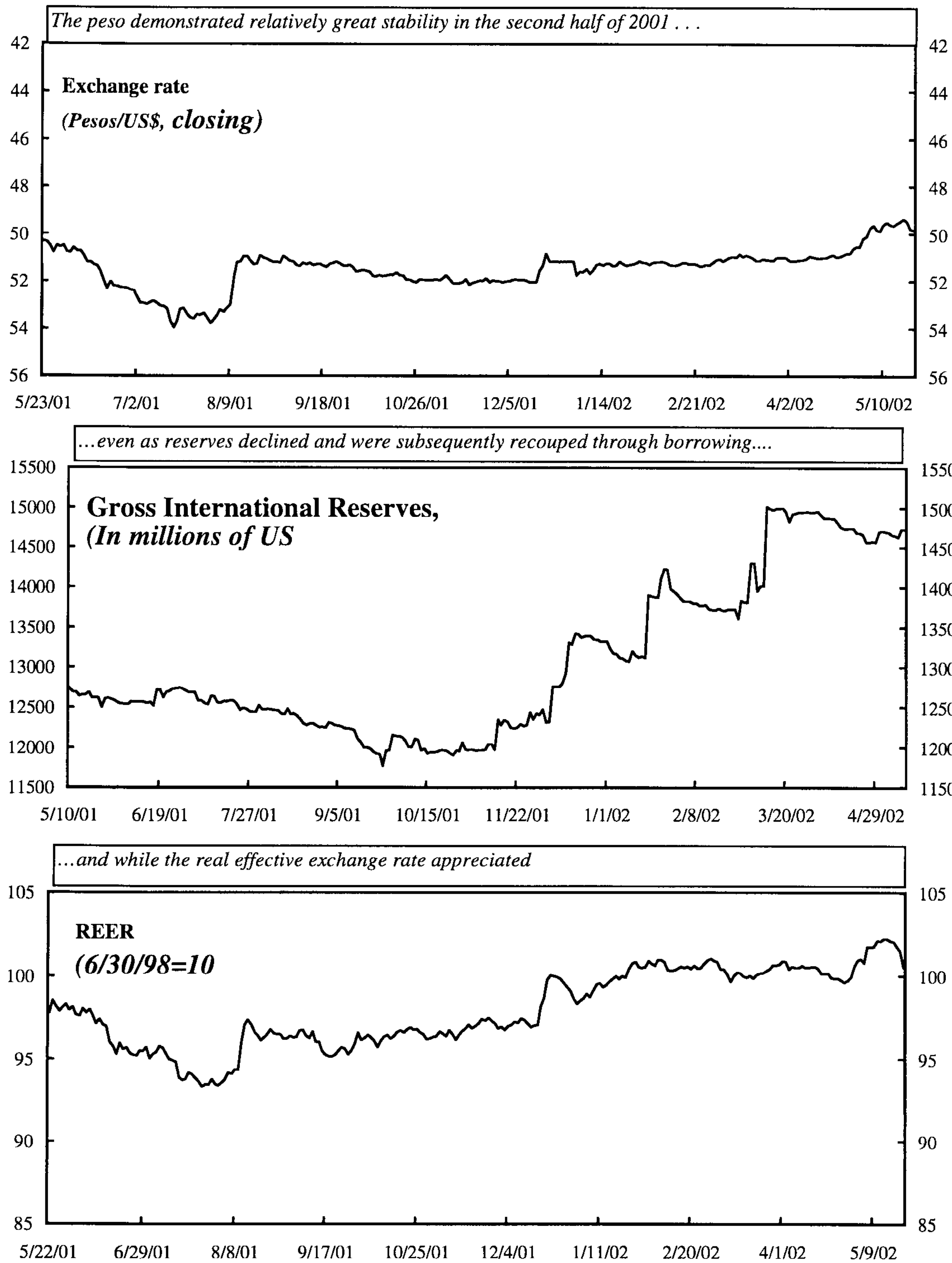



Figure 3. Philippines: Exchange Rate Developments



## VII. Inflation Targeting or Exchange Rate Targeting?[1]

### A. Introduction

1. **Under inflation targeting, pursuit of a separate exchange rate target runs the risk of undermining the credibility of policy framework if it breeds a conflict between two targets**. The conventional wisdom thus has it that a free-floating exchange regime is a critical prerequisite to a successful inflation targeting framework.

2. **The actual experience, however, calls for a slight qualification to the conventional wisdom, especially in early days of inflation targeting**. In several countries examined in this paper, the exchange rate was kept relatively flexible, but within explicit or implicit targets in early days of inflation targeting. Moreover, in theory, when inflation and exchange rate targets are mutually consistent, an apparent pursuit of the exchange rate target can be equivalent to the genuine pursuit of the inflation target.

3. **Such a possibility is particularly relevant for emerging markets, which are buffeted by frequent swings in market confidence**. Weakening market confidence raises the risk premium required of a country, adding pressure to the exchange rate. Confronted by a possibly debilitating effect—on both inflation and growth—of a sharp depreciation that could follow, an emerging market central bank often decides it must counter the pressure. However, once exchange rates are targeted implicitly or explicitly, it becomes critical to guard against the risk of overvaluation that could result from overreacting to exchange rate shocks.

4. **This chapter addresses the balancing act between inflation and exchange rate targets under inflation targeting. Section B discusses conceptual issues behind the conduct of exchange rate policy under inflation targeting framework**. This section draws on common experiences by emerging markets that have been discussed in the literature, without focusing on experiences of specific countries. Section C then discusses the actual choices made by three pioneer inflation targeting countries. Section D summarizes the experience of the Philippines in its transition year to inflation targeting, and Section V concludes.

### B. Conceptual Framework

5. **Inflation targeting is not so much a pre-set combination of rigid operating rules as a mix of interrelated institutional arrangements**. Common ingredients are a forward-looking inflation target, and enhanced transparency by which the central bank is held accountable to its objectives. Inflation target is usually set with a 1-2 year horizon, to allow for the long lag it takes for monetary policy adjustment to take effect. The central bank is put under an institutional obligation to deliver the targeted inflation rate, and the accountability is

[1] Prepared by Jaewoo Lee (RES).

enhanced or even ensured by frequent and transparent communication of the central bank's policy decision to the general public.

6. **Successful inflation targeting, however, does not have to imply targeting inflation only**. Rather, it requires that inflation is the supreme target to be pursued by monetary policy, in case there arise conflicts among multiple objectives of a central bank. In practice, many central banks appear to have pursued targets other than the inflation rate, often including steady output growth and the stable exchange rate, but successful inflation-targeting central banks have pursued auxiliary targets only to the extent that the pursuit of them did not compromise the supremacy of the inflation target.

7. **It is particularly difficult to draw a clear line between inflation and exchange rate targets**. Even after the inflation target is chosen as the nominal anchor—in contrast to fixing the exchange rate—operational question remains on whether the central bank would respond to substantial exchange rate changes. This latter question, which can be framed as the adoption of an intermediate exchange rate target, has begun to draw substantial attention among policy makers, as the membership of the inflation targeting club has been expanded to include many emerging markets. In a small open economy, the exchange rate can be a very useful intermediate target, given its potential importance as a determinant of inflation. Svensson (1999) and Senay (2001), for example, provide theoretical support for the inclusion of the exchange rate term in monetary policy rule.

8. **The operational difficulty, however, lies with identifying the cause of the exchange rate change**. If a nominal depreciation reflects a real shock that requires a real depreciation, no monetary policy response would be needed. If a depreciation reflects nominal shock that would fuel inflation with little real impact on the economy, a monetary policy response is called for. Such distinction, however, is equivalent to making a judgment on the equilibrium exchange rate, a task that has eluded policy makers on numerous occasions.

9. **Given the nearly insurmountable difficulty of this judgment, a central bank can be viewed to be tackling a statistical inference problem**. Whenever a nominal deprecation—or appreciation—is observed, a central bank tries to decide on the null hypothesis that the exchange rate shocks are nominal and thus need to be countered. A central bank will adopt a criterion for deciding whether to react to observed exchange rate shocks or not, by choosing a combination of the probabilities of type I and type II errors. Under a type I error, a central bank will regard a nominal depreciation shock to be real and fail to react, thereby fueling inflation. Under a type II error, a central bank will misinterpret a real depreciation shock to be nominal and counteract, thereby generating a real overvaluation if the real exchange rate was previously at an equilibrium level.

10. **Given the underlying distribution of real and nominal shocks, there is always a trade-off between the probabilities of type I and type II errors**. One widely observed choice is to leave the exchange rate determination fully to the market—often called a benign neglect of the exchange rate—and focus on other indicators of inflationary pressure. This

strategy amounts to choosing a small probability of type II error, at the cost of a large probability of type I error. It would keep the inflation within target and sustain macroeconomic stability, as far as the consequent exchange rate misalignment and its economic impact—the cost of type I error—are not significant. This has indeed been the case with mature inflation targeting economies.

11. **In emerging markets, however, a benign neglect can become a risky strategy**. Both the magnitude of exchange rate misalignment and the real impact of a given misalignment are larger in emerging markets than in advanced economies. Emerging markets have been subject to frequent and large swings in sovereign risk premium—measured as bond spread—which adds pressure to its currency. As much as they are caused by 'nonfundamental' factors, be they driven by pure noises or unwarranted contagion, these swings become a source of nominal shocks that can have inflationary consequence.

12. **In addition, the same-sized nominal shocks to the exchange rate are viewed to have a bigger impact in emerging markets, on both inflation and other variables**. Regarding the direct inflationary impact of the exchange rate depreciation, it is widely viewed that the exchange rate pass-through to inflation is higher in emerging markets than in advanced economies (see Calvo and Reinhart (2001), for example). The exchange rate depreciation that is not necessitated for a real exchange rate adjustment will thus fuel larger inflation in emerging markets. Beyond the direct inflationary impact, the misaligned exchange rate is viewed to have bigger macroeconomic consequence—and ultimately on inflation—in emerging markets which carry large dollarized external liability (Bernanke et al., Isard et al. (2002)).

13. **Reflecting the larger downside risk of the benign-neglect strategy, many emerging markets that adopted inflation targeting—implicitly or explicitly—have exhibited the apparent "fear of floating," a term coined by Calvo and Reinhart (2002)**. They interpret the fear of floating to result from emerging markets' efforts to target inflation, in the face of large fluctuations in risk premium that is in turn caused by lack of credibility, and find that many moderate- and low-inflation emerging markets have shown limited fluctuation in the exchange rate, coupled with a large volatility in the interest rate.

14. **Systematic focus on the exchange rate targets, under the banner of inflation targeting, corresponds to choosing a small probability of type I error at the cost of a larger probability of type II error**. This would generate a stable exchange rate coupled with low inflation, as far as major exchange rate misalignment is avoided. The danger lies with unnoticed repetition of type II errors. Cumulative outcome of such errors could be a significant overvaluation in the real exchange rate, which gets corrected by an abrupt and sharp adjustment, derailing the inflation targeting framework itself and costing the economy another nominal anchor.

15. **If an inflation targeting economy would focus on the exchange rate for its operational value, it would therefore be important to have in place a mechanism to guard against cumulation of type II errors**. One safeguard can be to ensure the supremacy

of the inflation target itself. Significant undervaluation would lead to overshooting of inflation targets, while significant overvaluation would lead to undershooting of inflation targets. Commitment to inflation targets will help to avoid excessive exchange rate misalignment. In this vein, the next section reviews experiences of three pioneer inflation targeting economies, which shed some light on the challenge confronting emerging-market inflation targeters. They all started inflation targeting with significant emphasis on the exchange rate, but have reduced the emphasis gradually and successfully.

## C. Experiences of Three Pioneers

16. **All three countries reviewed in this section are small open economies and are thus pre-conditioned to be heavily influenced by shocks to the exchange rate**. Probably as a result, they all placed substantial emphasis on the exchange rate in the conduct of their monetary policy, though in different degrees and modes. Also in all three countries, the original emphasis placed on the exchange rate gradually declined over time, as the inflation targeting framework took firm root. Their experience thus provides a useful benchmark for emerging markets that are in the early stages of inflation targeting, while remaining vulnerable to frequent exchange rate shocks.

### Chile

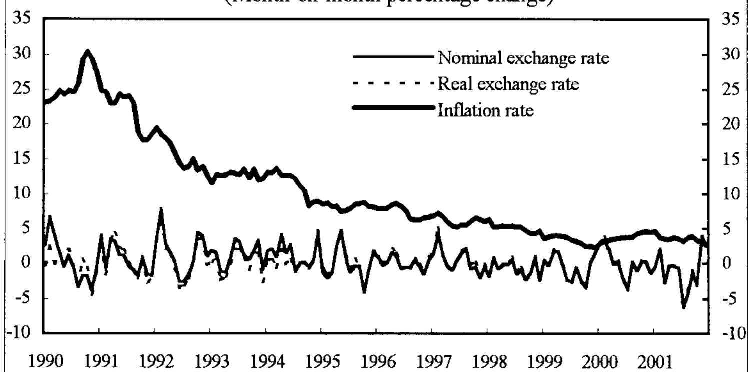
17. **Chile adopted a monetary policy framework based on an explicit inflation target in 1990, becoming one of the pioneers of the inflation targeting framework**. The framework was introduced in a high inflation environment, which had spawned widespread mechanism of indexation in many nontraded goods, labor, and financial markets (Morande (2001)). Given the high inflation inertia, price stabilization was achieved gradually, stretching over a decade to bring down the inflation rate from about 25 percent in 1990 to about 3 percent in recent years. Inflation targets were lowered each year from 1990 to 1999, by 10-40 percent of the inflation rate in preceding years.

18. **For the greater part of the first decade of inflation targeting, the central bank had also focused on other targets**. It endeavored to achieve a current account deficit target and maintained an exchange rate target—crawling band. The rationale for targeting the current account deficit was that foreign investors might interpret the high current account deficits as prognosis of economic crisis, thereby raising the cost of external capital and unduly limiting access to foreign capital.

19. **The central bank resorted to a heterodox set of instruments to achieve the multiple targets**. Occasionally, monetary policy itself was conducted with attention to current account deficit targets, when the current account bordered on surpassing the threshold level of comfort. However, several other instruments were employed to aid the central bank. Faced with significant capital inflows, the central bank accumulated foreign exchange reserves, while sterilizing the effect, until 1997. To address capital flows directly, mild capital controls were kept in place, finally being dismantled in 2000.

20. **On the exchange rate, a wide crawling target band was maintained until 1999. Figure 1 plots the inflation rate (y/y) and the monthly change in nominal and real exchange rates from 1990 to 2001**. The inflation rate has been brought down throughout the 1990s, while the exchange rate change remained limited relative to the rate of inflation. By late 1990s, the exchange rate can be seen to be fluctuating in a magnitude that is comparable to inflation rate.

**Figure 1. Chile, 1990-2002**
(Month-on-month percentage change)




Source: IMF, INS and IFS.

21. **However, the cardinal maxim of the inflation targeting framework was upheld by granting the inflation target supremacy over other targets in times of a clear conflict. Morande (2001) states**:

> *[W]henever a clear conflict arose between reaching the inflation target and this current account deficit goal—as reflected, for example, in pressures for a peso appreciation beyond the exchange rate band—the Central Bank chose to maintain the inflation target and modify the parameters of the exchange rate band (or strengthen the regulation of capital inflows or resort to sterilized interventions).*

22. **To interpret Chile's approach to the exchange rate through the prism of type I and II errors, she leaned toward minimizing the probability of type I error by adopting explicit exchange rate targets for most of the 1990s**. However, the probability of repeated type II errors was minimized by paying attention to other targets—including the current account—and, most importantly, by ensuring the supremacy of inflation target. By the late 1990s, the exchange rate turned much more flexible, completing its transition to the strategy of minimizing the probability of type II errors.

**Israel**

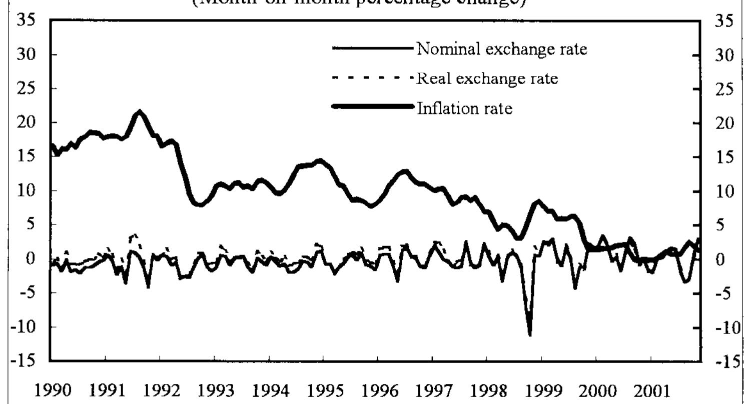
23. **Inflation targeting co-existed with nominal exchange rate targeting, while the inflation target has gradually been given a prominent place as the key objective of monetary policy**. An inflation target was first introduced in 1991 through "the back door," as an input into the determination of the crawling target band of the exchange rate (Leiderman and Bar-Or (2000)). A high degree of capital mobility lay bare occasional conflicts between the inflation target and the exchange rate target. Leiderman and Bar-Or report that in early 1997, the policy interest rate was higher than the level that was consistent with the prevailing exchange rate target band. This brought about sizeable capital inflows,

which in turn led to sterilized foreign exchange market intervention to prevent the currency from appreciating beyond the target band.

24. **Faced with this inherent policy dilemma, the authorities gradually shifted the focus of monetary policy toward inflation targeting**. Concurrently, foreign exchange transactions have been gradually liberalized and the flexibility of the exchange rate has been increased. The width of the target exchange rate band was widened substantially since 1997. Figure 2 shows that the variability of exchange rate—relative to the level of inflation—has steadily increased through the 1990s.

**Figure 2. Israel, 1990-2002**

(Month-on-month percentage change)




Source: IMF, INS and IFS.

25. **The commitment to inflation targeting and exchange rate flexibility was put to a test following the Russian crisis and LTCM failure in 1998**. As investors consolidated their positions, Israel suffered from capital outflows and a sharp exchange rate depreciation. However, the central bank chose not to intervene in the foreign exchange market, despite many calls to the contrary. It was viewed that intervention may exacerbate capital outflows and speculative pressure, and that this was an opportunity to allow private market forces to govern the determination of the exchange rate. Nor did the central bank raise interest rates until October 1998, when the inflation rate shot up and the risk emerged that the depreciation might translate into a permanent increase in the rate of inflation. Inflationary pressure soon abated, opening room for interest rate reduction in 1999. The supremacy of inflation target was proved.

26. **Similar to Chile, Israel can also be viewed to have sought to limit type I errors in early days, but again limiting type II errors by ensuring the supremacy of inflation target**. The emphasis on limiting type I errors was gradually reduced, with gradual liberalization of the exchange rate regime, and came closer to the practice of mature inflation targeting economies.

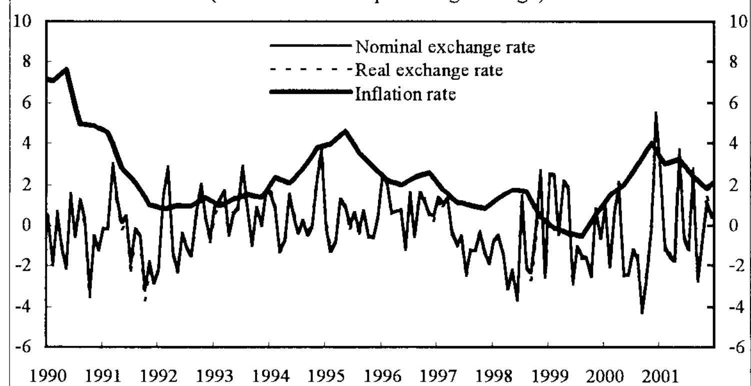
**New Zealand**

27. **The central bank entered into inflation targeting in the environment of an already stable inflation rate**. When the first Policy Targets Agreement was signed in March 1990, thereby heralding in the inflation targeting era, the inflation rate had fallen to about 5 percent from about 15 percent of the mid-1980s. The adoption of inflation targeting was

timed to prevent inflationary expectations from rebounding, rather than to achieve disinflation (Bernanke et al., 1999).

28. **Largely reflecting the already favorable inflation environment, the exchange rate regime was that of free-floating from the beginning (Figure 3)**. Nevertheless, the exchange rate target loomed large in the early years of inflation targeting. In the early 1990s, the central bank had relatively greater confidence in its understanding of the direct linkage between the exchange rate and inflation rate, than of the effect of the interest rate on inflation (Brash 2002). As a result, the conduct of monetary policy was oriented towards the exchange rate. Rather than targeting an exchange rate level in the conventional sense, the central bank worked with an undisclosed "conditional comfort zone" of the exchange rate, derived to be consistent with the inflation target given all other determinants of inflation.

**Figure 3. New Zealand, 1990-2002**
(Month-on-month percentage change)




Source: IMF, INS and IFS.

29. **With the gradual improvement in the central bank's understanding of inflation process, the orientation of monetary policy shifted from the direct inflation effect of the exchange rate towards a more medium-term effect of the real exchange rate and real interest rates on inflation through output**. Accordingly, the emphasis on the interest rate has increased, first by adopting Monetary Conditions Index (MCI) in 1997 as a signaling device. Finally in 1999, the central bank switched its signaling device from MCI to an Official Cash Rate, and sought to maintain the overnight interest rate within a 50-bp band around the target interest rate. All through the period, the exchange rate swing was of a magnitude broadly comparable to the rate of inflation.

30. **Most recently, exchange rate swings have been relatively large**. In 2000-2001, for example, the exchange rate depreciated sharply. Through 2000, the New Zealand dollar depreciated by more than 20 percent against the U.S. dollar, and by more than 10 percent in real effective terms. The depreciation was unusual in that it occurred against the background of strong commodity export prices and a narrowing current account deficit. Despite these swings, monetary policy remained firmly geared toward the inflation target. In fact, monetary policy remained broadly neutral and the long-term interest rate differential against the U.S. remained broadly unchanged, even as the exchange rate depreciated sharply.

31. **New Zealand's early emphasis on the exchange rate is better viewed as the strategy of paying attention to the consequence of type I error, rather than as a systematic effort to minimize the probability of type I error by targeting the exchange**

**rate**. The exchange rate was used more as an indicator of inflationary pressure, and it remained highly flexible throughout the 1990s. The strategy was rather that of minimizing the probability of type II errors, as was the practice with advanced economies, but avoiding or paying attention to the outcome of type I error by using the exchange rate as a key indicator of inflation outlook. Even that role as a key indicator shrank in importance over time as the inflation targeting framework matured.

### D. The Philippines: Transition to Inflation Targeting

32. **Prior to the formal adoption of inflation targeting framework in 2002, the Philippine central bank conducted monetary policy along the framework of inflation targeting already in 2001**. Indeed, the 2001 inflation rate at 6.1 percent was at the lower end of the intended annual target of 6-7 percent. Moreover, the central bank's public pronouncements have made it clear that the stance of monetary policy has been determined by the inflation outlook. Similarly, the central bank does not have an exchange rate target.

33. **Nonetheless, a review of recent monetary policy decisions is instructive. Year 2001 started with monetary policy being eased from a very tight stance of end-2000**. Through April, the reverse repo (RRP) rate was progressively reduced to 9 percent in May from 13.5 percent in January, the high level to which the rate was pushed up in response to the political crisis in late 2000.

34. **From May through September, when the currency was put under pressure, the monetary policy turned to a tightening bias**. The RRP rate was maintained at 9 percent during this period, despite continued reduction in the U.S. interest rate. Consequent widening in the interest rate differential helped to support the currency against mounting pressure. Moreover, the central bank resorted to more than $1 billion in non-deliverable forward (NDF) sales of foreign exchange to counter the mounting speculative pressure in July; reserve requirements were also increased.

35. **In October, pressure on the exchange rate began to subside**. At the same time, monetary policy began to be relaxed. The BSP cut its policy rate from 9 percent to 8.75 percent in October, in step with the worldwide rate cuts following September 11. As the global market sentiment improved apace, the overnight interest rate was lowered successively to reach 7 percent in March 2002, its lowest level since 1995.[2] By January 2002, the BSP could also unwind its once large NDF obligation without adverse impact on the exchange rate. At the same time, the inflationary pressure has remained subdued, with the inflation rate falling to 3 percent by June 2002, much below the original 2002 annual target of 5-6 percent.

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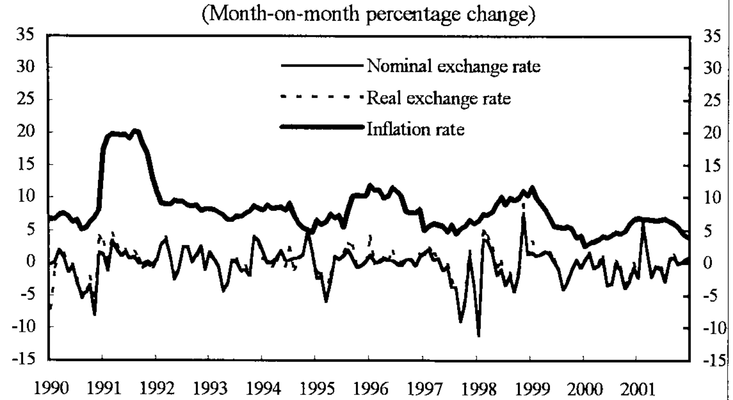
[2] The monetary policy continued to be eased in earlier months of 2002, while the U.S. Fed was maintaining the neutral stance at the time. This contrasts with the BSP's maintenance of the RRP rate against the continued easing by the U.S. Fed in the mid-2001.

36. **One possible interpretation of the monetary policy during this time is that it was geared toward countering the exchange rate pressure**. Certainly, the exchange rate variability remained smaller than the rate of inflation (or interest rates), in contrast to three pioneer countries (Figure 4). Under this interpretation, the large internal emphasis on the exchange rate corresponds to the strategy of limiting type I errors, at the risk of committing type II errors. While such a strategy was used successfully at least in Chile and Israel in the early phase of inflation targeting, the success entailed a complementary mechanism to guard against type II errors. In the case of the Philippines, there are several sources of concern about the possibility of type II errors.

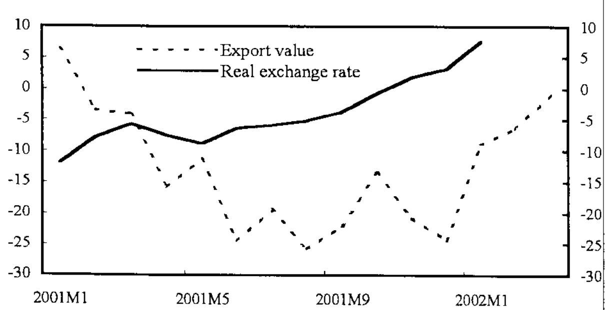
**Figure 4. Philippines, 1990-2002**
(Month-on-month percentage change)




Source: IMF, INS and IFS.

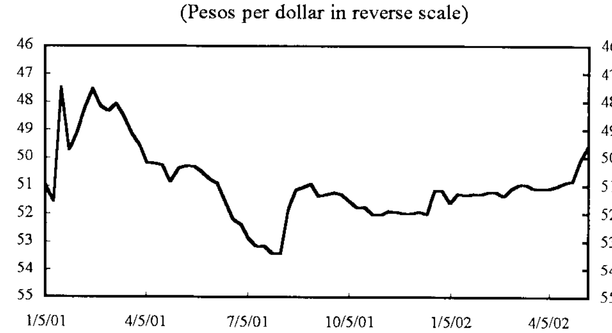
37. **The biggest source of concern on type II errors is external indicators.** Exports declined by 15 percent between 2000 and 2001, although the decline slowed to minus ½ percent in March 2002 (Figure 5). Moreover, export outlook has also weakened. The IMF projection for cumulative export growth in the next five years fell from more than 70 percent in 1999 to about 40 percent in 2000. Ceteris paribus, such drastic weakening in export performance would call for an adjustment involving real depreciation. However, the real exchange rate has depreciated by only 5 percent between 2000 and 2001, and has been appreciating since late 2001. The bilateral exchange rate with respect to the U.S.—the major trading partner—closely tracked P 52 per dollar for most of the second half of 2001, and strengthened to around P 50 per dollar in the first half of 2002 (Figure 6).

**Figure 5. Philippines: Export and Exchange Rate**
(Year-on-year percentage change)




Source: IMF, INS and IFS.

**Figure 6. Philippines: Exchange Rate**
(Pesos per dollar in reverse scale)




Source: The Philippines authorities.

38. **Internally, the inflation rate so far in 2002 has stayed below the original annual target of 5-6 percent, which does not contradict the possibility that the exchange rate is stronger than the equilibrium level, thereby improving inflation performance at the cost of overvaluation of the peso**. While the sharp reduction in the risk premium near end-2001 reflected a tendency toward stronger exchange rate, most of the gain in risk premium was capitalized in the subsequent reduction in interest rates. Hence, internal monetary indicators also do not preclude the possibility that the exchange rate might be stronger than the level consistent with inflation targets.

## E. Conclusion

39. **Large emphasis on the exchange rate was the practice with monetary policy in the initial stage of inflation targeting of several small open economies**. In Israel and Chile, explicit exchange rate target band was maintained as part of the gradual disinflation strategy, but with proper attention being paid to limiting the risk of type II errors that could feed overvaluation of the currency. In New Zealand, an implicit comfort zone was employed, owing to its informational value about inflation prospects. Over time, the emphasis on the exchange rate diminished—in all three countries—and the exchange rate flexibility increased—in Chile and Israel—as inflation targeting framework matured.

40. **The monetary policy of the Philippines appears to have placed large emphasis on maintaining exchange rate stability in 2001**. Such a strategy is similar to the type of inflation targeting practiced by other small economies, at least in their initial stages. However, going forward, a systematic effort to guard against type II errors would contribute to improving the performance of inflation targeting framework. Of course, it is intrinsically difficult to assess the underlying nature of stocks—whether they are real or nominal, temporary or permanent. This is one of the reasons why advanced economies tend to leave exchange rate determination to the market. And over time, the Philippines too should shift to a policy framework with greater flexibility. In the meantime, and as part of this transition, it may be useful to develop a formal mechanism for evaluating shocks, to limit the risk of type II errors that accompany overvaluation.

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