FIRST PILLAR:

Achieving Macroeconomic Stability

A large public sector deficit and a weak financial and banking sector spoil the country's macroeconomy and serve as major constraints to higher growth. Along these lines, ensuring macroeconomic stability requires focusing on fiscal consolidation measures through enhanced revenue generation and expenditure management to arrest the escalating public debt levels. It is crucial that this is supported by a prudent monetary and an effective external debt management policy to ensure external sector viability.

Improving private sector financing by strengthening the banking system and developing the capital market also remains crucial to achieve macroeconomic stability. Banks and the capital market play integral roles in generating the needed savings to finance and sustain investments in the country, hence their stability must be ensured.

At present, the biggest threat to macroeconomic stability is the fiscal deficit. The Philippines has been experiencing a deteriorating fiscal position, from a budget deficit of P19.6 billion in 1989 to P199.9 billion in 2003.

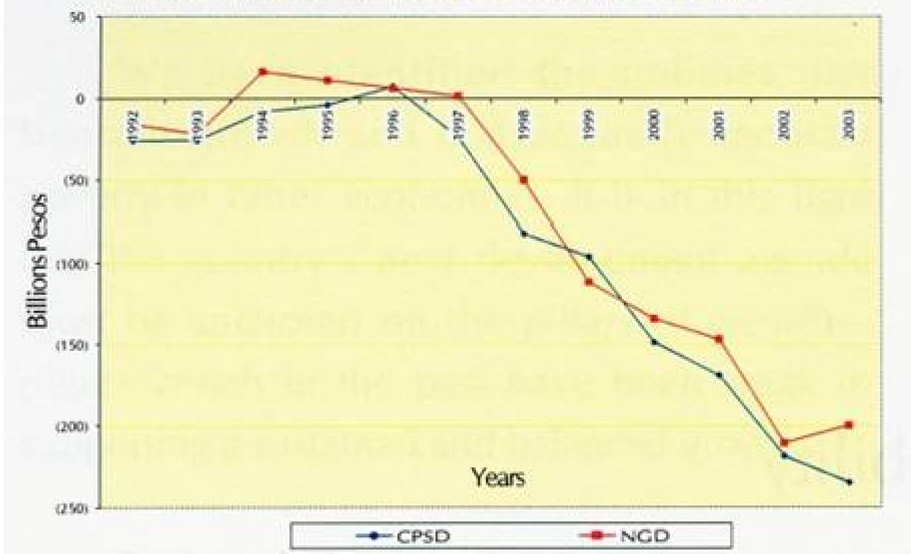
A. Addressing fiscal deficits

Table 6. Fiscal Balance and Outstanding Debt of the Central Government In ASEAN Countries, 1996-2003 (% of GDP)

Country	1996	1997	1998	1999	2000	2001	2002	2003
Overall Fiscal Balance to GDP Ratio								
Indonesia	n.a.	0.0	-3.7	-2.8	-1.6	-2.3	-1.8	-1.9
Malaysia	1.1	2.5	-1.5	-4.1	-4.2	-6.7	-5.6	-5.3
Thailand	2.4	-2.1	-7.6	-10.5	-3.2	-3.8	-1.4	0.4
Philippines	0.3	0.1	-1.9	-3.8	-4.1	-4.1	-5.2	-4.6
Debt to GDP Ratio								
Indonesia	23.9	24.2	68.8	53.3	48.6	n.a.	n.a.	n.a.
Malaysia	35.9	31.9	36.4	37.3	36.9	n.a.	n.a.	n.a.
Thailand	3.9	5.1	10.7	20.9	22.6	25.0	n.a.	n.a.
Philippines(without contingent liabilities	53.2	55.7	56.1	59.6	65.5	65.5	67.7	77.0
Philippines (with contingent liabilities)	61.3	66.9	67.6	72.0	80.1	79.1	84.7	93.2

Source: Manasan, 2002 and Asian Development Bank

Figure 4. Levels of Consolidated Public Sector and National Government Deficits, 1992-2003



Source: Department of Finance

On a broader front, the country's consolidated public sector deficit (CPSD) reached P235 B in 2003 which is equivalent to 5.4 percent of GDP. CPSD includes the financial positions of the National Government (NG), Government Owned and Controlled Corporations (GOCCs), Bangko Sentral ng Pilipinas (BSP), Government Financial Institutions (GFIs) and the Local Government Units (LGUs).

The continuing deficit position and the need to pay maturing obligations have caused the NG's debt (net of contingent liabilities) to balloon to P3.4 trillion in 2003. This amount is about 77 percent of GDP. If contingent liabilities were added, NG's debt will reach P4.1 trillion at the end 2003 or 93 percent of GDP. More alarmingly, the total public sector debt has reached P5.4 trillion as of September 2003, or 137 percent of GDP. This means every Filipino has to pay P65,853 to cover our outstanding public debt. Economists warn that if the country does not limit public borrowing, the Philippines will be bankrupt in two to three years.

The deficit problem is a result of spending more and collecting less. We should adopt the necessary measures to reduce this gap by examining our revenue collection and expenditure management program. Today, we collect only 12.5 percent of our GDP, compared to 17 percent in 1997.[1] The Philippines has the lowest revenue effort compared to Indonesia, Malaysia and Thailand (1999-2003) as shown in Table 7 below.

Table 7. Total Revenue in ASEAN Countries (% of GNP)

Country	1996	1997	1998	1999	2000	2001	2002	2003
Indonesia	17.4	18.5	13.8	18.6	15.8	20.7	18.7	16.9
Malaysia	23.0	23.3	20.0	19.5	18.1	23.8	23.2	20.2
Thailand	19.3	18.0	15.5	15.4	15.2	15.1	16.1	15.5
Philippines	18.2	18.7	16.4	15.3	14.7	14.4	13.2	13.4

Source: Philippine Institute of Development Studies

On the other hand, the country's public expenditure has increasingly become biased in favor of the ballooning debt service (28 percent of total expenditures in 2003) and the salaries and wages (34 percent).

Figure 5. Fiscal Inflexibility, % of GDP

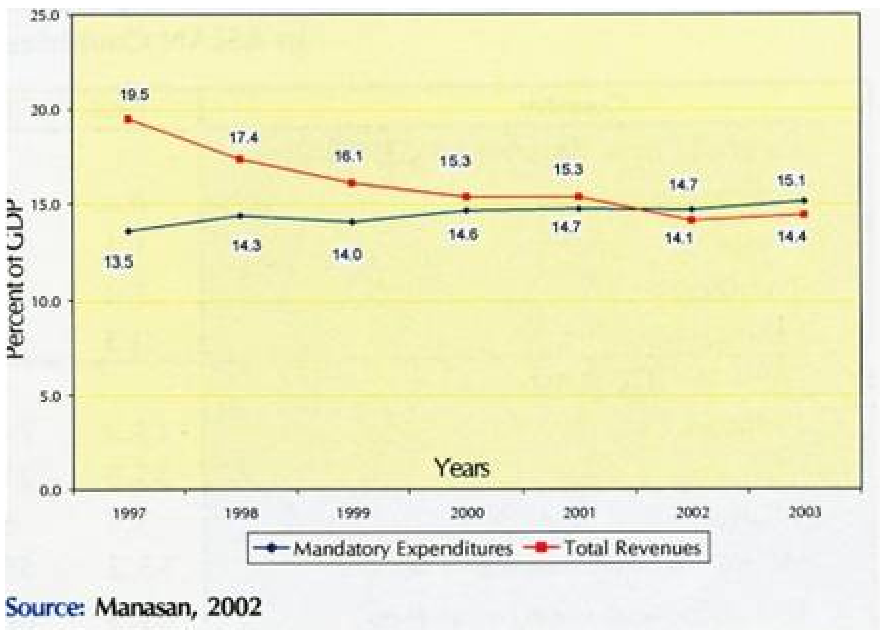
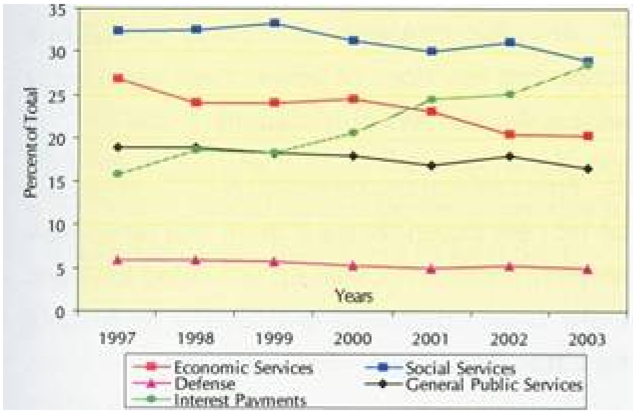


Figure 6. Government Expenditures, % of Total



Source: Budget of Expenditures and Sources of Financing, 1999-2004

Such bias effectively crowds out the social and economic expenditure needs. Although spending on social services continue to receive the biggest slice of the national budget, its share is continuously declining.

Direction for Reforms:

To arrest further escalation of the country's deficits, the government must consider the following measures:

1. Improve revenue collection. Tax policy should be designed relative to an overarching goal and should not be ad hoc and fragmented. The following interventions are highly recommended/suggested:

a. Administrative Reforms

- *Improve* tax *administration.* Efficient system, procedures and benchmarking of tax collection should be established.

- *Institutionalize an attrition system.* Its provisions include the transfer or severance from government service for failure to meet collection targets, provision of performance standards and review mechanisms and provision of incentives to performing collection agency.

b. Revenue Measures

- *Rationalize fiscal incentives.* The current fiscal incentives structure in the country is complicated, fragmented, inefficient, and costly in administrative and revenue terms. The vulnerability of the tax incentive system to syndicated crimes of graft and corruption has resulted to substantial revenue losses and distortions in resource allocation. Aside from the additional revenues that it will generate, rationalizing the current fiscal incentives structure is ultimately concerned with implementing an incentive system that is easy to manage, administer, and monitor, which will encourage a healthy business environment in the country.

- *Reduce exemptions from VAT.* VAT collection should reach 4 percent of GDP or 80 percent efficiency.

- *Index excise taxes on cigarettes and alcohol.* Its prices have fallen drastically in real terms. Retail prices of these sin products have not been adjusted, hence, for several years now, manufacturers have not been taxed properly.

- *Increase excise tax on petroleum products.* This should be done preferably with rebate vouchers for public transport and utilities to avert resistance from transport groups.

- *Pursue tax decentralization.* Local government units should be given more authority in the collection of its local taxes for greater accountability. Furthermore, in order to raise more local revenues, property taxes should be made more progressive (Manasan, 2004).

- *Introduce a second wave of privatization.* Sale of all government holdings in the semiprivate corporate sector, where no role of of government is self-evident (such as holdings in commercial banks - Cocobank, minority shares in PNB and DBP; business sector - San Miguel Corporation, National Steel Corporation, National Computer Center and PNOC; and media - Channel 9 and Channel 13) should be pushed. These holdings distort business and regulatory decisions since some of these businesses are with conflicts of interest with the government's objective.

2. Improve expenditure management. It may be worthwhile to do a thorough review of the expenditures of both national agencies and LGUs to seek areas of improving cost-efficiency or viability of projects.

- *Review allocations for Priority Dev-elopment Assistance Fund (PDAF)* (UPSE, 2004). This has been perceived highly political and promote corruption. The use of this fund must be made more transparent and aligned with the development agenda.

- *Strengthen performance assessment and evaluation system for each agency.* This can be done by strictly implementing the Sector Effectiveness and Efficiency Review (SEER) and Agency Performance Review (APR).

- *Adopt a medium-term expenditure framework.* In order to have better estimates on the programmed budget that is in line with policy priorities, the three-year budgeting system should be adopted and implemented. This will further reinforce the link between policy choices, budget and delivery of services that the government is responsible for.

- *Re-engineer the bureaucracy.* Streamline scope and functions of government agencies as well as government corporations.

- *Enact a fiscal responsibility bill.* There should be no new expenditures if there will be no new revenue for them. Clean-up unfunded laws and make certain that there will always be funding for future legislation.

3. Contain fiscal risks from GOCCs and contingent liabilities due to guarantees. The government has to keep track and understand the risks of contingent liabilities it is exposed to as past fiscal crises in the Philippines were triggered by extra-budgetary activities. It is then important for the government to effectively recognize, manage, report and provide for contingent liabilities (CLs) and off-budget risks of GOCCs.

- *Strengthen congressional oversight of GOCC operations during budget deliberations.*

- *Limit automatic guarantees to BOT investors and GOCCs.* Direct guarantees on GOCC loans should be reviewed and the degrees of guarantees given to them should be limited.

- *Undertake an assessment of capacity-building needs.* Strengthen institutional capacity to monitor and manage fiscal risks and the establishment of a centralized risk management unit.

- Make *Contingent Liabilities (CLs) more transparent.* Information on CLs' size, nature and, risks should be provided in budget documents.

- Set a *budget for* contingent *liabilities* separate *from* GAA that *should* be *approved by* Congress.

This budget will set limits on the CLs for the year, allocate and provide for guarantee calls.

4. Manage Public Debt Effectively. Considering the increasing size of the debt stock, the government should have a deliberate policy to mitigate the further increase of its total debt.

• *Ensure effective* debt *management at all times by borrowing preferably at least cost with longer maturities.*

B. Maintaining stable monetary

Inflation

Over the years, the country's price level was kept at low, single-digit levels despite hikes in petroleum prices, electricity charges and the depreciation of the peso. From an inflation rate of 6.6 percent in 1999, inflation fell to 3.0 percent in 2003, bringing the five-year inflation average to 4.6 percent. In 2002, the Bangko Sentral ng Pilipinas shifted to an inflation targeting framework of monetary policy with the primary objective of maintaining stable prices conducive to a balanced and sustainable growth.

Compared to 1997 levels, interest rates based on the benchmark 91-day Treasury Bill declined to single digit levels from 1997 to 2000. It hit its lowest annual average of 4.4 percent in 2002 although it climbed higher to 4.5 percent in 2003 (See Figure 7 below). For the near-term, interest rates are expected to remain benign. The Bangko Sentral, however, may need to review its monetary stance in the near-term in consideration of the hike in US interest rates.

Relatedly, the availability of credit and its ratio to the real economy (domestic credit as percent of GDP) remained low in 2003 (See Figure 8) compared to pre-crisis period in 1997. The country has a lower ratio of domestic credit to GDP compared to Malaysia, Thailand and Singapore. This highlights the need to further improve financial intermediation in the country necessary to boost domestic business and investments.

Following market pressures in *2003,* the peso-dollar exchange rate have relatively weakened compared to its levels for the period *1998-2000,* posting a high peso-to-dollar rate of *P 54.20* in *2003.* As of June *2004,* the pesodollar exchange rate averaged *P 55.90.*

Figure 7. Inflation and Interest Rates, in %

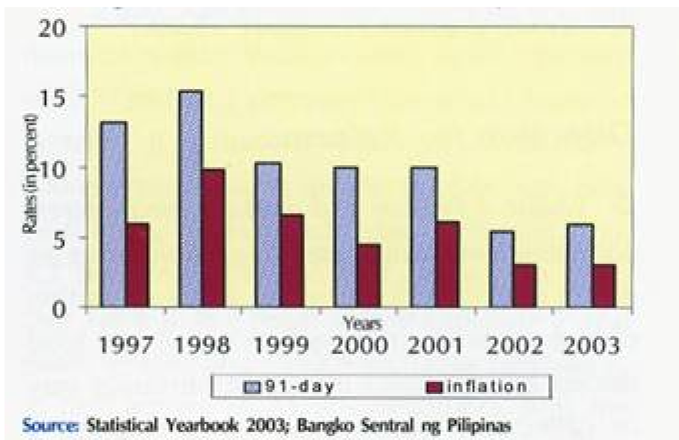
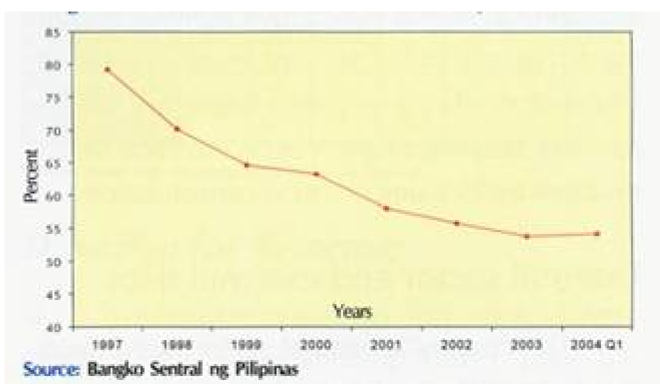


Figure 8. Domestic Credit as % of GDP, 1997-2004



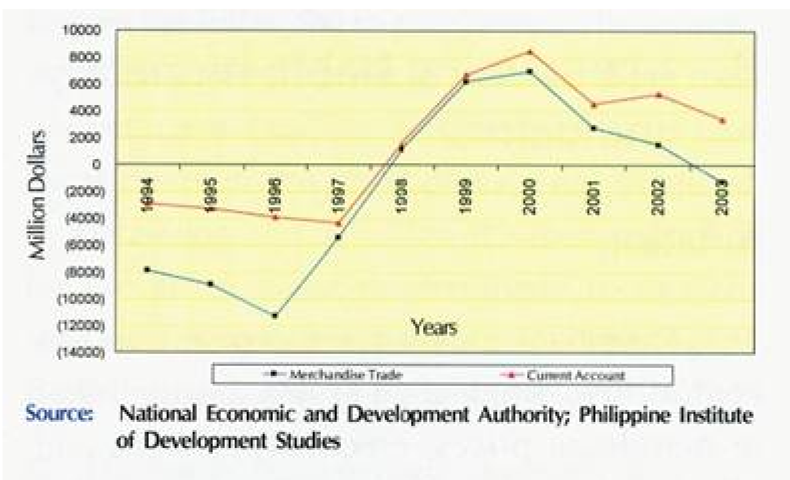
Direction for Reforms:

- *Ensure a* flexible and market-based *interest and foreign exchange* rates. If inflation increases due to demand side pressures (e.g. expectation of higher minimum wages, rising oil and food prices), an adjustment in interest rate policy may be called for. Steering the economy under a careful monetary course should allow interest rate adjustment to stimulate the economy while keeping inflation in check. Consistent with inflation targeting, monetary authorities should continue a market-based exchange rate policy, flexible enough to respond to any changes in the country's competitiveness. A sharp depreciation of the exchange rate could affect the government's inflation target and may prove harmful to both the private and public sectors' financial position. Complementing a prudent monetary stance requires keeping a tight rein on the fiscal deficit problem by focusing on fiscal consolidation.

External sector and external debt

The country's external sector faced major shocks in *2001.* A rebound, however, was noted in *2002* as increasing intra-regional trade in Asia tempered the sluggish demand from the country's traditional markets such as the US and Japan. In the period of *2001* to *2003,* exports shrank by *1.5* percent. However, this was countered by a larger contraction of imports by *2.9* percent. The level of gross international reserve for the period is enough to cover *4.6* months worth of imports of goods and payments for services, above the *4.2* months target of the government. Gross international reserves (GIR) as of end-December *2003* remained comfortable at *US$ 16.9* billion, adequate to cover *4.7* months worth of imports of goods and payment for services and income.

Figure 9. Merchandise Trade and Current Account Balance, 1994 - 2003 (In Million US $)



Source: National Economic and Development Authority; Philippine Institute of Development Studies

Direction for Reforms:

- *Promote* trade *cooperation and enhance trade competition policy.* Regional trade cooperation among ASEAN economies also needs to be reinvigorated. The East Asian region led by China's economy is set to record strong growth fueled mainly by a healthier global environment, improving domestic conditions and combined strength of China's economy. Globalization and China's accession into the World Trade Organization is seen to promote greater efficiency and productivity in East Asia through trade integration.

- *Expand the* export base. The country is still unable to reap the full benefits of globalization due to the slow pace of industrialization particularly in the manufacturing sector. This has resulted in a narrow export base with electronic products (semiconductors) accounting for more than *70* percent of total exports. The homogeneity of our export line is risky as the country remains heavily exposed to the fluctuating trends of just one sector. Export diversification programs should be explored, aimed at expanding the country's export base and developing international markets for high-value-added and labor-intensive goods.

- Assist *micro, small and medium* enterprises *(MSMEs) through financial and technical support.* The government must also look into ways of providing financial and technical support for MSMEs, in terms of loan grants and the upgrading of equipment and machinery. All in all, research must be directed towards finding ways for the government to minimize bureaucratic obstacles and ownership restrictions, provide adequate utility supplies, and allow for quick and easy access to international markets geared towards enticing local and foreign investors to engage in manufacturing and production in the country.

C. Strengthening the Financial sector

While the basic monetary indices have been kept in check, the financial sector is, however, continuously threatened by fragilities in the banking sector and the slow development of the capital markets. As banks and capital markets play integral roles in generating the needed savings to finance and sustain investments in the country, their stability must thus be ensured.

1. Addressing the Banking Sector's Problems

Banks remain the dominant sector in the financial market. Its assets make up *81.6* percent of GDP and *82.3* percent of the whole financial system. It is thus increasingly important to address the lingering problems of its high nonperforming loans which have increased from *4.7* percent in *1997* to *14.1* percent in *2003* (See Table *8)* as a result of over-exposure in real estate lending and foreign exchange borrowing. In fact, among its ASEAN neighbors, only the Philippines has not significantly reduced their banks' NPLs since the Asian financial crisis. Similarly, proper corporate governance practices among banks must be enforced to ensure the soundness and stability of bank operations.

Table 8. NPLs in the banking system of ASEAN Countries, as % of total loans

	1997	**199 8**	**1999**	**200 0**	**2001**	**200 2**	**2003**
Philippines	4.7	10.4	12.3	15.1	17.3	15.0	141
Indonesia	7.2	486	32.9	18.8	12.1	7.5	6.7
Korea	6.0	7.3	13.6	8.8	3.3	2.4	2.7
Malaysia		10.6	10.6	8.3	10.5	9.3	8.3
Thailand		45.0	39.9	19.5	11.5	18.1	14.0

Source: Asian Development Bank-East Asia Update

Direction for Reforms:

- *Synchronize regulatory* functions. Corporate governance among banks may be improved by synchronizing the functions of the regulatory bodies, i.e. Bangko Sentral ng Pilipinas and Securities Exchange Commission, to strengthen supervision and monitoring of banks and Non-Bank and Financial Institutions (NBFIs).
- *Address issues of ownership structure and jurisdiction.* Bank's corporate soundness can be ensured by amending Republic Act No. 7653, the New Central Bank Act to address the issue of ownership structure of banks and NBFIs and expand BSP's jurisdiction over quasi-banks, trust entities and other financial institutions.
- *Enact a Credit Reporting Law.* The limitations on banks' sharing of information on their borrowers must be relaxed to allow for better processing and more informed decisions. The creation of a Credit Information Bureau will likewise complement this effort.

2. Capital Mobilization from Non-Bank Sources

Public interest in savings instruments outside of the banking sector is low as the Philippine capital market is still in the early stages of development. Domestic credit depends largely on banks' lending and there is little participation in the equity market. This is evidenced by the small number of companies listed in the Philippine Stock Exchange and the low value of share trading. Table 9 below indicates that the Philippines has the least developed equities market compared to other Asian economies. Only about two companies/investors are added to the list of the Philippine bourse every year (World Federation Exchanges, 2001).

Table 9. Stock Market Performance-ASEAN and Other Selected Exchanges

Exchange	# of listed companies (as of 2003)	stock market importance (2001) (stock market value as % of GDP)
Philippines (PSE)	236	28.80
Jakarta (JSX)	333	*17.50
Kuala Lumpur (KLSE)	902	135.10
Singapore (SGX)	551	137.00
Thailand (SET)	418	31.30
Korea (KSE)	684	46.10
Shanghai (SSE)	780	-
Taiwan (TSEC)	674	-
Tokyo (TSE)	2,206	55.40

Note: *2000 data
Source: World Federation of

Exchanges Statistics,
www.fibv.com/WFE/home; IMF International Financial Statistics Yearbook 20001

Moreover, the insurance sector contributes a meager share of 6% to GDP (2001) as shown in Table 10. In contrast to countries with more developed capital markets, the country's pension funds are limited to mandatory schemes such as the GSIS and the SSS. The mutual fund industry, even as it has been growing significantly over the past five years, remains to contribute minimally to the over-all capital markets industry.

The stability of the key institutions that comprise the capital markets sector must also be ensured to improve investor confidence in other financial intermediaries. They must be governed in a manner that protects the interest of its stakeholders. Hence, proper corporate governance must be implemented for both non-bank financial institutions and corporations in general. Likewise, encouraging the development of more savings instruments will spur the development of the capital market.

ASEAN 5	Assets of deposit money banks Total financial assets			Assets of deposit money banks % of GDP			Assets of other financial institutions % of GDP			Assets of insurance companies % of GDP		
	1994	1997	2001	1994	1997	2001	1994	1997	2001	1994	1997	2001
Indonesia	89	n.a.	n.a.	51	58	49	n.a.	n.a.	n.a.	3.8	5.1	n.a.
Malaysia	65	64	69	79	115	117	39	52	44	10.9	12.4	17.9
Philippines	65	81	84	36	65	56	7	6	4	5.0	5.8	6.0
Singapore	n. a.	n.a.	n.a.	93	110	137	13	13	9	16.0	20.0	38.9
Thailand	89	79	73	89	118	99	10	15	24	5.3	5.3	n.a.

Source : Asian Development Bank

Direction for Reforms:

- *Enact a law on personal equity retirement account (PERA).* A law on personal equity retirement account must be enacted to provide an alternative financial instrument and augment non-bank savings.

- *Amend the Insurance Code*. Provisions of the Insurance Code which prevent the expansion of the industry must be amended. The tax structure of the industry must also be reviewed.

- *Manage pension systems efficiently.* In the absence of an institutionalized pension and retirement system, the two largest state-owned insurance companies, the Social Security System (SSS) and Government Service Insurance System (GSIS) must be made solvent and managed properly to contribute to investments growth.

- *Update the Investment Corporation Act.* The Investment Corporation Act that govern mutual funds must be updated to allow the expansion of growing investment companies, and rationalize the regulation of the industry.

- *Ensure efficiency in regulating corporations.* Current legislations must be reviewed to assess the weaknesses in regulating Philippine corporations. Reforms must be geared towards providing more protection to stockholders that include the appointment of outside or independent directors, and mandating board of directors to protect the interest of minority shareholders.

- *Disentangle* banks *from corporations.* This will prevent connected or syndicated lending and prohibit corporations from relying excessively on domestic credit. This can be done through efforts to strengthen bank regulations such as tightening disclosure requirements.