Philippine Economic *Outlook*

JUNE 2001

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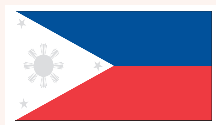
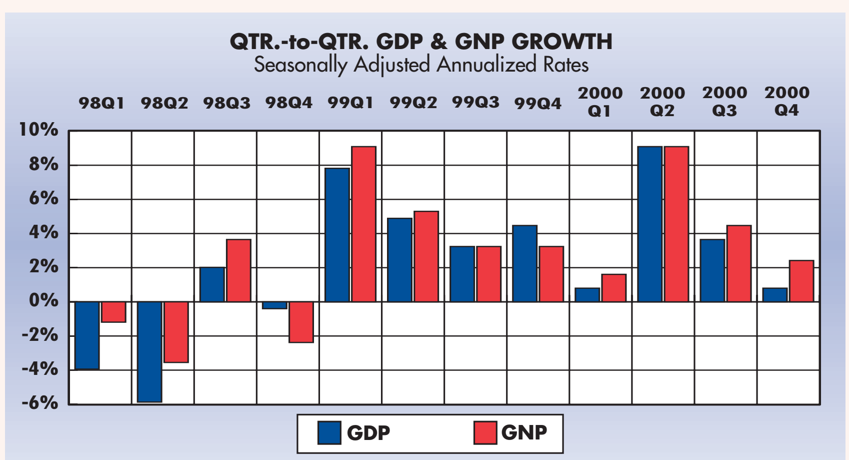
Introduction



As this report is drafted on the heels of the largely peaceful and successful May 14 national elections, it is impossible to make any comment on the Philippine economy without linking it to the political situation. As events in the Philippines over the last year have demonstrated, the political landscape is constantly shifting, sometimes in unexpected and (unfortunately) violent ways. Such an unsettled picture is depressing prospects for Philippine economic growth, particularly when it is viewed in the broader context of a slowing global economy. This combination of factors has caused the Embassy to reassess its forecast of Philippine real GDP growth for 2001 from a range of 3.2%-3.9% (in our February 2001 *Outlook*) to 2.7%-3.2%.

With that in mind, it is worth turning the clock back to 2000 and considering the events of that tumultuous year. A major bank collapsed in April (leading to significant runs on several others); the President was accused of high crimes and impeached; export growth was slowing — all in all, by any standard, a fairly unhappy series of events. And yet, the Philippine economy was able to grow 3.9% (real GDP over 1999) for the full year. We raise the point if only to remind ourselves of the resiliency of the Philippine economy and the Filipino people.

It is too early to say who won or lost in the elections, or what it all means. (We invite readers to consult our weekly economic "Wrap-Up," also posted on the Embassy web site http://usembassy.state.gov/manila, for updates on the elections.) Regardless of the outcome, the economic agenda for the remaining years of the Macapagal-Arroyo administration sounds strikingly familiar: power sector reform; continued reforms to improve bank



supervision and combat money laundering; further efforts to liberalize trade and investment. Of particular importance this year is containing the public sector deficit, which reached 4.4% of GNP in 2000 and is headed in a similar direction this year. Efforts to control spending are helping, but to ensure the government has the resources it needs to provide basic services and infrastructure, revenue collections (particularly taxes) must be improved. Further, the political scandals surrounding the ouster of President Joseph Estrada in January spotlighted problems of corruption and weak governance which the new administration will need to seriously address before investor confidence returns. Efforts in this direction will range from reforms of government procurement systems to prosecution and punishment of wrongdoers. Finally, the government must accelerate its efforts to deal with the looming problem of contingent liabilities and to redefine the roles of government financial institutions such as the Social Security System (SSS) and the Government Social Insurance System (GSIS).

President Macapagal-Arroyo has set a lofty and admirable goal for herself: the elimination of poverty in the Philippines by the end of the decade. Prompt, credible and sustained implementation of a broad economic reform package will go far to achieve this goal by boosting investor confidence and creating job opportunities for Filipinos. But even the best economic reform program will be seriously handicapped by the country's accelerating population growth rate (2.36% a year from 1995-2000. up from 2.32% annually for the previous five year period). To fully address the poverty question, the Philippines must deal with both these issues.

Output and Inflation

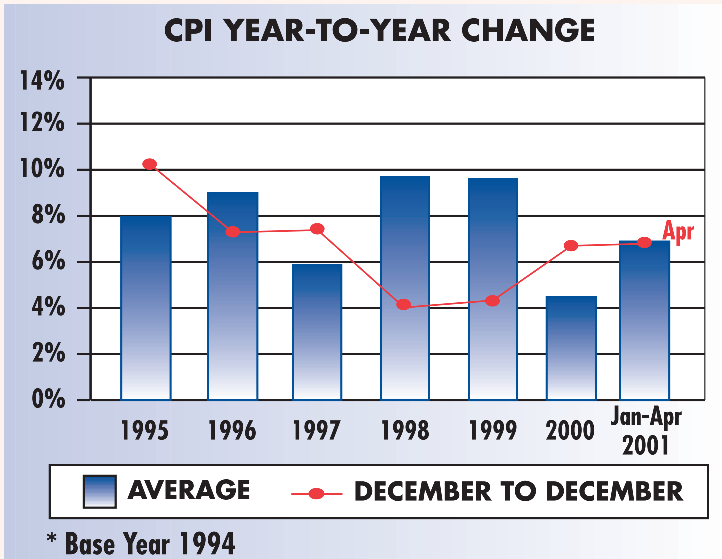
Seasonally adjusted figures (which lack detail) show that quarter-on-quarter economic growth sputtered during the last three months of 2000. Industrial sector output barely expanded while the agricultural sector suffered from typhoon-related losses. Economic growth also slowed according to the more widely used gauge of overall economic activity — measured as the year-on-year change of seasonally unadjusted data. Fourth-quarter Gross Domestic Product (GDP) increased by 3.6% year-on-year after expanding by over 4.5% during the second and third quarters. At 4.4% growth in real peso terms, Gross National Product (GNP) approximated its previous two quarters' performances, boosted by a 20% expansion in net factor incomes (mainly overseas workers' remittances and revenues from residents' investments offshore). The

fourth-quarter deceleration in Philippine GDP growth had been widely expected. A gambling scandal implicating then President Joseph Estrada rattled the already shaky financial and foreign exchange markets, exacerbating political uncertainties and clouding growth prospects.

On the production side, growth of all major sectors (i.e., agriculture, industry, and services) slowed compared with last year, as well as second and third-quarter growth rates. Industrial sector output (up 2.8%) sputtered to its slowest year-on-year growth performance since the last quarter of 1999. The manufacturing sub-sector's output increased by a slower 4.3% after expanding more than 6% during the first three quarters of 2000. The utilities sub-sector grew at its slowest pace since 1999's third quarter, while construction activity remained in the doldrums. Service sector output (up 4.1%) decelerated from its second and third quarter rates of expansion — reflecting slowed trade, financing, and real estate-related activities.

On the expenditure side, fourth-quarter statistics suggest that overall demand (i.e., the sum of consumer spending, government consumption, investments, and exports) — up 7.2% year-on-year in real peso terms — managed to hold up during the fourth quarter. Problematic government finances subdued public sector spending and private-sector construction demand remained depressed. However, consumer outlays, exports of goods and non-factor services, and capital formation (mainly reflecting a build-up in inventory levels after the net withdrawals generally seen since 1998) surpassed their respective first to third-quarter rates of expansion. That overall demand markedly outpaced GDP growth suggests that fourth-quarter imports (measured in real peso terms) supplied a larger share (about 65%) of the expansion in overall spending relative to domestic output (35%).

On a full-year basis, real GDP and GNP in 2000 — up by 3.9% and 4.2%, respectively — nevertheless grew at their strongest rates since 1998. Compared to 1999, the year-on-year expansion was spurred mainly by the private non-agricultural sector. Agricultural sector growth (3.4%) slowed after 1999's rebound from drought-depressed harvests. The industrial sector (up 3.6%) bettered its 0.9% growth performance, spurred mainly by the manufacturing sub-sector's 5.6% expansion. The service sector grew at a faster 4.4% clip, with the stronger performances of trade and transport/communications offsetting slower rates posted by financial, private, and government services. On the demand side, improvements in net exports and personal consumption mainly explained the acceleration in GDP from 1999's 3.3% pace. Total capital investments were sluggish at 0.8% growth, but avoided a further drop from the consecutive declines of 1998 and 1999 (which mainly reflected much smaller net inventory withdrawals). Investments in durable equipment (up 2.6%) broke from two years of consecutive declines. Construction spending contracted by 5.4%.



For 2001, the Macapagal-Arroyo administration hopes to hit at least the lower end of its 3.8% - 4.3% targeted GDP growth range (just about sustaining 2000's 3.9% GDP expansion). However, uncertainties cloud the economic horizon, which could dampen growth prospects despite positive factors such as election-related spending (through the nationwide May 14 elections), declining inventories, and the generally peaceful transition to a new presidency. With non-export industries yet to fully recover, the Philippine export sector faces bleak export prospects this year from its heavy dependence on the slowing U.S. and Japanese economies and on tapering world electronics demand. Agriculture remains a wild card with expectations of another (albeit milder) dry spell later in the year. The government continues to struggle with fiscal difficulties. Over-capacity, combined with lingering anxieties over the domestic political situation and prospects for further reforms under a new Congress, also may hold off more robust investment levels in the near-term. A number of indicators strongly suggest that the economy's expansion slowed markedly during 2001's first quarter. Our current forecast is for real GDP growth of 2.7% - 3.2% for the full year.

Cost-push pressures, which gained momentum during the last quarter of 2000, spilled over into 2001, exacerbated by weather-related supply-side pressures as the year opened. Year-on-year consumer price inflation averaged 6.8% during the first four months of 2001. A weaker currency could exert some pressure on domestic oil, transport, and utility prices. We nevertheless expect more moderate average inflation towards the fourth quarter — with consumer prices coming off a high 2000 base, and assuming that receding risks of further, sharp increases in import prices of oil products hold. Our current forecast for 2001 is for average year-on-year inflation of 6.3% - 6.7% (from 4.4% in 2000).

Labor and Employment

The unemployment rate (surveyed quarterly in January, April, July, and October) jumped from 9.5% in January 2000 to 11.4% in January 2001 — the highest recorded rate since 1986 for that survey period. The number of employed persons expanded by 1.3% year-on-year, equivalent to 354,000 more jobs. However, the number of unemployed persons rose by 24% (698,000) to 3.7 million as overall job creation fell far short of the more than one million new entrants into the Philippine labor force. Typhoon-related job losses in the agricultural sector displaced more than 300,000 workers, partially offsetting the 500,000 and 300,000 new jobs attributed to the service and industry sectors, respectively.

The statistics also show additional work for the underemployed in lieu of more aggressive new hiring. The underemployment rate declined from 21% (January 2000) to 16.9% (January 2001), equivalent to about a million less persons on the underemployed list. This year's full-year unemployment rate (the average of the quarterly surveys) is likely to remain at double-digits, given more modest economic growth prospects for 2001 and still relatively high underemployment. Another dry spell also may adversely affect agricultural employment later in the year.

Beyond short-term concerns and uncertainties, important longer-term policy challenges remain. Agriculture absorbs about 40% of the employed but accounts for barely a fifth of Philippine GDP, indicating the need to create more productive non-agricultural jobs. Unemployment and underemployment rates are far more severe in rural than in urban areas. As a result, rural residents make up the bulk of the Philippine population living below government-estimated poverty thresholds. The sector's low productivity has hampered its ability to efficiently supply industries with needed inputs, and low rural incomes limit the otherwise higher growth potential that could be spurred by a stronger consumer base.

Newly installed President Gloria Macapagal-Arroyo made good on her promise to address the country's employment problem during her first 100 days, holding a tripartite Employment Summit on March 15. Labor joined with government and employers in pledging to work cooperatively to create new jobs and preserve existing ones. The President said: "Employment must always be at the center of any social development agenda." The President also appointed an experienced professional as her Secretary of Labor and Employment. The new Secretary, Patricia Sto. Tomas, previously served as Undersecretary for Employment in the Department of Labor and Employment (DOLE); prior to that, she was the first Administrator of the Philippine Overseas Employment Administration (POEA). Sto. Tomas has assembled a strong team at DOLE, including holdover Undersecretary Jose Espanol. Manuel Imson, former Labor Attaché at the Philippine Embassy in Washington, takes over the key employment portfolio. Attorney Arthur Brion returns to DOLE as Undersecretary for Labor Relations. His predecessor, Rosalinda Baldoz, moves to POEA.

Ceremonies to mark Labor Day 2001 were moved from Malacañang Palace, besieged as it was by demonstrators, but continued much as planned. DOLE Secretary Sto. Tomas, representing the President, used the occasion to announce several new initiatives, including a suspension of Department Order No. 10 (1997) on labor-only contracting; allocation of P27 million in state insurance funds for displaced workers; and establishment of a P50 million development fund for worker training and a P30 million legal assistance fund for overseas workers.

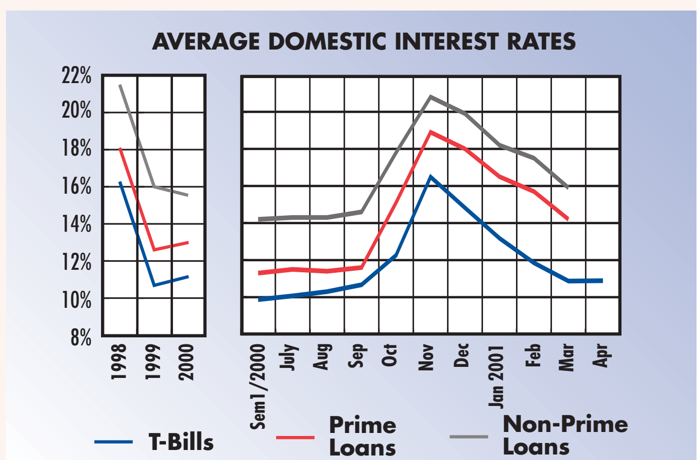
In February, the Congressional Labor Commission presented its report on reforms to the Labor Code to President Macapagal-Arroyo. The president "received" the report, saying she was holding off on "accepting" it until it had been further reviewed and refined. That process will have to wait until after a new Congress is seated in late July.

In April, the 22nd National Conference of Employers resolved to urge the government to help create a business-friendly labor environment while enforcing basic worker rights. Among other things, the employers favor a shift to a productivity-based compensation system in place of "unsustainable" across-the-board wage increases. The employers also want the government to recognize varied forms of work, including contractual and casual employment. President Macapagal-Arroyo used her address to the Conference to announce the formation of a Cabinet cluster, headed by the DOLE Secretary, on safety nets for sectors affected by globalization.

It is worth noting that in the May elections, a number of House seats are set aside for "sectoral" representatives and political parties. Both labor and employers got into the "party-list" act, although the results of the voting have not yet been announced.

Financial Markets

The peaceful transition of political power in January, a calmer foreign exchange market, and declining U.S. interest rates provided the Bangko Sentral ng Pilipinas (BSP, the central bank) latitude to ease monetary policy. The BSP cut overnight rates by a total of 300 basis points between late January and April, following cuts (totaling 250 basis points) announced between December 2000 and mid-January 2001. That cumulative 550 basis-point reduction since December 2000 rolled back BSP overnight rates to their May 2000 levels (9.5% and 11.75% for borrowing



and lending rates, respectively). Treasury bill rates softened with declining overnight rates. The benchmark 91-day T-bill rate — which averaged 12.863% during 2001's first weekly auction — had tapered to 10.102% by the end of April. The average four-month rate (10.622%) was higher than 2000's January-September (8.908%) and full-year (9.937%) averages in nominal terms but represented a decline in real terms.

Under a new head, the Philippine Treasury's strategy to control financing costs has been to maximize borrowings from the cheaper (i.e., shorter-term) end of the yield curve. The Treasury suspended its weekly bond auctions (which formerly rotated among the 2, 5, 7, and 10-year issues) starting March in favor of "re-issuing" bonds through the government's over-the-counter window. It did not award about 19% (P13.7 billion) of its total scheduled T-bill offering for the January to April period, reflecting occasional bid rejections for the longer-term 182-day and 364-day instruments. The Treasury sold P15 billion worth of "retail" bonds in April (targeted for small investors) with a shorter, four-year maturity than the five and seven-year papers authorized under the Estrada administration. The small-denominated bonds carried a 14.25% coupon rate (higher than the 13.625% return on five-year bonds issued during the second half of 1999). The Treasury also has been pre-announcing its borrowing requirements to minimize second-guessing by dealers. However, an underdeveloped secondary market poses limitations to flattening the yield curve. On May 8, the Treasury returned to the auction market with a P4 billion, two-year T-bond offering. The offering, oversubscribed and fully awarded, was sold at a coupon rate of 13.25% (versus 13.625% when the bonds were last auctioned on February 13). The Treasury planned to auction off P4 billion worth of 5-year bonds later that month, while indicating that bond auctions would be held on an "as needed" (versus regular, weekly) basis.

Commercial banks' published loan rates tapered with BSP and Treasury rates. Prime rates were averaging about 13.5% as of end-April (down from nearly 17% at the end of December), and non-prime rates at 15.2%. Those levels remained somewhat higher than the published 11.8% prime and 14.8% non-prime rates at the end of September 2000. Looking ahead, we expect a combination of currency, fiscal, and inflation developments to make domestic interest rates stickier coming down, unless U.S. policy rates soften further.

Outstanding loans of the commercial banking system (inclusive of inter-bank credits) ended 2000 with a modest 2.5% year-on-year expansion. However, the nominal level of non-performing loans (NPLs) grew at a faster 25.8% clip, yielding a higher NPL ratio (15.1%) than at the end of 1999 (12.3%). January 2001 estimates showed a stronger 4.5% year-on-year expansion in the commercial banking system's loan portfolio. Banks' overall NPL ratio nevertheless increased to 16% as NPLs (up 24.6% from January 2000) outpaced loan expansion. The January data represents the second-highest NPL ratio thus far since the Asian crisis (next to the 16.3% ratio registered in November 2000). NPL ratios would have been higher without some P98.5 billion in restructured loans (equivalent to 6.2% of total commercial bank credits).

Bankers doubt that NPL ratios have peaked, noting that businesses are struggling with both weaker export and domestic markets. Credit expansion is also likely to remain modest. Saddled with NPLs and a growing portfolio of foreclosed assets, banks remain cautious lenders, while weaker economic prospects spell conservative credit demand. Banks are exploring the possibility of transferring non-performing assets to an asset management company (AMC) to improve liquidity and clean up their books. Overall, the Philippine banking system's generally healthy capital adequacy ratios (16.5% on average as of end-2000 versus the BSP's 10% statutory floor) and adjustments in loan-loss reserves (6.5% of outstanding loans) have helped the banking system avoid systemic problems. Still, it should be noted that the Philippine banking system's capital adequacy ratio as of end-2000 declined from end-1999's 17.5% figure. Moreover, two large commercial banks (including the partially government-owned Philippine National Bank) pose potential risks pending their rehabilitation and/or re-capitalization. While systemic risk is small, it is worth noting that significant troubles at any major commercial bank could lead to a swift reversal of depositor sentiment; the resulting strain on the system to service withdrawals could be substantial.

The BSP continues to encourage consolidation in the banking system through time-bound incentives and a temporary moratorium (since September 1999) on the issuance of new bank licenses. From January to March 2001, the BSP approved two mergers involving three commercial banks and a thrift bank. The BSP has approved 31 acquisitions and/or mergers thus far since the Asian crisis (involving 26 commercial, 16 thrift, and six rural banks). Two commercial, 38 thrift, and 116 rural banks were unable to meet minimum capitalization levels required by the end-2000 extended deadline, suggesting there is room for further consolidation. About 17 acquisition and/or merger proposals are pending with the BSP.

The Bangko Sentral ng Pilipinas has also demonstrated greater resolve in weeding out weak financial institutions. Smaller-capitalized thrift and rural banks (which constitute about 10% of banking system assets) have been more severely affected by the shakeout. Three more rural banks (constituting 1% of the total resources of the rural banking system) closed during the first three months of the year — for a total of 104 bank closures since mid-1997 (involving two commercial, 13 thrift, and 90 rural banks). It is worth noting that the judiciary is not always helpful; cases are often brought against government examiners in their personal capacity for "abuse of power" in closing banks; cases brought against bank owners and managers for fraud often languish. Urban Bank (one of two commercial banks which closed during the Asian crisis) was all set to reopen within the second quarter under the ownership and management of Bank of Commerce. The reopening fell through at the last minute, with the banks' new investor spooked by legal uncertainties surrounding the bank's April 2000 closure.

The Bangko Sentral ng Pilipinas recently issued implementing regulations to adopt, by July 2001, internationally acceptable, risk-based capital adequacy standards patterned after the Basle framework. The BSP had long wanted to shift to that framework as an important step towards aligning Philippine prudential requirements with international best practice. Legal constraints prevented it from taking that step, until the passage of the "General Banking Law of 2000" (GBL, signed in May) cleared the way. In response to the GBL's more liberal foreign ownership provisions, at least three foreign banks with local commercial bank subsidiaries have expanded, or are working to expand, their presence in the Philippine market; and at least one foreign bank has expanded by acquiring a thrift bank subsidiary. Meanwhile, in a positive development for the long-term capital market, the Bankers Association of the Philippines is determined to launch an electronic, fixed-income exchange before the end of the year. The BAP is working with the government to thresh out certain tax issues (including high documentary stamp taxes) which tend to inhibit active secondary-market trades. At the end of March, the Bangko Sentral ng Pilipinas also launched the familiarization stage of a Real Time Gross Settlement System (RTGS) covering interbank loans and government securities under repurchase agreements with the BSP — transactions which, under RTGS, are now settled on a gross, trade-by-trade basis.

On the anti-money laundering front, the BSP and Bankers Association of the Philippines are working to finalize guidelines which will implement, under specified conditions, a voluntary secrecy waiver for non-residents' foreign-currency deposit accounts. Administrative measures are fast running out, however, and major legislative impediments to getting the Philippines off the Paris-based Financial Action Task Force's "non-cooperative" list remain. Work is just beginning on the legislation needed to criminalize money laundering and to relax stringent bank secrecy laws.

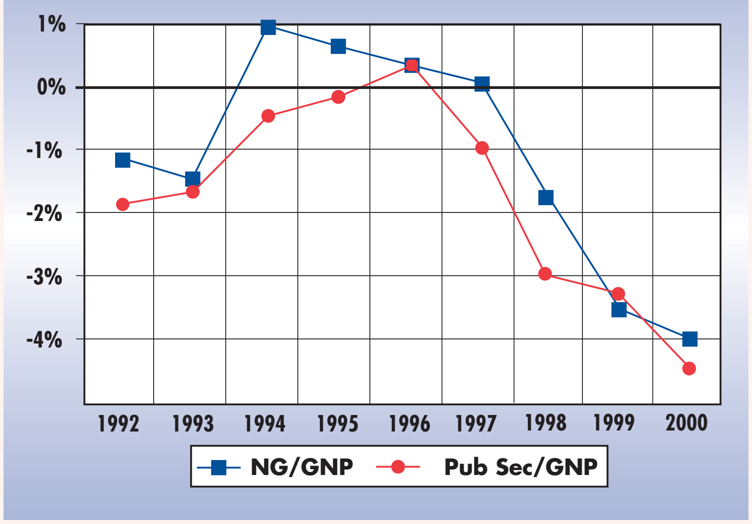
Longer-term prospects towards a more transparent and credible equities market brightened with the July 2000 passage of the "Securities Regulation Code" (SRC, which rewrote the 1982 "Revised Securities Act"). The SRC provides for the demutualization of the Philippine Stock Exchange (PSE). The bourse expects to meet the August 8 deadline to convert to a stock company and plans to eventually offer its shares to the public after establishing viable profit centers. Other SRC provisions strengthen investor protection by: codifying the full disclosure approach to the regulation of public offerings; tightening rules on insider trading; segregating broker-dealer functions; requiring mandatory tender offer requirements; significantly increasing sanctions for violations of securities laws and regulations; and mandating steps to improve internal PSE (and other exchange) management. It is worth noting that the PSE management has voiced its opposition to some of these reforms, even to the extent of filing legal challenges.

Share prices remain in the doldrums, mired by external and domestic news and developments. The Philippine Stock Price Index (PHISIX) received a strong boost shortly after President Macapagal-Arroyo was sworn into office — hitting a 1,953.00 intra-day high on January 22 (the highest since February 16, 2000) and closing on that day at 1,708.06 (the highest since April 17, 2000). Since then, however, stock prices have generally faltered on thin volumes. Weak corporate-profit reports, movements in U.S. and regional markets, and slowed global and domestic economic prospects overshadowed domestic interest-rate cuts. By mid-March, the PHISIX was closing below the 1,500 mark. Late April saw the PHISIX fall to under 1,400 as pro-Estrada riots spooked investors. With the riots quickly quashed, the PHISIX moved up in subsequent days and ended the first week of May at 1,442.46 (still down, however, from 2000's 1,494.50 closing level). As of early May, traders expected near-term movements to be tied mainly to election-related developments.

Fiscal Performance

The national government's P136.1 billion fiscal deficit in 2000 — more than double the originally programmed

PUBLIC SECTOR & NG SURPLUS/DEFICIT AS % OF GNP



ceiling — bloated the deficit of the consolidated public sector (which includes government-controlled firms, social security agencies, and the Bangko Sentral ng Pilipinas). The public sector deficit ended 2000 at nearly P154 billion (equivalent to 4.4% of GNP), almost double the P77.6 billion level planned for that year. Looking forward, the planned restructuring of the electric power sector, including the partial privatization of the heavily indebted National Power Corporation, would be a positive step towards stabilizing overall public sector finances. Another important challenge the government faces is to address threats to the long-term viability of state-run pension funds (the Social Security System and Government Service Insurance System) arising from imbalances between contributions received and benefits paid (which pose a potential burden on national government resources).

The Macapagal-Arroyo administration is operating on a "re-enacted" 2000 budget for the 2001 fiscal (also calendar) year. The national government plans to submit a P10.9 billion supplemental budget when the outgoing 11th Congress reconvenes briefly in June to wind up business. The bulk of that supplemental request is earmarked for personnel-related outlays (including a 5% government salary increase, as well as retirement and other social security benefits). Overall, the goal for 2001 is to contain the national government's 2001 fiscal gap to P145 billion (3.7% of GNP) and that of the consolidated public sector to P148.2 billion (3.8% of GNP). The medium-term program calls for declining national government deficits starting in 2002, towards achieving a balanced budget by 2006.

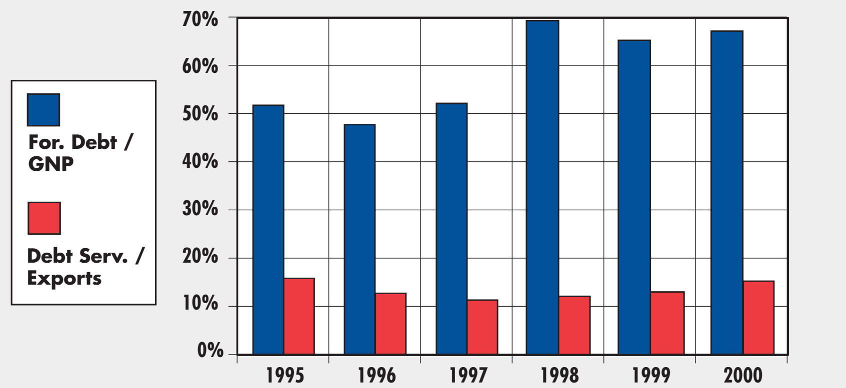
The government faces yet another challenging year of fiscal juggling. The 2001 spending program is tight. About 96% of the P71.3 billion (11.1%) increase in total cash disbursements is earmarked for "non-discretionary" expenditures (i.e., personnel-related services, debt servicing, and legally mandated transfers to local government units). This disbursement program translates to practically no growth for other expenditure items and, more alarmingly, to a 15% (P12 billion) year-on-year reduction for infrastructure outlays. Weak revenues could put a further squeeze on the already tight spending plan. The national government's revenue program has been set at P568.2 billion, 12.4% (62.5 billion) higher than 2000 inflows. That expansion hinges on a 15% (P67.7 billion) increase in tax revenues — 65% to 70% of which depends on domestic economic growth and the balance on improving tax collection efficiency.

According to preliminary estimates, total national government revenues for the first quarter of 2001 were P4.7 billion short of the programmed level. Tax collections were P9 billion off the mark, with more than P8 billion of that shortfall reflecting unmet internal revenue targets. Indicators suggest that a first-quarter economic slowdown may have contributed to the lower-than-expected collections. On the other hand, disbursements were P15.3 billion below the programmed level, which contained the three-month deficit to P38 billion (well within the P48.5 billion ceiling set for that period). It remains to be seen to what extent "under-spending" can continue to offset persistent revenue shortfalls.

Beyond the short-term challenges, structurally weak public finances pose a serious threat to the Philippines' long-term growth potential. Weak tax administration has been a long-standing problem. The Philippines' tax-to-GNP ratio is among the poorest in the region, hitting no more than 16.3% (posted in 1997) in more than two decades. That ratio sank to 13.8% in 1999 and languished further to 12.9% last year despite what was supposed to have been a stronger, broader-based economic recovery. On the expenditure side, the large (about 70%) share of "non-discretionary budget" items leaves the government with little leeway for fiscal maneuvering without sacrificing essential infrastructure investments and social development objectives. Personnel costs alone eat up about a third of the budget pie.

More aggressive efforts and stronger political will are required to achieving long-term fiscal viability. Corruption and inefficient tax collection have increased public resistance to new taxes, as well as eroded the intended gains of past tax restructuring efforts. The government's fiscal team has strongly resolved to live within its means by exercising fiscal austerity. However, revenue mobilization is crucial to sustaining a responsible deficit-reduction program. Reform of tax policy and administration is all the more urgent to ensure the Philippines has the resources it needs to make the basic expenditures needed to support a growing economy.

FOREIGN DEBT RATIOS



	1995	1996	1997	1998	1999	2000
FOREIGN DEBT/GNP (%)	51.7	48.6	53.0	69.5	64.7	65.6
DEBT SERVICE/ EXPORTS (%)	15.8	12.7	11.6	11.7	12.9	12.2

Foreign Debt and Debt Service

The national government's 2001 budget calls for total borrowings of P191.5 billion for debt amortization and deficit financing. The government plans to raise about 85% of that amount through domestic borrowings and the balance (equivalent to roughly $1.5 billion) from foreign borrowings. The heavy reliance on the domestic debt market reflects concerns over possible effects of foreign exchange rate pressures on non-hedged foreign-denominated obligations. The government also hopes to finance the budget at the least cost by drawing nearly $1 billion from already-committed official development assistance (ODA) loans while limiting its exposure to voluntary international capital markets to $500 million. Although spreads have tightened under a more stable political environment and the country faces better prospects for raising funds from voluntary capital markets, the cost of emerging-market debt remains relatively high. In addition, two large credit-rating agencies (Standard & Poor and Moody's Investor Service) — which downgraded the country's sovereign outlook last November — recently maintained their "negative" outlook for the Philippines.

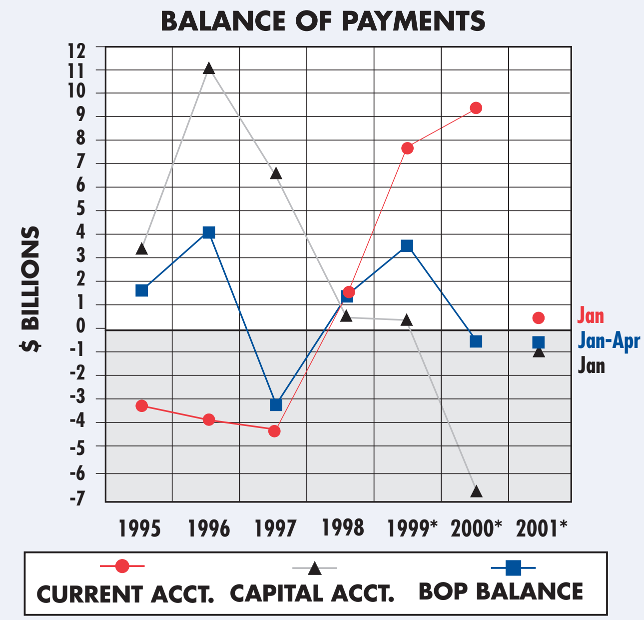
The government's envisioned draw-downs of official development assistance (ODA) funds will depend heavily on the ability to deliver on unfinished reforms which have already suffered delays (including restructuring the power sector and further measures to strengthen the banking system). Donors have long complained of implementation delays. The country's portfolio of unutilized ODA currently stands at about $13 billion. The new government is working to rationalize and prioritize its ODA portfolio to save on commitment fees and to better manage the limited resources currently available for local counterpart financing.

More receptive markets following the transition to a new government and the need to refinance obligations scheduled to mature during the year encouraged the Bangko Sentral ng Pilipinas to launch a three-year term-loan facility in March. The BSP raised $740 million from 19 local and foreign banks under that arrangement (which was 1.85 times oversubscribed and carried a 270 basis-point margin over LIBOR). The facility represented the first sovereign deal under the Macapagal-Arroyo administration. The BSP followed through in April with a $200 million floating rate note maturing in 2-1/2 years.

The government and the International Monetary Fund (IMF) have agreed on a periodic review of economic and policy developments under a "post-program monitoring" framework. The arrangement will not involve financial support from the Fund. The Philippines' two-year $1.4 billion standby arrangement with the IMF — twice extended from the March 2000 deadline — ended in December. The Philippines failed to make a graceful exit and to draw the last $300 million tranche from that facility, mainly because of the government's burgeoning fiscal deficit.

According to the most recent quarterly estimates, the Philippines' recorded external debt (based on foreign credits approved or registered with the Bangko Sentral ng Pilipinas) stood at $52.1 billion as of end-2000. That level represented a slight increase ($214 million) from end-September and a $150 million decline year-on-year. Net borrowings expanded by $1.2 billion quarter-on-quarter but were partially offset by currency revaluation adjustments during the period (mainly a weaker Japanese yen vis-à-vis the US$). Medium and long-term loans constituted nearly 89% of outstanding external obligations (with a weighted average maturity of 17 years). Almost half of external obligations were obtained from official creditors (defined as foreign governments and their export credit agencies, and multilateral financial institutions) at more concessional terms.

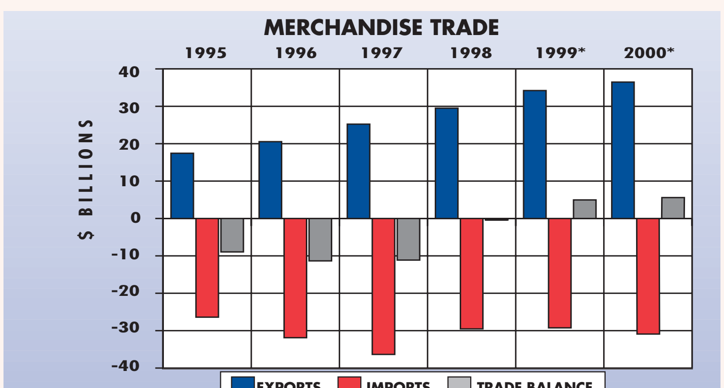
The foreign debt service burden remained manageable in 2000, equivalent to 12.2% of merchandise and service exports (from 12.9% in 1999). That lower foreign debt-service ratio reflected somewhat smaller debt service requirements for the year and a 4.1% expansion in goods and services export receipts. That ratio could rise in 2001, however, as debt service requirements outpace export revenues. Export receipts from goods and services (including remittances from Filipino overseas workers, a major source of foreign exchange) have moderated in recent years. These suggest vulnerabilities to unexpected reversals in export markets — highlighting the importance of addressing the weak state of government finances and attracting more sustainable, non-debt sources of balance of payments financing.



*Revised to reflect recommendations of IMF Technical Mission

Merchandise Trade and Balance of Payments

The Philippines ended 2000 with a $512 million balance of payments (BOP) deficit. Year-on-year, the current account surplus increased from $7.6 billion (9.4% of GNP) to $9.3 billion (11.7% of GNP) as the merchandise trade surplus widened. However, the capital and financial account — which ended 1999 about $1.6 billion in the red — plunged deeper into deficit ($6.8 billion). Net foreign direct investments mustered a modest increase to $1.6 billion. On the other hand, net portfolio investments ($45 million) dwindled from 1999's P6.3 billion surplus, combining with net repayments of foreign loans and short-term trade credits, as well as net outflows of other short-term capital. The Philippines last posted a BOP deficit in 1997.



EXPORTS	17.447	20.543	25.228	29.496	34.210	37.295
IMPORTS	-26.391	-31.885	-36.355	-29.524	-29.251	-30.380
TRADE SURP/DEFICIT	-8.944	-11.342	-11.127	-0.028	4.959	6.915

*Revised to reflect recommendations of IMF Technical Mission

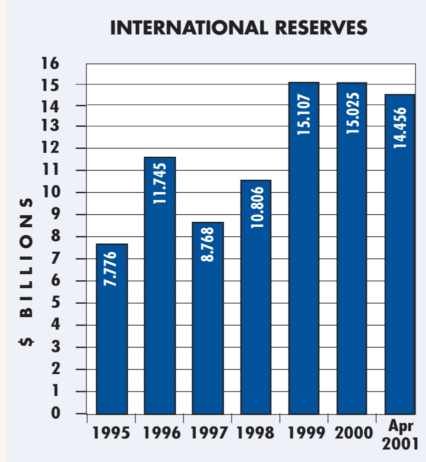
The merchandise trade surplus widened from $5 billion (1999) to $6.9 billion (2000). Export growth (up 9% in US$ terms) slowed to a single-digit pace for the first time since 1992 but outpaced the import bill's 3.9% year-on-year expansion. The export slowdown mainly reflected the slower growth in export receipts from shipments of electronics and telecommunications parts and equipment (which contributes about 60% to merchandise export earnings). That category slowed to 4.8% growth after expanding by an average annual rate of 30% since the mid-1990s. Industry analysts attributed the slowdown to softer prices for maturing products and technologies. They also noted that exports were bound to taper after the investment surge seen in the electronics industry from 1994 to 1997 (about $1.5 billion each year) came on stream. Total non-oil imports declined 1.2% year-on-year in US$ terms, with the bulk of the import bill's overall increase reflecting much higher world oil prices.

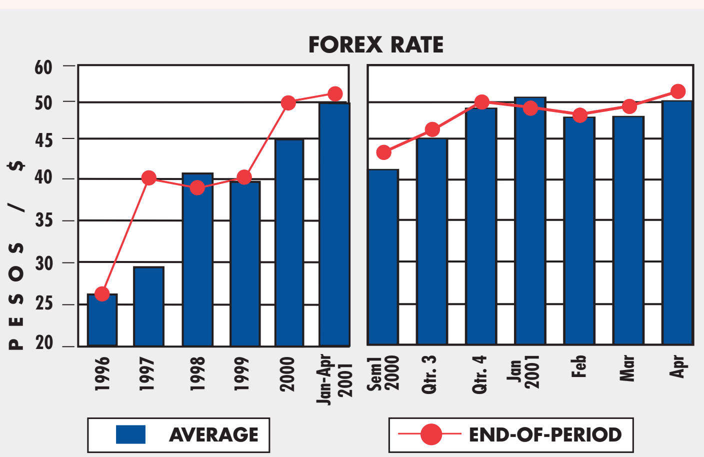
Export growth will falter further in 2001 as world economic growth and global electronics demand slow. The U.S. and Japan alone have historically contributed between 45% to 50% of export revenues, while about 60% of total export receipts come from shipments of electronic equipment and parts. Industry experts currently expect zero growth for electronics, as cyclical inventory adjustments to new-generation products combine with weak world demand. According to preliminary estimates, first-quarter 2001 export revenues declined 0.5% year-on-year, while the two-month import bill contracted by 9.3%. Low inventories may give imports some push in the months ahead, but offsetting factors (i.e., a weaker economy, the import-dependent nature of the country's major export products, and improved prospects for more stable world oil prices) spell tepid import growth. Although details are not yet available, the balance of payments is estimated to have ended the first four months of 2001 with a $784 million deficit, implying continued net outflows in the capital and financial account. With foreign investment flows apparently still on a "wait-and-see" mode and smaller foreign borrowings planned, the country's BOP appears headed for yet another deficit this year.

Although 2000 marked the second and third consecutive years, respectively, of trade and current account surpluses for the Philippines — a trend expected to continue in 2001 — longer-term BOP vulnerabilities remain. The Philippines' trade and current accounts have historically posted surpluses during periods of weak economic expansion. Long-term BOP stability will also depend heavily on the Philippines' ability to maintain and attract foreign direct investments in a more and more fiercely competitive world economy.

Foreign Exchange Rate and International Reserves

The foreign exchange market rebounded strongly on the first trading day (January 22) after President Macapagal-Arroyo was sworn in as the Philippines' new president. During that day, the peso (which had sunk to a historic intra-day low of nearly P56/US$ on January 17) traded at an intra-day high of P46/US$ (the highest seen in four months) and closed at P49.30. Positive political developments and generally calm regional markets gave the peso room to recover further for another month or so. The peso closed above the P48/US$ mark most days from February 12 to March 8, before losing ground from regional currency pressures (spurred mainly by Japan's weakening yen). The peso breached the P50/US$ mark in mid-April and closed that month at P51.40/US$. April 30's closing rate, 1.1% weaker than the trading day before, reflected the result of continuing protests of the arrest of former President Estrada. The prompt restoration of order helped the foreign exchange rate recover in the first week of May to P50.38/US$ (0.7% weaker than P50.01 at the end of 2000). Traders expected short-term movements to be tied increasingly to election-related news.





*End-of-period data refers to average foreign exchange rate on last trading day of indicated period.

Developments in the balance of payments combined with efforts to temper foreign exchange volatility in the first few weeks of the new year to reduce the international reserve cushion of the Bangko Sentral ng Pilipinas. Between end-December 2000 and end-February 2001, the BSP's gross international reserves (GIR) had declined from $15 billion to $14.2 billion. That level increased to $14.7 billion in March (boosted by the Bangko Sentral's $740,000 term-loan), before tapering to $14.5 billion by end-April. Lethargic imports have so far prevented a radical decline in terms of months of import cover. The end-April GIR cushion equaled 4.3 months worth of goods and services imports (compared with end-2000's buffer of 4.5 months) and equaled 2.5 times the Philippines' recorded short-term foreign debt. Considered as "secondary reserves", the BSP also estimated that banks' foreign currency deposit units (FCDUs) had about $13.8 billion in deposits as of end-2000, nearly 90% of which represented deposits of Philippine residents.

Population

In April, the Philippine National Statistics Office (NSO) released the final results of the May 2000 census (the full report can be viewed on the NSO web site at http://www.census.gov.ph). The figures were not encouraging. After years of steady decline (from 3.08% a year in the 1960s to 2.32% a year for the 1990-1995 period), Philippine population growth rates accelerated to 2.36% a year for the period 1995-2000. This gave the country a population of 76.5 million people on May 1, 2000. A growth rate of 2.36% means 1.7 million new Philippine citizens every year — equivalent to a city with three times the population of Washington, DC. At this rate, the population of the Philippines would double in 29 years.

At such a growth rate, the Philippines faces an enormous challenge in trying to reduce, let alone eliminate, poverty. Consider the vast amount of investment in infrastructure alone (i.e., schools, roads, housing, hospitals, water and sewage systems) that would be needed to support 1.7 million new Filipinos each year. Then add on top of that the private investment in plant and equipment needed to ensure jobs for all. The prospects are daunting, even discouraging.

Past progress in efforts to encourage family planning efforts can be regained with relatively little effort or cost. Key steps to rein in population growth can include simple efforts such as reducing tariffs and taxes on contraceptives and other health care needs, as well as steps to encourage competition in wholesale and retail markets for drugs and medicines. But the key to the success of any such programs will be a sustained effort and determined political leadership.

Challenges and Prospects

The combination of nearly six months of political upheaval and weakened prospects for global economic growth make it difficult to paint a rosy picture for the remaining months of 2001. Eking out about 3% GDP growth for the full year may be about the best that can be expected, under the circumstances.

But the fact remains that the Philippines could do many things to get itself out from "under the circumstances." The key to many of the needed actions will, of course, be resources, so as a first priority the government must redouble its efforts to improve revenue collections. In addition to improving enforcement to generate more revenue in the short term, the government should start now to consider ways to more deeply and broadly improve tax administration and policy to ensure a predictable flow of revenues in the future. Wrapped up in this issue, however, is a broad range of legislative, bureaucratic, and judicial reforms that will be needed to combat corruption and improve governance and transparency, reforms that must extend to all corners and levels of government. With increased revenues, the government could expand and improve its efforts to provide basic services like education (to ensure a steady flow of skilled, English-speaking workers prepared to enter the 21st century world of "e-business") and infrastructure (so exporters can get their products from the factory to the airport or seaport on decent roads).

The road ahead for the Philippines is full of ruts and bumps, some exogenous and some homegrown. Some of the low-hanging fruit of reform has already been harvested, such as the beginnings of trade and investment liberalization. The challenge will be to sustain those efforts, while moving forward for the more difficult reforms. Efforts to increase protection of intellectual property rights, for example, will require not just new legislation, but also additional funding for enforcement efforts and improvements in the judicial systems that investigate and hear such cases. Sustained success will be required to get the country off the United States' Special 301 list, to which the Philippines was elevated in April. The challenge will be for President Macapagal-Arroyo, the new Congress, and the broad range of NGOs, investors, businessmen, farmers, Church officials — that group commonly referred to here as "civil society" — to forge strong partnerships to ensure that reform laws are drafted and passed, and then implemented in a real and sustained manner. The formula for success is clear, but it requires Filipinos to come together and work for the betterment of all.

PROJECTIONS FOR 2001: SELECTED INDICATORS

	1999 Actual	2000 Actual	2001 Forecast[a]
GDP Growth (Year-on-Year, %)	3.3	3.9	2.7-3.2
GNP Growth (Year-on-Year, %)	3.7	4.2	2.9-3.5
Average Year-on-Year Inflation (1994=100, in %)	6.6	4.4	6.3-6.7
Average 91-day T-bill Rate (%)	9.99	9.94	10.5-11.0
Average Forex Rate (Pesos/US$)	39.04	44.19	50.50-51.50
Exports ($Billions)	34.2	37.3	37.3-38.1
Growth (Year-on-Year, %)	18.8	9.0	0.0-2.0
Imports ($Billions)	29.3	30.4	31.0-31.6
Growth (Year-on-Year, %)	4.1	3.9	2.0-4.0
Trade Balance ($Billions)	4.9	6.9	6.3-6.5

[a]Embassy projections as of May 2001

Sources: National Economic and Development Authority, Bangko Sentral ng Pilipinas, Bureau of Treasury

PHILIPPINES: KEY ECONOMIC INDICATORS
(In Million USD, unless otherwise noted)

	1999	2000	2001 *p/*	
Domestic Economy				
Population (millions, 2000 census)	74.7	76.5	78.3	
Population growth (%)	2.36	2.36	2.36	
GDP (current) ***a/***	76,653	75,190	-	
GNP (current) ***a/***	80,727	79,320	-	
Per Capita GDP, current dollars ***a/***	1,026	983	-	
Real GDP (% change, yr.-on-yr.)	3.3	3.9	-	
Real GNP (% change, yr.-on-yr.)	3.7	4.2	-	
Consumer Price Index (ave. % change, yr.-on-yr. 1994=100)	6.7	4.4	6.8	Jan-Apr
Production, Employment, Fiscal Accounts				
Unemployment rate (%) ***b/***	9.8	11.2	11.4	Jan
Industrial prod. (1985=100), % change yr.-on-yr.	0.9	3.6	-	
Nat'l gov't budget surplus/(deficit) ***a/***	(2,856)	(3,080)	(770)	Jan-Mar
as % of GNP	(3.5)	(3.9)	-	
Consolidated public sector surplus/(deficit) ***a/***	(2,570)	(3,481)	-	
as % of GNP	(3.2)	(4.4)	-	
Interest Rates (%)				
Weighted average T-bill rate (all maturities)	10.67	11.15	11.70	Jan-Apr
Average prime loan rate	12.6	12.9	15.47	Jan-Mar
Balance of Payments *f/*				
Exports (FOB)	34,210	37,295	5,694	Jan-Feb
Growth (%, yr.-on-yr.) ***f/***	18.8	9.0	1.7	Jan-Feb
Imports (FOB)	29,251	30,380	4,665	Jan-Feb
Growth (%, yr.-on-yr.) ***f/***	4.1	3.9	(9.3)	Jan-Feb
Trade balance	4,959	6,915	1,030	Jan-Feb
Current account surplus (deficit)	7,647	9,349	518	Jan
as % of GNP	9.5	11.8	-	
BOP surplus/(deficit)	3,588	(512)	(783)	Jan-Apr
Foreign Debt, as of end of period *c/*	52,210	52,060	-	
Debt service paid	6,055	6,027	632	Jan
Debt service (% of exports of goods and services)	12.9	12.2	16.7	Jan
BSP International Reserves, as of end of period	15,107	15,025	14,456	Apr
Exchange Rate (pesos/$)				
Average exchange rate	39.09	44.19	49.48	Jan-Apr
Closing ave. exchange rate ***d/***	40.30	49.99	51.34	Apr
Foreign Direct Investment (BSP registrations) *e/*				
Total (cumulative, since 1973)	11,412	12,810	12,900	Feb
U.S. (cumulative, since 1973)	2,806	3,052	3,057	Feb
U.S. share (%)	24.6	23.8	23.7	Feb
U.S.-Philippine Trade (Phil. Data)				
Philippine exports to U.S., FOB	10,445	11,381	1,589	Jan-Feb
Growth (%, yr.-on-yr.)	3.4	9.0	(5.5)	Jan-Feb
Philippine imports from U.S., FOB	6,365	4,879	820	Jan-Feb
Growth (%, yr.-on-yr.)	(3.0)	(23.3)	(21.7)	Jan-Feb
Philippine trade balance with U.S.	4,080	6,501	770	Jan-Feb
U.S. share of Philippine imports (%)	20.8	15.5	17.6	Jan-Feb

a/ originally peso values, converted to USD; ***b/*** annual figures computed as average of quarterly surveys (Jan/Apr/Jul/Oct); ***c/*** excludes "net due to" accounts of foreign commercial banks and private sector loans not approved and/or registered by/with the BSP; ***d/*** average on last trading day of indicated period; ***e/*** principally exercised to enable foreign exchange purchases from the banking system for capital repatriation and profit remittances; ***f/*** 1999 and 2000 figures reflect recent IMF-recommended technical revisions (but 1999 export and import growth rates were computed using unrevised 1999 data for comparability with 1998 figure); ***p/*** preliminary

Sources: National Economic and Development Authority; Department of Finance; Bangko Sentral ng Pilipinas