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**Working Paper**

## Currency Crisis: Where Do We Go From Here?

PIDS Discussion Paper Series, No. 1999-10

**Provided in Cooperation with:**

Philippine Institute for Development Studies (PIDS), Philippines

*Suggested Citation:* Lamberte, Mario B. (1999) : Currency Crisis: Where Do We Go From Here?, PIDS Discussion Paper Series, No. 1999-10, Philippine Institute for Development Studies (PIDS), Makati City

This Version is available at:

<https://hdl.handle.net/10419/187396>

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Philippine Institute for Development Studies

## Currency Crisis: Where Do We Go from Here?

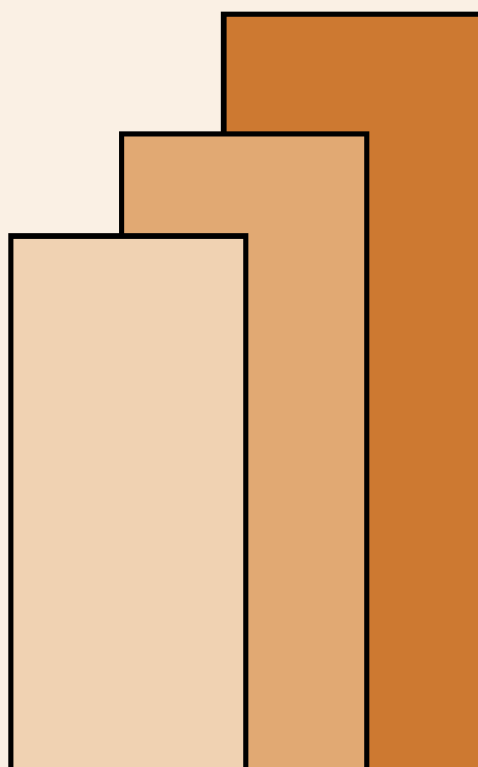
*Mario B. Lamberte*

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April 1999

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# CURRENCY CRISIS: WHERE DO WE GO FROM HERE?<sup>1</sup>

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## **I. Introduction**

The financial flu that started in Thailand in July 1997 quickly spread to other Asian countries. Indeed, the quickness and magnitude of the havoc the contagious flu inflicted on the emerging Asian economies are unimaginable. Just a few months before the regional crisis struck, most pundits considered some Asian economies such as Korea, Thailand, Malaysia, Indonesia, Singapore, Taiwan, and the Philippines, good investment havens. Currently, these economies are submerging under the weight of massive corporate and banking bankruptcies, causing untold economic, social and political problems. Interestingly, even international credit rating agencies failed to comprehend the emerging problems facing Southeast Asian economies and to anticipate the timing of the currency crisis.<sup>2</sup> Their emphasis on traditional country risk indicators, such as debt service payments, fiscal deficit, etc., totally missed the balance sheet problems facing the banks and the non-bank corporate sector.

Many have pointed out that the virus of the Asian flu already existed long before July 1997, but it was just waiting for any sign of weakness in the Asian economies to make its move. There were vital signs of the existence of such virus. More specifically, the emerging Asian economies pegged their currencies to the US dollar either formally or informally. They benefited from this policy in terms of rapid export growth when the US dollar depreciated against the Japanese yen. Growth in corporate earnings attracted huge inflows of foreign capital, which was facilitated by a more liberal policy on capital mobility. But when this situation reversed in 1995, currencies in emerging Asian economies became overvalued, making their exports less competitive internationally. The sharp devaluation of the Chinese yuan in 1994 further aggravated this situation. With imports becoming cheaper and exports less competitive, most emerging Asian economies began to run huge current account deficits. Thus, it was just a matter of time for these economies to make the necessary correction for the overvaluation of their currencies. However, when the correction came, it came in a big way with short-term

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<sup>1</sup>This paper was presented at the conference "Who is Afraid of Capital Controls?" on 4 November 1998 at the EDSA Shangri La sponsored by the Human Development Network (HDN) Forum. This is part of a larger research project of the Institute that examines the impact of the Southeast Asian financial crisis on the Philippine economy. The author is grateful to Ms. Ma. Chelo Manlangit for research assistance and Ms. Juanita Tolentino for secretarial assistance.

<sup>2</sup> It would be worthwhile to point out Wyplosz's (1998) observation that past crises often occurred without warning signals and came as a big surprise. Indeed, some observers like Young (1992) predicted a slowdown in Asian economies, but not a crisis.

foreign investors rushing to the door. As can be seen from **Table 1**, the devaluations ranged from 36 percent to 76 percent for emerging economies that ran huge current account deficits in 1996 and 1997. Surprisingly, even the currencies of Singapore and Taiwan, which have been running huge current account surpluses, were dragged down by the sharp devaluations experienced by their neighboring countries, prompting some quarters to howl at currency and stockmarket speculators. Notwithstanding the high interest rates pursued by these countries backed up by IMF bail-out packages, still capital continued to flow out, suggesting that currencies of these countries would remain unstable for quite some time. Krugman (1998a) suggested temporarily imposing currency controls as a way out for the crisis-hit Asian economies. Indeed, Malaysia took this route ostensibly to isolate itself from currency and stockmarket speculators, while the rest of crisis-hit Asian economies have been resisting this temptation. The continued weakness of the Japanese economy and a Chinese yuan devaluation could lead to another round of currency instability in the region before Asian economies can fully recover from the recent currency crisis, making the imposition of capital controls more tempting to do.

Should the Philippines give way to this temptation? This paper argues that the Philippines does not have to re-impose currency controls, in general, and capital controls, in particular, which it already substantially dismantled in the past few years, to deal with the on-going economic crisis. Instead, the paper offers some measures to minimize the vulnerability of the economy to a crisis similar to the present one.

To put the debate on capital controls on a broader perspective, the next section reviews the issues on the sequencing of economic liberalization. This is followed by a discussion on the forms of controls imposed by two countries on capital flows and the extent of their effectiveness. The fourth section describes the economic liberalization measures the Philippines has implemented since the 1980s and the existing foreign exchange regulations. The sixth section discusses some indicators that would point out the vulnerability of the Philippine economy to a crisis similar to the current regional crisis and recommends some measures so that the economy can better handle such crisis. The last section concludes the study.

## **I. Sequencing of Liberalization**

The currency crisis currently affecting the Asian region is not entirely new to the face of the earth. As documented well in Corbo and de Melo (1985), the Southern Cone economies of Latin America experienced similar problems in the late 1970s and early 1980s. To the surprise of many observers, this occurred at a time when the Southern Cone countries were liberalizing their economies to achieve a respectable growth rate. This is the same condition that existed in Asian countries when the currency crisis struck their economies.

Unwittingly, the liberalization of the Latin Cone economies facilitated the buildup of foreign debt, which eventually led to banking panics and massive corporate failures. This prompted authorities to reintroduce some controls on economic activities to

save failing banks and corporations. The dismantling of the controls and subsequent reintroduction of some controls to address unanticipated emerging problems led some analysts to think that apart from instituting the appropriate reform measures, proper sequencing of the implementation of these reform measures matter a lot. To maximize the gains from the reform measures, McKinnon (1991) suggested the following order of economic liberalization:

Fiscal control should precede financial liberalization. This is to be followed by liberalization of the domestic trade and financial markets. Next is the liberalization of the current account of the balance of payments. The liberalization of the capital account of the balance of payments should come as the last stage in the optimum order of economic liberalization.

As suggested by McKinnon, the gradual economic liberalization will eventually lead to full convertibility of the capital account of the balance of payments. Needless to say, the three elements mentioned above are preconditions to the liberalization of the capital account.<sup>3</sup>

The IMF recognizes the need for properly sequenced and careful liberalization, so that a larger number of countries can benefit from access to the international capital markets (Fischer 1998). In this regard, the IMF is currently working on an amendment of its charter that will make the liberalization of capital movements a purpose of the Fund.

Not all, however, subscribe to the order of economic liberalization put forward by McKinnon. As pointed out by Johnston (1998), one view holds that early capital account liberalization can play an important catalytic role in broader economic reforms, and can help overcome entrenched vested interests that otherwise postpone necessary reforms. The close linkage between political and economic power is pretty common in developing countries, weakening political will to implement much needed reforms. Accordingly, an open capital account can exert pressure on the authorities to institute the reforms.

Others hold the opposite view. No less than Keynes himself who said that “it is widely held that control of capital movements, both inward and outward, should be a permanent feature of the post-War system.”<sup>4</sup> Bhagwati added that if one believes in free trade, he does not necessarily believe in capital account convertibility. He advised that countries that have not yet liberalized their capital account should be left alone and should not be enticed by donor agencies to do so.<sup>5</sup>

Some economists (e.g., Roubini 1998, Sachs 1998) would rather go for a selective capital control. More specifically, they want some controls to be applied on short-term capital inflows (i.e., short-term loans and portfolio inflows) but not on foreign direct investment (FDI) and long-term loans. This is called the “sand-in-the-wheels” policy

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<sup>3</sup> A lot of authors echoed the same idea. For example, see Wyplosz (1998) and Johnston (1998).

<sup>4</sup> This is taken from Grenville (1998).

<sup>5</sup> This is taken from the IMF Economic Forum on “Capital Account Liberalization: What’s the Best Stance?” held on 2 October 1998.

targeting short-term capital flows, which are perceived by authorities as volatile and destabilizing. The controls are applied on inflows, not on outflows of capital. Accordingly, the objective is to prevent the problem from arising, rather than to attempt to clean up afterwards. One way of doing it is to impose a Tobin tax on short-term capital to make short-term speculation more costly while having little effect on long-term investment.

At the other end of the spectrum are economists, like Greenspan and Dornbusch, who go for unfettered capital mobility. Greenspan points out that

“free flow of short-term capital facilitates the servicing of direct investments as well as the financing of trade. Indeed, it is often difficult to determine whether certain capital flows are direct investments or short term in nature.”<sup>6</sup>

There are practical problems associated with designing capital controls when short-term capital flows cannot be clearly distinguished from long-term capital flows. The standard balance of payments table, which classifies capital inflows into various categories, is less useful in distinguishing which capital is really short-term or long-term. For instance, foreign capital invested in short-term time deposits or government securities can actually be rolled over several times. On the other hand, foreign capital invested in long-term instruments can be withdrawn on short notice if there is an active secondary market providing liquidity to those instruments. Controls imposed on secondary market of such instruments can certainly affect the primary market for long-term securities.

Dornbusch (1998) argues for the simultaneous liberalization of the both the current and capital accounts. He points out that “Since gradualism and sequencing are more likely to be hijacked by political pressures adverse to the best utilization of resources and a persuasive case for gradualism has never been made, full stream ahead is the right answer.” He also thinks that the Tobin tax on capital flows will be ineffective in preventing capital outflows, especially if the tax rate is much less than the rate of currency devaluation. Dornbusch points out that “Any one who contemplates 30 percent depreciation will happily pay 0.1 percent Tobin tax.” The same result would emerge – massive corporate bankruptcies.

## **I. Capital Controls in Action**

It would be worthwhile at this point to describe the types of capital controls imposed by some countries. In this regard, Malaysia is chosen because it is the first, and perhaps, the last country in the Asian region, to re-impose controls in response to the regional currency crisis. The other country is Chile because it has a long experience with various forms of capital controls and its recent capital control program has often been cited by many observers as a good example of how to deal with surges in capital inflows,

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<sup>6</sup> This is quoted from the testimony of Chairman Alan Greenspan before the Committee on Banking and Financial Services, U.S. House of Representatives on 16 September 1998.

which emerging economies in Asia experienced a few years before the regional currency crisis struck.

When Malaysia started to feel the pain of the Asian regional currency crisis, the authorities tried to implement the textbook approach for dealing the problems; that is, they tightened monetary policy and slashed government expenditures by postponing the implementation of mega-projects. As the economy continued to plunge and exchange rate remained unstable, it abandoned its original program and adopted in July 1998 the National Economic Recovery Plan, which relaxed monetary policy and increased fiscal spending. Together with these measures was the imposition of controversial currency controls, which were more sweeping than anticipated. Prime Minister Mahathir justified the currency controls on the grounds that the free market had failed "disastrously" because of "abuses". Malaysia's program has two primary objectives:

1. to eliminate speculative flows that had battered the Malaysian ringgit and the stock market for more than a year; and
1. to allow a progressive reduction in interest rates (without the risk of a deterioration in the exchange rate or capital flight) to encourage increased investment and consumption, and thus a reactivation of the economy.

The program includes: the fixing of the exchange rate of 3.8 ringgit to the dollar; the repatriation by October 1 of all ringgit held abroad; an end to offshore trading in ringgit instruments and to domestic credit facilities for overseas banks and stockbrokers; the retention of the proceeds of the sale of Malaysian securities in the country for a year; payment in foreign currency for imports and exports; and central bank approval for the conversion of the ringgit into foreign currency.

It is still too early to assess the impacts of these currency controls on the Malaysian economy. However, Krugman (1998b) quickly cautioned the Malaysian Prime Minister that its recently imposed currency controls should only be temporary, say three years or less, to buy space for economic growth and must be regarded as an aid to reform, not an alternative.

Chile has a much longer experience with capital controls. But unlike earlier capital controls that were aimed at limiting capital flight, the Chilean capital control program was aimed at changing the composition of capital inflows in favor of long-term capital. Like other emerging economies, Chile was experiencing surges in capital inflows in the 1990s. It imposed capital controls to support its tight monetary policy without necessarily undermining its export competitiveness. Its capital control program has several components:<sup>7</sup>

1. *Sterilised intervention.* The central bank has intervened in the foreign exchange market to prevent the real exchange rate from appreciating excessively, purchasing dollars in exchange for local currency to maintain the exchange rate within a 12.5 percent band around a dollar-DM-yen

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<sup>7</sup> OADB, July 24, 1998, III.

reference rate. The impact on the money supply has been sterilised by massive placements of central bank promissory notes.

1. *Investment regulations.* Capital investment is subject to a number of laws and restrictions specifying minimum entry amounts and the time which must elapse before capital can be repatriated:
  - Decree Law 600 requires foreign capital to enter Chile through a foreign investment contract with a specified minimum duration, which varies according to the industrial sector concerned. Capital cannot be repatriated until one year after entry, although there are no restrictions on the repatriation of profits.
  - Law 18,657 creates Foreign Capital Investment Funds. Foreign investment in public securities and equities is allowed, subject to a minimum amount of 1 million dollars, which must be invested within one year. Capital invested in these funds cannot be repatriated for a minimum of five years. Profit repatriation is not restricted.
1. *Reserve requirements.* The central bank has imposed reserve requirements on capital inflows, which attempt to discriminate between long-term capital investments and short-term “non-productive” inflows. Short-term inflows are subject to a one-year reserve requirement of 30 percent. This unremunerated reserve requirement (URR) effectively serves as a tax on short-term inflows. The aim is to reduce speculative capital inflows and increase the proportion of direct investment and long-term credit in the capital account.<sup>8</sup>
1. *Other mechanisms.* Chile has also used several other policy instruments to restrict the speculative inflow of capital, including minimum conditions for external bond and equity issues, and reductions in the availability and increases in the cost of swap facilities at the central bank. The authorities have also taken measures to encourage capital outflows, including the liberalization of pension fund regulations, in order to avoid excessive money supply growth.

Several studies were already made evaluating the effectiveness of the Chilean capital control program.<sup>9</sup> The results of these studies generally show that the effectiveness of the program in reducing short-term capital flows is ambiguous. At best, its effectiveness in changing the composition of capital inflows is very limited and short-lived.<sup>10</sup> The private sector eventually found a way of circumventing the capital controls and succeeded it. It is to be noted that Chile imposed the same URR in the 1970s and

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<sup>8</sup> Let  $r$  be the unremunerated reserve requirement, and  $i_f$  the nominal foreign interest rate, then the effective cost of foreign borrowing to a resident after the imposition of the reserve requirement,  $ei_f$ , becomes:

$$ei_f = i_f / (1 - r).$$

<sup>9</sup> For a good review of these studies, see IMF, *International Capital Markets: Developments, Prospects, and Key Policy Issues* (September 1998).

<sup>10</sup> Brazil's capital controls also failed to achieve the objective of limiting the volume of inflows or changing the composition of capital inflows. In fact, it abolished the tax of 1 percent levied on foreigners investing in the stock market in 1995 in the wake of the Mexican crisis to encourage inflows. Colombia's capital control program failed to reduce net capital inflows but succeeded in changing the composition of inflows (see Reinhart and Smith 1997a).



early 1980s, but unlike in the 1990s it failed to prevent the major banking and currency crisis in 1982. Edwards (1998) attributes the stability Chile has achieved in the 1990s to the much improved banking regulations after the introduction of banking reforms in 1986 rather than to capital controls. This is the same point stressed by Dornbusch (1998) in his critique on capital controls.

In their study using general equilibrium model, Reinhart and Smith (1997b) found that for the capital control to be effective in reducing capital inflows, the tax rate on capital inflows must be punitive. They also found that the benefit of capital inflow taxes is small and tends to vanish very quickly, suggesting that any capital control should only be temporary and must be removed shortly after the shock to the world real interest rate. Interestingly, Chile has recently started to relax its capital controls to encourage more capital inflows.

## **I. Economic Liberalization in the Philippines**

This section discusses the economic reforms implemented by the Philippine authorities since the 1980s and the existing foreign exchange regulations.

### **a. Economic Reforms**

The Philippines has its share of the Asian regional crisis, albeit less than those of its neighboring Asian countries. GDP growth rate for 1998 will likely be flat, which can be mainly attributed to the poor performance of the agriculture sector that was badly hit by the El Nino weather phenomenon and the slowdown of the industrial sector. But the Philippines is no stranger to economic crisis. A balance of payments crisis, the worst in Philippine history, hit the country in 1983-1984. Another one occurred during the 1990 Gulf war. Notwithstanding these crises, the Philippine authorities have continued the process of restructuring the economy through a series of reform measures. Although some of these reforms were made under certain adjustment programs supported by multilateral agencies, however, a considerable number of them were unilaterally done by the Philippine authorities. These are discussed below.

A comprehensive tax reform program aimed at raising more government revenues and, at the same time, addressing equity and efficiency concerns was implemented in 1986. It consisted of the following: (1) a shift from schedular to a more global approach in taxing individual income from compensation, business, trade and exercise of profession; (2) increase in personal and additional exemptions; (3) separate treatment of income of spouses; (4) an increase in the final withholding tax rate on interest income and royalties to a uniform rate of 20 percent; (5) the phase-out of the final withholding tax previously levied on dividends; (6) the unification of the earlier dual tax rate levied on corporate income to 35 percent; (7) the introduction of the value-added tax (VAT) in place of the sales/turnover tax and a host of other taxes; (8) the conversion of unit rates formerly used for excise taxes to *ad valorem* rates; (9) the abolition of export taxes; and

(10) further reduction in tariff rates.<sup>11</sup> Between 1990 and 1997, some tax measures were introduced to finetune the earlier tax measures and also to raise more revenues to support the fiscal adjustment program. In 1997, another round of comprehensive tax reform program was implemented for purposes of: (1) widening the tax base; (2) simplifying the tax structure to minimize leakages from undeclared revenues, overstated deductions and corruption; and (3) making the system more elastic and easier to administer to ensure adequate revenues in the future. Aside from the above-mentioned tax measures, the government seriously started in 1986 its privatization program, contributing a substantial amount to government revenues.

Because of the tax reforms, the tax effort increased from 11 percent in 1986 to 16.3 percent in 1997, which is comparable with those of its neighboring countries. As a result, the share of tax revenue in the total government revenue rose from an average of 82 percent during the period 1986-1991 to 86 percent during the period 1992-1996. A large chunk of the non-tax revenue came from privatization program.

The 1983-1984 balance of payments crisis taught the government a good lesson on fiscal management. Since 1986, fiscal policy was aimed at prudently managing the government fiscal position to support strong economic recovery and sustainable growth. By 1994, the national government achieved its objective of running a budget surplus (**Table 2**). In 1996, the consolidated public sector account recorded a surplus for the first time in two decades.

The deregulation of the domestic economy started in the mid-1980s. Price ceilings on all basic commodities, except oil products, were removed. The deregulation of the oil industry came only recently. The highly protected sectors of the economy, such as telecommunication, transport (air, water and land), and energy sectors, were opened up in the early 1990s. BOT scheme was introduced to allow greater private sector participation in the financing and implementation of government projects. The foreign investment act was passed in 1991, liberalizing entry of foreign investors within the provisions of the Philippine Constitution. As a general rule, there are no restrictions on the extent of ownership of export enterprises (defined as those exporting at least 60 percent of their output). As for enterprises oriented to the domestic market, foreigners are allowed to invest as much as 100 percent, unless the participation is prohibited or limited to a smaller percentage by existing laws and/or the provisions of the foreign investment act. All these measures have significantly improved the efficiency of the domestic economy as can be seen from the variety and favorable prices of goods and services being offered by players in each industry.

The 1983-1984 balance of payments crisis revealed the weaknesses of the banking system, eventually resulting in the weeding out of weak and poorly managed banks. Since then, the financial sector has undergone a massive restructuring (**Table 3**). Starting in November 1985, banks have been weaned away from the cheap

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<sup>11</sup> This is taken from Manasan (1998).

rediscounting window of the central bank so that they could be motivated to mobilize funds.

The authorities sought to enhance competition in the financial system by decontrolling interest rates, lifting the moratorium on opening new commercial banks and by substantially relaxing the rules on branching. Government-owned banks' participation in the credit markets was re-oriented towards supplementing the private banking system's initiatives rather than supplanting them. This is done by having the government financial institutions concentrate on wholesale lending rather than on retail lending and using private banks as credit conduits. The latest reform measure in the financial sector was the liberalization of the entry and scope of operations of foreign banks. The law that was passed encourages foreign banks not only to go into wholesale banking but also to engage in retail banking to provide more competition with local banks. As of December 1997, there were 20 domestic universal banks, 16 ordinary domestic commercial banks, 1 branch of a foreign bank with a universal bank license, 13 branches of foreign banks, 4 subsidiaries of foreign banks, 117 thrift banks, 832 rural banks, 12 non-bank financial institutions with quasi-banking license, and 6,935 non-bank financial institutions without quasi-banking functions.

The Central Bank introduced some measures to strengthen prudential regulations. These included, among others, the improvement in banks' reporting requirements and specific guidelines for asset valuation and loan loss provisions to tighten, standardize and apply criteria uniformly to all banks; regularly reviewing and increasing the minimum capital requirement; and several measures to curb insider abuse.

The process of deregulating the foreign exchange market started in mid-1991 and has continued to the present time. In some cases, the Central Bank phased-in the relaxation of some rules to test the reaction of the market. In other cases, it was done immediately.<sup>12</sup> A very important measure done by the Central Bank was the lifting of the prohibition on off-floor trading. The creation of the Philippine Dealing System, which started operating in April 1992, was the response of the Bankers Association of the Philippines (BAP) to the lifting of the ban on off-floor trading.

The creation of a new central bank, i.e., the Bangko Sentral ng Pilipinas (BSP), is a major institutional measure initiated by the government in 1993. It addresses two closely related issues: the independence of the central bank and the absorption by the national government of loss-inducing liabilities of the old central bank incurred in the early 1980s. This reform was facilitated by two factors. One was in response to the excessive use by the Executive Branch of the central bank to do quasi-fiscal functions, and the other was the growing sentiment in other parts of the world to make central banks a truly independent entity.

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<sup>12</sup> The existing foreign exchange regulations are discussed below.

Trade liberalization in the Philippines was done over a long period.<sup>13</sup> The first phase of the tariff reform program, which was implemented during the period 1981-1985, reduced all tariff ranges within 50 percent from highs of 100 percent. This was followed by an import liberalization program implemented during the period 1986-1988, which brought down the percentage of import restricted items to less than 10 percent. Another round of tariff reform program was implemented during the period 1991-1995, which narrowed the tariff range to mostly within 30 percent. The last and on-going tariff reform program, which commenced in 1996, aims at further narrowing down the tariff range to within 3 and 10 percent (excluding some agricultural products) by the year 2000. The Philippines is committed to implement a uniform 5 percent tariff by the year 2004.

After the 1983-1984 balance of payments crisis, the Philippine authorities tried to improve its management of external debt with some success. As can be seen from **Table 4**, the ratios of debt service burden to export shipments, exports of goods and services, current account receipts and GNP had been declining during the period 1986 –1996. The ratio of foreign exchange liabilities to GNP had also been declining while the ratio of gross international reserves to debt service burden had been increasing during the same period.

#### **b. Existing Foreign Exchange Regulations in the Philippines**

It may be worthwhile to discuss at this point the existing foreign exchange regulations of the Philippines to see where the country is right now in the spectrum of capital account convertibility.

##### *Sale and Purchase of Foreign Exchange*

In general, anybody may sell foreign currency for pesos to a bank without restriction. However, the purchase of foreign currency from the banking system is subject to certain restrictions and documentation. Residents may purchase foreign exchange from a bank up to \$10,000,<sup>14</sup> or equivalent, without need for documentary evidence of the underlying transaction over a 15-banking day period. Non-residents may only buy foreign currency from the banking system to the extent of the amount shown to have been previously sold by them to a bank. Non-resident individuals departing the Philippines may convert unspent pesos at airports or other ports of exit up to a maximum of US\$200 without proof of previous sale of foreign currency.

Pesos may not be taken into or out of the country in an amount exceeding P10,000 without authorization by the BSP.

##### *Trade-Related Foreign Exchange Transactions*

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<sup>13</sup> This is based on Medalla (1998).

<sup>14</sup> The ceiling used to be \$100,000 before the currency crisis.

Exporters of goods and services and overseas Filipino workers (OFWs) are given complete freedom in the disposition of their foreign exchange earnings. They may deposit their foreign exchange receipts in Foreign Currency Deposit Units (FCDUs). Exporters can hedge by selling expected export receipts forward in the foreign exchange market.

Banks may sell foreign currency to importers, without prior approval from BSP, for letters of credit, documents against payment, documents against acceptance, open account arrangements and direct remittance. However, all of the above require presentation of documents evidencing the underlying import transaction before foreign currency can be sold by the bank.

#### *Loan-related Foreign Exchange Transactions*

In general, loans to enterprises that are serviced using foreign currency purchased from the banking system must have prior BSP approval, except for the following: short-term export advances from buyers abroad; short-term loans to exporters, provided the loans are used to finance purchase of export-related goods from abroad; short-term loans to manufacturers, provided the loans are used to finance purchase of production-related goods from abroad; certain trade-related loans; and loans granted by foreign companies to their local branches. In these cases the loans must be registered with BSP even though prior approval is not required.

Applications for loan approval must be filed with the BSP at least 15 working days prior to the target completion of negotiations. The loans must be registered with BSP at least 15 working days prior to loan draw down.

Any Philippine enterprise planning to borrow an amount equivalent to at least US\$10 million must advise BSP of their borrowing plans at least six months prior to negotiations or mandate awards in the case of medium- and long-term loans, and at least one month in the case of short-term loans. The BSP usually grants approval only for foreign currency loans for export- or investment-related projects.

#### *Issuance of Securities in the International Capital Markets*

All issues of peso-denominated instruments in international capital markets require prior BSP approval. The transaction should not involve the import or export of Philippine currency, either physically or electronically.

#### *Foreign Investments*

Foreign investments need to be registered with BSP if the foreign exchange needed to service the repatriation of capital or the remittance of dividends, profits and any earnings that accrue, is to be purchased from the banking system. Proof of an actual transfer of assets into the Philippines is needed for the investment to be registered with the BSP.

All investments are classified into: direct foreign equity investments; foreign investment in government/listed securities; and foreign investment in money market instruments.

Repatriation of capital may be made any time upon presentation of appropriate documents. Any proceeds (i.e., profits, dividends, etc.) from an investment can be immediately repatriated in full. They may, however, be temporarily deposited in a bank prior to repatriation and any interest earned on the deposit can be remitted automatically without further registration. Reinvestments of the proceeds of an investment must also be registered with BSP.

#### *Outward Investment*

Philippine residents may purchase foreign currency from the banking system to invest abroad up to US\$6 million per investor per year without BSP approval or registration. Whether BSP approval is required or not, every application submitted to a bank to purchase foreign exchange for outward investment must be accompanied by a project feasibility study and a written undertaking to remit and sell for pesos, through the banking system, the dividends and profits earned from the investment. Any dividends or profits must be remitted to the Philippines within 15 days from receipt and converted into pesos within three working days after remittance.

#### *Forward Foreign Exchange*

All banks wishing to engage in forward exchange dealing must secure authorization from BSP. The BSP has prohibited banks from entering into non-deliverable forwards (NDFs) with non-residents where the bank sells foreign currency without prior BSP approval.

#### *Overbought/Oversold Foreign Exchange Position of Banks*

The BSP limits the open foreign exchange position of banks. The maximum amount a bank can be overbought in foreign currency against pesos is equal to 5 percent of its capital or US\$10 million (whichever is smaller), and the oversold ceiling is equal to 20 percent of its capital. The BSP has changed these ratios several times in the last five years to prevent banks from using their dollar resources for speculation. Most recently, it has required the consolidation of banks' accounts with their subsidiaries and affiliates when computing their net foreign exchange positions. The foreign exchange exposure of the bank must be revalued on a monthly basis.

The foreign exchange deregulation allowed the country to attain Article VIII status of the IMF. Thus, it can be said that the Philippines has already achieved current account convertibility. However, the same cannot be said of the capital account. Although the capital account of the balance of payments has been substantially liberalized in the last few years, still it is far from being fully convertible. In fact, some

of the controls were tightened in response to the crisis. However, it should be pointed out that the remaining capital controls in place are milder than those recently imposed by Malaysia and Chile.

The discussions above show that the Philippines has already undertaken wide-ranging policy reforms to restructure the economy in the last twenty years. The restructuring of the economy is far from being complete and more reforms are to be expected in the coming years. What is clear though is that the implementation of the reforms did not show a pattern close to the optimum order of economic liberalization proposed by McKinnon. Although the liberalization of the capital account started much later than the liberalization of the current account, however, it was done much faster than the latter.

## **V. Should the Philippines Impose Capital Controls?**

Before answering the question posed above, it is worthwhile to review briefly some factors that would show the vulnerability of the Philippine economy to a currency crisis and the effects of the huge peso depreciation on corporate debt and banks' balance sheets.

After a lackluster performance of the Philippine economy in the 1980s, it showed marked improvements in the 1990s. GDP growth rate had been increasing during the period 1992-1996, peaking at 5.8 percent in 1996. Concomitant with this was the rapid expansion of the business sector. To finance growth, the business sector had been borrowing heavily from the banking system. Thus, the total outstanding loans of the commercial banking system to the business sector rose to 52 percent of GDP in 1996, which was double that of 1993, and peaked at 58 percent in 1997 (**Table 5**). There were indications that the proportion of business sector loans denominated in foreign currency had been increasing in the 1990s. For instance, total loans of the foreign currency deposit units (FCDU) of the banking system rose from 4.4 percent of GDP in 1993 to 13.1 percent in 1996 and peaked at 17.4 percent in 1997 (**Table 5**).<sup>15</sup> The business sector, particularly the "blue-chip" companies had also been increasingly relying on foreign loans. Its share in the total foreign exchange liabilities of the country rose from 15.5 percent in 1992 to 21.8 percent in 1996, and increased further to 27.5 percent in 1997 (**Table 6**). Interestingly, the share of domestic banks in the total foreign exchange liabilities of the country had also been increasing from 2.6 percent in 1992 to 12 percent and 11.8 percent in 1996 and 1997, respectively. It suggests that the domestic banking system had been actively intermediating foreign loans most probably for less reputed corporations that could not directly access foreign capital. Banks then undertook both maturity and currency transformation, opening up to additional sources of weakness.

One of the indicators of the vulnerability of the country to a run on the currency is the amount of short-term loans and debt-service payments that could be covered by the

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<sup>15</sup> These are foreign currency denominated loans from the Foreign Currency Deposit Units (FCDUs) of banks.

gross international reserves available at the *Bangko Sentral ng Pilipinas*. Foreign creditors may not renew their short-term foreign loans the moment they see a marked deterioration in the domestic economy. Although the outstanding short-term foreign loans remained relatively stable during the period 1992-1995, it declined when expressed as a percent of total foreign exchange liabilities of the country (**Table 7**). In 1996 and 1997, however, short-term foreign loans, both in terms of outstanding amount and as a percent of total foreign exchange liabilities of the country, rose markedly.

If the ratio of debt-service payments plus short-term debt to gross international reserves were taken, it can be observed that the Philippines' vulnerability to a run on currency had declined substantially since 1992. However, the ratios were still high even when compared with those of Thailand. The ratio of M3 to gross international reserves, which also indicates the degree of financial vulnerability of the country as residents may try to obtain foreign currency for their domestic currency holdings during periods of economic instability, has been very high in the 1990s. Meanwhile, net portfolio inflow increased significantly in 1995 and 1996, adding more vulnerability of the country to a run on currency. In fact, it became negative in 1997 as a result of the currency instability.

The increased reliance on foreign currency denominated loans and rise in portfolio inflows, particularly in the two years immediately preceding the July 1997 currency crisis, could be attributed to a combination of two factors: the relative stability of the exchange rate especially in 1995, 1996 and the first six months of 1997 and the fairly large spread between the domestic and foreign exchange rates (**Table 8**). The peso was pegged to the US dollar, albeit informally, even though its trade with the US was roughly 25 percent of its total trade. When the dollar appreciated sharply against the yen and the European currencies after 1995, the Philippine peso also appreciated sharply against said currencies. Even though the peso looked stable at between P26.20 and P26.38 until June 1997, in fact the peso appreciated against the yen and other major European currencies, except the British pound.<sup>16</sup> It is to be noted that the *Bangko Sentral* engaged in sterilized intervention during this period to meet the monetary targets agreed upon between the government and IMF. This occurred against the background of a more open capital account. Thus, many corporations resorted to borrowing in foreign currency abroad or from FCDUs of domestic banks to save on interest cost. In many instances, banks encouraged their clients to borrow in foreign currency. Most of these loans were unhedged on the expectations that the exchange rate would remain the same. Also, most corporations were unfamiliar with hedging instruments.

The sharp depreciation of the peso in July 1997 had put many corporations more heavily indebted. As can be seen from **Table 9**, most of the debt-to-equity ratios of the top 1000 corporations in the country classified by sector inched up in 1997, suggesting that they had a fair amount of foreign currency denominated debts. The subsequent rise in the domestic interest rate and slowdown in demand had further weakened the financial conditions of many corporations.<sup>17</sup>

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<sup>16</sup> Wyplosz (1998) calculated that the real exchange rate appreciated by 47 percent during the period 1990-1997.

<sup>17</sup> Admittedly, some companies would have collapsed any way even in the best of economic environments.



The sad plight of the corporate sector contaminated the balance sheets of banks. The non-performing loans of the banking system rose from 4 percent of total loans outstanding in June 1997 to 10.1 percent in May 1998 and slightly went down to 9.7 percent in June 1998 (**Table 10**). One small commercial bank and six thrift banks were closed by the *Bangko Sentral*, while two medium-sized thrift banks were rescued by large commercial banks during the first ten months of 1998.

Given the discussions above, we can now ask the question: Should the Philippines impose capital controls to mitigate the impact of the regional crisis on the domestic economy and avoid encountering similar problems in the future? The answer is no for a number of reasons.

First, let us take the sequencing of liberalization argument for imposing capital controls. As already mentioned above, the Philippines did not adhere to the optimal sequence of liberalization suggested by McKinnon, which might have contributed to the currency crisis. Thus, the imposition of capital controls is called for until reforms in other sectors of the economy are completed. However, it could be argued the other way; that is, the Philippines could maintain the status quo with respect to the capital account but accelerate the needed reforms in other areas of the economy. For instance, the agriculture sector is still a highly protected sector. The same is true with the utilities and retail trade sectors. Some tax measures also need to be reviewed and rationalized. For instance, taxes on financial instruments create substantial distortions in the financial market.

The experience in the past clearly shows that it is very difficult to introduce reforms in many sectors of the economy. The danger with the imposition of capital controls is that it could be viewed as a signal for the weakening in the resolve of the government to continue with or to hold on to the reform measures already put in place and could open the flood gates for re-regulating many sectors of the economy. In fact, there has been strong clamor coming from certain industries for more protection from competing imports since the onset of the crisis. The same sectors are asking for the rationing of the available foreign exchange of the country in their favor.

In the end, the cost of imposing capital controls just to abide by the proposed proper sequencing of the reforms could be more costly to the economy. The process of liberalization outlined by McKinnon should take into account the starting condition of the country. Certainly, the Philippines is already far advance in terms of liberalization. That there is yet no persuasive case for gradualism as pointed out by Dornbusch should make us extra cautious in imposing capital controls.

Second, let us take the argument that the Philippines impose selective capital controls similar to that of Chile favoring long-term capital and discouraging short-term capital which is very volatile. As pointed out above, the results of some studies do not show persuasive evidence that Chile's selective capital control policy had been effective. Market participants can always find ways to circumvent regulations. The danger is that,

to avoid controls, capital flows will be channeled through riskier, less regulated financial institutions and instruments. It is to be noted that before the 1990s, the Philippines had rigid capital controls; still, a massive capital flight occurred during the 1983-1984 balance of payments.

The timing of imposing selective capital controls is also awkward because of the present direction of capital flows. More importantly, Chile's recent decision to relax its controls on capital to attract more foreign capital during this lean period signals to the rest of the emerging economies that this is not the proper time to impose such measures to prop up a sagging economy.

If the Philippines opts not to impose capital controls, then how can it reduce its vulnerability to a crisis similar to the ongoing Southeast Asian currency crisis? If we look back to the analysis made earlier, we can identify three factors that greatly contributed to the vulnerability of the Philippines to such crisis. These are: inappropriate exchange rate policy; poor corporate governance; and inadequate prudential regulations for banks. These are three interrelated factors that must be addressed squarely.

As shown above, the exchange rate was relatively stable, especially in 1995 and 1996, which could be attributed to a large extent to the sterilization measures adopted by the *Bangko Sentral*.<sup>18</sup> This could have been taken by market players as a signal that the country preferred to have a fixed exchange rate, at least informally. The defense of the peso made by the *Bangko Sentral* during the first few days of the crisis merely reinforced this view. Given the wide differential between domestic and foreign interest rates, the relatively stable exchange rate made it attractive for domestic corporations and banks to borrow abroad. Were a more flexible exchange rate policy adopted, domestic corporations and banks could have been made aware of the risks they were facing when they contracted foreign currency denominated debts.

Related to this is the lack of awareness of the corporate sector to hedging instruments. Exporters have natural hedge, but domestic-oriented corporations, which contracted foreign currency denominated debts, lacked that natural hedge. Instruments for hedging and managing risks, therefore, need to be developed and fully understood by market players. Hedging instruments can redistribute risks and assign them to those who can manage risks very well. Borrowers need to understand that the acquisition of hedging instruments comes with a price, which increases the effective cost of borrowing. In fact, if borrowers had only hedged their foreign currency denominated loans, the interest rate differential they observed could have been smaller than if their borrowings were unhedged. The, however, is that the price borrowers have to pay for buying hedging instruments could be lower than the losses they incur if the exchange rate moves against their position. In any case, borrowers have to weigh heavily this factor before deciding to borrow in foreign currency.

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<sup>18</sup> Lamberte (1995) found this policy to be ineffective.

In this modern world, the private corporate sector serves as the principal engine of growth in the economy. The Philippines can attest to this especially in the 1990s when the corporate sector grew significantly in terms of number and asset size. However, they need good corporate governance so that they can sustain their growth. Corporate governance is the assurance by a corporation that its assets will be managed in the best interests of owners and stakeholders. However, good corporate governance had hardly been exercised by many Philippine corporations. There were a lot of cases in which management and controlling owners of corporations misused corporate assets (e.g., expanding plant capacity without rigorous feasibility study, buying or establishing subsidiaries, etc.), often appropriating for themselves hefty salaries and bonuses despite deteriorating corporate financial conditions.

This is because existing governance instruments did not provide corporate owners and management with the incentive to use resources efficiently. For instance, disclosure of material information is not given emphasis. Even publicly listed corporations have remained opaque to most investors, especially to foreign investors.

Foreign investors, such as mutual funds, are usually not interested in the control of management of corporations but in the value of their stocks. When the controlling majority and management of a corporation pursues objectives other than profitability, such as expansion of market share and diversification, which are financed through excessive borrowing, foreign investors will likely divest themselves quickly to preserve the value of their money. Indeed, the 1990s witnessed the expansion of many corporations well beyond their core competencies.

While lack of transparency yields opportunities for making huge profits that warrant taking large risks, however, it can make the market susceptible to a herd behavior – that is, once doubts start, they can be self-fulfilling (Sachs 1998). Over-optimism based on lack of information about the conditions of corporations could easily change to over-pessimism. However, a culture of transparency and timely, accurate information can restrain the boom by enabling investors to assess risk more accurately, and it can cushion overreaction once a downward slide begins (Reisen 1998).

Finally, it is important to point out that a currency problem may originate from the banking system or it may start from the corporate sector and cause a problem in the banking system that ultimately may affect the entire economy. However, a safe and sound banking system will be resilient to such problem even in the face of sudden changes in investors' sentiments. This, of course, requires an effective prudential system to ensure that banks lend and invest safely and that owners put enough of their own money at risk to discourage them from gambling with depositors' money.

It cannot be denied that the Philippine banking system entered the 1990s with a much healthier balance sheet because weak banks were weeded out in the wake of the balance of payments crisis in the mid-1980s. However, with the deregulation of the financial sector in the 1990s, new banks entered the banking system enhancing its

competitiveness. This occurred against the background of weak prudential system. For example, “fit-and-proper rule” was not applied in the licensing of new banks allowing new investors with little background and experience in banking to establish banks. Risk-based capital standards were not put in place. Best practices in loan loss provisioning to ensure that banks’ financial capital is intact were not applied. The lack of transparency and inadequate disclosure requirements of banks even those that are publicly listed did not encourage banks to establish good internal governance. A system of prompt corrective action that specifies actions that the regulators must take as the condition of a bank deteriorates was not put in place. Delays in taking actions on ailing banks had weakened the public confidence in the banking system.

Given this background, destructive competition would naturally arise. Newly established banks took on more risks without adequate capital backing, encouraging other banks to do the same. Some banks even encouraged their clients to borrow in foreign currency without explaining to them that they will be exposed to currency risk aside from interest rate risk.

Admittedly, a good prudential system will take some years to develop. The General Banking Act has to be overhauled and the capacity of the supervisory staff upgraded. This is the propitious time to start reforming the prudential system of the banking system and upgrading the capacity of supervisory agency because short-term capital inflows will unlikely reach the level similar to that achieved before currency crisis in the next few years. Foreign investors are now more cautious when it comes to investing in emerging economies, not to mention the fact that yields on financial instruments in the US and European countries have lately become very attractive to investors.

## **I. Concluding Remarks**

This paper has reviewed the arguments for and against the imposition of capital controls in the Philippines and discussed the liberalization process undertaken by the authorities since the 1980s. The view espoused by this paper is that there is no need to impose selective capital control similar to that of Chile. However, to make the country less vulnerable to a currency crisis similar to that of the Southeast Asian currency crisis, the paper recommends three major measures: adoption of a flexible exchange rate; improving corporate governance; and strengthening the banking system by improving prudential regulations to make it resilient in the face of sudden changes in investors’ confidence.

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TABLE 1. SOUTHEAST ASIAN CURRENT ACCOUNT BALANCES AND CURRENCY MOVEMENTS			
	Current Account		Currency Decline
Nation	Balance		
	As Percent of GDP		Relative to US Dollar
	1996	1997	7/1/97 - 2/2/98
Indonesia	-3.4	-4.5	-76
Malaysia	-6.3	-9.9	-39
Philippines	-4.5	-2.9	-36
Singapore	15.2	16.2	-16
S. Korea	-4.9	-2.7	-43
Taiwan	4	1.8	-17
Thailand	-7.9	-4.2	-49
Source: J.P. Morgan, World Financial Markets, First Quarter 1998			

**TABLE 2. CONSOLIDATED PUBLIC SECTOR FINANCIAL POSITION**

**Annual Data: 1985 – 1997**

	1985	1986	1987	1988	1989	1990	1991	1992	1993	1994	1995	1996	1997
PERCENT TO GNP													
CONSOLIDATED PUBLIC SECTOR SURPLUS/(DEFICIT)	-5.9%	-6.6%	-1.8%	-3.1%	-3.8%	-4.7%	-2.0%	-1.9%	-1.7%	-0.5%	-0.1%	0.2%	-0.9%
PUBLIC SECTOR BORROWING REQUIREMENT	-3.0%	-4.3%	-1.3%	-1.9%	-2.7%	-4.1%	-1.3%	-1.5%	-3.7%	-0.4%	-0.8%	-0.6%	-1.6%
National Government	-2.2%	-5.2%	-2.5%	-2.9%	-2.1%	-3.4%	-2.1%	-1.2%	-1.5%	0.9%	0.6%	0.3%	0.1%
CB Restructuring									-1.0%	-1.4%	-1.0%	-0.6%	-1.0%
Monitored GOCCs	-1.4%	-1.1%	0.0%	0.4%	-0.3%	-1.8%	-0.6%	-0.8%	-1.7%	-0.6%	-0.1%	-0.5%	-0.7%
OPSF					-0.9%	-0.1%	0.8%	0.4%	-0.5%	0.1%	-0.5%	0.2%	0.0%
Adjustment of Net Lending and Equity to GOCCs	0.6%	1.8%	1.5%	0.8%	0.5%	0.5%	0.5%	0.2%	0.8%	0.4%	0.1%	0.1%	0.1%
Other Adjustments		0.3%	-0.3%	-0.2%	0.1%	0.7%	0.0%	-0.1%	0.2%				
OTHER PUBLIC SECTOR	-3.0%	-2.3%	-0.5%	-1.2%	-1.1%	-0.6%	-0.7%	-0.4%	2.0%	0.0%	0.7%	0.8%	0.7%
SSS/GSIS	1.0%	0.1%	0.8%	0.6%	0.8%	1.0%	0.6%	0.6%	0.8%	-0.7%	0.0%	0.4%	0.2%
BSP	-2.7%	-3.1%	-1.6%	-2.1%	-2.3%	-2.0%	-1.7%	-1.6%	-0.1%	0.3%	0.2%	-0.1%	0.1%
GFIIs	-3.3%	-2.1%	0.1%	0.2%	0.3%	0.3%	0.2%	0.3%	0.4%	0.2%	0.3%	0.4%	0.2%
LGUs	0.1%	0.1%	0.1%	0.1%	0.2%	0.2%	0.1%	0.1%	0.4%	0.3%	0.1%	0.2%	0.2%
Timing Adjustments of Interest Payments to BSP									0.5%	-0.1%	0.2%	-0.1%	0.1%
Other Adjustments	1.9%	2.5%	0.1%	0.0%	-0.1%	0.0%	0.0%	0.2%	0.0%	0.0%	0.0%	0.0%	0.0%
CONSOLIDATED PUBLIC SECTOR PRIMARY SURPLUS/(DEFICIT)	-2.8%	-1.5%	5.1%	3.9%	3.0%	2.5%	4.6%	4.5%	4.3%	4.8%	4.3%	4.1%	

Source: Department of Finance



**Table 3. Financial Sector Reform in the Philippines, 1986-1994**

<b>Policy Measures</b>	<b>Before Reform</b>	<b>After Reform</b>	<b>Date</b>
<b>I. Selective Credit Control</b>			
1. Central Bank rediscount window	Rediscount rate: varies by type of economic activities (allowable spread: 1%-11%)  Rediscount value: varies by type of economic activities (value: 60%-100%)	Uniform floating rate for all; no prescribed spread.  Uniform: 80%	November 1985  November 1985
2. Central Bank special credit programs	Directly managed special credit programs	Central Bank-managed special credit programs transferred to government financial institutions	1987-1988
<b>II. Bank Competition</b>			
1. Bank Entry	New commercial banks - moratorium since 1980; Other banks - no moratorium.  Foreign banks - no entry since 1949.	New commercial banks - moratorium lifted  Ten foreign banks allowed to have 6 branches each; foreign banks may acquire or establish a bank up to 60% of the total equity of each bank.	1989  1994
2. Branching	Restrictive branching policy - the country was divided into five service areas: heavily overbranched areas; overbranched areas; ideally branched areas; underbranched areas; and encouraged branching areas.	Branching was liberalized but the Central Bank retained discretionary power with respect to the opening of branches in certain areas considered "overbanked".  Banks may open branches anywhere they like provided they meet the required minimum capital requirement.	May 1989  May 1993
3. Government Banks	Largely doing retail lending that directly competes with private banks	More focus on wholesale lending using private banks as conduits.	since 1987
4. Interest Rates			
a. Deposit rates	No cap since 1981		
b. Lending rates	No cap since 1983	same	

Policy Measures	Before Reform	After Reform	Date
Private banks Special credit programs	Cap on end-user rate	No cap on end-user	1987
III. Prudential Measures		<p>Prohibiting concurrent officerships between banks or between a bank and a non-bank financial intermediary except with prior approval of the Monetary Board.</p> <p>Requiring each bank to cause an annual financial audit to be conducted by an external independent auditor not later than 30 days after the close of the calendar year.</p> <p>Requiring all banks and non-bank financial intermediaries to adopt the Statements of Financial Accounting Standards.</p>	<p>September 1986</p> <p>December 1986</p> <p>December 1987</p>
	Deposits of insider-borrower were protected by the Secrecy of Bank Deposits Law.	<p>The Central Bank declared a policy that it shall refrain from sustaining weak banks, except in times of general financial emergency or when specific banks face problems of liquidity rather than of solvency.</p> <p>Including contingent liabilities in the determination of the limit to which banks can lend to a single borrower or a group of affiliated borrowers.</p> <p>Insider-borrower shall waive the secrecy of their deposits for examination purposes.</p> <p>Increasing the minimum capital requirements for banks. Latest:</p> <p>Universal banks - ₱2.25B Commercial banks - ₱1.125B Thrift banks - ₱150M Rural banks - ₱20M</p>	<p>May 1989</p> <p>June 1993</p>

Policy Measures	Before Reform	After Reform	Date
IV. Foreign Exchange Markets			
1. Foreign exchange trading	On-floor	Off-floor through an electronic screened-based network for sharing information and undertaking transactions.	December 1992
2. Export receipts	Mandatory surrender of foreign exchange receipts.	Foreign exchange earners may retain 100% of total receipts and can use them freely without prior Central Bank authorization.	September 1992
3. Foreign exchange purchases	Limits on foreign exchange purchases such as travel, educational expenses, etc.	No limit.	September 1992
4. Repatriation and remittances of investments	Staggered from 3-9 years subject to Central Bank approval.	Full and immediate repatriation without Central Bank approval for foreign investments duly registered with the Central Bank or custodian bank.	September 1992
5. Outward investment by residents	Not allowed.	Allowed initially up to US\$1M, but lately increased to US\$6M.	1992 - 1994
6. Access to domestic FCDU loans.	No access.	Direct exporters allowed access.	September 1992
		Indirect exporters allowed access	July 1994

Source: Mario B. Lamberte, "Recent Financial Structure Reforms and Macroeconomic Management in the Philippines," PIDS (February 1995).

**TABLE 4. SELECTED EXTERNAL DEBT RATIOS**

Amount in million US dollars; Ratios in percent

Item	1986	1987	1988	1/ 1989	1990	2/ 1991	1992	1993	1994	1995	1996	1997
<b>I. Debt Service Burden (DSB) 3/</b>												
<b>Total</b>	<b>3,091</b>	<b>3,005</b>	<b>3,002</b>	<b>3,139</b>	<b>3,547</b>	<b>2,828</b>	<b>2,942</b>	<b>3,229</b>	<b>4,188</b>	<b>5,032</b>	<b>5,026</b>	<b>5,597</b>
Principal	1,117	1,092	994	915	1,712	1,140	1,607	1,791	2,647	2,853	2,820	3,029
Interest	1,974	1,913	2,008	2,224	1,835	1,688	1,335	1,438	1,541	2,179	2,206	2,568
Export Shipments	4,842	5,720	7,074	7,821	8,186	8,840	9,824	11,375	13,483	17,447	20,543	25,228
Exports of Goods & Services	8,633	9,174	10,666	12,407	13,028	14,464	17,267	18,872	24,033	31,821	39,549	48,063
Current Account Receipts	9,078	9,749	11,444	13,239	13,745	15,292	18,093	19,618	25,074	32,968	40,734	49,733
Gross National Product	29,250	32,616	37,546	41,958	44,073	45,656	53,889	55,321	65,742	76,180	87,084	85,742
Foreign Exchange Liabilities (End-of-Period)	28,256	28,649	27,915	27,616	28,549	29,956	30,934	34,282	37,079	37,778	41,875	45,433
Gross International Reserves (End-of-Period)	2,459	1,959	2,059	2,375	2,048	4,526	5,338	5,922	7,122	7,762	11,745	8,768
<b>II. Ratios</b>												
DSB to Export Shipments	63.84	52.53	42.44	40.14	43.33	31.99	29.95	28.39	31.06	28.84	24.47	22.19
DSB to Exports of Goods & Services	35.80	32.76	28.15	25.30	27.23	19.55	17.04	17.11	17.43	15.81	12.71	11.65
DSB to Current Account Receipts	34.05	30.82	26.23	23.71	25.81	18.49	16.26	16.46	16.70	15.26	12.34	11.25
DSB to Gross National Product	10.57	9.21	8.00	7.48	8.05	6.19	5.46	5.84	6.37	6.61	5.77	6.53
Foreign Exchange Liabilities to Gross National Product	96.60	87.84	74.35	65.82	64.78	65.61	57.40	61.97	56.40	49.59	48.09	52.99
Gross International Reserves to Debt Service Burden	79.55	65.19	68.59	75.66	57.74	160.04	181.44	183.40	170.06	154.25	233.68	156.66

p Preliminary

1 Excludes interest rebate of \$33 million.

2 Based on the revised methodology from 1990 onwards.

3 Debt service burden represents principal and interest payments after rescheduling.

Source: SPEI, Bangko Sentral ng Pilipinas

**TABLE 5. STRUCTURE OF LOANS OF THE COMMERCIAL BANKING SYSTEM****In Million Pesos**

	1990	1991	1992	1993	1994	1995	1996	1997	April 1998
1. Total Loans, Net 1/	215,631.86	230,783.61	278,040.32	376,176.66	483,937.94	678,679.98	1,117,966.31	1,400,081.67	1,378,635.33
% of Total Assets 2/	42.02	41.63	44.46	48.69	49.57	53.34	58.06	54.58	55.57
2. Restructured Loans, Net	4,265.97	4,920.54	8,433.57	9,252.72	8,386.55	5,289.13	13,257.97	14,271.35	15,624.68
% of Total Loans	1.98	2.13	3.03	2.46	1.73	0.78	1.19	1.02	1.13
3. ROPOA, Net	2,992.22	3,323.01	4,317.45	7,860.50	8,913.08	8,762.05	10,898.42	18,406.90	23,018.98
% of Total Loans	1.39	1.44	1.55	2.09	1.84	1.29	0.97	1.31	1.67
4. FCDU Loans (M US \$)	879.00	741.00	1,697.00	2,344.00	3,478.00	5,323.00	10,811.00	10,547.00	9,317.00
% of Total FCDU Assets	20.54	16.42	29.36	32.98	35.62	43.17	54.65	46.25	45.82

1 Excluding Interbank Loans

2 1994,1997 and 1998 were based on unadjusted total assets

Source: *Bangko Sentral ng Pilipinas*

**TABLE 6. TOTAL FOREIGN EXCHANGE LIABILITIES: BY BORROWER****End of Period****In Million US Dollars**

<b>Item</b>	<b>1992</b>	<b>% of Total</b>	<b>1993</b>	<b>% of Total</b>	<b>1994</b>	<b>% of Total</b>	<b>1995</b>	<b>% of Total</b>	<b>1996</b>	<b>% of Total</b>	<b>1997</b>	<b>% of Total</b>	<b>March 1998</b>	<b>% of Total</b>
Banking System 1/	4,709	14.67	3,298	9.28	4,143	10.70	5,452	13.85	8,632	20.61	10,664	23.47	11,086	24.28
Central Bank	2,337	7.28	-	-	-	-	-	-	-	-	-	-	-	-
Bangko Sentral	-	-	1,288	3.62	855	2.21	1,212	3.08	1,415	3.38	2,499	5.50	3,275	7.17
Commercial Banks	2,372	7.39	2,010	5.66	3,288	8.49	4,240	10.77	7,217	17.23	8,165	17.97	7,811	17.11
Government Banks 2/	924	2.88	1,489	4.19	2,308	5.96	2,240	5.69	1,838	4.39	2,187	4.81	2,162	4.73
Private Banks	1,448	4.51	521	1.47	980	2.53	2,000	5.08	5,379	12.85	5,978	13.16	5,649	12.37
Foreign Banks	603	1.88	422	1.19	376	0.97	259	0.66	348	0.83	609	1.34	686	1.50
Domestic Banks	845	2.63	99	0.28	604	1.56	1,741	4.42	5,031	12.01	5,369	11.82	4,963	10.87
Public and Private	27,381	85.33	32,236	90.72	34,580	89.30	33,915	86.15	33,244	79.39	34,768	76.53	34,575	75.72
Public	22,406	69.82	26,940	75.81	27,721	71.59	26,664	67.73	24,132	57.63	22,271	49.02	22,063	48.32
Public-NG & Others	22,406	69.82	25,293	71.18	26,015	67.18	25,172	63.94	22,943	54.79	21,393	47.09	21,227	46.49
CB – BOL	-	-	1,647	4.63	1,706	4.41	1,492	3.79	1,189	2.84	878	1.93	836	1.83
Private	4,975	15.50	5,296	14.90	6,859	17.71	7,251	18.42	9,112	21.76	12,497	27.51	12,512	27.40
of w/c: Red Clause														
Advances / Export Advances	1,053	3.28	1,097	3.09	508	1.31	426	1.08	421	1.01	496	1.09	498	1.09
<b>Total</b>	<b>32,089</b>	<b>100.00</b>	<b>35,535</b>	<b>100.00</b>	<b>38,723</b>	<b>100.00</b>	<b>39,367</b>	<b>100.00</b>	<b>41,875</b>	<b>100.00</b>	<b>45,433</b>	<b>100.00</b>	<b>45,662</b>	<b>100.00</b>

Notes:

1 Effective July 3, 1993, accounts of old CB were split between Bangko Sentral ng Pilipinas &amp; Central Bank - Board of Liquidators.

2 Accounts of the Development Bank of the Philippines have been reclassified from public non-banking to banking sector liabilities starting 1996.

Source: Bangko Sentral ng Pilipinas

**TABLE 7. DEBT-SERVICE, SHORT-TERM FOREIGN LOANS AND NET PORTFOLIO INLOW**

In Million US Dollars; Rates in values

Year	Short-Term Foreign Loans		Debt-Service Payments	GIR	M3	Exchange Rates (End-of-Pd)	(Debt-Service + ST Foreign Loans) G I R	Net Portfolio Inflow		M3 GIR
	Outstanding	% of Total Foreign Loans						Levels	% of GNP	
1992	5,256.00	16.379	2,336.00	5,218.14	15354.18	25.10	1.455	155.00	0.29	2.94
1993	5,035.00	14.169	3,973.00	5,801.47	17329.24	27.70	1.553	897.00	1.62	2.99
1994	5,197.00	13.421	2,892.00	6,994.62	24881.65	24.42	1.156	901.00	1.37	3.56
1995	5,279.00	13.410	3,458.00	7,632.62	29051.13	26.21	1.145	1,485.00	1.95	3.81
1996	7,207.00	17.211	5,047.00	11,620.04	33526.06	26.29	1.055	2,101.00	2.44	2.89
1997	8,439.00	18.575	7,207.00	8,649.63	26663.58	39.98	1.809	(406.00)	(0.47)	3.08
Jun-98	8,162.00	17.830	3,641.00	10,448.02	25726.02	42.09	1.130	389.00 1/	0.56	2.46

1/ Jan-Jun 1998

Source: Bangko Sentral ng Pilipinas SPEI

**TABLE 8. NOMINAL EXCHANGE RATE AND INTEREST RATE SPREAD**

Year		Nom. Exchange Rate (\$/P)	Interest Rate Spread		
			91-day T-bill	90-day LIBOR	Spread
<b>1992</b>	1992.1	25.38	18.74	4.39	14.35
	1992.2	25.58	15.08	4.00	11.08
	1992.3	25.12	15.62	3.28	12.34
	1992.4	25.10	14.77	3.63	11.14
<b>1993</b>	1993.1	25.51	13.31	3.24	10.07
	1993.2	27.27	10.75	3.34	7.41
	1993.3	29.81	10.88	3.12	7.76
	1993.4	27.70	14.36	3.36	11.00
<b>1994</b>	1994.1	27.57	15.05	3.89	11.16
	1994.2	26.91	14.74	4.64	10.10
	1994.3	26.00	11.45	5.12	6.33
	1994.4	24.42	9.64	6.38	3.26
<b>1995</b>	1995.1	25.99	11.24	6.27	4.97
	1995.2	25.58	14.14	6.01	8.13
	1995.3	26.07	10.05	5.86	4.19
	1995.4	26.21	10.94	5.75	5.19
<b>1996</b>	1996.1	26.20	12.76	5.39	7.37
	1996.2	26.20	12.91	5.56	7.35
	1996.3	26.26	12.10	5.62	6.48
	1996.4	26.29	11.59	5.55	6.04
<b>1997</b>	1997.1	26.37	10.54	5.61	4.93
	1997.2	26.38	10.45	5.80	4.65
	1997.3	33.87	13.90	5.72	8.18
	1997.4	39.98	16.70	5.91	10.79

Source: Bangko Sentral ng Pilipinas SPEI



**TABLE 9. TOP 1000 CORPORATIONS IN THE PHILIPPINES**  
**DEBT - EQUITY RATIO**  
**TOTAL / AVERAGE BY SECTOR**

SECTOR	1996	1997
1 Agriculture, Hunting and Forestry	1.6404	1.7116
2 Fishing	2.4864	3.2378
3 Mining and Quarrying	0.4409	0.7239
4 Manufacturing	1.2381	1.6124
5 Electricity, Gas and Water	2.3791	3.1262
6 Construction	1.7279	2.2961
7 Wholesale and Retail Trade	2.2953	2.7589
8 Hotels and Restaurants	0.7628	1.0447
9 Transport, Storage and Communication	1.7208	2.8850
10 Financial Intermediation	2.7735	2.9234
11 Real Estate, Renting and Business Activities	0.7065	0.8708
12 Public Administration and Defense; Compulsory Social Security	0.2827	0.1898
13 Education	0.3435	0.2408
14 Health and Social Work	0.6025	0.7071
15 Other Community, Social and Personal Service Activities	0.8429	1.1038

*Source: BusinessWorld Top 1000 Corporations 1997-98*

**TABLE 10. NON - PERFORMING LOANS, TOTAL LOANS  
AND LOAN LOSS PROVISIONS OF THE BANKING  
SYSTEM**

Annual Data: 1980 - Latest available

Ratios in Percent

Y E A R	NPL / Total Loans				Loan Loss Prov. / Total Loans			
	KBs*	TBs	RBs	Total	KBs*	TBs	RBs	Total
1980	10.966	5.623	26.976	11.288	2.062	0.168	1.783	1.950
1981	13.440	16.530	26.290	14.106	0.933	0.358	2.516	0.964
1982	15.352	7.281	20.204	15.203	1.270	0.475	1.954	1.265
1983	12.072	7.961	22.215	12.232	1.327	0.472	2.301	1.319
1984	21.013	15.070	36.272	21.245	2.537	0.667	2.905	2.465
1985	22.637	15.478	42.752	23.057	3.452	1.137	3.315	3.345
1986	20.442	14.358	41.811	20.879	22.228	1.115	3.638	20.591
1987	13.714	9.895	37.295	14.492	8.035	0.837	3.990	7.308
1988	10.797	8.030	34.906	11.618	5.966	0.854	4.078	5.483
1989	8.236	6.684	31.239	8.941	5.424	0.691	4.181	4.968
1990	7.175	7.238	28.502	7.863	4.683	1.403	4.252	4.417
1991	6.612	7.605	26.331	7.308	4.008	1.792	4.160	3.829
1992	6.132	7.870	24.426	6.837	3.395	1.724	3.765	3.266
1993	4.708	6.017	21.327	5.267	2.628	1.365	3.281	2.546
1994	3.931	8.359	18.166	4.711	1.883	3.077	3.219	2.027
1995	3.233	7.894	16.068	3.983	1.591	2.665	2.758	1.718
1996	2.799	7.741	14.139	3.513	1.240	2.685	2.036	1.387
1997								
Mar	3.294	7.434	14.858	3.946	1.319	2.271	2.022	1.422
Jun	3.373	7.742	14.633	4.030	1.305	2.106	1.941	1.393
Sep	3.962	10.091	14.950	4.756	1.435	2.166	1.847	1.509
Dec	4.688	10.633	16.177	5.433	2.211	3.119	1.953	2.275
1998								
Mar p	7.420	14.321	16.177	8.167	2.590	3.564	1.953	2.651
Apr p	8.595	16.263	16.177	9.371	2.678	3.658	1.953	2.737
May p	9.441	16.090	16.177	10.127	2.744	3.492	1.953	2.784
June p	8.947	16.760	16.177	9.710	2.744	3.949	1.953	2.818

Source: Bangko Sentral ng Pilipinas

