February 2009
IMF Country Report No. 09/62

Philippines: 2008 Article IV Consultation—Staff Report; Staff Supplement; Public Information Notice on the Executive Board Discussion; and Statement by the Executive Director for the Philippines

Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. In the context of the 2008 Article IV consultation with the Philippines the following documents have been released and are included in this package:

- The staff report for the 2008 Article IV consultation, prepared by a staff team of the IMF, following discussions that ended on November 14, 2008 with the officials of the Philippines on economic developments and policies. Based on information available at the time of these discussions, the staff report was completed on December 22, 2008. The views expressed in the staff report are those of the staff team and do not necessarily reflect the views of the Executive Board of the IMF.

- A staff supplement of January 14, 2009, updating information on recent developments

- A Public Information Notice (PIN) summarizing the views of the Executive Board as expressed during its January 16, 2009 discussion of the staff report that concluded the Article IV consultation.

- A statement by the Executive Director for the Philippines.

The document listed below has been or will be separately released.

Selected Issues Paper

The policy of publication of staff reports and other documents allows for the deletion of market-sensitive information.

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INTERNATIONAL MONETARY FUND

PHILIPPINES

Staff Report for the 2008 Article IV Consultation

Prepared by the Staff Representatives for the 2008 Consultation with the Philippines

Approved by James Gordon and Tessa van der Willigen

December 22, 2008

- **Discussions**: Manila, November 5–14, 2008. The mission met: Finance Secretary Teves, Bangko Sentral ng Pilipinas (BSP) Governor Tetangco, Budget Management Secretary Andaya, National Economic Development Authority Secretary Recto, other senior government officials, and private sector representatives.

- **Team**: Messrs. I.H. Lee (Head), Eskesen, Iizuka (all APD), Botman (FAD), Halikias (SPR), Ree (MCM), and Baqir (Resident Representative). Mr. Warjiyo (OED) attended some of the meetings.

- **Consultation focus**: Near-term financial sector and macroeconomic policies to safeguard domestic and external stability in the context of adverse global trade and financial spillovers. Medium-term policies to lower vulnerability.

- **Policy dialogue**: In recent years, the exchange of views with the Philippine authorities has been frank and constructive. Fund advice has found particular traction in the areas of fiscal consolidation, building a credible monetary policy regime, and sustaining reforms of the financial system and supervision.

- **Outreach**: The mission held a press conference on November 14, which was well attended and received extensive local media coverage.

- **Exchange rate**: Largely market determined. The Philippines has accepted the obligations under Article VIII, Sections 2, 3, and 4, and maintains an exchange rate free of restrictions on payments and transfers for current international transactions.

- **Data**: Data provision is adequate overall, but shortcomings remain. The 2004 Data ROSC identified national accounts and balance of payments statistics as weak. The authorities have made progress in these areas with technical assistance from STA.

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Executive Summary

Background: GDP growth is projected to decline to 4.4 percent in 2008 and further to 3½ percent in 2009, driven by softening external and private domestic demand. A deepening of the global economic downturn presents downside risks to this outlook. Inflation is expected to reach 9½ percent in 2008 and decline to 6 percent in 2009, led by a decline in commodity prices and weaker demand.

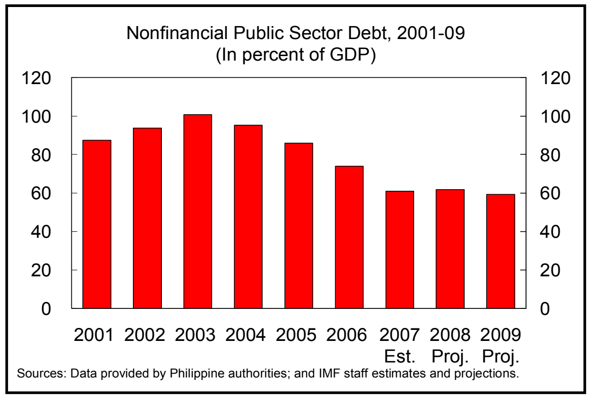
Policy issues: In light of the turbulence in the world economy and financial markets, the discussions centered primarily on the spillovers from the worsening external environment and policies to manage the associated near-term risks.

Staff's views: The BSP should continue to closely monitor the banking sector, including off-balance sheet activities. The BSP should also stand ready to apply existing liquidity facilities flexibly. The current prompt corrective action (PCA) framework is largely adequate to deal with spillovers, but a more rules-based approach could be considered over the medium term, and BSP staff should be legally protected against litigation. The proposed doubling in deposit insurance in a bill before Congress is welcome, but a provision allowing greater flexibility to raise the ceiling if needed should also be introduced. The Philippine Deposit Insurance Corporation (PDIC) should be recapitalized and the banking resolution tool kit could be further enhanced. The current neutral monetary stance appropriately balances the risks to inflation and growth, but there is scope to ease monetary policy if downside risks to growth materialize. The exchange rate is broadly in line with fundamentals, posing no threat to external stability. Fiscal policy could help cushion the current slowdown, but credibility considerations related to fiscal discipline leaves only room for a measured loosening. Looking ahead, the introduction of a formalized medium-term fiscal framework and streamlining of government-owned and controlled corporations would support fiscal consolidation efforts.

Authorities' views: Bank surveillance has been strengthened and steps have been taken to reduce risks related to off-balance sheet activities. There was agreement on the importance of legal protection of supervisors, the need to recapitalize the PDIC, and the merit in having flexibility to raise deposit insurance coverage further if needed. However, the current prompt corrective action and banking resolution frameworks were considered appropriate and there was no immediate need for enhancements. It was too early to ease monetary policy considering the high level of inflation. Moreover, a lowering of interest rates could add to downward pressures on the exchange rate, which would also be inflationary. However, there would be room to ease rates if downside risks to growth materialize and inflation expectations decline sufficiently. The exchange rate was assessed to be in line with longer-term fundamentals, similar to staff's assessment. Fiscal policy should play a counter-cyclical role, but there was agreement that near-term fiscal easing should be limited to preserve credibility. Fiscal consolidation remains a key medium-term policy objective.

I. Introduction

1. **Following solid economic performance in recent years, the economy now faces headwinds**. Over the past three years (ending 2007), GDP growth averaged 5¾ percent and gross public debt declined by more than 30 percent of GDP. Progress on fiscal consolidation and financial sector reform has allowed the economy to better capitalize on the benefits from globalization. However, managing the spillovers from the global financial turmoil and economic slowdown now present challenges.



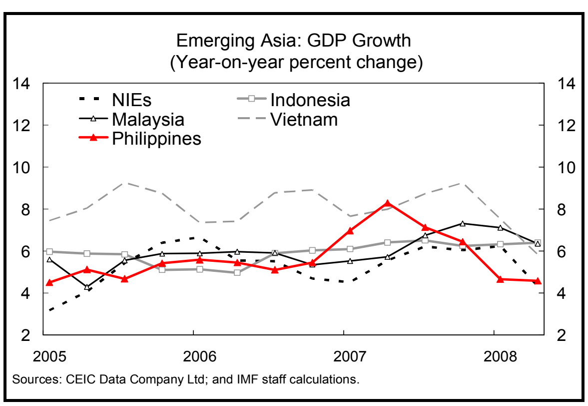
2. **Political support for reforms may wane**. The government has fended off calls for a repeal of the VAT on petroleum products following the sharp rise in oil and food prices earlier in the year. However, pressure to delay tax policy reforms could grow as the 2010 Presidential elections draw nearer.

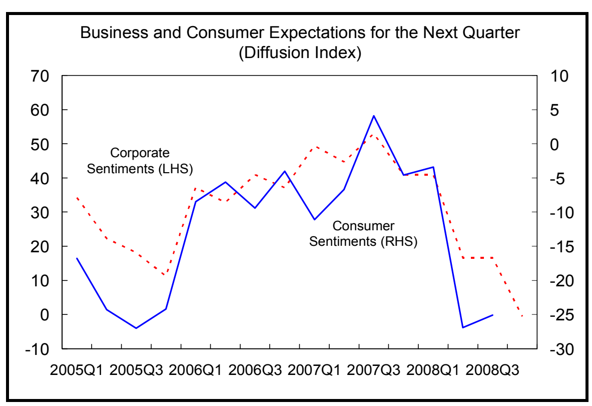
3. **The 2008 Article IV consultation took place in the context of a more challenging economic and political environment**. The discussions focused on policies to safeguard domestic, including financial, and external stability, especially in light of the ongoing global financial turmoil. They also focused on medium-term policies to lower vulnerability.

II. Recent Economic Developments

4. **The impact of the global economic strains has been contained so far, but the Philippine economy is not immune**.

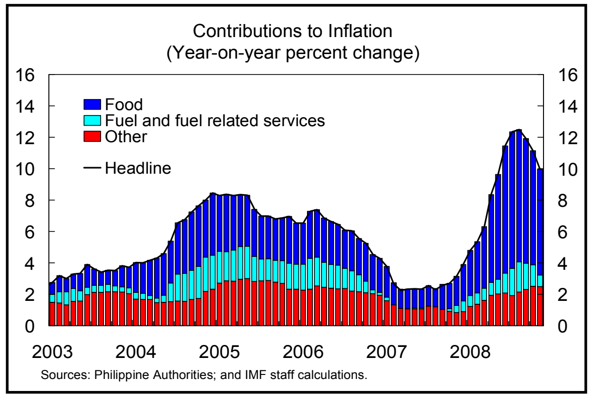
- *GDP growth moderated to 4.6 percent in the first three quarters of 2008 from 7.2 percent in 2007*. The slowdown was driven by weaker external demand and consumption as the oil and food price shock reduced real income, outweighing the



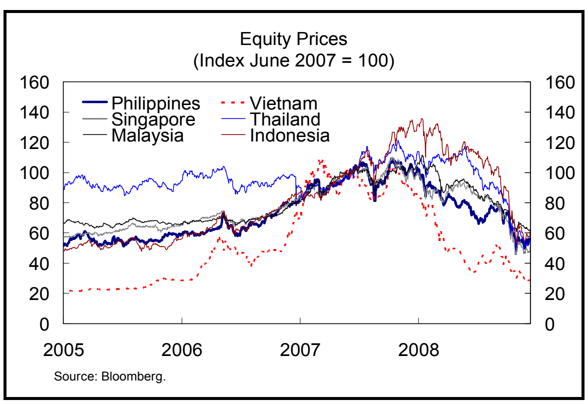


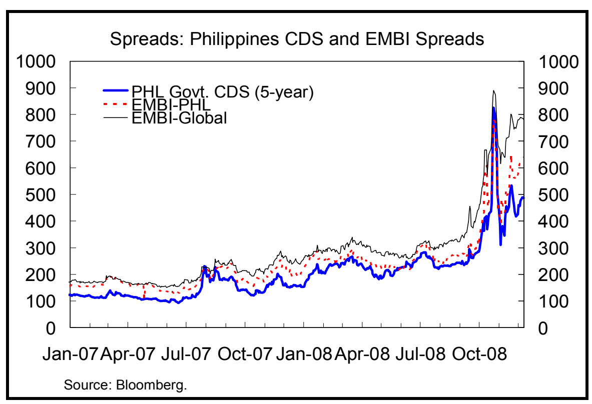
positive impact from robust remittances. Later in the year, the global financial turmoil further weighed down business and consumer sentiment, indicators of which suggest the moderation will continue into next year.

- *Inflation is high, but the momentum has slowed.* Headline inflation peaked in August at 12½ percent (year-on-year) led by higher food and fuel prices. However, it fell to 9.9 percent in November as annual gains in commodity prices receded. Moreover, there is currently no evidence of additional inflation pressures, including from wage adjustments.

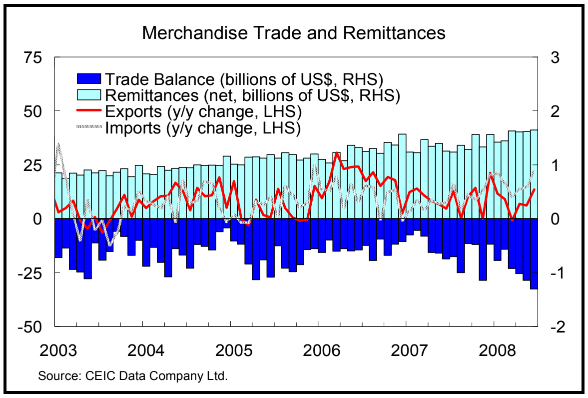


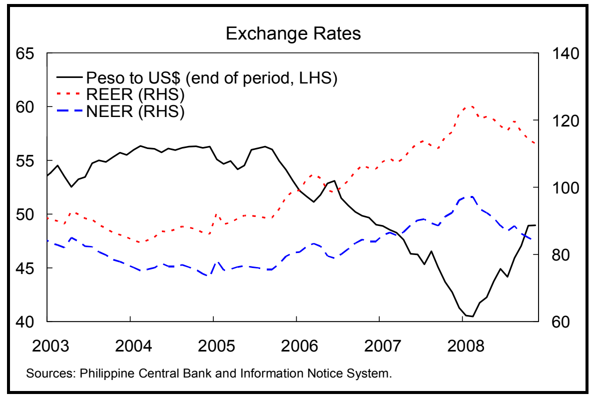
- *The spillover from the global financial turmoil to domestic financial and currency markets has intensified since September.* Equity prices have declined by around 45 percent in 2008, with almost half of the decline taking place since the turmoil of mid-September. The wealth effect has been limited, however, with less than 2 percent of the population invested in capital markets. Measures of credit risk have increased with (market-based) expected default frequencies of banks at elevated levels and Philippine sovereign spreads wider by 300 bps (EMBI+ PHL) since end-August. Yet, spreads remain 175−200 bps lower than the EMBI+ Global average, reflecting reforms in recent years and foreign exchange reserve accumulation during good times.





- *The external position has weakened and the exchange rate has depreciated.* Remittances have held up well so far, increasing by 17 percent (year-on-year) through September, reflecting the geographical and professional diversification of the Philippine workers (including presence in the Middle East). Even then, the current account surplus declined during the first half of the year as external demand waned and commodity prices increased sharply. Capital inflows also weakened during the same period. Net foreign equity outflows reached US$800 million through November, of which a third took place since end-August. Against this background, the peso has depreciated by 20 percent against the U.S. dollar and the real effective exchange rate by around 6 percent in 2008.



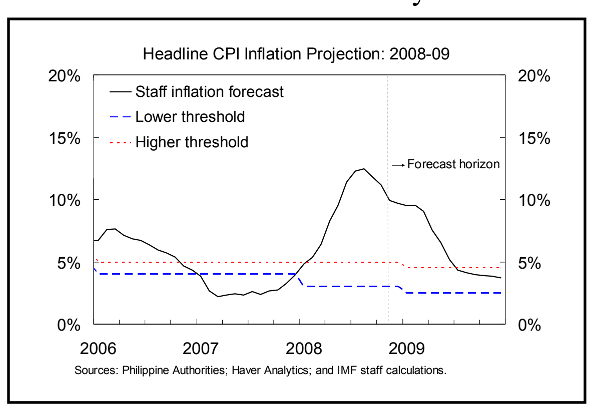


- *During the first half of the year, corporations saw their average profits cut by a third due to waning demand.* Nevertheless, strong profit growth in the past few years and some pre-financing during the capital market boom have reportedly provided a cushion to allow the large corporates to better weather the cyclical downturn in the near term. Moreover, the peso credit market, which is still liquid, could support somewhat higher domestic credit demand. However, smaller businesses, particularly in trade-oriented activities, appear to be under some stress due to slowing business and rising costs of trade credits.

III. Outlook and Risks

5. **Economic activity is expected to slow over the near term**.

- *Growth is projected to decelerate to 4½ percent and 3½ percent in 2008 and 2009*, respectively. On the supply side, the electronics industry is most susceptible to the external slowdown with industry analysts expecting the U.S. book-to-bill ratio to decline sharply given significant oversupply. Retail trade and financial services are also expected to grow at a slower clip with consumer sentiment already at its lowest since 2005. Staff projects inflation to reach 9½ percent in 2008 and 6 percent in 2009 (period average). With the steep decline in global commodity prices and weakening domestic demand, inflation is projected to fall within the target range of 3½ ± 1 percent in the later part of 2009, even after taking into account the pass-through from the recent peso depreciation.



- *Risks to the near-term outlook are tilted to the downside*. Financial sector stress could intensify if the global financial turmoil worsens or is drawn out (see Section IV.A). A deepening of the global economic downturn would weaken the external position, especially if remittances contract as the recession in the United States deepens and economic activity in the Middle East slows (Box 1). Fiscal reform delays, possibly due to the upcoming elections, could further push up financing costs as investors charge a higher risk premium. On the upside, globally coordinated fiscal stimulus, if it were to take place, could mitigate the downside risk.

Box 1. How Exposed is the Philippines to a U.S. Slowdown?

Philippines' economic linkages to the United States are quite strong. Trade linkages account for about 12 percent of GDP (including trade through third countries). Moreover, financial linkages and remittances present channels for adverse balance sheet and wealth effects.

The correlation with the U.S. cycle has almost doubled since the mid-1990s. Quantitative analysis suggests that a 1 percentage point decline in U.S. growth could lower growth in the Philippines by about 0.4–0.6 percentage point (directly and through other trading partners such as China). The extent of spillovers appears to have increased over time—in part, this may be the result of the development of the electronics sector in the Philippines and also reflect the rising importance of remittances from the United States.

Impact of a 1 Percent Decline in U.S. Growth 1/

	VAR Framework	Cross-Country Regression	Event Study
Japan	0.2	0.3	0.7
Australia	0.5	0.7	0.4
New Zealand	0.3	0.9	0.0
China	0.0	0.1	0.2
India	0.0	-0.2	-0.1
Hong Kong SAR	0.8	1.0	1.5
Korea	0.1	0.1	0.5
Singapore	0.9	1.1	4.1
Taiwan POC	0.9	1.2	2.9
Indonesia	0.4	0.2	-0.3
Malaysia	0.7	0.5	1.8
Philippines	**0.4**	**0.6**	**0.6**
Thailand	0.5	1.0	0.5
Asia	0.2	0.3	0.6
(excl. China and India)	0.5	0.5	1.1

Source: *Asia & Pacific Regional Economic Outlook*, April 2008
1/ In percentage points.

6. **The medium-term outlook depends critically on reform progress and the duration of the global economic slowdown**.

- *Growth is expected to pick up only moderately over the medium term in the baseline scenario*. As heightened risk aversion subsides and inflation recedes further, private investment and consumption will likely strengthen. However, absent deeper tax reforms to finance much-needed infrastructure and social spending, and measures to tackle a weak business environment, the upside is constrained.

- *A "worse" case scenario could entail a more prolonged period of strained conditions in the global financial system*. The world economy would be in a deeper recession than currently envisaged in the baseline, with spreads widening substantially and domestic growth falling well below potential. Economic activity would slow markedly and remain lackluster over the next couple of years. This environment will likely impose significant stress on the domestic banking system and could result in an extended period of bank restructuring, which in turn will further subdue economic activity. The balance of payments position could weaken considerably with a sustained decline in workers remittances, and the peso would be subjected to substantial downward pressures.

7. **The authorities broadly concurred with the staff's assessment**. Growth in 2009 is expected to be slightly higher than projected by staff, reaching 3.7−4.7 percent on account of stronger domestic economic fundamentals and supportive macroeconomic and financial sector policies (see Sections IV.A and IV.B). This was in part based on a more optimistic view on the resilience of workers remittances. The recent decline in oil prices was not expected to materially affect remittances from the Middle East, in part because many of the ongoing construction projects started before the spike in oil prices and were expected to be completed. Moreover, Filipino workers in the United States are increasingly employed in less cyclically sensitive professions (i.e., health care). However, the authorities shared staff's view that the near-term economic outlook was subject to downside risks and an elevated level of uncertainty, especially as regards external demand. The authorities expect inflation to fall within the target range during the second half of 2009, in line with staff's projections.

IV. Policy Discussions

Discussions centered primarily on (i) policies to manage the near-term risks related to spillovers from the worsening external environment and (ii) medium-term policies to reduce vulnerabilities, in particular the agenda for financial sector reform and fiscal consolidation.

A. Safeguarding Financial Stability—Tackling Global Spillovers

8. **Adverse global spillovers have so far been contained, but present challenges**.[1]

- *The exposure to failed and distressed global financial institutions is limited.* As of end-September 2008, direct exposures to Lehman Brothers stood at US$350 million (3 percent of equity), but a large part has already been provisioned for. Combined exposure to Lehman Brothers and 10 other distressed major global financial institutions amounted to US$1.5 billion or 13 percent of banking system equity. However, the exposures are concentrated in a few banks.

- *Banks are exposed to market risks through their large holdings of debt securities.* These account for about a quarter of total bank assets and consist primarily of Philippine government bonds, of which about half are denominated in foreign currency. Local banks are also exposed to credit linked notes (CLNs), issued by international banks and tied to foreign currency-denominated government securities. As such, changes in domestic interest rates or in sovereign spreads are leading to

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[1] See accompanying selected issues chapter on financial contagion for further details.

large mark-to-market losses.[2] Exposure to other structured products are, however, limited.

- *Banks have increased their off-balance sheet activities since 2007 in the form of unit trust funds and matching pools of investors with specific projects.* The size of these activities amounts to around P 1.2 trillion, or 20 percent of on-balance sheet assets.

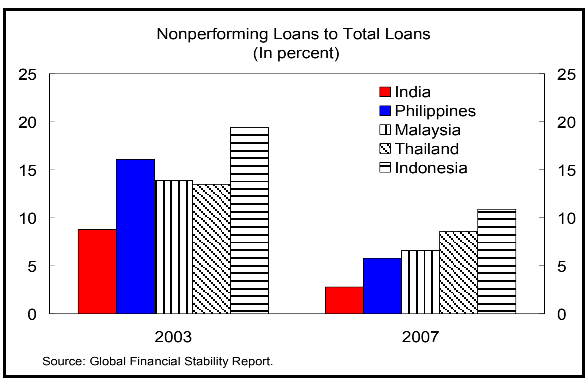
- *Profits fell in most banks during the first three quarters of 2008*. Despite increased lending, partly driven by a drying up of external funding and depressed equity markets, profits fell due to significant mark-to-market losses on fixed income instruments, lower service fees, and smaller interest margins. Moreover, a few large banks wrote down their claims on failed foreign financial institutions, particularly in the third quarter.

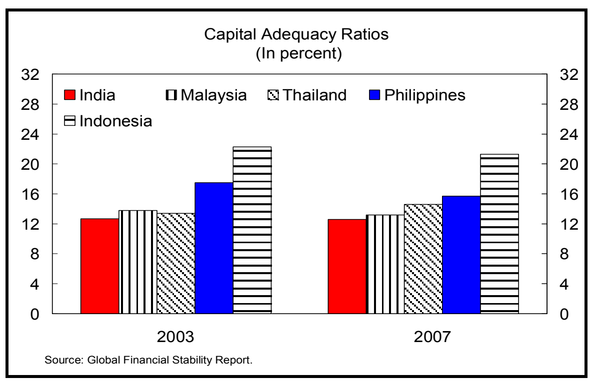
- *Banks are still weighed down by legacy assets.* The gross nonperforming assets (NPA), including foreclosed properties, are still large relative to banking system capital, and provisioning remains low.[3] Moreover, the NPA-to-equity ratio is high at around 30 percent.

9. **The banking sector confronts these problems from a relatively strong position**.

- *Nonperforming loans (NPL) have declined in the last few years*, falling further during the first half of 2008 to 5.2 percent of total loans (excluding interbank loans) and 84 percent have been provisioned for.

- *The CAR of the banking system as a whole is high by regional standards,* averaging around 15 percent by end-June 2008, although some banks are closer to the statutory limits.





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[2] Staff calculations suggest that a 100 basis point widening in EMBI-PHL credit spreads (currently around 500 bps) results in capital losses on US$-denominated government bonds and credit-linked notes of around 3 percent of equity, leading to a ½ percentage point decline in the capital adequacy ratio (CAR).

[3] Real estate (including foreclosed) holdings are generally not assessed at market value, but loss allowances are shown in balance sheet. If all foreclosed assets were mark-to-market, a 40 percent decline in real estate prices could wipe out 9 percent of banking capital (equivalent to a 1.5 percentage point decline in the average CAR).

10. **Moreover, risk-management practices have improved and surveillance has strengthened**. In line with the regional trend, commercial and universal banks adopted Basel II in June 2007, applying the standardized approach for credit risk and either the basic indicators approach or the standardized approach for operational risk. The implementation of Basel II resulted in lower CARs for the banking system, around 300 basis points, due to capital charge for operational risk and more punitive risk weights on NPLs, Real and Other Property Acquired (ROPA), and foreign currency securities. On its part, the BSP has stepped up its risk-based supervision in recent years, enhancing the CAMELs framework for monitoring bank risks.[4]

Basel II Implementation Schedule for Asia

	2007	2008	2009	2010
Hong Kong	Basic/Standardized/FIRB	AIRB		
Singapore		Standardized/FIRB/AIRB		
Japan	Standardized/FIRB	AIRB		
Korea		Standardized/FIRB	AIRB	
Taiwan	Standardized/FIRB	AIRB		
Thailand		Standardized/FIRB	AIRB	
Malaysia		Standardized		FIRB/AIRB
India		Standardized		FIRB/AIRB
Indonesia			Standardized	FIRB/AIRB
China				FIRB/AIRB
Philippines	Standardized			FIRB/AIRB

Source: FitchRatings.

Policy issues and staff views

11. **The banking system is exposed to domestic and external channels of risk**.

- *Through the local economy*: The economic slowdown will further reduce earnings and worsen asset quality as households, SMEs, and export-oriented firms find it more difficult to service their debt. In this environment, it will also be harder to dispose of the large portfolios of foreclosed properties.

- *Global spillovers*: A key risk to banks stems from mark-to-market losses. For some banks, these losses have already been significant and implied problems meeting the asset cover requirement for Foreign Currency Deposit Units (FCDUs), exacerbating the downward pressure on the peso. Off-balance sheet entities, including trust accounts, could entail reputational risks and other contingency risks for banks in case of significant redemption pressures.

As a result, some of the weaker banks could be subject to heightened stress in the baseline scenario, but especially if the global economic and financial environment deteriorates further than envisaged and triggers additional spillovers.

[4] CAMELS stands for Capital Adequacy, Asset Quality, Management, Earnings, Liquidity and Sensitivity to Market Risks.

12. **In response, the BSP has introduced a number of measures to help address the fallout from the global financial crisis**.

- *Surveillance and communication*: The BSP has enhanced its day-to-day monitoring of the banking system and stress-testing exercises, and it has sought to assure depositors that the banking system remains sound. However, there may be scope for stepped-up surveillance, including closer monitoring and supervision of off-balance sheet activities.

- *Regulatory forbearance*: Largely in accordance with the provision of the October 2008 amendments to International Accounting Standards (IAS 39), the BSP allowed banks[5] a window up until November 14 to reclassify securities from mark-to-market accounts to hold-to-maturity accounts and UDSCLs (unquoted debt securities classified as loans) based on any prevailing fair value between July 1 and November 14, 2008.[6] Also, the BSP exempted until March 31, 2009, unrealized mark-to-market losses from the calculation of banks' FCDU asset cover requirement. The staff highlighted the importance of the BSP's resolve to *not* let these measures impair transparency about the soundness of financial institutions. Moreover, to the extent pressures on emerging market bonds are expected to remain for a while, these measures delay rather than solve the problem.

- *Liquidity support*: The BSP has appropriately introduced a number of measures to support interbank liquidity (see Section IV.B). Staff encouraged flexible application of existing liquidity facilities as needed to stem any further stress.

13. **Strengthening the prompt corrective action (PCA) framework would be a good preparatory measure to adequately deal with any bank distress**. The current PCA framework appears broadly adequate to deal with spillovers from the global turmoil on individual local banks. In the short run, the BSP should be given legal authority to disclose enforcement actions, while preserving the right for secrecy in situations where disclosure may aggravate panic, rather than ameliorate it. Importantly, the amendments to the BSP charter ensuring legal protection of BSP staff, a long-standing issue, should be implemented without any further delay.

14. **The staff supports the authorities' plan to raise the deposit insurance ceiling, but saw scope for a more flexible framework**. The proposed doubling of deposit insurance to P 500,000 is welcome. However, to further strengthen safeguards during times of severe

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[5] BSP circular 628 and SEC Memorandum Circular 10 clarify that reclassification option shall not be availed to Unit Investment Trust Funds (UITFs), mutual funds, and investment companies.

[6] However, the BSP allowed reclassification of CLNs linked to foreign currency government bonds issued by the Republic of the Philippines without bifurcating of the embedded derivatives. This diverges from the international financial reporting standard, which requires derivatives to always be fair valued.

stress, the deposit insurance framework should provide for greater flexibility to raise the ceiling *if needed*.[7] It will also be key to recapitalize the Philippine Deposit Insurance Corporation (PDIC) to match the higher insurance liabilities under the new limits, and change to a risk-based contribution structure to help foster financial soundness.[8]

15. **The mission welcomes the envisaged enhancement of the banking resolution tool kit, including through the proposed introduction of a bridge-bank facility**. However, a more flexible application of the purchase-and-assumption (P&A) tool,[9] not contingent on the finalization of depositor payout, should also be considered. It could make takeovers more attractive and possibly lessen the need for activation of deposit insurance. To further enhance the effectiveness of the banking resolution framework, rights of existing shareholders of ailing banks should be limited; restructuring decisions should be legally irreversible; and PDIC staff should be protected against litigation.

16. **Medium-term considerations include the following**:

- *Shift to a more rules-based PCA framework,* including by formalizing triggers at multiple stages of financial soundness tied to accelerated stringency of remedial actions. This could help fast-track action on banks experiencing distress.

- *Address large overhang of foreclosed properties*, which are about 50 percent larger than the NPLs, with provisioning below 18 percent. They impair the return on capital and also leaves banks more vulnerable to property cycles. There is benefit to selling these properties with some haircut, rather than wait until property prices reach a certain threshold or establish joint ventures with developers to manage these properties. The current environment would, however, argue for a gradual sell-off.

- *Further develop capital markets to strengthen financial intermediation.* Less than 250 companies are listed on the stock exchange and only a fraction of shares are traded actively. Domestic bond markets have deepened in recent years, but government securities still account for 95 percent of the market. These underdeveloped capital markets reflect high industrial concentration and large conglomerates funding their operations from retained earnings and bank borrowing.

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[7] The current limit is P 250,000 (US$5,300), which covers only about 14 percent of the total value of deposits. Moreover, the PDIC capital base is small with only P 50 billion readily available in the deposit insurance fund. The PDIC has, however, a credit facility at the BSP, and under its charter could issue its own bonds.

[8] The audited net assets of the Philippine Deposit Insurance Corporation (PDIC) are relatively low at 1½ percent of system deposits (P 49 billion; end-2006). Moreover, premiums are uniformly capped at 0.2 percent of the insured amount irrespective of risk profiles of banks.

[9] Bundling certain assets and liabilities together for sale from a failed bank can sometimes help bank liquidators better recover than selling or arranging a merger for the whole bank. This bundled sale is called P&A as the purchaser of the assets simultaneously assumes the liabilities.

Improving the business climate should go in tandem with future developments of the capital market where a strong clearance and settlement infrastructure is a key precondition. Continued efforts to shift the public bond mix toward domestic issuance could help deepen debt markets. Moreover, transition towards funded pension schemes could help generate local portfolio investment demand.

The authorities' views

17. **The authorities agreed with the basic contours of the staff's assessment, although they found the existing contingency framework adequate**.

- *Channels of risk*: They shared staff's view on the domestic and external channels of risk. However, they noted a number of risk-mitigating circumstances: (i) despite a pickup in lending in recent years, the loan-to-deposit ratio is still low; (ii) sector loan concentration is limited and NPLs have continued to fall; (iii) bank capitalization is high and exposures to risky financial instruments are low; and (iv) corporates generally have strong balance sheets.

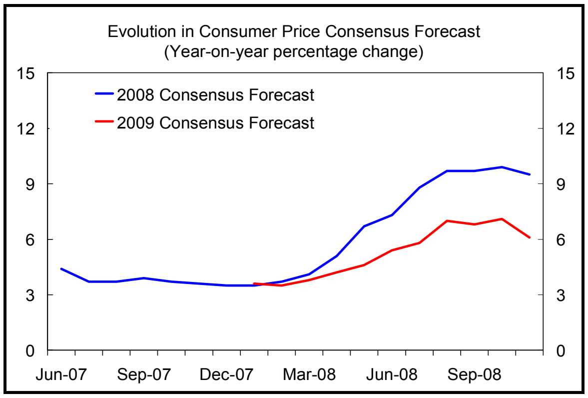
- *Contingency measures*: The authorities agreed with the need for a proactive approach for remedial action and considered their existing PCA framework as adequate to deal with banks under stress. They pointed out that a more rules-based PCA approach would leave them with less flexibility to deal with individual bank cases, which often differ and require a more idiosyncratic response. Legal protection of supervisors and restriction of shareholder rights during bank restructuring were considered a priority. They also agreed with the need to recapitalize the PDIC and saw some merit in having flexibility to raise the deposit coverage temporarily if needed. At the same time, they did not think a more flexible application of the P&A tool would necessarily lead to more effective bank resolution, but could actually cause instability if it was perceived as a restriction on depositor rights. The authorities also pointed out that steps have been taken to reduce risks related to off-balance sheet activities, including through the introduction of enhanced client suitability requirements and disclosure/sales provisions of unit investment trust funds.

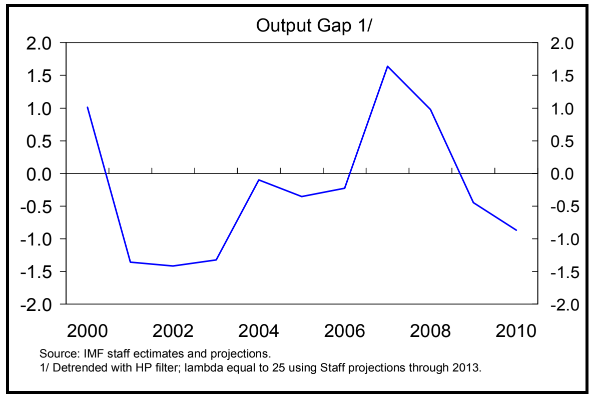
B. Monetary and Exchange Rate Policies

18. **The authorities' concerns have now shifted from inflation to global economic and financial spillovers**.

- *Monetary policy was tightened midyear in response to the rapid rise in inflation, but subsequently moved to a neutral stance.* The BSP raised policy rates in June, July, and August by a combined 100 bps—taking the reverse repo rate (RRP) to 6 percent.

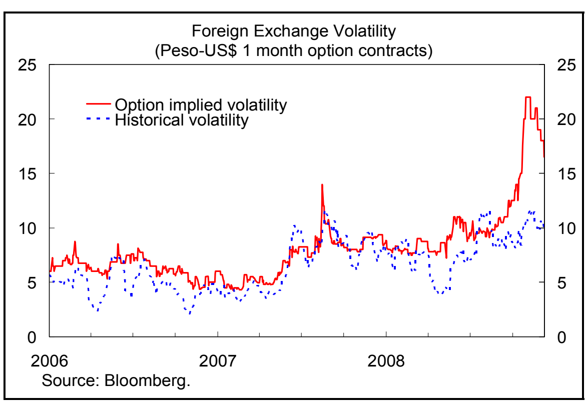
However, the BSP left rates unchanged at the October and November monetary meetings, citing an improving inflation outlook.

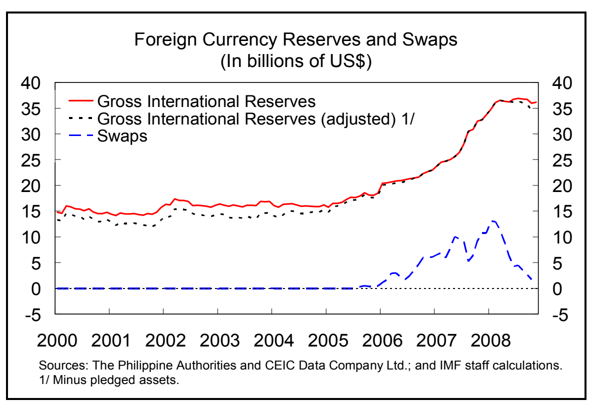




- *The central bank has taken a number of steps to support liquidity.* While peso liquidity is still adequate, the reserve requirement was preemptively reduced by 2 percentage points to 19 percent, and the amount allocated for the rediscount window was doubled from P 20 billion to P 40 billion. To address some segmentation of the dollar interbank market, the BSP opened a dollar-denominated deposit window and a short-term dollar repurchase facility. Moreover, banks have entered a "gentleman's agreement" to reduce their over-bought dollar positions by 50 percent, step up interbank dollar lending, and increase scrutiny over clients' foreign investments.

- *The exchange rate has come under pressure from the weakening balance of payments and a shift to long dollar positions.* In response, the BSP has drawn down US$9 billion of its foreign exchange swap position so far in 2008 and built up a US$1.4 billion short position of nondeliverable forwards. Gross international reserves have been kept steady at around US$36 billion (240 percent of short-term debt), partly propped up through higher external borrowing by the BSP.





Policy issues and staff views

19. **The shift from a tightening to a neutral monetary stance was appropriate considering the rebalancing of risks**. Staff shares the BSP's assessment that inflationary

pressures are beginning to recede, led by falling commodity prices and a softening demand outlook. Moreover, the downside risks to growth and the elevated level of uncertainty surrounding the near-term outlook are important considerations.

20. **If downside risks materialize, the policy response would depend on the nature of the shock**. In the event the economic slowdown proves protracted and inflation expectations adjust sufficiently downwards, a likely scenario, monetary policy could be eased (Box 2). In this case, the exchange rate should be allowed to fully adjust to the changing external environment, limiting interventions to smoothing erratic movements. However, in the case of a temporary financial shock arising from further global portfolio adjustment, the BSP could use a mix of interest rate hikes and limited unsterilized intervention to support the peso. In both cases, preserving the level of reserves at a sufficiently high level will help provide confidence in the peso and the resilience of the financial system.

21. **The exchange rate is assessed to be broadly in line with the level implied by longer-term fundamentals**. As such, it does not pose a threat to external stability. This assessment rests on a number of observations, including (i) interventions in recent years have been in both directions, intended to smooth erratic exchange rate changes; (ii) current account balances projected at a constant real effective exchange rate imply only a small improvement in the net foreign asset position over the medium term; and (iii) quantitative estimates suggest the exchange rate does not deviate significantly from its long-term equilibrium level, especially when taking remittances into account.[10]

Equilibrium Exchange Rate Estimates: CGER

	Current account assumptions			Real exchange rate	
	Elasticity	Underlying balance 1/	Equilibrium balance 1/	Gap 2/	Gap, adjusted for multilateral consistency 2/
Macroeconomic balance approach: 3/	0.24	0.5	-1.2	-8.2	-5.3
External sustainability approach: 3/	0.24	0.5	-1.7	-10.6	-9.2
Equilibrium real exchange rate approach:	n.a.	n.a.	n.a.	12.9	12.3

Sources: CGER and; IMF staff estimates.

Note: Reference period for the CGER and the mission team's assessments are September and November, 2007, respectively.

1/ Ratio of current account balance to GDP.
2/ Undervaluation="-".
3/ Based on medium-term projections through 2013.

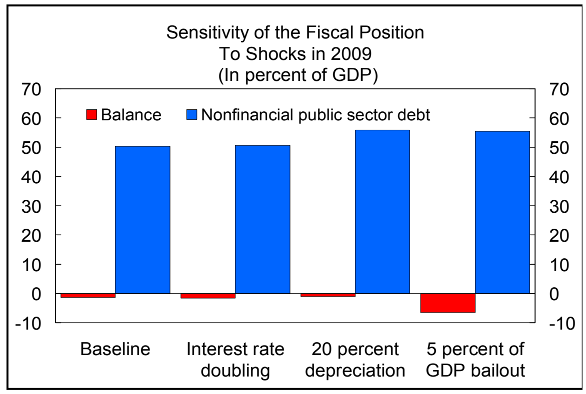
[10] Incorporating remittances into the analysis suggests that the current level of the real exchange rate is even closer to equilibrium. Moreover, this also reduces the discrepancy between the macroeconomic balance and equilibrium exchange rate approaches (for further details, see the Selected Issues Paper chapter on exchange assessment and remittances).

Box 2. Vulnerabilities if Downside Risks Materialize

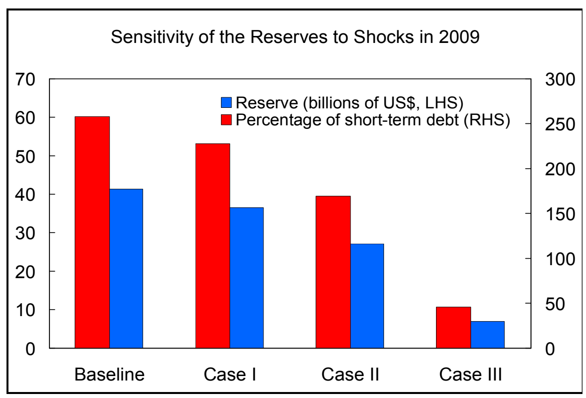
A significant slowdown in the global economy and continued financial turmoil (international capital markets accessible but at a much higher cost and stronger capital reflows to advanced countries) could seriously disrupt the economy.

- **Financial sector**: Banks will be impacted through both domestic and global channels as discussed in Section IV.A. A number of banks could buckle and the authorities would need to protect depositors and restructure weak but viable banks to contain the crisis.

- **Public finances**: Revenues will fall, but the immediate impact of rising funding costs would be limited due to the high share of fixed rates. However, a significant depreciation of the exchange rate would push up the debt level. Financial sector bail outs or realization of contingent liabilities (including from government guarantees) would dent the fiscal position markedly, but not threaten sustainability (see also Appendix II).



- **External position**: Sensitivity analysis shows a large effect on the external position from declines in investor confidence and remittance inflows. If FDI, portfolio flows, and rollover of private and public sector debt are cut in half (Case I), the impact is manageable. However, if in addition foreign investors liquidate half of their portfolio equity stock and one-fourth of their FDI stock (Case II), there is a more pronounced impact. Moreover, if workers remittances drop by 25 percent and total foreign currency deposits are withdrawn (Case III), a low probability scenario, reserves almost completely evaporate (see also Appendix I).



The authorities' views

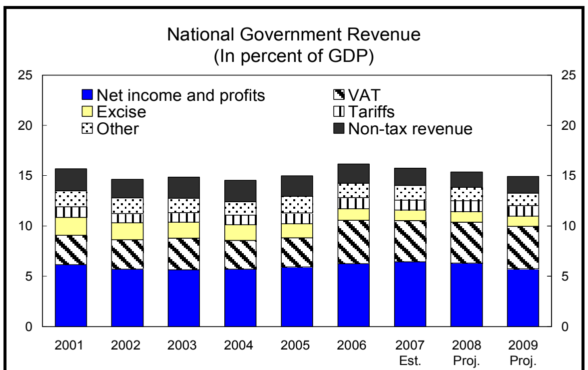
22. **The authorities broadly agreed with staff's recommendations**. It was too early to ease monetary policy at this stage with inflation still running high despite the recent deceleration. Moreover, the authorities were concerned that lower interest rates could add to the downward pressures on the exchange rate, which could also fuel inflation given the large share of imports in the consumption basket. However, the outlook for commodity prices and the projected economic slowdown was expected to reduce price pressures. Together with monetary easing elsewhere, this could provide them with some monetary flexibility. If

downside risks to growth were to materialize and inflation expectations decline sufficiently, the authorities would stand ready to reduce policy rates. That being said, monetary policy should not carry the burden alone, but fiscal policy should also provide counter-cyclical impetus.

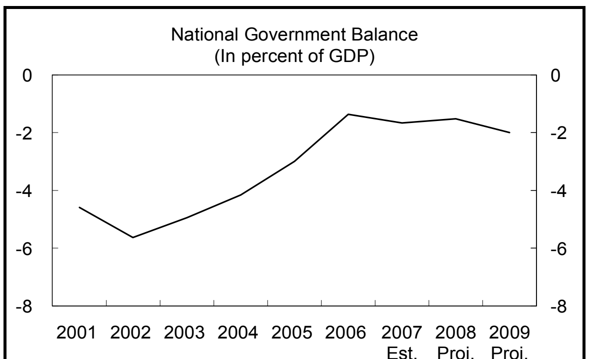
23. **The authorities concurred with staff's assessment of the exchange rate**. They welcomed staff's efforts to enrich the quantitative exchange rate assessment by taking into account remittances, an important determinant of the exchange rate in the Philippines. They further pointed out that the peso is market determined and interventions are limited to lessen undue volatility. This had been demonstrated clearly by the large appreciation of the peso until end-2007 and the subsequent significant depreciation. In this regard and as part of an ongoing discussion of the classification of the Philippine's exchange rate system, the authorities reiterated their concern that the Fund's continued focus on formal and narrow classifications of exchange rate regimes is not in sync with operational realities. Furthermore, it could detract too much attention from the underlying economic issues at hand.

C. Fiscal Policy

24. **The 2008 budget will likely record a deficit of 1½ percent of GDP, a slight improvement over last year's 1.7 percent of GDP.** The tax effort is expected to remain broadly unchanged at around 14 percent of GDP as windfall gains from high oil prices will be broadly offset by changes to the income tax law (Box 3) and weaknesses in domestic VAT collection. On the expenditure side, higher current spending is expected to be offset by lower-than-budgeted capital expenditure, reflecting weak absorptive capacity. Nonfinancial public sector debt in percent of GDP is projected to rise modestly this year, due largely to a weaker exchange rate, reversing the recent trend.



Sources: Data provided by Philippine authorities; and IMF staff estimates and projections.



Sources: Data provided by Philippine authorities; and IMF staff estimates and projections.

25. **The 2009 deficit target has been revised up and financing conditions could become more challenging in 2009**. The originally envisaged 2009 budget deficit target was ½ percent of GDP, in line with plans to balance the budget in 2010. In light of the slowing economy, the proposed deficit has been revised up to 1½ percent of GDP to accommodate higher capital outlays and a modest increase in pro-poor spending. It now awaits Senate approval. On this basis, the public sector gross financing requirement for 2009 is estimated at

Box 3. Recent Tax Policy Reforms and Options for Tax Base Broadening

Recent and planned reforms aim to stimulate investment and support household consumption, but result in a significant revenue loss—about 0.6 percent of GDP. Reforms include:

- **Personal income tax**: The exemption levels for personal income taxes were raised; the optional standard deduction (OSD) was increased from 10 percent to 40 percent of gross income in lieu of listed allowable deductions; the OSD is now available to corporations (estimated loss of P 20 billion).
- **Corporate income tax**: The corporate income tax rate to be reduced from 35 percent to 30 percent in early 2009 (estimated loss of P 26 billion).
- **Personal Equity and Retirement Act (PERA)**: Contribution is possible up to P 50,000 per year (P 100,000 for married couples) and entails a 5 percent tax credit. Withdrawals, after reaching age 55, are tax exempt (estimated loss of P 2 billion).

The authorities and staff agree that, to offset the revenue loss, tax base broadening and administration reform remain key:

- **Rationalizing tax incentives**: A compromise Bill currently being discussed would phase out the income tax holiday (ITH) in six years. After it expires, companies would be subject to a lower income tax rate of 15 percent or a 5 percent tax on gross income earned.
- **Accelerating tax administration reform**: Implementation of tax administration reforms agreed with the authorities in 2005 has been slow. The priorities at the Bureau of Internal Revenue include taxpayer registration, arrears collection, returns filing, and improving audits. Progress in customs administration reform has been particularly poor; priorities continue to be strengthening management controls and the integrity of the import and export clearance system and upgrading enforcement/intelligence functions.
- **Raising and indexing excises**: Unifying, raising, and indexing excise rates on tobacco and alcohol products, as proposed in House Bill No. 3759 (estimated gain of P 31.8−P 33.8 billion).

18½ percent of GDP, of which close to 40 percent is external. The power sector is a significant contributor to the foreign currency financing requirement, although this can partly be met from past privatization proceeds. Also, gross financing needs could increase significantly in percent of GDP if the peso were to depreciate further or contingent liabilities were to be realized, including from outstanding guarantees as well as government-linked corporations and financial institutions.

Public Sector Gross External Financing Need
(In billions of U.S. dollars)

	2008	2009
Amortization	6.2	6.3
Medium- and long-term debt	5.5	5.2
Bonds and notes	0.5	0.8
Debt as of end-2007	0.5	0.7
New borrowing	0.0	0.1
Other	5.0	4.4
Debt as of end-2007	5.1	3.7
New borrowing	0.6	1.8
Short-term debt	0.7	1.1
Interest	3.3	3.7
Memorandum item:		
Amortization of foreign currency debt held by residents	1.2	1.3

Sources: BSP, DoF; and IMF staff estimates.

26. **Large deficits have emerged at the National Food Authority (NFA)**. The NFA buys imported and domestically produced rice and, on average, sells at a lower price to targeted poor or in remote regions where poverty is prevalent. With higher import volumes

and food prices, NFA's deficit is projected at 1 percent of GDP this year from a broadly balanced position in 2007.

27. **Power sector privatization remains a priority**. To date, the government has privatized around 70 percent of its generating assets (Luzon-Visayas grid), including two generation plants this year, and plans to finalize the privatization of the generating assets by 2009. FDIs will be key for the successful completion of the privatization plan and sustainable power sector development. In this regard, the slow adjustment of electricity-tariffs to global input prices (e.g., oil price) and lack of transparency in the pricing mechanism are concerns for investors.

Policy issues and staff views

28. **Staff saw some scope for a measured fiscal policy easing to cushion the slowdown**. The 2009 deficit target relies on an ambitious revenue target of 15.9 percent of GDP. Staff projects revenues of 14.9 percent of GDP and, thus, in the absence of additional tax efforts or some expenditure restraint, meeting the deficit target would be difficult. This could rekindle investor concerns about the authorities' commitment to fiscal discipline, especially in light of the declining tax effort, increasing debt-to-revenue ratio, and the current challenging financing environment. Consequently, staff suggested that the deficit be capped at 2 percent of GDP, the bulk of which could be financed domestically without placing undue strain on the local market given the high level of peso liquidity in the banking system. To achieve this deficit, without unduly squeezing expenditure, it would be preferable to raise the tax effort through administrative and legislative measures, such as reforming sin taxes and streamlining fiscal incentives in line with current proposals before Congress (Box 3). Otherwise, expenditures on infrastructure, wages, and maintenance and operations will have to be kept broadly unchanged from projected 2008 levels (in percent of GDP), while protecting higher spending on well-targeted pro-poor programs.

29. **Plans to streamline the operations of the NFA and other government-owned and controlled corporation (GOCCs) should move forward**. Since the NFA does not target at the household level, the authorities' goal of protecting the poor can be better realized through fundamental reform of NFA aimed at full cost recovery of operations and limiting its role to providing food security. The generated savings could in turn be used for well-targeted conditional cash transfer schemes.

30. **It is important to carry through with the planned privatization of the power sector to promote more cost-efficient supply of electricity**. In this regard, more transparent and market-based tariff adjustments would be desirable to attract investors' interest. At the same time, the timing of the planned auctions should be flexible in view of the prevailing market conditions.[11]

[11] See selected issues chapter on the power sector for further details.

31. **The introduction of a more formalized medium-term fiscal framework could help better anchor fiscal policy**. A good first step in this direction would be to submit the medium-term expenditure framework alongside the budget to the legislature. Consideration could also be given to adopting a Fiscal Responsibility Law, focusing on responsible and transparent budget management, including a provision requiring that new spending or tax proposals are fully financed. This could eventually be supplemented by the introduction of an explicit numerical rule to anchor fiscal policy.[12]

32. **Public sector debt is broadly sustainable, but staff encouraged closer monitoring and management of contingent liabilities, including from outstanding government guarantees**. As elaborated in Appendix I, the public debt level is sustainable but sensitive to exchange rate changes and contingent liability shocks. For example, in the event of a 10 percent of GDP increase in public debt from realization of contingent liabilities or bank recapitalization, it would take the government five years to return debt to the pre-shock level. Combined with a more formalized medium-term fiscal framework, closer monitoring of contingent liabilities could help enhance the risk management of the public sector balance sheet.

The authorities' views

33. **The authorities agreed that the near-term fiscal easing should be measured to strike the right balance between fiscal credibility and growth concerns**. They considered their deficit target achievable, but acknowledged that the current uncertain economic environment presented risks to the revenue outlook. In this regard, they were hopeful that current proposed changes to sin taxes and tax incentives could be approved by the legislature. In the event they could not attain their revenue target, they would scale back expenditure and agreed that a deficit cap of around 2 percent of GDP would be appropriate.

34. **The authorities reiterated their commitment to fiscal consolidation over the medium term and were receptive to the introduction of a more formalized medium-term framework**. They agreed with staff that the need to enhance social and physical infrastructure called for revenue-based consolidation in line with current proposals. As staff, they saw merit in strengthening the targeting of existing cash-transfer schemes and taking steps to further build absorptive capacity to improve execution of capital spending programs. They also considered the gradual rationalization of NFA and the introduction of monitorable performance targets of other GOCCs as an integral part of the consolidation process, and were intent on finalizing the privatization of the power sector. Finally, the authorities were interested in establishing a more formalized fiscal framework to further strengthen fiscal management, but cautioned that this would require cooperation from Congress, which had not supported a previously proposed Fiscal Responsibility Law.

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[12] See selected issues chapter on fiscal policy during downturns and alternative fiscal rules.

V. STAFF APPRAISAL

35. **The Philippines face a challenging economic environment, but starts from a position of relative strength**. Growth is expected to slow to 4.4 percent in 2008 and 3½ percent in 2009, led by deceleration in external demand and private consumption as remittances level off. Inflation is projected to decline from 9½ percent in 2008 to 6 percent in 2009 as commodity prices recede further and demand eases. However, a prolonged global downturn present downside risk to the growth outlook.

36. **Financial sector reform in recent years has strengthened bank soundness, but the sector is exposed to domestic and external sources of risk**. Supervision has been strengthened in recent years through the upgrading of the BSP's supervisory capacity, the introduction of the risk-based CAMELs approach, and the adoption of the Basel II and international accounting standards. Nevertheless, banks will not be able to escape the impact of the economic slowdown on their earnings and asset quality. Moreover, on the external side, a continuation of strained conditions in global financial markets could lead to further losses on the large security holdings. External financing conditions could be tight and off-balance sheet activities may entail reputational risks in case of severe redemption pressures.

37. **To help forestall further fallout from the global financial crisis, the BSP should continue to closely monitor the banking sector and retain supervisory vigilance**. Heightened surveillance should continue, including close monitoring of off-balance sheet activities. While the relaxation of mark-to-market accounting rules has provided some relief, it does not constitute a permanent solution and it is important that it is not allowed to impair transparency about financial soundness. The BSP's proactive steps to address liquidity strains are welcome and staff encourages a flexible application of existing facilities as needed to stem further stress.

38. **The PCA framework is broadly appropriate, but there is some scope for improvement**. The BSP should be given legal authority to disclose enforcement actions, while preserving the right to nondisclosure if needed to avoid loss of market confidence. The introduction of a more rules-based framework and triggers tied to increasingly stringent remedial action could also be considered over the medium term. Concurrently and without any further delay, the BSP charter should be amended to strengthen legal protection of BSP staff.

39. **The proposed increase in deposit coverage to P 500,000 is welcome, but further steps to strengthen the bank resolution framework are encouraged**. Flexibility to increase deposit insurance coverage temporarily would be important in high stress cases. The envisaged introduction of a bridge-bank facility is welcome, but could be complemented by a more flexible application of the purchase-and-assumption tool to strengthen the resolution toolkit. Bank restructuring decisions should be irreversible and PDIC staff should be protected against litigation.

40. **The current neutral monetary stance appropriately balances the risks to inflation and growth, but may have to be adjusted if downside risks materialize**. The credibility of the inflation targeting framework has helped anchor inflation expectations. BSP's commitment to the framework was underscored when they, in mid-2008, decisively hiked rates to address second-round effects from the commodity price shock. A protracted slowdown, now a likely scenario, provide scope for monetary easing if inflation expectations continue to adjust downwards. The exchange rate should in this case be allowed to adjust fully to the changing external environment, with interventions limited to smoothing erratic movements. A temporary financial shock, on the other hand, may call for a hike in interest rates and limited unsterilized intervention. Even then, preserving sufficiently high reserves will help provide confidence in the peso and the resilience of the financial system.

41. **The exchange rate is assessed to be broadly in line with the level implied by longer-term fundamentals**. As such, it does not pose a threat to external stability. Interventions in recent years have largely been in both directions, intended to smooth erratic exchange rate changes. Moreover, quantitative estimates suggest the exchange rate does not deviate significantly from its long-term equilibrium level.

42. **Fiscal policy should help to cushion the current slowdown**. Fiscal consolidation has significantly reduced the public debt-to-GDP ratio in recent years. However, the room for fiscal stimulus is limited as the debt level still remains high and the tax effort has declined, with gains from the landmark EVAT reform eroded by other tax measures. Based on this, fiscal easing should be *measured* to avoid compromising credibility, capping the fiscal deficit at 2 percent of GDP. To achieve this, the authorities should raise the tax effort through administrative measures and tax reform. Otherwise, expenditures will have to be contained, except for outlays on well-targeted pro-poor cash benefits.

43. **Looking ahead, a formalized medium-term fiscal framework should be considered**. A good first step would be to submit the medium-term expenditure framework alongside the budget to the legislature. Consideration could also be given to adopting a fiscal responsibility law, which could involve provisions requiring that new tax or expenditure measures be fully financed. It could also involve the introduction of a numerical fiscal rule to help anchor fiscal policy.

44. **Operations of the NFA and other GOCCs should be streamlined further and privatization of the power sector should continue**. The authorities' goal of protecting the poor can be better realized through fundamental reform of NFA aimed at full cost recovery of operations and limiting its role to providing food security, using the savings for well-targeted conditional cash transfer schemes. A comprehensive review of the operations of other GOCCs, eventually leading to monitorable performance targets, remains a priority as well. To attract investments in power companies, a more transparent and market-based tariff adjustment mechanism would be desirable. The authorities should proceed with remaining power sector privatization, although timing of the planned auctions may need to be delayed due to the prevailing constrained market conditions.

45. Staff recommends the next Article IV consultation be on the standard 12-month cycle.

Table 1. Philippines: Selected Economic Indicators, 2004-09

Nominal GDP (2007): P6,648 billion ($144.1 billion)
Population (2007): 88.6 million
GDP per capita (2007): $1,624
Poverty headcount ratio at $2 a day at PPP (2003): 43 percent
IMF quota: SDR 879.9 million
Main products and exports: Electronics and agricultural products
Unemployment rate (2007): 7.3 percent

	2004	2005	2006	2007	2008 Est.	2009 Proj.
GDP and prices (percent change)						
Real GDP	6.4	5.0	5.4	7.2	4.4	3.5
CPI (annual average)	6.0	7.7	6.2	2.8	9.4	6.0
CPI (end year)	8.6	6.7	4.3	3.9	9.7	3.5
Investment and saving (percent of GDP)						
Gross investment	16.7	14.6	14.5	15.3	15.4	14.9
National saving 1/	18.6	16.6	19.0	19.7	16.4	16.6
Public finances (percent of GDP)						
National government balance (authorities definition)	-3.8	-2.7	-1.1	-0.2	-0.9	-1.7
National government balance (authorities definition) excl. privatization receipts)	-4.2	-3.0	-1.2	-1.5	-1.4	-1.8
National government balance 2/	-4.2	-3.0	-1.4	-1.7	-1.5	-2.0
Nonfinancial public sector balance 3/	-5.0	-2.1	0.1	0.4	-0.9	-1.7
Revenue and grants 4/	20.5	22.1	23.0	24.1	22.7	21.5
Expenditure 5/	25.5	24.1	22.9	23.7	23.6	23.1
Nonfinancial public sector debt 6/	95.2	85.9	73.9	60.9	61.7	59.2
Monetary sector (percent change, end of period)						
Broad money (M3)	10.3	10.3	22.7	10.6	13.1 8/	...
Interest rate (91-day treasury bill, end of period, in percent) 7/	8.4	6.4	5.1	4.2	6.5 9/	...
Credit to the private sector	4.9	-0.3	6.7	8.5	17.0 8/	...
External Sector						
Export value (percent change)	9.8	3.8	15.6	6.4	3.7	5.3
Import value (percent change)	8.0	8.0	10.9	8.4	14.8	3.0
Current account (percent of GDP)	1.9	2.0	4.5	4.4	1.0	1.7
Capital and Financial account (US$ billions, excluding errors and omissions)	-1.6	2.2	0.0	2.9	1.1	-1.8
Foreign direct investment (net)	0.1	1.7	2.8	-0.5	1.2	1.1
Other	-1.7	0.5	-2.8	3.4	-0.1	-3.0
Errors and omissions (US$ billions)	-0.3	-1.8	-1.6	-0.6	-1.7	-1.7
Overall balance (US$ billions)	-0.3	2.4	3.8	8.6	1.1	-0.8
Total external debt (percent of GDP) 10/	70.7	62.6	51.8	45.7	39.1	40.2
Debt-service ratio (percent of exports)	19.7	18.5	18.6	17.9	17.8	16.7
Reserves, adjusted (US$ billions) 11/	15.2	18.0	23.0	33.8	35.6	35.6
Reserves / Short-term liabilities, adjusted 12/	125.8	120.1	172.7	215.2	246.8	256.9
Exchange rate (period averages)						
Pesos per U.S. dollar	56.0	55.1	51.3	46.1	44.2 9/	...
Nominal effective exchange rate (1990 =100)	75.7	76.9	82.0	89.3	90.6 8/	...
Real effective exchange rate (1990 =100)	86.2	92.3	102.5	112.3	119.5 8/	...

Sources: Philippine authorities; and IMF staff estimates and projections.

1/ Defined as the difference between gross investment and current account.
2/ Fund definition. Excludes privatization receipts of the national government, and includes net deficit from restructuring the central bank.
3/ Includes the national government, Central Bank-Board of Liquidators, 14 monitored government-owned enterprises, social security institutions, and local governments.
4/ The sum of all nonfinancial public sector revenue net of intra-public sector payments. It is assumed that 80 percent of Bureau of Treasury revenue represents interest and dividends from other parts of the nonfinancial public sector. Privatization receipts are excluded.
5/ Defined as difference between nonfinancial public sector revenue and balance.
6/ Debt is consolidated (net of intra-nonfinancial public sector holdings of debt).
7/ Secondary market rate.
8/October 2008.
9/ November 2008.
10/ Defined as external debt plus liabilities of foreign banks in the Philippines to their headquarters, branches and agencies, external debt not registered with the central bank and private capital lease agreements.
11/ Gross reserves less gold and securities pledged as collateral against short-term liabilities.
12/ Reserves as a percent of short-term debt (including medium- and long-term debt due in the following year). Both reserves and debt were adjusted pledged assets.

Table 2. Philippines: National Government Cash Accounts, 2005-09

(In percent of GDP; unless otherwise noted)

	2005	2006	2007	2008		2009	
				Budget	Proj. 1/	Budget	Proj. 1/
Revenue and grants	15.0	16.2	15.8	16.6	15.4	15.9	14.9
Tax revenue	13.0	14.3	14.0	15.2	13.9	14.7	13.3
Net income and profits	5.9	6.2	6.4	6.6	6.3	6.5	5.7
Excises	1.4	1.1	1.0	1.0	1.0	...	1.0
VAT	2.9	4.3	4.1	5.2	4.1	...	4.2
Tariffs	1.1	1.1	1.0	1.0	1.1	...	1.0
Other 2/	1.7	1.4	1.4	1.5	1.4	...	1.3
Nontax revenue	2.0	1.9	1.7	1.4	1.5	1.2	1.7
Expenditure and net lending	18.0	17.5	17.4	17.1	16.9	16.7	16.9
Current expenditures	15.6	15.2	14.4	14.2	14.2	13.4	14.2
Personnel services	5.4	5.4	5.3	5.5	5.1	5.0	5.0
Maintenance and operations	1.6	1.7	1.9	1.9	1.7	2.0	1.8
Allotments to local government units	2.2	2.3	2.3	2.3	2.3	2.3	2.5
Subsidies	0.1	0.2	0.3	0.1	0.2	0.1	0.1
Tax expenditure	0.4	0.3	0.5	0.2	0.7	0.3	0.3
Interest	5.8	5.4	4.2	4.2	4.2	3.7	4.4
National government	5.5	5.1	4.0	4.1	4.0	3.5	4.2
Central Bank-Board of Liquidators	0.3	0.2	0.1	0.2	0.2	0.2	0.2
Capital and equity expenditure 3/	2.4	2.3	2.9	2.8	2.5	3.2	2.6
Net lending	0.0	0.0	0.1	0.2	0.2	0.1	0.1
Balance	-3.0	-1.4	-1.7	-0.6	-1.5	-0.7	-2.0
On the authorities' presentation 4/	-2.7	-1.1	-0.2	0.0	-0.9	-0.5	-1.7
Financing	3.0	1.4	1.7	0.6	1.5	0.5	2.0
Net external financing	1.7	2.0	0.8	0.5	0.0	0.3	0.3
Net domestic financing	1.3	-0.6	0.8	0.0	1.5	0.2	1.7
Privatization	0.0	0.1	1.4	0.4	0.5	0.1	0.1
Memorandum Items:							
Nonfinancial public sector balance 5/	-2.1	0.1	0.4	…	-0.9	…	-1.7
Consolidated public sector balance 5/	-1.8	0.2	-0.8	…	-0.8	…	-1.5
Primary national government balance	2.8	4.0	2.5	3.7	2.7	2.9	2.4
National government debt 6/	62.8	55.4	47.7	…	47.0	…	44.8
(percent of NG revenues)	419.4	342.4	302.6	…	306.3	…	300.2
Nonfinancial public sector debt 7/	85.9	73.9	60.9	…	61.7	…	59.2
(percent of NFPS revenues)	389.5	321.5	253.1	…	272.1	…	276.1
National government gross financing requirements 8/	21.1	22.0	17.8	…	14.9	…	16.9
Health and education spending (current and capital; commitment basis)	2.2	2.2	2.2	2.1	2.1		…
GDP (in billions of pesos) 9/	5,444	6,033	6,648	7,285	7,543	8,692	8,244

Sources: Philippine authorities; and IMF staff projections.

1/ Staff projections based on currently-identified measures, assuming modest gains from tax incentives reform and from administrative improvements. For 200
also assumes some expenditure compression relative to the budget.
2/ Includes other percentage taxes, documentary stamp tax, and noncash collections.
Non-cash collections are also reflected as tax expenditures under current expenditures.
3/ Excludes purchase of NPC securities and other on lending; includes capital transfers to LGUs. May exceed public investment
in years when capital transfers to LGUs exceed their reported capital spending.
4/ Includes privatization receipts as revenue and excludes the operations of the Central Bank-Board of Liquidators (CB-BOL).
5/ Excludes privatization receipts from revenue.
6/ Consolidated (net of national government debt held by the sinking fund) and excluding contingent/guaranteed debt.
7/ Nonfinancial public sector includes the national government, CB-BOL, 14 monitored government-owned enterprises, social security
institutions, and local governments. Debt is consolidated (net of intra-nonfinancial public sector holdings of debt).
8/ Defined as the deficit, plus amortization of medium- and long-term debt, plus the stock of short-term debt at the end of the last period,
plus market financing on behalf of NPC.
9/ For the budget, the lower bound of the range of GDP estimates.

Table 3. Philippines Balance of Payments, 2004–09
(In billions of U.S. dollars)

	2004	2005 1/	2006	2007	Proj. 2008	Proj. 2009
Current account balance	**1.6**	**2.0**	**5.3**	**6.3**	**1.7**	**2.8**
Trade balance	-5.7	-7.8	-6.7	-8.2	-15.0	-14.2
Exports, f.o.b.	38.8	40.3	46.5	49.5	51.1	53.8
Imports, f.o.b.	44.5	48.0	53.3	57.7	66.1	68.0
Of which: oil and related products	4.7	6.3	8.0	9.6	13.7	12.0
Services (net)	-1.8	-1.3	0.1	1.1	1.3	1.0
Receipts	4.0	4.5	6.4	8.4	9.8	10.8
Payments	5.8	5.9	6.3	7.4	8.6	9.8
Income	-0.1	-0.3	-1.3	-0.5	-0.3	-0.4
Receipts, of which:	3.7	3.9	4.4	5.5	5.3	5.4
Remittances of resident workers abroad	2.9	2.9	2.8	3.0	3.3	3.4
Payments	3.8	4.2	5.6	6.0	5.6	5.9
Interest payments	2.4	2.8	3.3	3.4	3.8	3.8
Transfers (net)	9.2	11.4	13.2	14.0	15.7	16.4
Receipts	9.4	11.7	13.5	14.4	16.2	17.1
Of which: nonresident workers remittances	8.6	10.7	12.5	13.3	14.8	15.6
Payments	0.3	0.3	0.3	0.4	0.5	0.7
Capital and financial account	**-1.6**	**2.2**	**0.0**	**2.9**	**1.1**	**-1.8**
Capital account	0.0	0.0	0.1	0.0	0.1	0.1
Financial account	-1.6	2.2	-0.1	2.9	1.0	-1.9
Direct investment	0.1	1.7	2.8	-0.5	1.2	1.1
Portfolio investment	-1.7	3.5	3.0	4.4	-0.9	-1.3
Equity	0.5	1.5	2.5	3.3	-1.1	-1.3
Debt	-2.2	2.0	0.5	1.1	0.2	0.0
Other investment	0.0	-2.9	-5.9	-1.0	0.8	-1.8
Errors and omissions	**-0.3**	**-1.8**	**-1.6**	**-0.6**	**-1.7**	**-1.7**
Overall balance	**-0.3**	**2.4**	**3.8**	**8.6**	**1.1**	**-0.8**
Overall financing	**0.3**	**-2.4**	**-3.8**	**-8.6**	**-1.1**	**0.8**
Monetization of gold and revaluation	1.1	1.5	0.6	2.2	0.7	0.7
Change in net international reserves (increase =-)	-0.7	-3.9	-4.4	-10.9	-1.8	0.1
Memorandum items:						
Current account/GDP	1.9	2.0	4.5	4.4	1.0	1.7
Short-term debt (original maturity)	7.6	9.4	7.7	9.9	8.9	9.1
Short-term debt (residual maturity)	13.1	15.5	13.3	15.7	14.4	13.8
Adjusted gross reserves 1/	15.2	18.0	23.0	33.8	35.6	35.6
(in percent of short-term debt by residual maturity) 2/	125.8	120.1	172.7	215.2	246.8	256.9
Net international reserves	14.6	17.7	23.0	33.7	35.6	35.6
Monitored external debt (in billions) 3/	61.5	61.9	60.9	65.9	66.1	65.7
(in percent of GDP)	70.7	62.6	51.8	45.7	39.1	40.2
Debt service ratio 4/	19.7	18.5	18.6	17.9	17.8	16.7
Export value (percent change)	9.8	3.8	15.6	6.4	3.7	5.3
Import value (percent change)	8.0	8.0	10.9	8.4	14.8	3.0
Gross external financing needs 5/	12.5	11.1	10.1	6.9	14.0	11.7
GDP	86.9	98.8	117.6	144.1	169.1	163.3

Sources: Philippine authorities; and IMF staff projections.

1/ Gross reserves less gold and securities pledged as collateral against short-term liabilities.
2/ As a percent of short-term debt excluding pledged assets of the central bank.
3/ Monitored external liabilities are defined as external debt plus liabilities of foreign banks in the Philippines to their headquarters, branches and agencies, some external debt not registered with the central bank, and private capital lease agreements.
4/ In percent of exports of goods and non-factor services.
5/ Defined as the current account deficit, plus amortization on medium- and long-term debt, plus short-term debt at the end of the previous period.

Table 4. Philippines: Depository Survey, 2006-08

(In billions of pesos; unless otherwise noted)

	2006	2007 1/	2008 1/						
	Dec	Dec	Apr	May	Jun	Jul	Aug	Sep	Oct
Net foreign assets	1,366	1,659	1,763	1,820	1,862	1,850	1,818	1,881	1,877
Central bank	1,077	1,365	1,501	1,553	1,593	1,578	1,620	1,657	1,648
Net international reserves	1,128	1,397	1,534	1,587	1,626	1,609	1,652	1,691	1,683
Medium- and long-term foreign liabilities	51	32	33	34	33	31	32	34	35
Deposit money banks	289	294	262	267	270	272	198	224	228
Net domestic assets	2,445	2,422	2,295	2,297	2,399	2,314	2,363	2,405	2,446
Net domestic credit	3,007	3,162	3,195	3,220	3,297	3,244	3,406	3,474	3,496
Public sector credit	1,040	1,027	1,095	1,086	1,097	1,026	1,065	1,135	1,118
National Government	762	767	833	838	847	767	791	861	846
Credits	986	1,082	1,153	1,153	1,166	1,173	1,186	1,198	1186
Foreign exchange receivables	4	0	0	0	0	0	0	0	0
Treasury IMF Accounts	-58	-51	-54	-56	-58	-56	-57	-58	-57
Deposits	-170	-265	-266	-259	-261	-350	-338	-280	-283
Local government and others	278	261	261	248	250	259	273	274	272
Claims on CB-BOL 2/	0	0	0	0	0	0	0	0	0
Private sector credit	1,967	2,134	2,100	2,134	2,200	2,218	2,342	2,339	2378
Other items net	-562	-740	-900	-923	-898	-930	-1,043	-1,069	-1050
							…		
Total liquidity	3,811	4,081	4,058	4,117	4,262	4,164	4,182	4,287	4322
M4	3,722	3,925	3,898	3,964	4,090	4,049	4,106	4,218	4263
M3 (peso liquidity)	2,870	3,174	3,064	3,083	3,197	3,143	3,184	3,287	3320
Foreign currency deposits, residents	853	751	834	882	893	906	923	930	942
Other liabilities	89	155	160	153	171	115	75	69	59
	Annual percentage change								
Net foreign assets	49.9	21.4	16.5	20.1	17.7	12.5	5.4	11.1	10.7
Net domestic assets	6.3	-1.0	-6.1	-2.8	1.5	0.4	10.0	10.8	12.4
Net domestic credit	7.2	5.2	7.2	7.3	8.3	5.9	11.6	13.5	13.0
Public sector	8.3	-1.2	8.7	4.9	2.0	-6.6	-1.9	4.0	5.3
Private sector	6.7	8.5	6.3	8.6	11.8	12.8	19.0	18.8	17.0
M4	19.0	5.5	0.8	4.6	5.9	5.8	10.3	13.4	14.6
M3	22.7	10.6	0.8	3.7	5.1	4.1	9.8	13.5	13.1

Sources: Philippine authorities; CEIC; and IMF staff estimates.

1/ Based on New Depository Corporation Survey.

2/ The Central Bank-Board of Liquidators was established in 1993 to absorb the debts of the old central bank.

Table 5. Philippines: Medium-Term Outlook, 2006–13

(Currently identified measures scenario)

	2006	2007	Staff Proj. 2008	2009	2010	2011	2012	2013
GDP and prices								
Real GDP	5.4	7.2	4.4	3.5	4.4	5.0	5.4	5.5
GDP per capita (US$)	1,352	1,624	1,871	1,772	1,848	1,940	2,044	2,156
CPI (average)	6.2	2.8	9.4	6.0	3.5	3.5	3.5	3.5
Labor								
Employment (average, million)	32.6	33.6	34.5	35.1	35.8	36.7	37.7	38.8
Investment and saving								
Gross investment	14.5	15.3	15.4	14.9	15.4	15.7	16.0	16.2
Private	12.4	12.7	12.3	12.4	12.7	13.1	13.2	13.3
Public	2.1	2.6	3.2	2.6	2.7	2.6	2.8	2.9
National saving 1/	19.0	19.7	16.4	16.6	17.1	16.3	16.0	15.8
Private	16.8	17.9	14.1	15.6	16.5	15.5	15.1	14.7
Public	2.3	1.7	2.4	1.0	0.6	0.8	0.9	1.1
Foreign saving	-4.5	-4.4	-1.0	-1.7	-1.7	-0.6	0.0	0.4
Public finances								
Nonfinancial public sector balance 2/	0.1	0.4	-0.9	-1.7	-2.2	-2.0	-2.0	-2.0
Primary balance	5.8	5.0	3.6	3.1	2.7	2.7	2.5	2.4
Revenue and grants 3/	23.0	24.1	22.7	21.5	21.6	21.8	22.0	22.1
Expenditure (primary) 4/	17.2	19.1	19.1	18.3	18.9	19.1	19.5	19.7
Interest	5.8	4.6	4.5	4.8	5.0	4.7	4.6	4.4
Nonfinancial public sector gross financing	24.2	17.9	15.7	18.5	19.7	18.1	17.9	17.5
Domestic	18.9	16.0	14.8	16.9	18.6	15.9	15.6	15.2
Foreign currency	5.3	1.9	0.9	1.6	1.2	2.2	2.3	2.3
National government balance (authorities definition)	-1.1	-0.2	-0.9	-1.7	-1.9	-1.8	-1.6	-1.5
National government balance 5/	-1.4	-1.7	-1.5	-2.0	-2.3	-2.1	-1.9	-1.7
Nonfinancial public sector debt 6/	73.9	60.9	61.7	59.2	59.3	57.9	56.2	54.2
External sector								
Export value (percent change)	15.6	6.4	3.7	5.3	9.0	9.4	9.1	9.1
Import value (percent change)	10.9	8.4	14.8	3.0	9.8	11.0	10.1	9.0
Trade balance (in percent of GDP)	-5.7	-5.7	-8.8	-8.7	-9.3	-10.1	-10.7	-10.8
Current account (in percent of GDP)	4.5	4.4	1.0	1.7	1.7	0.6	0.0	-0.4
FDI (net, US$ billions)	2.8	-0.5	1.2	1.1	1.8	1.9	2.1	2.3
Reserves, adjusted (US$ billions) 7/	23.0	33.8	35.6	35.6	37.4	37.3	37.1	37.3
Reserves / Short-term liabilities, adjusted 8/	172.7	215.2	246.8	256.9	227.0	222.9	218.6	206.1
Gross external financing requirements (US$ billions) 9/	10.1	6.9	14.0	11.7	10.8	15.3	16.7	17.8
Total external debt (in percent of GDP) 10/	51.8	45.7	39.1	40.2	38.2	36.0	34.2	32.9
Debt service ratio (in percent of exports of G&S)	18.6	17.9	17.8	16.7	14.3	17.4	15.8	14.1

Sources: Philippine authorities; and IMF staff estimates and projections.

1/ Defined as the difference between gross investment and current account.
2/ Nonfinancial public sector includes the national government, CB-BOL, 14 monitored government-owned enterprises, social security institutions, and local governments.
3/ The sum of all nonfinancial public sector revenue net of intra-public sector payments. It is assumed that 80 percent of Bureau of Treasury revenue represents interest and dividends from other parts of the nonfinancial public sector. Privatization receipts are excluded.
4/ Defined as difference between nonfinancial public sector revenue and primary balance.
5/ Fund definition. Excludes privatization receipts of the national government, and includes net deficit from restructuring the central bank.
6/ Debt is consolidated (net of intra-nonfinancial public sector holdings of debt).
7/ Gross reserves less gold and securities pledged as collateral against short-term liabilities.
8/ Reserves as a percent of short-term debt (including medium and long-term debt due in the following year). Both reserves and debt were adjusted for gold-backed loans.
9/ Defined as the current account deficit, plus amortization on medium- and long-term debt, plus short-term debt at the end of the previous period.
10/ Defined as external debt plus liabilities of foreign banks in the Philippines to their headquarters, branches and agencies, some external debt not registered with the central bank and private capital lease agreements.

Table 6. Philippines: Banking Sector Indicators, 2003–08

(End of year; unless otherwise indicated)

	2003	2004	2005	2006	2007	2008 Q2
Capital adequacy						
Total capital accounts to total assets	13.1	12.6	12.0	11.7	11.7	10.7
Capital adequacy ratio (consolidated basis)	17.4	18.4	17.6	18.1	15.7	15.5
Asset quality						
NPL ratio 1/	16.1	14.4	10.3	7.5	5.8	5.2
NPA ratio 2/	13.2	11.8	8.8	6.9	5.8	5.6
Distressed asset ratio 3/	27.0	25.3	20.0	15.7	13.0	11.6
NPL coverage ratio 4/	51.5	58.0	73.8	75.0	81.5	84.1
NPA coverage ratio 5/	30.9	33.2	39.2	37.3	39.7	43.5
Profitability						
Return on assets	1.1	0.9	1.1	1.3	1.3	1.1
Return on equity	8.5	7.1	8.8	10.6	10.8	9.6
Cost-to-income ratio	...	65.5	64.0	66.5	65.2	70.3
Liquidity						
Liquid assets to deposits	47.9	53.2	53.1	52.1	51.9	51.7
Loans (gross) to deposits	80.3	73.4	72.4	69.3	70.9	72.9

Sources: Philippine authorities; and IMF staff calculations.

Note: ROPA = Real and Other Property Acquired. ROPA is a measure of the stock of foreclosed properties held by a bank.

1/ Nonperforming Loans (NPL) Ratio (excluding IBL).

2/ (Nonperforming loans + ROPA) over total gross assets.

3/ Ratio of (NPLs + Gross ROPA + current restructed loans) to (Gross total loan portfolio + Gross ROPA).

4/ Ratio of loan loss reserves to NPLs.

5/ Ratio of valuation reserves (for loans and ROPA) to NPAs.

Table 7. Philippines: Indicators of External Vulnerability, 2003-09
(In percent of GDP, unless otherwise indicated)

	2003	2004	2005	2006	2007	2008	2009
						Est.	Proj.
External indicators (including external liquidity):							
Gross international reserves, adjusted (in billions U.S. dollars) 1/	14.9	15.2	18.0	23.0	33.8	35.6	35.6
Maturing short-term debt (in billions U.S. dollars)	8.2	7.6	9.4	7.7	9.9	8.9	9.1
Amortization of medium and long-term debt (in billions U.S. dollars)	5.9	5.4	6.0	5.6	5.8	5.5	6.7
Net FDI inflows (in billions of U.S. dollars)	0.2	0.1	1.7	2.8	-0.5	1.2	1.1
FX deposits (in billions of U.S. dollars) 2/	13.7	15.8	16.7	19.0	19.6	19.6	...
Total gross external debt	79.2	70.7	62.6	51.8	45.7	39.1	40.2
Public sector indicators:							
Overall non-financial public sector balance 3/	-5.6	-5.0	-2.1	0.1	0.4	-0.9	-1.7
Primary balance 3/	0.7	1.6	4.3	5.8	5.0	3.6	3.1
Nonfinancial public sector debt (NFPSD)	100.8	95.2	85.9	73.9	60.9	61.7	59.2
NFPSD denominated in FX or linked to the exchange rate (in percent of NFPSD)	67.8	65.9	60.9	61.2	56.9	58.5	55.9
Short-term general government debt (original maturity, in percent of NFPSD)	14.5	15.4	16.6	17.7	17.3	19.8	18.9
Average effective interest rate of government debt (in percent)	6.3	6.9	7.4	7.8	7.5	7.3	8.1
Amortization of total debt	23.2	23.1	22.2	24.2	18.3	14.8	16.8

Sources: Philippine authorities; and IMF staff estimates and projections.

1/ Gross reserves less gold and securities pledged as collateral against short-term liabilities.
2/ As of June, 2008.
3/ Data for 2008 and 2009 are Fund staff projections.

APPENDIX I: DEBT SUSTAINABILITY ANALYSIS

The Philippines' public sector debt is broadly sustainable. In the baseline scenario, no new measures are introduced over the medium term apart from the planned reduction in the corporate income tax (CIT) rate in 2009 and the full-year impact of the 2008 increase in personal income tax thresholds. In this scenario, the nonfinancial public sector (NFPS) debt will initially increase, mostly due to exchange rate depreciation, and then decline to 54 percent of GDP in 2013. While the debt dynamics are favorable overall, they remain vulnerable to shocks, especially to the exchange rate and, to a lesser extent, growth.

Projected external debt dynamics are generally benign. In recent years, external debt has steadily declined—from nearly 80 percent of GDP in 2002 to just over 40 percent in 2007. Under the staff's baseline scenario, the external debt ratio would fall gradually over the medium term to around 33 percent in 2013. This level of external indebtedness compares favorably with other emerging market economies, and past empirical work suggests that it entails limited vulnerabilities, although some remain:

- *Continued vulnerability to the exchange rate:* A one-time real depreciation of 30 percent is estimated to entail a 20 percentage point jump in the external debt ratio from its 2008 level, which would remain above 60 percent in the medium term.

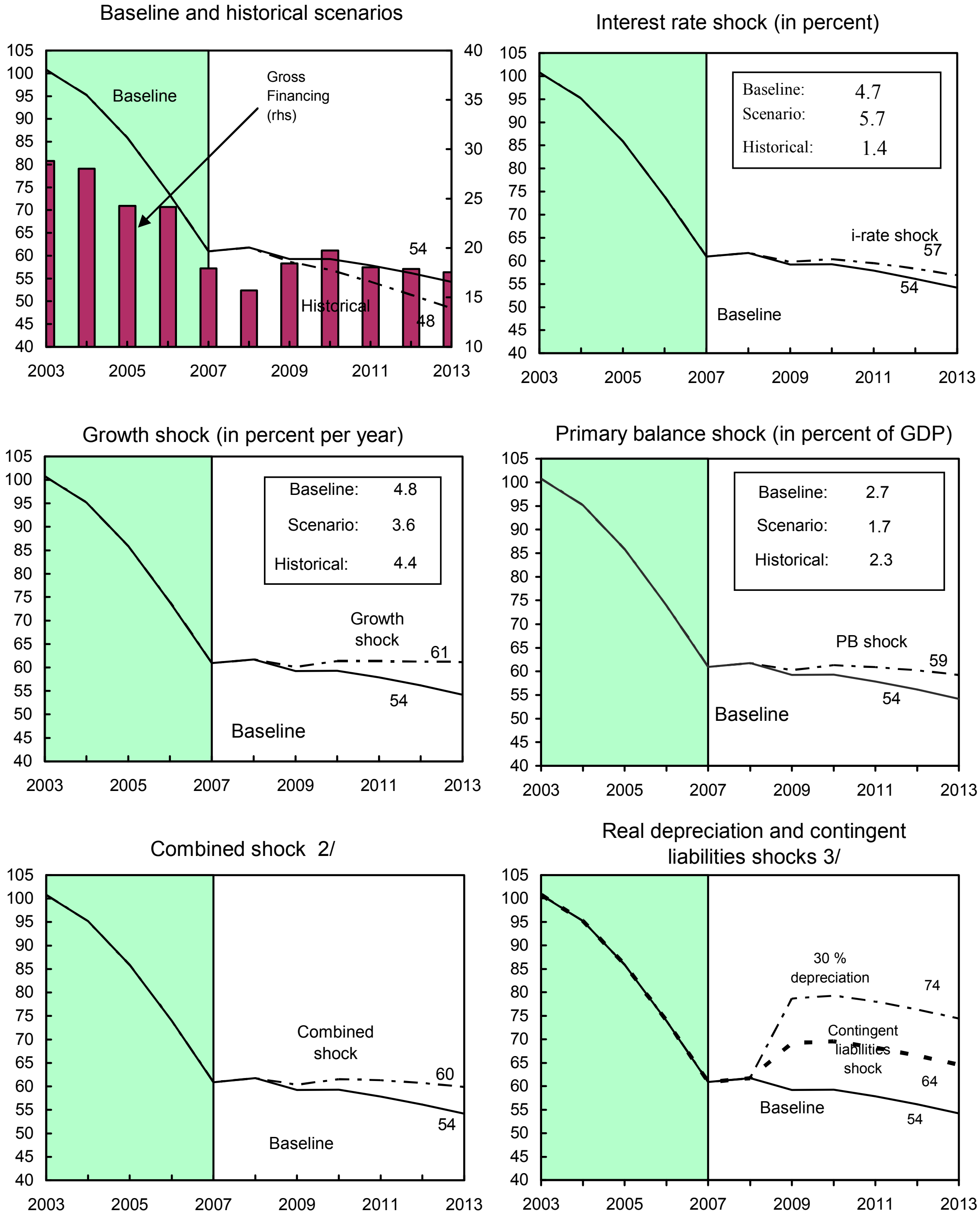
- *Rising resilience to interest rate and growth shocks:* Given the lengthening of maturities and tilt toward domestic financing, external debt is less affected by world interest rates and domestic growth shocks. It is only moderately affected by noninterest shocks to the current account.

Table A.1. Philippines: Public Sector Debt Sustainability Framework, 2003-13
(In percent of GDP, unless otherwise indicated)

	Actual					Projections						
	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	**Debt-stabilizing primary balance 10/**
Baseline scenario: Public sector debt 1/	100.8	95.2	85.9	73.9	60.9	**61.7**	**59.2**	**59.3**	**57.9**	**56.2**	**54.2**	**0.3**
Of which: foreign-currency denominated	68.3	62.7	52.3	45.2	34.7	36.1	33.1	30.6	29.1	27.4	25.7	
Change in public sector debt	7.1	-5.6	-9.3	-12.0	-13.0	0.8	-2.5	0.1	-1.4	-1.7	-1.9	
Identified debt-creating flows (4+7+12)	1.2	-6.1	-10.9	-12.1	-13.7	-6.3	-3.4	-2.0	-2.6	-2.6	-2.5	
Primary deficit	-0.7	-1.6	-4.3	-5.8	-5.0	-3.6	-3.1	-2.7	-2.7	-2.5	-2.4	
Revenue and grants 2/	20.8	20.5	22.1	23.0	24.1	22.7	21.5	21.6	21.8	22.0	22.1	
Primary (noninterest) expenditure	20.1	19.0	17.8	17.2	19.1	19.1	18.3	18.9	19.1	19.5	19.7	
Automatic debt dynamics 3/	1.4	-4.2	-6.9	-6.3	-9.0	-2.7	-0.4	0.6	-0.1	-0.3	-0.4	
Contribution from interest rate/growth differential 4/	-1.3	-5.0	-3.6	-2.6	-2.3	-2.7	-0.4	0.6	-0.1	-0.3	-0.4	
Of which: contribution from real interest rate	2.9	0.7	0.6	1.6	2.5	-0.4	1.5	3.0	2.6	2.6	2.5	
Of which: contribution from real GDP growth	-4.2	-5.7	-4.2	-4.2	-4.8	-2.4	-2.0	-2.4	-2.7	-2.9	-2.8	
Contribution from exchange rate depreciation 5/	2.7	0.8	-3.3	-3.7	-6.8	...	...	...	...	...	...	
Other identified debt-creating flows	0.6	-0.4	0.4	0.0	0.2	0.0	0.2	0.2	0.2	0.2	0.2	
Privatization receipts (negative)	0.0	0.0	0.0	-0.1	-1.4	-0.5	-0.1	-0.1	-0.1	-0.1	-0.1	
Recognition of implicit or contingent liabilities	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Other (specify, e.g., bank recapitalization)	0.6	-0.4	0.4	0.1	1.6	0.4	0.3	0.3	0.3	0.3	0.3	
Residual, including asset changes (2-3) 6/	5.8	0.6	1.6	0.1	0.7	7.1	0.9	2.1	1.2	0.9	0.6	
Public sector debt-to-revenue ratio 1/	484.5	463.6	389.5	321.5	253.1	272.1	276.1	274.4	265.2	255.1	245.6	
Gross financing need 7/	28.8	28.0	24.3	24.2	17.9	15.7	18.5	19.7	18.1	17.9	17.5	
In billions of U.S. dollars	22.9	24.4	24.0	28.4	25.8	26.5	30.1	34.3	33.6	35.7	37.7	
Scenario with key variables at their historical averages 8/						**61.7**	**58.7**	**56.8**	**54.2**	**51.4**	**48.4**	**-0.9**
Key Macroeconomic and Fiscal Assumptions Underlying Baseline												
Real GDP growth (in percent)	4.9	6.4	5.0	5.4	7.2	4.4	3.5	4.4	5.0	5.4	5.5	4.7
Average nominal interest rate on public debt (in percent) 9/	7.3	7.3	7.5	7.5	6.8	8.4	8.5	9.1	8.5	8.6	8.5	
Average real interest rate (nominal rate minus change in GDP deflator, in percent)	3.6	1.2	1.0	2.3	4.0	-0.3	2.9	5.6	5.0	5.1	5.0	
Nominal appreciation (increase in U.S. dollar value of local currency, in percent)	-4.5	-1.2	6.0	8.0	18.7	...	...	...	...	...	...	
Inflation rate (GDP deflator, in percent)	3.8	6.1	6.5	5.1	2.8	8.7	5.6	3.5	3.5	3.5	3.5	
Growth of real primary spending (deflated by GDP deflator, in percent)	1.3	0.6	-1.7	1.8	19.5	4.3	-0.8	7.7	6.3	7.4	6.5	
Primary deficit	-0.7	-1.6	-4.3	-5.8	-5.0	-3.6	-3.1	-2.7	-2.7	-2.5	-2.4	

1/ Nonfinancial public sector includes the national government, CB-BOL, 14 monitored government-owned enterprises, social security institutions, and local governments. Debt is gross and consolidated (net of intra-nonfinancial public sector holdings of debt).
2/ Revenue is the sum of all nonfinancial public sector revenue net of intra-public sector payments. It is assumed that 80 percent of Bureau of Treasury revenue represents interest and dividends from other parts of the nonfinancial public sector.
3/ Derived as [(r - p(1+g) - g + ae(1+r)]/(1+g+p+gp)) times previous period debt ratio, with r = interest rate; p = growth rate of GDP deflator; g = real GDP growth rate; a = share of foreign-currency denominated debt; and e = nominal exchange rate depreciation (measured by increase in local currency value of U.S. dollar).
4/ The real interest rate contribution is derived from the denominator in footnote 2/ as r - π (1+g) and the real growth contribution as -g.
5/ The exchange rate contribution is derived from the numerator in footnote 2/ as ae(1+r).
6/ For projections, this line includes exchange rate changes.
7/ Defined as public sector deficit, plus amortization of medium- and long-term public sector debt, plus short-term debt at end of previous period.
8/ The key variables include real GDP growth; real interest rate; and primary balance in percent of GDP.
9/ Derived as nominal interest expenditure divided by previous period debt stock.
10/ Assumes that key variables (real GDP growth, real interest rate, and other identified debt-creating flows) remain at the level of the last projection year.

Figure A1. Public Debt Sustainability: Bound Tests 1/
(Public debt in percent of GDP)



Sources: International Monetary Fund, Country desk data, and staff estimates.

1/ Shaded areas represent actual data. Individual shocks are permanent one-half standard deviation shocks. Figures in the boxes represent average projections for the respective variables in the baseline scenario and scenario being presented. Ten-year historical average for the variable is also shown.

2/ Permanent 1/4 standard deviation shocks applied to real interest rate, growth rate, and primary balance.

3/ One-time real depreciation of 30 percent and 10 percent of GDP shock to contingent liabilities occur in 2007, with real depreciation defined as nominal depreciation (measured by percentage fall in dollar value of local currency) minus domestic inflation (based on GDP deflator).

Table A.2. Philippines: External Debt Sustainability Framework, 2003-13
(In percent of GDP, unless otherwise indicated)

	Actual					Projections						
	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	**Debt-stabilizing noninterest current account 6/**
Baseline: external debt	79.2	70.7	62.6	51.8	45.7	**39.1**	**40.2**	**38.2**	**36.0**	**34.2**	**32.9**	**-0.5**
Change in external debt	1.5	-8.5	-8.1	-10.8	-6.1	-6.6	1.2	-2.1	-2.2	-1.8	-1.3	
Identified external debt-creating flows (4+8+9)	-3.9	-9.2	-13.7	-19.1	-15.8	-2.8	-3.0	-4.0	-3.0	-2.6	-2.3	
Current account deficit, excluding interest payments	-3.6	-4.8	-5.3	-7.8	-7.7	-4.0	-4.9	-4.9	-4.1	-3.2	-2.5	
Deficit in balance of goods and services	9.8	8.6	9.2	5.6	5.0	8.1	8.1	8.2	9.0	9.5	9.5	
Exports	48.6	49.3	45.3	45.1	40.1	36.1	39.6	41.0	42.0	42.7	43.5	
Imports	58.4	57.9	54.5	50.7	45.1	44.2	47.6	49.2	51.0	52.2	53.0	
Net nondebt creating capital inflows (negative)	-0.8	-0.7	-3.2	-4.5	-1.9	0.0	0.1	-0.6	-0.6	-0.8	-1.0	
Automatic debt dynamics 1/	0.5	-3.7	-5.2	-6.7	-6.3	1.3	1.8	1.5	1.7	1.4	1.2	
Contribution from nominal interest rate	3.2	2.9	3.3	3.3	3.3	3.0	3.2	3.1	3.5	3.2	2.9	
Contribution from real GDP growth	-3.7	-4.6	-3.1	-2.8	-3.0	-1.7	-1.4	-1.7	-1.8	-1.8	-1.8	
Contribution from price and exchange rate changes 2/	0.9	-2.0	-5.4	-7.1	-6.5	...	...	...	...	...	...	
Residual, incl. change in gross foreign assets (2-3) 3/	5.4	0.7	5.6	8.2	9.8	-3.9	4.2	2.0	0.8	0.8	1.0	
External debt-to-exports ratio (in percent)	162.9	143.5	138.2	114.9	114.0	108.3	101.7	93.2	85.8	80.2	75.8	
Gross external financing need (in billions of U.S. dollars) 4/	13.1	12.5	11.1	10.1	6.9	14.0	11.7	10.8	15.3	16.7	17.8	
in percent of GDP	16.5	14.4	11.2	8.6	4.8	8.3	7.2	6.2	8.2	8.4	8.3	
Scenario with key variables at their historical averages 5/						**39.1**	**33.7**	**29.6**	**24.6**	**19.5**	**14.7**	**-2.3**
Key Macroeconomic Assumptions Underlying Baseline												
Real GDP growth (in percent)	4.9	6.4	5.0	5.4	7.2	4.4	3.5	4.4	5.0	5.4	5.5	
GDP deflator in U.S. dollars (change in percent)	-1.2	2.6	8.3	12.9	14.3	12.4	-6.6	1.9	2.0	2.0	2.0	
Nominal external interest rate (in percent)	4.3	4.0	5.3	6.2	7.7	7.6	8.0	8.3	9.7	9.6	9.2	
Growth of exports (U.S. dollar terms, in percent)	2.4	10.6	4.6	18.3	9.4	5.6	5.9	10.2	9.6	9.3	9.5	
Growth of imports (U.S. dollar terms, in percent)	2.6	8.1	7.2	10.5	9.3	15.0	4.2	9.8	10.9	10.1	9.1	
Current account balance, excluding interest payments	3.6	4.8	5.3	7.8	7.7	4.0	4.9	4.9	4.1	3.2	2.5	
Net nondebt creating capital inflows	0.8	0.7	3.2	4.5	1.9	0.0	-0.1	0.6	0.6	0.8	1.0	

1/ Derived as $[r - g - \rho(1+g) + \varepsilon\alpha(1+r)]/(1+g+\rho+g\rho)$ times previous period debt stock, with r = nominal effective interest rate on external debt; ρ = change in domestic GDP deflator in U.S. dollar terms, g = real GDP growth rate, ε = nominal appreciation (increase in dollar value of domestic currency), and α = share of domestic-currency denominated debt in total external debt.

2/ The contribution from price and exchange rate changes is defined as $[-\rho(1+g) + \varepsilon\alpha(1+r)]/(1+g+\rho+g\rho)$ times previous period debt stock. ρ increases with an appreciating domestic currency ($\varepsilon > 0$) and rising inflation (based on GDP deflator).

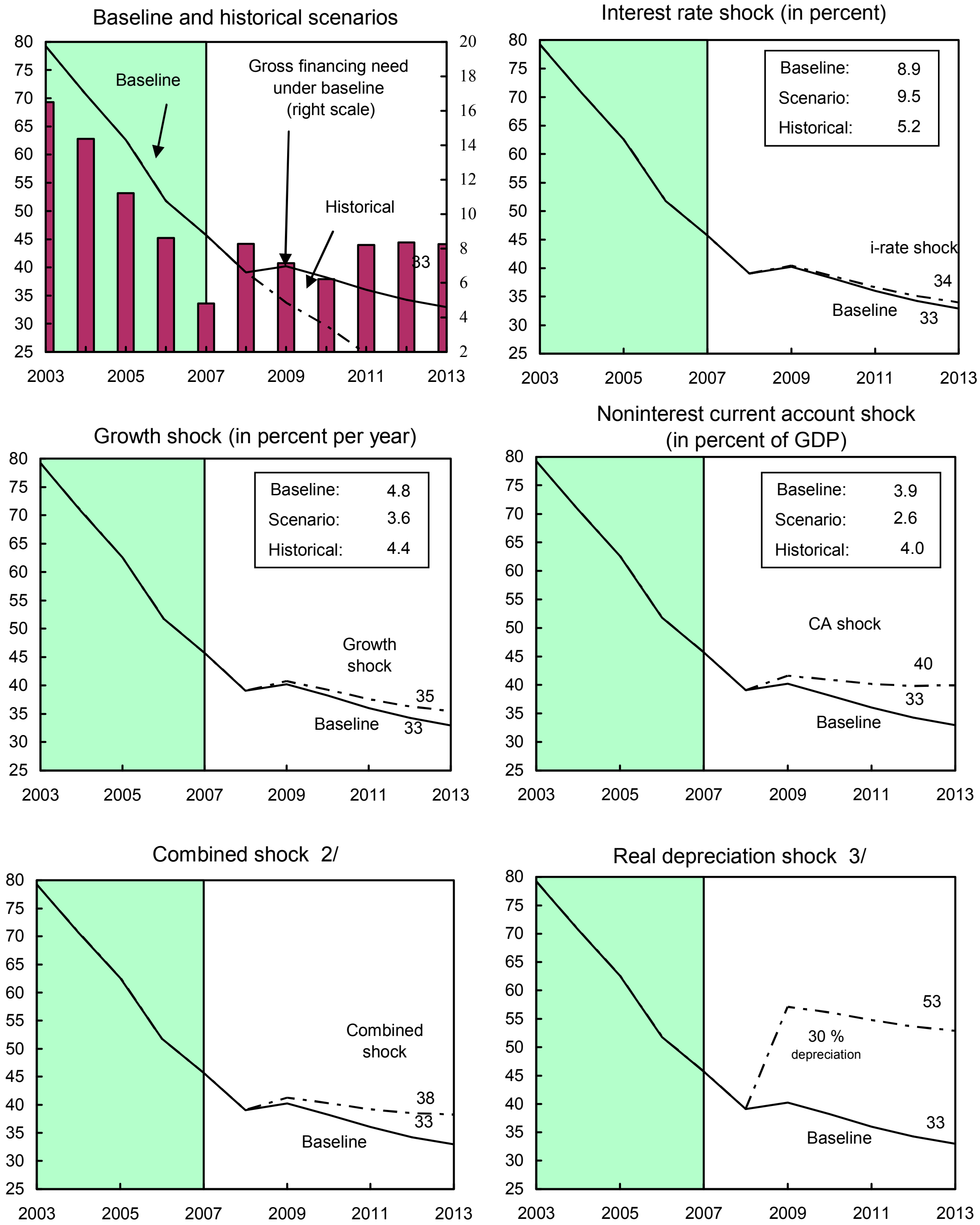
3/ For projection, line includes the impact of price and exchange rate changes.

4/ Defined as current account deficit, plus amortization on medium- and long-term debt, plus short-term debt at end of previous period.

5/ The key variables include real GDP growth; nominal interest rate; dollar deflator growth; and both noninterest current account and non-debt inflows in percent of GDP.

6/ Long-run, constant balance that stabilizes the debt ratio assuming that key variables (real GDP growth, nominal interest rate, dollar deflator growth, and nondebt inflows in percent of GDP) remain at their levels of the last projection year.

Figure A.2. Philippines: External Debt Sustainability: Bound Tests 1/
(External debt in percent of GDP)



Sources: International Monetary Fund, Country desk data, and staff estimates.

1/ Shaded areas represent actual data. Individual shocks are permanent one-half standard deviation shocks. Figures in the boxes represent average projections for the respective variables in the baseline and scenario being presented. Ten-year historical average for the variable is also shown.
2/ Permanent 1/4 standard deviation shocks applied to real interest rate, growth rate, and current account balance.
3/ One-time real depreciation of 30 percent occurs in 2008.

INTERNATIONAL MONETARY FUND

PHILIPPINES

Staff Report for the 2008 Article IV Consultation—Informational Annex

Prepared by the Asia and Pacific Department

December 22, 2008

Contents — Page

ANNEX I: PHILIPPINES: FUND RELATIONS

(As of November 30, 2008)

I. **Membership Status**: Joined: December 27, 1945; Article VIII

II. **General Resources Account**:

	SDR Million	% Quota
Quota	879.90	100.00
Fund holdings of currency	792.25	90.04
Reserve position in Fund	87.66	9.96

III. **SDR Department**:

	SDR Million	% Allocation
Net cumulative allocation	116.60	100.00
Holdings	6.91	5.93

IV. **Outstanding Purchases and Loans**: None

V. **Financial Arrangements**:

Type	Approval Date	Expiration Date	Amount Approved (SDR Million)	Amount Drawn (SDR Million)
Stand-by	04/01/1998	12/31/2000	1,020.79	783.23
EFF	06/24/1994	03/31/1998	791.20	791.20
Stand-by	02/20/1991	03/31/1993	334.20	334.20

Post-program monitoring ended following the advance repurchase made by the Philippines on December 29, 2006.

VI. **Projected Obligations to Fund**: SDR million; based on existing use of resources and present holdings of SDRs:

	Forthcoming			
	2009	2010	2011	2012
Principal	...	...	...	...
Charges/Interest	1.18	1.15	1.15	1.15
Total	1.18	1.15	1.15	1.15

VII. **Exchange Arrangement**:

The exchange arrangement is classified as an independent float. The value of the Philippine peso is determined in the interbank foreign exchange market; the Bangko Sentral intervenes in the spot and forward markets in order to smooth undue short-term fluctuations in the exchange rate and to strategically build reserves.

VIII. **Article IV Consultation**:

The Philippines is on the standard 12-month cycle. The 2007 Article IV consultation was discussed by the Executive Board on March 12, 2008.

IX. **FSAP and ROSC Participation**:

MCM: The Philippines' FSAP was conducted during the fourth quarter of 2001; FSAP missions visited Manila in October and November–December 2001. The final version of the report was discussed with the authorities in June 2002. The associated FSSA was discussed by the Executive Board together with the Article IV staff report in September 2002.

FAD: Discussions on fiscal transparency were held in Manila in September 2001. The ROSC report was discussed by the Executive Board in September 2002 together with the Article IV staff report, and published in October 2002. The update to the ROSC report was published in June 2004. FAD adviser has visited Manila six times (June and September 2006, January, March, May, and July 2007). (Funding is available for a further three visits, if warranted by an improvement in reform progress).

STA: ROSC Data Module mission was conducted in September 2003, and the report was published in August 2004.

X. **Technical Assistance**:

An MCM resident banking supervision advisor has been stationed in Manila since May 2003, to assist the BSP in the implementation of a new supervisory model. An MCM mission visited Manila in February 2005 to review the payment systems, central bank accounting, and government bond market development. An MCM mission took place in July 2006 to review the regulation and infrastructure of the domestic debt market. Another MCM visited Manila in November 2006 to advise on liberalization of the foreign exchange market.

An STA peripatetic mission visited Manila in July–August 2003, January–February 2004, and February–March 2005 to provide technical assistance in balance of payments and international investment position statistics and in implementing the recommendations made by the ROSC Data Module mission. An STA mission took place in March–April 2006 to assist the authorities in compiling and disseminating government finance statistics in accordance with GFSM 2001.

An FAD mission to provide a briefing to the new tax commissioner took place in April-May 2001. An FAD mission reviewed VAT and excise administration in December 2001. An FAD staff member participated in the July 2004 PPM mission to evaluate and advice on tax measures. An FAD mission visited Manila in November–December 2005 to provide assistance in the areas of tax and customs administration and another mission was fielded in March 2006 to reach agreement with the authorities on the priorities of the BIR reform agenda. An FAD tax administration advisor visited Manila seven times during the period June 2006 to September 2008 to assist the Tax Administration Reform Group.

An LEG legal expert visited Manila to discuss anti-money laundering initiatives in March 2002.

XI. **Resident Representative**:

A Resident Representative has been stationed in Manila since January 1984. Mr. Reza Baqir assumed the post of Resident Representative in July 2005.

XII. **Fourth Amendment to the Articles of Agreement**:

The authorities have formally communicated to the Fund their acceptance of the Fourth Amendment, which was ratified by the Upper House of Parliament (Senate) in August 2001.

ANNEX II: PHILIPPINES: RELATIONS WITH THE WORLD BANK GROUP

World Bank lending and nonlending activities

Since the World Bank started operations in the Philippines, it has committed approximately $12 billion under IBRD loans and $239 million under IDA credits (fewer cancellations). As of September 30, 2008, the Philippine portfolio consisted of 26 projects, amounting to $1.41 billion with undisbursed balance of $923.5 million. Two projects were approved in FY08: the Bicol Power Restoration Project ($12.9 million) and the National Roads Improvement and Management Project 2 ($232 million). Based on net commitments and by sector, the current portfolio can be broken down as follows: human development ($371 million, 26 percent); transport and energy ($323 million, 23 percent); rural development and environment ($304.8 million, 22 percent); urban development (244.0 million, 17 percent); social development ($136.8 million, 10 percent); and governance and economic management ($32.9 million, 2 percent).

The current Philippines Country Assistance Strategy (CAS) builds on the government's 2004–10 Medium-Term Philippines Development Plan and has two main goals: economic growth and social inclusion. It also identifies two important levers for pursuing these goals: achieving fiscal stability and improving governance. The CAS supports *Islands of Good Governance* (successful experiences of public service delivery and effective public institutions) in national government agencies, local governments, and dynamic sectors in the Philippines that demonstrate how improved accountability and service delivery can lead to better economic and social outcomes. The CAS Progress Report of June 2007 re-affirmed the relevance of the CAS theme of supporting *Islands of Good Governance,* recommended an extension of the CAS for one year (to end-FY09), and a scaling up of the Bank's lending based on the increased fiscal space and government demand for more Bank assistance.

The extended coverage of the current CAS is up to June 2009. The World Bank is now in the process of formulating a new CAS to cover the period July 1, 2009 to June 30, 2012. Emerging shifts in strategy include: increasing focus on direct poverty alleviation; operationalizing the focus on governance; expanding and re-focusing the knowledge agenda; and strengthening linkages to global issues—climate change and disaster risk management. The new CAS is expected to be discussed by the Bank's Board in April 2009.

An important aspect of World Bank support to the Philippines is in the form of analytical and advisory activities leveraged through partnerships with other organizations, administration of trust funds, and policy dialogue. The World Bank is implementing a more programmatic approach to its AAA program in the Philippines, and will continue this with *Inclusive Growth* as the AAA flagship theme that addresses the topical issue in the Philippines today of how to get more growth and how to make it more inclusive. The Inclusive Growth AAA is in addition to AAA on macro/fiscal, governance, health, education, local government issues, rural poverty reduction, environment and social safeguards. Two major pieces of ESW were delivered in FY08, including a Country Procurement Assessment Report and a Development Update for the Philippines Development Forum (PDF), and three key ESW products **are**

expected in FY09—**the** Philippines Development Report, Inclusive Growth, and Country Environment Assessment.

The Bank has an extensive outreach program in the Philippines to promote knowledge sharing. Currently, there are 11 Knowledge for Development Centers (KDCs) around the country that make available Bank publications and development literature either through on-line access or through hard copies. The Bank has also partnered with the Asian Institute of Management to create a Global Distance Learning Network that offers distance learning sessions for a broad national, regional, and international audience. In addition, the Bank also maintains an external country website (www.worldbank.org.ph).

Partnership

Strategic partnerships, supported by large bilateral and multi-donor trust funds administered by the World Bank, are beginning to form a growing line of business in the Philippines, as the government and its development partners move toward coordinated sector-wide approaches in delivering development assistance to various sectors, in line with the Paris Declaration.

The PDF, formerly called the Consultative Group (CG), is the primary mechanism of the government for facilitating substantive policy dialogue among various development partners and other stakeholders on the country's development agenda. The main event is held in country every 12 months, and the next PDF is scheduled to convene in March 2009. The PDF is chaired by the Philippine Government, represented by the Department of Finance, and the World Bank serves as the co-chair. The PDF has eight working groups in the following areas to facilitate the policy dialogue throughout the year related to their specific themes: MDGs and social progress; growth and investment climate; economic and fiscal reforms; governance and anti-corruption; Mindanao, sustainable rural development; infrastructure, and decentralization and local government. The World Bank is actively engaged as co-lead convener or participant in all the PDF working groups.

Table 1. Board Approvals for Loans between July 1, 2000 and September 30, 2008
(In millions of U.S. dollars)

Name	IBRD Amount	Effective Date
Land Administration Management Project (LIL)	4.79	1/9/01
Metro Manila Urban Integration Project	60.00	12/6/01
LGU Urban Water and Sanitation Project 2	30.00	5/16/02
Social Expenditure Management 2	100.00	12/11/02
Kalahi Community Development Project	100.00	12/16/02
Second Agrarian Reform Communities Project	50.00	6/4/03
ARMM Social Fund	33.6	5/19/03
Judicial Reform	21.9	12/04/03
Rural Power	10.00	5/06/04
Laguna de Bay Institutional Strengthening and Community Participation	5.00	4/02/04
Diversified Farm Income and Market Development	60.00	10/29/04
Second Women’s Health and Nutrition Project	16.0	12/28/05
Second Land Administration and Management Project	19.0	10/11/05
Third Manila Sewerage Project	64.0	3/06/06
National Program Support for Basic Education	200.0	1/01/07
National Program Support for Health	110.0	3/27/07
Support for Strategic Local Development and Investment	100.0	2/28/07
Development Policy Loan	250.0	12/21/06
National Program Support for Tax Administration Reforms	11.0	6/25/07
Mindanao Rural Development Project 2	83.8	7/03/07
National Program Support for Environment and Nat. Resources Mgmt.	50.0	11/27/07
Bicol Power Restoration Project	12.9	5/21/08
National Roads Improvement and Management Project 2	232.0	NYE

NYE: not yet effective.

Table 2. IBRD/IDA Lending Operations as of September 30, 2008
(In millions of U.S. dollars)

	IBRD	IDA	TOTAL 3/
Total disbursed 1/	9,650.5	244.0	9,894.5
Total commitments 1/	11,839.2	239.5	12,078.7
Total undisbursed	997.5	0	997.5
Total repaid	7,161.4	70.2	7231.6

1/ Net of cancellations.

Table 3. IFC investments as of September 30, 2008
(In millions of U.S. dollars)

Total commitments held by IFC and participants	978.53
Total commitments held by IFC alone	973.64
Approvals pending commitments:	
IFC	250
Participants	0

ANNEX III: PHILIPPINES: RELATIONS WITH THE ASIAN DEVELOPMENT BANK

From January 2005 to June 30, 2008, the Asian Development Bank (AsDB) approved seven public sector loans totaling $1.409 billion,[1] including $1.35 billion for five policy-based loans[2] and $28.5 million for 25 technical assistance and grant-financed projects; generated $559 million in co-financing; approved $434.4 million for private sector operations; and supported two peso bond issues totaling P 7.5 billion to finance local currency operations.[3]

Since joining the AsDB in 1966, the Philippines has received 202 loans for a total of $10.15 billion, and 332 technical assistance grants amounting to $152.36 million. Energy and agriculture account for the largest proportion of lending (Table 1). Since 1998, 76 percent of lending has been for policy-based operations and 24 percent for investment projects.

Table 1. Philippines: Cumulative AsDB Lending to the Philippines
(As of September 30, 2008)

	No. of Loans	Amount of Loans ($ million)	Percent (by amount)
Energy	25	2,657.1	26.2
Agriculture	47	1,572.3	15.5
Multisector	28	1,175.8	11.6
Finance	19	1,128.0	11.1
Transport and Communication	23	996.8	9.8
Water	20	731.1	7.2
Private Sector	18	595.3	5.9
Law	3	553.0	5.4
Health	6	317.4	3.1
Education	8	252.0	2.5
Industry and Trade	5	174.0	1.7
Total	**202**	**10,152.8**	**100.0**

AsDB's private sector operations, which are made without government guarantee, amounted to $632.2 million, including 18 loans of $595.3 million and 20 equity investments of $36.8 million. The Philippines is one of the largest clients for these activities. Private sector operations can be applied flexibly across projects, though the focus would be on the development of critical infrastructure projects and promotion of key financial sector initiatives. Targeted infrastructure projects include power generation and transmission, renewable energy, energy efficiency, water supply, sanitation and waste management sectors,

[1] Two project loans for $59 million were among these.

[2] In 2007, two policy-based loans totaling $550 million (94 percent of all lending) and one project loan were approved.

[3] These comprised bond issues of P 2.5 billion in October 2005 and P 5 billion in May 2007 to fund a loan to a special-purpose vehicle for the resolution of nonperforming loans.

toll road construction and operation, light rail systems, housing finance, and port operations. In the financial sector, target opportunities include (i) provision of a loan to domestic banks or nonbank companies to support microfinance and small and medium enterprises; (ii) asset backed securities; (iii) support for the issuance of corporate bonds to develop the capital market, and (iv) partial credit guarantees to support lending to small and medium-term enterprises.

The AsDB's Philippines Country Strategy and Program 2005–07 (CSP) provides the framework for the alignment of AsDB's activities with Philippine priorities. In 2007, the AsDB and the Government of the Philippines agreed on an operational program for 2007–08, which extended the CSP by one year through the Country Operations Business Plan (COBP) 2007–08. In 2008, AsDB and the government agreed on an operational program for 2009–10, which extends the CSP by another two years. The strategic focus of the CSP on fiscal consolidation, improved investment climate, and accelerated attainment of the Millennium Development Goals remains valid. The extension of the CSP to 2010 will align the cycle of the Country Partnership Strategy (CPS) with the government's planning cycle. The indicative assistance pipeline for lending products includes a total of $624 million for 2009 and $350 million for 2010. AsDB would continue its support for medium-term reforms via the Development Policy Support Program, the Financial Market Regulation and Intermediation Program, and the Local Government Financing and Budget Reform Program. The share of policy-based loans in total loans is expected to be 66 percent.

In the recent Country Assistance Program Evaluation (CAPE)[4] conducted by AsDB's Operations Evaluation Department, AsDB's assistance over the past four years was assessed as highly relevant, aligned with national priorities. The assistance program was particularly effective in helping the government achieve progress in addressing the need to improve fiscal performance. AsDB has directly supported government efforts to increase development effectiveness and has helped implement new, more transparent procurement regulations. Loans, technical assistance projects and advocacy have had a significant impact on the direction of sector reforms and capacity development, especially for financial sector regulation and intermediation, and local government reform. To increase its relevance, AsDB's partnerships outside the national government are being intensified or created, including those with government-owned and controlled corporations, Local government units, the Supreme Court and other pillars of justice, business groups, and civil society.

[4] AsDB. 2008. *Philippines Country Assistance Program Evaluation: Increasing Strategic Focus for Better Results.* Manila.

ANNEX IV: PHILIPPINES: STATISTICAL ISSUES

Data provision has some shortcomings, but is broadly adequate for surveillance. A Report on the Observance of Standards and Codes (ROSC)—Data Module was published on the IMF website in August 2004. The ROSC identified the national accounts and balance of payments statistics as needing particular attention. The country subscribed to the Special Data Dissemination Standards in August 1996.

A. National Accounts

Despite the authorities' efforts to improve quality, weaknesses remain in the national accounts. These include large discrepancies in GDP estimates between the expenditure and production sides (the official GDP estimates), with consequent differences in estimates of GDP growth.

The data ROSC identified a number of causes for these problems.[5]

- **Deaths and births of establishments are not adequately captured**. This gap is of growing importance given the rapid structural change in the economy in recent years, with a large number of new establishments, in particular in the electronics and information technology industries.

- **Compilation relies on an outdated benchmark year and fixed input-output ratios**. Estimates are derived by extrapolation of the 1988 benchmark year using fixed input-output ratios. For example, GDP statistics for the electronic sector suggest that value added remained at 10 percent of exports over the past years in spite of industry evidence that the domestic component of exports has been rising sharply.[6]

- **Statistical techniques in estimating GDP at constant prices are inadequate**. For most activities, not all components of the production accounts are compiled, instead only value added is estimated. Value added at current prices is calculated by extrapolating the benchmark year value with an indicator for the value of output; data in constant prices are estimated using a price deflator for output. In addition, the national accounts constant price estimates for merchandise exports and imports are constructed by multiplying 1985 values by quantity data (weights) from the foreign trade statistics for current years. Because of this inappropriate method, implicit deflators for electric machinery products appear high compared with developments in world market prices.

The consumer price index has been compiled since February 2004 using weights based on the 2000 Family Income and Expenditures survey. A notable change was that the weight

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[5] Currently, the authorities are compiling new national accounts series based on the *1993 SNA* guidelines.

[6] Industry representatives indicate that the domestic component has increased significantly to around 30 percent in recent years.

given to the group comprising food, beverages, and tobacco decreased to 50 percent in 2000 from 55 percent in 1994, the previous weight reference year.

B. External Sector Statistics

Steps have been taken to improve the quality of balance of payment statistics. In 2005, Bangko Sentral ng Pilipinas (BSP) created a new Department of Economic Statistics, with one of its units to concentrate on compiling, analyzing, and publishing the balance of payments and the international investment position. Progress since 2004 has included a significant improvement in the measurement of imports to correct an underestimation of imports of electronic goods on a consignment basis, improvements in the classification and recording of remittances, the introduction of a new methodology for measuring trade credits, and progress in the direct investment survey. Data for external debt and reserves are generally of good quality, although the data ROSC mission identified scope for improvement.

The revisions to imports have narrowed the gap between national trade data and those of partner countries on a net basis. An interagency task force on import statistics was established in July 2002 to improve the measurement of activity in the electronics sector, which accounts for about 43 percent of trade flows. Results of surveys covering electronics sector raw material imports confirmed that imports were routinely underestimated in reports to the National Statistics Office. Import figures have therefore been revised substantially, back to 2000.[7] However, substantial differences remain with partner country data on gross flows of exports and imports, with the latter about 15 percent higher than the corresponding national data. The BSP is continuing research on the factors behind discrepancies in data related to trade in processed goods, such as electronics and textiles.

Challenges remain for addressing certain compilation issues. Since deregulation in the early 1990s, international transactions have increasingly flowed through nontraditional channels that are not adequately covered by the statistical reporting system. The Foreign Currency Deposit Units (FCDUs), which account for about 70–75 percent of foreign exchange settlements, are exempt from reporting requirements because of strict banking secrecy rules. Steps have been taken to measure cross-border transactions that skirt the domestic banking system, such as flows through inter-company accounts.[8] Enterprise surveys, for example, have been introduced, although these are conducted on a voluntary basis and will take time to implement fully. Unless modifications are made to secrecy rules associated with FCDU accounts to facilitate the collection of data for statistical purposes,

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[7] Data from 1996–99 have not been revised and remain underestimated.

[8] According to recent household surveys, typically about 30 percent of remittances of Overseas Filipino Workers were not channeled through the banking system, suggesting that remittances may have been underestimated by about US$3 billion (3.8 percent of GDP) in 2002.

compilers of the balance of payments will continue to face challenges in securing adequate source data.

C. Monetary and Financial Statistics

Compilation of monetary and financial statistics (MFS) largely conforms to the Fund's methodology. The October 2007 MFS mission introduced the standardized report forms (SRFs) for reporting monetary statistics to the IMF and an integrated monetary database (IMD) that will meet the data needs of the BSP, APD, and STA. The IMD will become operational when the BSP submits data in the SRFs.

D. Government Finance Statistics

While the Philippines meets the requirements of fiscal transparency in many important respects, the fiscal and data ROSCs found areas that require strengthening. An important problem is that the budget is presented on an obligations basis, while the deficit is reported on a cash basis. In addition, the budget classification differs from the accounting classification, complicating comparisons of budget and outcomes. Moreover, for levels of the public sector beyond the budgetary central (national) government, consolidated fiscal outturns for items other than the fiscal balance are generally unavailable. In addition, there is a discrepancy between stocks and flows resulting from differences in time of recording and inconsistency in the coverage and classification of some transactions related to debt guarantees and assumed debt. The authorities agreed to compare the coverage of data in the two debt recording systems, standardize the classifications of these transactions, and improve the recording of debt transactions according to international best practice.

The introduction of a standardized chart of accounts, and the electronic New Government Accounting System has facilitated the compilation of annual financial statements for all the levels of the public sector. The accounting system allows for the compilation of accrual based accounts and also provides for the compilation of a statement of cash flows. These statements become available six months after the end of a reference period. In addition, the mission worked with the authorities to revise classifications in the chart of accounts, in order to allow for the consolidation of data for the nonfinancial public sector as a whole. Also, it recommended separating the market and nonmarket activities of the government-owned-and-controlled-corporations, so that consolidated data for the general government sector could be compiled.

Annual data covering only the budgetary central government are reported for publication in the *GFSY*, and monthly budgetary central government data are published in the *IFS*. A dedicated unit in the Department of Finance was created to compile government finance statistics in accordance with *GFSM 2001* framework.

TABLE OF COMMON INDICATORS REQUIRED FOR SURVEILLANCE

(As of December 5, 2008)

	Date of Latest Observation	Date Received	Frequency of Data[7]	Frequency of Reporting[7]	Frequency of Publication[7]	Memo Items: Data Quality – Methodological Soundness[8]	Memo Items: Data Quality – Accuracy and Reliability[9]
Exchange Rates	Dec 08	Dec 5/08	D	D	D		
International Reserve Assets and Reserve Liabilities of the Monetary Authorities[1]	Nov 08	Dec 5/08	D	D	M		
Reserve/Base Money	Sep 08	Nov 120/08	D	W	W	O, LO, LO, LNO	LO, O, O, O, LO
Broad Money	Sep 08	Nov 12/08	M	M	M		
Central Bank Balance Sheet	Aug 08	Oct 20/08	M	M	M		
Consolidated Balance Sheet of the Banking System	Jun 08	Nov 4/08	M	M	M		
Interest Rates[2]	Dec 08	Dec 5/08	D	D	D		
Consumer Price Index	Nov 08	Dec 5/08	M	M	M	O, O, O, O	O, LO, O, LO, LO
Revenue, Expenditure, Balance and Composition of Financing[3] – General Government[4]	Q2/08	Jul/08	Q	Q	Q	LO, LO, O, O	LO, LO, LO, LO, LO
Revenue, Expenditure, Balance and Composition of Financing[3]– Central Government	Oct 08	Nov 18/08	M	M	M		
Stocks of Central Government and Central Government-Guaranteed Debt[5]	Q2/08	Sep 17/08	Q	Q	Q		
External Current Account Balance	Q2/08	Sep 18/08	Q	Q	Q	O, LO, LO, LO	LNO, LO, O, LO, LO
Exports and Imports of Goods and Services	Q2/08	Sep 18/08	Q	Q	Q		
GDP/GNP	Q3/08	Nov 27/08	Q	Q	Q	LO, LO, O, LO	LNO, LNO, O, LO, O
Gross External Debt	Q2/08	Sep 30/08	Q	Q	Q		
International Investment Position[6]	2007	Sep 30/08					

[1] Includes reserve assets pledged or otherwise encumbered as well as net derivative positions.
[2] Both market-based and officially determined, including discount rates, money market rates, rates on treasury bills, notes, and bonds.
[3] Foreign, domestic bank, and domestic nonbank financing.
[4] The general government consists of the central government (budgetary funds, extra budgetary funds, and social security funds) and state and local governments.
[5] Including currency and maturity composition.
[6] Includes external gross financial asset and liability positions vis-a-vis nonresidents.
[7] Daily (D), Weekly (W), Monthly (M), Quarterly (Q), Annually (A), Irregular (I); Not Available (NA).
[8] Reflects the assessment provided in the data ROSC or the Substantive Update (published on August 25, 2004, and based on the findings of the mission that took place during September 1–16, 2003) for the dataset corresponding to the variable in each row. The assessment indicates whether international standards concerning concepts and definitions, scope, classification/sectorization, and basis for recording are fully observed (O), largely observed (LO), largely not observed (LNO), or not observed (NO).
[9] Same as footnote 8, except referring to international standards concerning source data, statistical techniques, assessment and validation of source data, assessment and validation of intermediate data and statistical outputs, and revision studies.

INTERNATIONAL MONETARY FUND

PHILIPPINES

Staff Report for the 2008 Article IV Consultation

Supplementary Information

Prepared by the Asian and Pacific Department
(In consultation with SPR)

Approved by James Gordon and Tessa van der Willigen

January 14, 2009

I. INTRODUCTION

1. This supplement to the Staff Report for the 2008 Article IV Consultation provides updates on recent economic and policy developments. These developments do not affect the overall analysis and policy recommendations contained in the staff report.

II. RECENT ECONOMIC DEVELOPMENTS AND OUTLOOK

2. The economic outlook has become more challenging than previously anticipated. The downtrend in economic sentiment indicators and high frequency trade data already point to a faster slowdown in economic activity. Notwithstanding fiscal stimulus plans, external demand is projected to worsen more rapidly in main trading partner countries. Moreover, countries hosting Philippine workers, including in the Middle East, are facing a more abrupt economic slowdown. In light of these developments, staff now expects the economy to grow 2.9 percent in 2009, below the earlier projection of 3.5 percent. Headline inflation fell from 9.9 percent in November to 8.0 percent in December, primarily driven by receding food and fuel prices. In line with slowing demand, inflation is expected to fall to 4.8 percent in 2009 compared to a previous forecast of 6 percent.

3. Domestic financial markets have improved somewhat in recent weeks. Equity prices have remained broadly stable since mid-December 2008 in line with developments elsewhere, but volatility is high. Credit spreads have narrowed since mid-December and the peso has strengthened, but high option price volatility points to continued investor uncertainty.

4. Banks' losses on securities were contained during the third quarter as some banks took advantage of the temporary relief from mark-to-market rules. Broadly as expected, some of the largest banks reported mark-to-market losses for the third quarter of 2008 (ranging

from 4 to 11 percent of capital). However, nonperforming loans have remained broadly stable to date. Unrelated to the recent financial turmoil, the Bangko Sentral ng Pilipinas (BSP) in December 2008 and January 2009 placed 18 small rural banks under receivership of the PDIC. These banks had insufficient assets to cover their liabilities, and had performed unsafe and unsound banking practices. While this action could still be challenged at the higher court, it reflects the BSP's resolve to deal with unsound banking practices. In a bid to strengthen bank capital, the BSP is in the process of introducing differentiated capital requirements consistent with pillar 2 of the Basel II framework.

5. The current account surplus is narrowing. Exports fell by an average of 13½ percent in October and November, the largest annual decline since 2001. Similarly, growth in remittance inflows slowed to 3.3 percent in October from 16.4 percent in September. However, weakening domestic demand and receding commodity prices have led to a marked slowdown in imports, containing the drop in the current account balance. Nevertheless, international reserves rose slightly (US$0.3 billion) in December to $37.1 billion partly on account of income on BSP's foreign assets, while the swap position remained broadly unchanged.

III. Monetary and Fiscal Policy

6. The BSP lowered policy rates by 50 basis points at the December policy meeting. The Monetary Board noted that the outlook was supported by the shift in the balance of risks, following the easing of commodity prices, the moderation in inflation expectations, and the expected slowdown in economic activity. The rate cut was consistent with staff's recommendation.

7. Recent fiscal developments suggest a lower-than-anticipated deficit in 2008, while the deficit in 2009 is expected to be in line with the original projections. Recent data suggest that tax revenues could be higher than originally projected by staff, while expenditures are likely to be in line with initial forecasts. The 2009 budget has been passed by the House and the Senate and is currently awaiting passage from the bicameral session of Congress. Considerations are being given to reallocating expenditure within the existing envelope to stimulate the economy. The authorities also contemplate front-loading spending, which may prove difficult due to the delayed budget approval and capacity constraints. Staff considers the cap on the 2009 deficit at 2 percent of GDP still appropriate since within this envelope, the smaller 2008 deficit would imply a larger fiscal expansion in 2009.

8. The national government successfully sold $1.5 billion worth of 10-year bonds in the international debt market in early 2009, completing the government's external funding requirement for 2009 and making the Philippines the first sovereign debt issuer in Asia this year. The offering was four times oversubscribed.

Table 1. Philippines: Selected Economic Indicators, 2004-09

Nominal GDP (2007): P6,648 billion ($144.1 billion)
Population (2007): 88.6 million
GDP per capita (2007): $1,624
Poverty headcount ratio at $2 a day at PPP (2003): 43 percent
IMF quota: SDR 879.9 million
Main products and exports: Electronics and agricultural products
Unemployment rate (2007): 7.3 percent

	2004	2005	2006	2007	2008 Est.	2009 Proj.
GDP and prices (percent change)						
Real GDP	6.4	5.0	5.4	7.2	4.4	2.9
CPI (annual average)	6.0	7.7	6.2	2.8	9.3	4.8
CPI (end year)	8.6	6.7	4.3	3.9	8.0	4.1
Investment and saving (percent of GDP)						
Gross investment	16.7	14.6	14.5	15.3	15.5	15.0
National saving 1/	18.6	16.6	19.0	19.7	17.5	16.8
Public finances (percent of GDP)						
National government balance (authorities definition)	-3.8	-2.7	-1.1	-0.2	-0.5	-1.7
National government balance (authorities definition) excl. privatization receipts)	-4.2	-3.0	-1.2	-1.5	-1.0	-1.9
National government balance 2/	-4.2	-3.0	-1.4	-1.7	-1.1	-2.0
Nonfinancial public sector balance 3/	-5.0	-2.1	0.1	0.4	-0.6	-1.8
Revenue and grants 4/	20.5	22.1	23.0	24.1	23.1	21.5
Expenditure 5/	25.5	24.1	22.9	23.7	23.7	23.3
Nonfinancial public sector debt 6/	95.2	85.9	73.9	60.9	59.9	60.4
Monetary sector (percent change, end of period)						
Broad money (M3)	10.3	10.3	22.7	10.6	13.1 8/	...
Interest rate (91-day treasury bill, end of period, in percent) 7/	8.4	6.4	5.1	4.2	5.8 9/	...
Credit to the private sector	4.9	-0.3	6.7	8.5	17.0 8/	...
External Sector						
Export value (percent change)	9.8	3.8	15.6	6.4	0.9	-0.4
Import value (percent change)	8.0	8.0	10.9	8.4	7.5	-0.4
Current account (percent of GDP)	1.9	2.0	4.5	4.4	2.0	1.8
Capital and Financial account (US$ billions, excluding errors and omissions)	-1.6	2.2	0.0	2.9	1.0	-1.9
Foreign direct investment (net)	0.1	1.7	2.8	-0.5	1.2	1.1
Other	-1.7	0.5	-2.8	3.4	-0.1	-3.0
Errors and omissions (US$ billions)	-0.3	-1.8	-1.6	-0.6	-1.7	-1.7
Overall balance (US$ billions)	-0.3	2.4	3.8	8.6	2.6	-0.7
Total external debt (percent of GDP) 10/	70.7	62.6	51.8	45.7	39.2	40.9
Debt-service ratio (percent of exports)	19.7	18.5	18.6	17.9	18.6	18.0
Reserves, adjusted (US$ billions) 11/	15.2	18.0	23.0	33.8	37.2	37.2
Reserves / Short-term liabilities, adjusted 12/	125.8	120.1	172.7	215.2	257.6	262.5
Exchange rate (period averages)						
Pesos per U.S. dollar	56.0	55.1	51.3	46.1	44.5	...
Nominal effective exchange rate (1990 =100)	75.7	76.9	82.0	89.3	90.0 13/	...
Real effective exchange rate (1990 =100)	86.2	92.3	102.5	112.3	119.2 13/	...

Sources: Philippine authorities; and IMF staff estimates and projections.

1/ Defined as the difference between gross investment and current account.
2/ Fund definition. Excludes privatization receipts of the national government, and includes net deficit from restructuring the central bank.
3/ Includes the national government, Central Bank-Board of Liquidators, 14 monitored government-owned enterprises, social security institutions, and local governments.
4/ The sum of all nonfinancial public sector revenue net of intra-public sector payments. It is assumed that 80 percent of Bureau of Treasury revenue represents interest and dividends from other parts of the nonfinancial public sector. Privatization receipts are excluded.
5/ Defined as difference between nonfinancial public sector revenue and balance.
6/ Debt is consolidated (net of intra-nonfinancial public sector holdings of debt).
7/ Secondary market rate.
8/ October 2008.
9/ December 2008.
10/ Defined as external debt plus liabilities of foreign banks in the Philippines to their headquarters, branches and agencies, external debt not registered with the central bank and private capital lease agreements.
11/ Gross reserves less gold and securities pledged as collateral against short-term liabilities.
12/ Reserves as a percent of short-term debt (including medium- and long-term debt due in the following year). Both reserves and debt were adjusted pledged assets.
13/ Average as per November 2008.

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International Monetary Fund
700 19th Street, NW
Washington, D. C. 20431 USA

IMF Executive Board Concludes 2008 Article IV Consultation with the Philippines

On January 16, 2009, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with the Philippines.[1]

Background

Following solid economic performance in recent years, the economy faced headwinds initially from the commodity price shock and subsequently from the global economic and financial turmoil. After reaching 7.2 percent in 2007, GDP growth moderated to 4.6 percent during the first three quarters of 2008, led by weaker external demand and consumption as the oil and food price shock reduced real income. Headline inflation peaked in August at 12.4 percent, but fell to 8.0 percent in December as commodity prices receded. The external position has weakened due to high commodity prices, lower exports, and more recently, capital outflows. The exchange rate depreciated accordingly, compounded by a shift to long dollar position. Yet, international reserves remain at US$37 billion, 240 percent of short-term debt.

The spillover from the global financial turmoil to domestic financial and currency markets has intensified since September. Equity prices have declined by around 48 percent in 2008, with almost half of the decline taking place since the mid-September flare up in turmoil. The wealth effect has been limited, however, with less than 2 percent of the population invested in capital markets. Measures of credit risk have increased with

[1] Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. A staff team visits the country, collects economic and financial information, and discusses with officials the country's economic developments and policies. On return to headquarters, the staff prepares a report, which forms the basis for discussion by the Executive Board. At the conclusion of the discussion, the Managing Director, as Chairman of the Board, summarizes the views of Executive Directors, and this summary is transmitted to the country's authorities.

(market-based) expected default frequencies of banks at elevated levels and Philippine sovereign spreads wider by 300 bps (EMBI+ PHL) since end-August. Yet, spreads remain 150–200 basis points lower than the EMBI+ Global average, reflecting reforms in recent years and reserve accumulation during good times.

The exposure to failed and distressed global financial institutions is limited. As of end-September 2008, direct exposures to Lehman Brothers stood at US$350 million (3 percent of equity), but a large part has already been provisioned for. Combined exposure to Lehman Brothers and ten other distressed major global financial institutions amounted to US$1.5 billion or 13 percent of equity. However, banks are exposed to market risks through their large holdings of debt securities and credit linked notes. As such, recent changes in domestic interest rates and in sovereign spreads have led to mark-to-market losses. Nonetheless, the banking system remains on average well-capitalized.

Monetary policy was recently eased as the inflation outlook improved due to receding commodity prices and the expected economic slowdown. The Bangko Sentral ng Pilipinas (BSP) has taken a number of steps to help address the fallout from the global financial crisis on local banks. The reserve requirement was recently reduced by 2 percentage points to 19 percent and the amount allocated for the rediscount window was doubled. To address tightness in the dollar interbank market, the BSP opened a dollar-denominated deposit window and a dollar repurchase facility. The BSP has also enhanced its day-to-day monitoring of the banking system and stress-testing exercises, and mark-to-market rules have been relaxed to bring relief to banks.

The 2008 budget will likely record a deficit of 1 percent of GDP, an improvement over the 2007 deficit of 1.7 percent of GDP. The tax effort is expected to remain broadly unchanged at around 14 percent of GDP. Expenditures are expected to be slightly lower, partly due to lower capital expenditure reflecting weak absorptive capacity. Nonfinancial public sector debt in percent of GDP is projected to decline modestly in 2008.

Executive Board Assessment

Executive Directors noted that the Philippine economy faces strong headwinds, but starts from a position of strength. Directors expected growth to moderate over the near term as external demand falls, and private consumption wanes with more modest remittance inflows. Weaker domestic demand, accompanied by receding commodity prices, should anchor expectations of lower inflation.

Directors welcomed the strengthening of financial sector soundness and supervision in recent years, which should enable banks to better withstand the impact of the economic slowdown. Nevertheless, continuing strains in global financial markets could lead to further losses on banks' security holdings, reduce the availability of external financing, and raise risks related to banks' off-balance sheet activities.

To limit the fallout from the global financial crisis, Directors encouraged the BSP to continue to monitor closely the banking sector and maintain supervisory vigilance. While regulatory forbearance, including the relaxation of mark-to-market accounting rules, has provided banks with temporary relief, Directors emphasized the importance of maintaining transparency regarding banks' financial positions. Directors welcomed the BSP's proactive steps to address liquidity strains, and called for existing liquidity facilities to be used flexibly, as needed to relieve further stress.

Directors agreed that the prompt corrective action (PCA) framework to address financial sector vulnerability is broadly appropriate, but saw scope for improvement, including stepped-up surveillance of off-balance sheet activities. The BSP should be given legal authority to disclose enforcement actions when disclosure does not undermine market confidence, and the BSP's charter should be amended to strengthen the legal protection of bank supervisors. Directors called in general for setting in place a more rules-based PCA framework over the medium term, with a few Directors emphasizing the need to maintain flexibility to deal with specific situations.

Directors supported the proposed increase in the Philippines Deposit Insurance Corporation (PDIC) deposit coverage, and noted the importance of allowing for flexibility to temporarily raise it further if the financial sector experiences high stress levels. Recapitalization of the PDIC will be key to support the enhanced deposit protection. Directors welcomed the proposed enhancements to the bank resolution toolkit, including the bridge-bank facility, and several Directors encouraged the authorities to reconsider a more flexible application of the purchase-and-assumption tool. Directors recommended that bank restructuring decisions be made irreversible, and that the legal protection of PDIC staff be strengthened.

Directors noted that the credibility of the inflation targeting framework has helped anchor inflation expectations. They considered appropriate the recent easing of monetary policy in light of the receding inflation pressures and the emergence of downside risks to growth. They saw scope for further monetary easing if inflation expectations continue to fall. They recommended that the exchange rate remain flexible so as to adjust to the changing external environment, with the central bank's participation in the foreign exchange market limited to smoothing erratic movements. A strategy of raising interest rates and limited unsterilized intervention, while preserving a prudently high level of foreign exchange reserves, should be considered in response to a temporary financial shock. A few Directors cautioned, however, that such a strategy should avoid inducing procyclical movements in interest rates.

Directors concurred with staff's assessment that the exchange rate of the Philippine peso is broadly in line with longer-term fundamentals and does not threaten external stability.

Noting that fiscal consolidation has reduced the public debt-to-GDP ratio significantly in recent years, Directors agreed that fiscal policy could help to cushion the current slowdown. However, given the still-high level of public debt, there should be a measured fiscal stimulus to avoid compromising fiscal sustainability and policy credibility. To provide more scope for fiscal easing and outlays on well-targeted pro-poor cash transfers, Directors suggested raising the tax collection effort, broadening the tax base, and rationalizing tax incentives. Directors welcomed the authorities' intention to limit the fiscal deficit to no more than 2 percent of GDP by being prepared to scale back expenditures in the event of a shortfall in tax revenues. They encouraged the authorities to develop specific contingency plans to address unexpected pressures on the fiscal accounts.

Directors considered that a formal medium-term fiscal framework would help strengthen fiscal policy planning. They supported the introduction of a fiscal rule, and a fiscal responsibility law providing for the full financing of new tax and expenditure measures.

Directors called for a further streamlining of the National Food Authority and other government-owned and controlled corporations. They looked forward to the completion of the privatization of the power sector.

Philippines: Selected Economic Indicators, 2004−09

	2004	2005	2006	2007	Staff Proj. 1/ 2008	2009
Growth and prices (in percent change)						
GDP growth	6.4	5.0	5.4	7.2	4.4	2.9
CPI inflation (average)	6.0	7.7	6.2	2.8	9.3	4.8
Public finances (in percent of GDP)						
National government balance (authorities' definition)	-3.8	-2.7	-1.1.	-0.2	-0.5	-1.7
National government balance 2/	-4.2	-3.0	-1.4	-1.7	-1.1	-2.0
Nonfinancial public sector balance 3/	-5.0	-2.1	0.1	0.4	-0.6	-1.8
Revenue and grants 4/	20.5	22.1	23.0	24.1	23.1	21.5
Expenditures 5/	25.5	24.1	22.9	23.7	23.7	23.3
Nonfinancial public sector debt 6/	95.2	85.9	73.9	60.9	59.9	60.4
Money and credit (in percent change)						
Broad money (M3) 7/	10.3	10.3	22.7	10.6	13.1	....
91-day T-bill rate (end period, in percent) 8/	8.4	6.4	5.1	4.2	5.8	....
Credit to the private sector (net) 7/	4.9	-0.3	6.7	8.5	17.0	....
External sector						
Current account balance (in percent of GDP)	1.9	2.0	4.5	4.4	2.0	1.8
Gross international reserves, adjusted						
In billions of U.S. dollars 9/	15.2	18.0	23.0	33.8	37.2	37.2
In percent of short-term liabilities 10/	125.8	120.1	172.7	215.2	257.6	262.5

Sources: The Philippine authorities; IMF staff estimates and projections.
1/ Projections are based on baseline scenario.
2/ IMF definition. Excludes privatization receipts of the national government, and includes net deficit from restructuring the central bank.
3/ Includes the national government, Central Bank-Board of Liquidators, 14 monitored government-owned enterprises, social security institutions, and local governments.
4/ The sum of all nonfinancial public sector revenue net of intra-public sector payments. It is assumed that 80 percent of Bureau of Treasury revenue represents interest and dividends from other parts of the nonfinancial public sector. Privatization receipts are excluded.
5/ Defined as difference between nonfinancial public sector revenue and balance.
6/ Debt is consolidated (net of intra-nonfinancial public sector holdings of debt).
7/ As of October 2008.
8/ As of December 2008.
9/ In addition to monitoring the level of gross international reserves (GIR), the IMF also monitors Adjusted Reserves, which are calculated by subtracting from GIR the value of the BSP's foreign assets that have been pledged as collateral for short-term liabilities. These pledged assets (gold and other securities) remain foreign reserve assets of the BSP and so are considered part of GIR. However, they are not as readily usable as other components of GIR since pledged assets must be set aside while the short-term liabilities they secure remain outstanding.
10/ Short-term liabilities include medium- and long-term debt due in the following year, and exclude loans backed by gold and securities pledged as collateral.

Statement by Perry Warjiyo, Executive Director for the Philippines
January 16, 2009

1. The Philippine authorities value the constructive exchange of views with the Fund staff during the Article IV consultation and their candid assessments of key economic and financial developments as well as policy responses. They also appreciate the papers on selected issues which provide valuable inputs to the discussions, particularly those related to assessing spillover effects of the global financial crisis, incorporating remittances in exchange rate assessment, and presenting alternative fiscal responses during economic downturn. The authorities affirm their commitment to sound macroeconomic management and structural reforms to better withstand the challenges in the economy as a result of the global crisis.

The Philippine economy has been holding up relatively well from the current global financial crisis and economic downturn

2. The economic growth moderated to 4.6 percent over the first three quarters of 2008 from a solid growth of 7.2 percent in 2007. The weaker external demand and impacts of oil and food price shocks on domestic consumption weighed down the growth performance and offset the favorable impacts of robust remittances and expanding services sectors. Macroeconomic stability has remained broadly intact. Prudent monetary policy response resulted in inflation decelerating to 8.0 percent in December 2008 from a peak of 12.4 percent in August. Current account recorded a surplus of US$1.2 billion during the period January-September 2008 following the robust remittances and positive export growth. The economy has also been resilient in absorbing the strains of capital outflows and corresponding pressures on the exchange rate with net international reserves further increasing to US$35.5 billion as of end 2008.

3. The authorities fully recognize that the Philippine economy would not be completely immune from the spillover effects of the global financial crisis and economic slowdown. Global economic slowdown, particularly in the US, Europe and Asia, would unduly weaken the external demand and moderate the export growth of the Philippines. Nonetheless, the authorities are confident that continued robust remittances, including revenues from business process outsourcing, along with stronger domestic economic fundamental and supportive macroeconomic and financial policies, would provide ample cushions to the economy from further downturns, allowing growth to revert to trend in the medium term. Economic growth is projected to decelerate to 3.7-4.7 percent in 2009 before it picks up to 5.2 – 6.2 percent in 2010. On inflation, latest baseline forecasts (as of December 18) showed a deceleration in the inflation path in 2009. Inflation is expected to be within the 4.5 percent ± 1.0 percentage point target for 2010. Current account will remain in surplus,

estimated at about US$2.0 billion in 2009, which will further strengthen the external position of the economy.

4. The authorities are determined to maintain sound macroeconomic management and further advance the structural reform agenda. The immediate challenge is to arrest the slowdown of economic activity. The authorities envisage a moderate fiscal policy easing in the proposed 2009 budget to cushion the slowdown without undermining fiscal consolidation and long-term sustainability. Monetary policy continues to be geared toward price stability, consistent with the inflation targeting framework, while the exchange rate remains to be market determined. Recent declines in fuel and food prices have improved both the inflation outlook and expectations, providing greater flexibility to the Bangko Sentral ng Pilipinas (BSP) to ease monetary policy. In the financial sector, focus is being given to assessing the vulnerabilities of the system and implementing measures to ensuring the availability of liquidity and thus help address the spillover effects from the global financial crisis. At the same time, contingency measures for dealing with banks under stress have been strengthened.

A moderate fiscal easing is envisaged without undermining fiscal sustainability

5. Consistent with fiscal consolidation, the deficit (excluding privatization receipts) of the National Government is projected at 1.4 percent of GDP in 2008, a moderate improvement from 1.5 percent in 2007. In an effort to stimulate investment and support household consumption, the authorities introduced tax reforms in the areas of personal income tax, corporate income tax, and Personal Equity and Retirement Act (PERA). The reforms, while resulting in tax revenue loss of about 0.6 percent of GDP in 2008, are expected to yield a higher tax collection over the medium term. The tax revenue loss has been matched by the windfall gains from high oil prices and prioritized spending to further improve the fiscal performance. Current expenditures were maintained at the budgeted level of 14.2 percent of GDP while absorptive capacity constraints resulted in a lower than budgeted capital spending of 2.5 percent of GDP.

6. For 2009, in light of the slowing economy, the authorities are proposing a fiscal deficit of 1.5 percent of GDP to accommodate higher capital expenditures and an increase in pro-poor spending. The authorities believe that this stance of fiscal policy strikes the appropriate balance between the needs for a moderate fiscal easing in the near term and continued progress in fiscal consolidation. To achieve the programmed deficit, they are confident that tax revenues could be increased to 15.9 percent of GDP while expenditures will moderate slightly to 16.7 percent of GDP. Nonetheless, in the event of a shortfall in tax revenues, expenditures would be scaled back and the deficit would be capped at 2 percent of GDP. Spending for social and physical

infrastructure will be enhanced through better targeting of existing cash-transfer schemes and improvements in the absorptive capacity of capital spending.

7. Fiscal reforms remain the priority in the agenda of the authorities. They agreed that the tax base needs to be broadened, particularly through rationalization of tax incentives, accelerating reforms in tax administration, and raising and indexing excise taxes. Fiscal consolidation will also be supported by gradual rationalization of the National Food Authority (NFA) and introduction of performance targets to other Government Owned and Controlled Corporations (GOCCs). Power sector privatization remains a priority with the turnover of the transmission facilities from the National Transmission Corporation, a GOCC, to a private entity, namely, the National Grid Corporation of the Philippines. To further strengthen fiscal management, the authorities welcome the staff's suggestion to introduce a more formalized medium-term fiscal framework, but stressed that this would need strong support of Congress.

Monetary policy strikes the appropriate balance of achieving the inflation target and mitigating the risks to growth and financial stability

8. The credibility of the inflation targeting framework (ITF) in the Philippines has helped anchor inflation expectations. For the most part of 2008, monetary policy addressed the second-round inflationary effects of high oil and food prices. BSP raised the policy rates by a combined 100 bps in June, July and August in response to the less favorable inflation outlook following the rapid rise in inflation. Subsequently, the policy has shifted to a neutral stance in October and November due in part to the upside risks associated with a weaker peso, even when inflation has decelerated. To address the risks of tight liquidity in the banking system, the reserve requirement was preemptively reduced from 21 percent to 19 percent and the amount allocated for the rediscount window doubled from PhP 20 billion to PhP 40 billion. Partly on account of the strong commitment of the BSP, inflation declined by 4 percentage points from a peak of 12.4 percent in August to 8 percent in December while the availability of liquidity in the banking system was ensured.

9. Staff's assessment that the Philippines' exchange rate is in line with fundamentals is appreciated. The authorities also value the staff's efforts in incorporating remittances in the quantitative assessment of exchange rate equilibrium. That said, a pressing challenge for monetary policy under the current global financial crisis is the volatility of capital flows. While the credible ITF has been successful in anchoring price stability, large capital flow reversals have posed a challenge to maintaining external stability. Consistent with the country's exchange rate regime, the peso remains to be market determined with BSP's participation in the foreign exchange market aimed only at smoothing volatility and promoting more orderly market movements. The

peso, like the currencies of other emerging economies, has been under strains of depreciation stemming from capital flow reversals and the uncertain global environment. Nonetheless, the accumulation in international reserves over the past years has provided the BSP ample policy space to dampen the disruptive effects of exchange rate volatility.

10. With the latest forecast of a decelerating inflation path over the two-year policy horizon, BSP decided to cut the policy rates by 50 bps in its December 18, 2008 meeting. The central bank believes that inflation will be falling within the target by 2010. The outlook is also supported by the downward shift in the balance of risks, following the easing of commodity prices, the moderation of inflation expectations, and the expected slowdown in economic activity. Overall, BSP believes that as inflation pressures continue to recede, as also evidenced in the further slowdown in inflation in December, there is greater latitude to ease policy rates. As such, monetary policy will continue to focus on achieving price stability while allowing room for economic growth.

Measures have been adopted to strengthen the banking resilience from spillover effects of the global financial crisis

11. The Philippine banking sector has faced the current global financial crisis in a relatively solid footing, due to strengthened prudential regulations and effective oversight of financial institutions over the past years. With the capital adequacy ratio averaging at around 15 percent, bank capitalization is high by regional standards while exposures to risky financial instruments are low. Loan-to-deposit ratio is near maximum at around 72 percent given reserve requirement at 21 percent (reduced to 19 percent on November 19, 2008). Sector loan concentration is limited and NPLs have declined in the last few years to around 5 percent of total loans. Moreover, risk management practices have improved and surveillance strengthened. Commercial and universal banks have adopted Basel II since June 2007, in line with the regional trend.

12. Nonetheless, the authorities shared the general thrusts of staff's assessment on the domestic and external channels of vulnerability risks from protracted global financial crisis. In response, the BSP has adopted a number of measures to further enhance the resilience of the banking sector. To address the risks of tight liquidity in the banking system, the BSP has introduced a number of measures to support interbank liquidity. Surveillance in the banking system remains strong through day-to-day monitoring and stress-testing exercises. To further safeguard deposits in the banking system, doubling of deposit insurance coverage to PhP 500,000 has been proposed while public communication has been intensified to assure depositors of the soundness of the banking system. Regulatory forbearance in mark-to-market accounting has also been introduced in line with international best practice.

13. The authorities believe that the existing contingency framework remains adequate, but took note of the staff's suggestion for further improvements in some areas. For remedial actions in dealing with banks under stress, the existing prompt corrective action (PCA) framework is considered as appropriate. The authorities take the view that the staff's suggested rule-based approach may in fact restrict the flexibility that the BSP may require from time to time to address special circumstances across individual bank situations. Although the authorities are generally receptive to the proposal for a bridge bank facility, they reiterated their position that the added benefits from a more flexible application of the purchase-and-assumption (P&A) model should not come at the expense of curtailing the underlying rights of depositors. The BSP broadly agrees with the principle of increasing the maximum deposit insurance coverage in the context of the package of reforms that are meant to strengthen the Philippine Deposit Insurance Corporation (PDIC). However, the matter of the recapitalization of the PDIC is itself subject to legislative action. They also agreed on the imperative for legal protection of all supervisors and the restriction of shareholder rights during bank restructuring.

Concluding Remarks

14. The Philippine economy has been holding up relatively well under the current global financial crisis and economic downturn. While economic growth has moderated as external demand weakened, overall macroeconomic and financial stability has remained. The authorities are fully cognizant that the economy would not be completely isolated from a prolonged and perhaps deep global economic downturn. As in the past, they are firmly committed to sound macroeconomic management and structural reforms to better fortify the economy in addressing the challenges in the near term and allowing growth to revert to trend in the medium term. In doing so, they value the Fund's views and intend to continue working closely with it through the regular Article IV consultations and technical assistance programs.