February 2010
IMF Country Report No. 10/45

Philippines: 2009 Article IV Consultation–Staff Report, Public Information Notice on the Executive Board Discussion; and Statement by the Executive Director for the Philippines

The following documents have been released and are included in this package:

- The staff report, prepared by a staff team of the IMF, following discussions that ended on November 25, 2009 with the officials of Philippines on economic developments and policies. Based on information available at the time of these discussions, the staff report was completed on January 4, 2010. 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 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 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 2009 Article IV Consultation

Prepared by the Staff Representatives for the
2009 Consultation with the Philippines

Approved by James Gordon and Tessa van der Willigen
January 4, 2010

- **Discussions**: Manila, November 16–25, 2009. The mission met: Finance Secretary Teves, Bangko Sentral ng Pilipinas (BSP) Governor Tetangco, Budget Management Secretary Andaya, National Economic Development Authority Secretary Santos, other senior government officials, and private sector representatives.

- **Team**: Messrs. I.H. Lee (Head), Eskesen, Ide, Li (all APD), Tuladhar (FAD), Khandelwal (SPR), Choi (INS), and Botman (Resident Representative). Ms. Vongpradhip (OED) attended some of the meetings.

- **Consultation focus**: With signs of a nascent recovery, the discussions focused on the need to put in place a credible fiscal consolidation strategy while avoiding premature exit from other supportive macroeconomic policies. Discussions also focused on policies to enhance financial sector stability and sustain growth over the medium term.

- **Policy dialogue**: Fund advice has found traction in the areas of fiscal consolidation, monetary policy regime, and reforms of the financial system and supervision.

- **Outreach**: The mission held a press conference on November 25, which was well attended and received extensive local media coverage.

- **Exchange rate**: Philippine's currency is the peso, which is classified as a floating exchange rate regime. The Philippines has accepted the obligations of Article VIII, Sections 2, 3, and 4, and maintains an exchange system free of restrictions on payments and transfers for current international transactions.

- **Data**: Data provision is overall adequate, 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: Growth is projected at ¾ percent in 2009 and is expected to recover to around 3¼ percent in 2010. The slowdown was cushioned by supportive fiscal and monetary policies and resilient remittances. The recovery will likely be led by private consumption as confidence improves. Investments and exports are also expected to benefit from the global recovery. Risks to this outlook are broadly balanced.

Policy issues: The discussions focused on the need to put in place a credible fiscal consolidation strategy while avoiding premature exit from other supportive macroeconomic policies. Discussions also focused on policies to enhance financial sector stability and sustain growth over the medium term.

Staff's views: In view of the nascent recovery, staff recommends a measured fiscal withdrawal in 2010 given the limited fiscal space. To demonstrate commitment to fiscal prudence, the authorities should announce a credible medium-term fiscal consolidation plan in parallel with the 2010 budget anchored on revenue raising measures. Exit from supportive monetary policies should await clear signs that the recovery is on a solid footing. The financial sector is relatively sound, but still faces some vulnerabilities. The authorities should consider introducing risk-based capital requirements and a counter-cyclical macro-prudential framework. Passage of amendments to the New Central Bank Act (NCBA) is also key to provide the supervisors with needed legal powers and protection. To shift to higher growth over the medium term, the budget should be reoriented towards public investment and the weak business environment must be revamped to encourage private sector activities.

Authorities' views: The authorities plan to contain the fiscal deficit in 2010, but noted that it would be difficult to introduce revenue raising measures ahead of the May election. They shared staff's views that it would be useful to introduce a credible medium-term fiscal consolidation plan anchored on tax reform. They did not see an urgent need to tighten the monetary policy stance given the within-target inflation projected over the policy horizon, and agreed that exit from supportive monetary policies should commence only when there are clear signs that the recovery is self-sustainable. They were also mindful that a premature rate hike could attract capital inflows. The authorities concurred that the exchange rate was broadly in line with fundamentals and intend to continue to limit foreign exchange interventions to smoothing operations. The financial sector is assessed to be generally sound, with banks benefiting from high capital buffers and low nonperforming loans. The authorities were also closely following the international debate on the lessons from the global crisis for micro- and macro-prudential regulation. They are planning to introduce a counter-cyclical liquidity framework and are eager to see the passage of the amendments to the NCBA. They acknowledge that structural reforms were imperative to generate higher growth.

I. Introduction

1. **The economy was adversely impacted in late 2008 and early 2009 by the spillovers from the global economic slowdown, but signs of stabilization have emerged**. The Philippine economy entered the crisis from a position of relative strength with limited direct exposure to strained global financial institutions, much improved bank soundness, adequate international reserves, and lower public debt due to fiscal consolidation in the preceding years. Moreover, resilient remittances and a timely policy response helped cushion the impact on the economy. Signs of stabilization have emerged in recent months in tandem with the improved global economic trends and outlook.

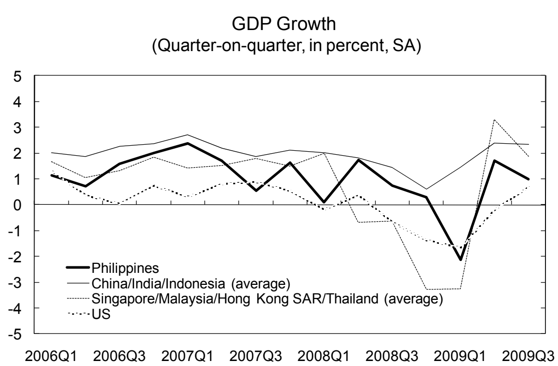
2. **Mission focus**: The 2009 Article IV discussions focused on two main themes. First, how can the authorities best safeguard the nascent economic recovery? Second, which policies are needed to reduce vulnerabilities and support growth over the medium term?

II. Recent Economic Trends and Outlook

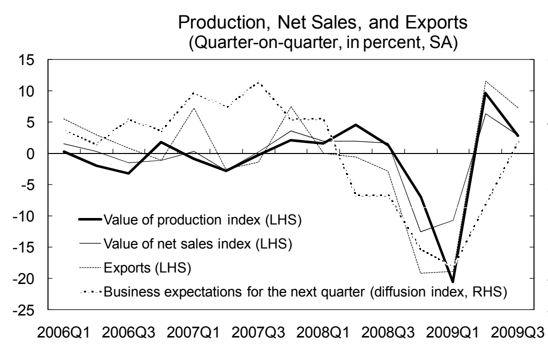
A. Stabilization and Signs of Nascent Recovery

3. **Following the dip early in the year, economic activity has rebounded while inflation remains low**.

- *Growth*: The Philippine economy avoided a technical recession, as second and third quarter GDP rebounded by 1.7 percent and 1.0 percent (q/q), respectively following the 2.1 percent (q/q) contraction in the first quarter when precautionary savings dampened private consumption and weak exports discouraged investment. The rebound was driven by resilient remittances, supportive macroeconomic policies, and a modest rebound in exports on a sequential basis, underpinned by global restocking.



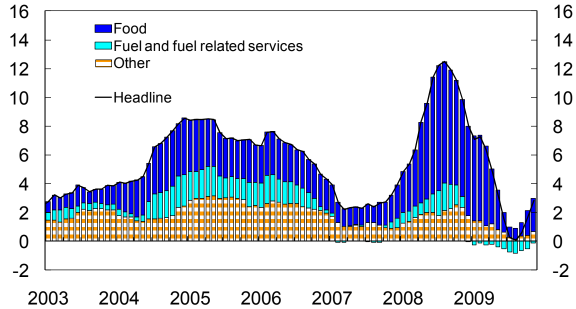
Sources: CEIC Data Company Ltd; and IMF staff calculations.



Sources: CEIC Data Company Ltd; and IMF staff calculations.

- *Inflation:* Consumer price inflation has trended down during the year, reaching 3¼ percent (y/y) during January–November 2009, slightly below the middle of the BSP's inflation target range of 3½ ± 1 percent. The deceleration in inflation has primarily been driven by the decline in food and commodity prices following their 2008 spike. Core inflation has also declined over the year from around 7 percent (y/y) at end-2008 to 2¾ percent (y/y) as of November 2009.

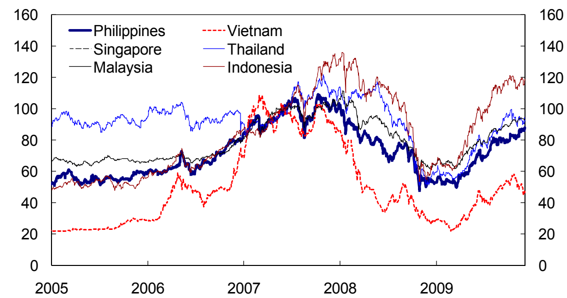
Contributions to Inflation
(Year-on-year percent change)



Sources: Philippine Authorities; and IMF staff calculations.

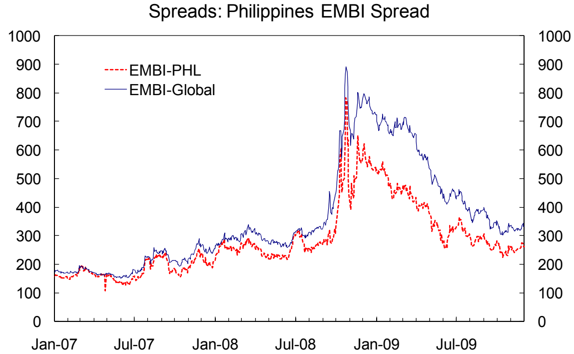
- *Financial markets:* Market conditions have normalized with equity prices at pre-crisis levels, broadly in line with regional trends. Credit spreads have narrowed supported by the return of risk appetite and ample liquidity in advanced economies. The improved market sentiment has encouraged increased corporate and sovereign bond issuances.

Equity Prices
(Index June 2007 = 100)



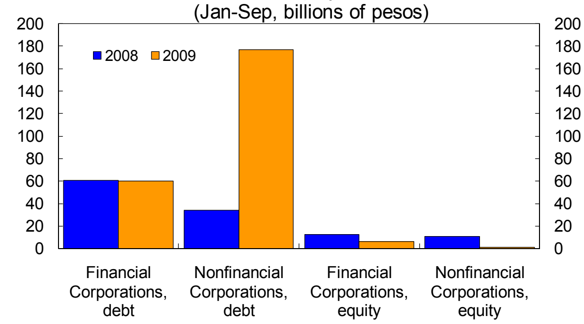
Source: Bloomberg.

Spreads: Philippines EMBI Spread



Source: Bloomberg.

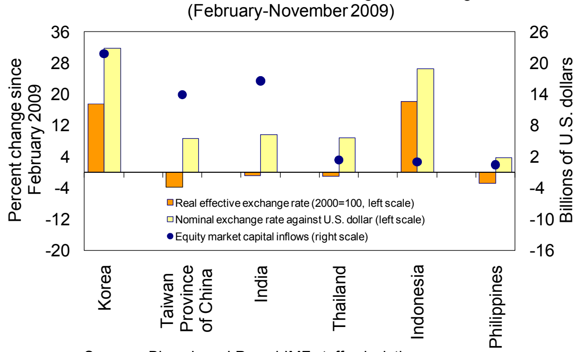
Bond and Equity Issuance 1/
(Jan-Sep, billions of pesos)



Sources: Bloomberg; and Philippines Stock Exchange.
1/ Domestic issuance in foreign and domestic currency.

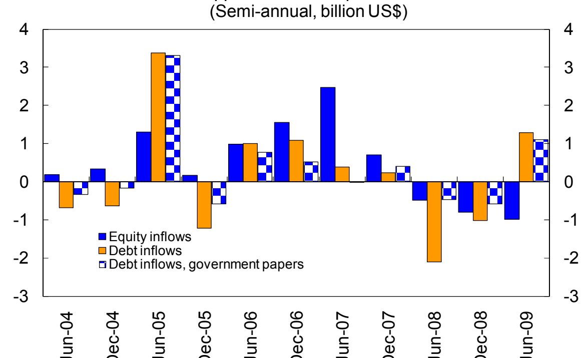
- *Capital flows*: The Philippines has not experienced the same strong reflow of capital as many of its Asian peers. While the return of risk appetite has led to a resumption of foreign inflows, the funds have primarily flowed into Philippine government and corporate bond markets. The recovery in the stock market, on the other hand, has primarily been fueled by local investors.

Selected Asia: Portfolio Inflows and Change in Exchange Rates
(February-November 2009)

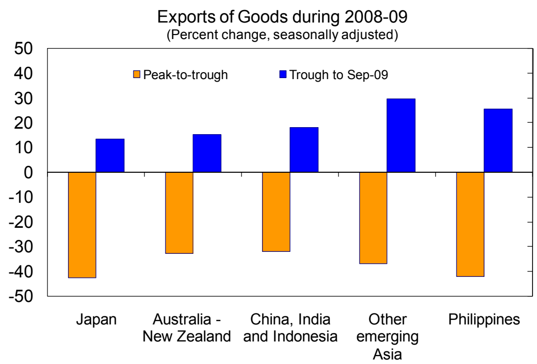


Sources: Bloomberg LP; and IMF staff calculations.

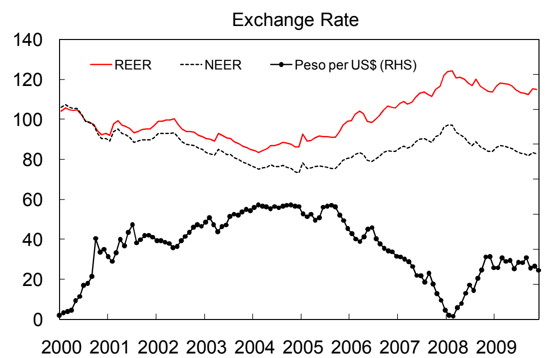
Philippines: Gross Capital Inflows
(Semi-annual, billion US$)



- *Current account and exchange rate*: The current account has held up well. Exports were severely affected by the crisis on account of the high share of electronics, although they have recovered recently on a sequential basis. The trade balance was less affected due to the significant decline in food and commodity prices, and a drop in imports of capital and intermediate goods. Moreover, resilient remittance flows have helped prop up the current account balance. The exchange rate has appreciated around 7 percent against the U.S. dollar since the height of the crisis in November 2008, but has depreciated by around 2 percent on a trade-weighted basis over the same period.



Sources: CEIC Data Company Ltd.; and IMF staff calculations.



Sources: The Philippine Authorities; CEIC Data Company Ltd.; and IMF staff calculations.

B. Economic Recovery Underway but Return to Higher Growth Not Assured

4. **Economic activity is expected to recover gradually over the near term and risks appear broadly balanced**.

- *Baseline:* Growth is expected at ¾ percent in 2009 and to recover to around 3¼ percent in 2010. The recovery in 2010 will likely be led by private consumption as confidence and remittances improve. Exports and investments are also expected to benefit from the global recovery.

- *Risks to short-term outlook*: The risks are broadly balanced and largely depend on the global economic outturn through the export and remittance channels. On the domestic side, the output losses from the devastation caused by the two recent typhoons could turn out to be higher than currently estimated. A wider-than-anticipated fiscal deficit could dampen investor confidence and result in higher risk premia. On the upside, the post-typhoon rebuilding efforts could spur higher investment and consumption.

5. **Sustaining the recovery over the medium term will require progress in key reform areas**.

- *Baseline:* Potential growth will likely be lower than during the pre-crisis period. External demand and remittances from advanced economies could prove permanently lower in the post-crisis environment (Box 1). Furthermore, a weak recovery could affect bank balance sheets, including banks' willingness to lend. This baseline already assumes 2 percent of GDP in tax measures over the medium term, which could be partly generated from the sin tax reform measures currently awaiting Congressional approval. However, in the absence of these tax measures, public debt would remain at an elevated level (Appendix I, "no policy change" scenario).

- *Reform scenario*: To exceed the baseline growth rate, structural reforms will be required in a number of areas. While subject to the same external risks as in the baseline scenario, stepped-up fiscal reforms, including a substantial strengthening of the tax base, would allow for higher outlays on growth-enhancing infrastructure and a deepening of social programs. In addition, product market and governance reforms to tackle the weak business environment could further raise the growth potential through stronger domestic and foreign investment. This would not only help strengthen domestic sources of growth, but would support competitiveness and allow the Philippines to tap into new export markets, especially in Asia.

6. **The authorities broadly agreed with the staff's assessment.** They expected that the economy would continue to recover on account of resilient remittances and supportive macroeconomic policies. However, due to the negative impact of the recent typhoons on economic activity in the fourth quarter, they expect that growth will reach the lower end of the 0.8–1.8 percent forecast range in 2009, but recover to 2.6–3.6 percent in 2010, in line with the staff's projections. They also shared staff's view that the rebalancing of the global economy could reduce Philippines' potential growth in the medium term. Inflation was projected to fall within the target range over the policy horizon and was broadly in line with staff's forecast.

III. Policy Discussions

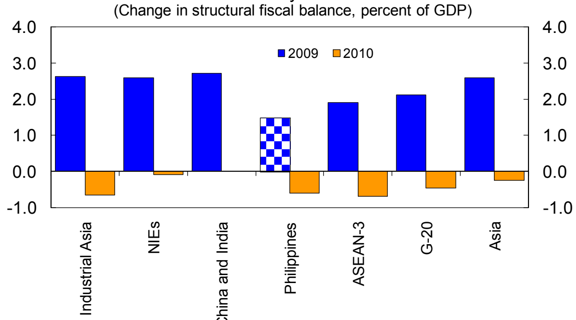
Discussions focused on the need to put in place a well-designed fiscal consolidation strategy while avoiding premature exit from supportive macroeconomic policies in light of the moderate recovery. Discussions on the medium-term policies centered around the need to reduce vulnerabilities and support economic growth through further progress on fiscal consolidation, enhanced financial sector stability, and an improved business climate.

A. Fiscal Policy—Balancing Stimulus and Sustainability

Background

7. **Fiscal policy was loosened in response to the crisis, but poor revenue performance will likely lead to a breach of the deficit target**. The 2009 budget targeted a national government deficit (IMF definition) of 3¾ percent of GDP,

2009 Discretionary Fiscal Measures
(Change in structural fiscal balance, percent of GDP)



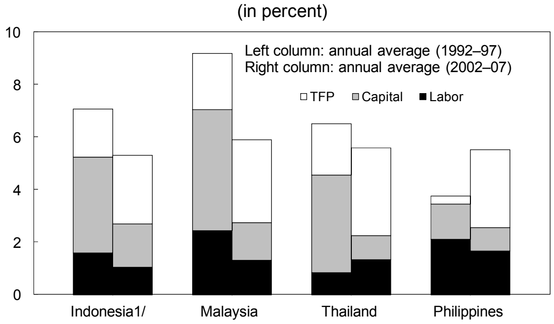
Source: IMF staff estimates.
1/ Weighted average for country groupings.

Box 1. Sustainability of the Recovery in the Post-Crisis Period

Two different approach are used to identify the main drivers of growth in the years prior to the global economic crisis:

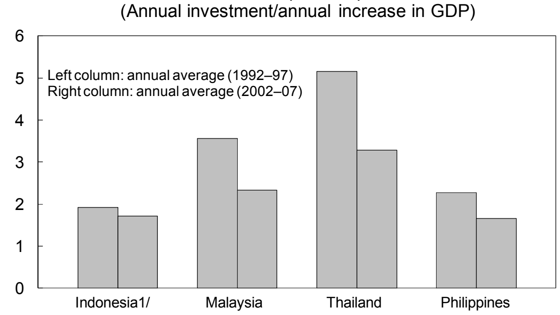
- ***Growth accounting***: Staff analysis suggests that the contribution of Total Factor Productivity (TFP) to growth has been large in the recent past. At the same time, the Incremental Capital Output Ratio (ICOR) has declined suggesting gains in capital efficiency in the Philippines (and other ASEAN economies) in recent years. The latter may also partly reflect that investment levels pre-Asian crisis were not sustainable.

Growth Contribution in ASEAN Economies
(in percent)



Source: IMF staff estimates.
1/ Because of data availability, annual average (1994–97) is used for Indonesia.

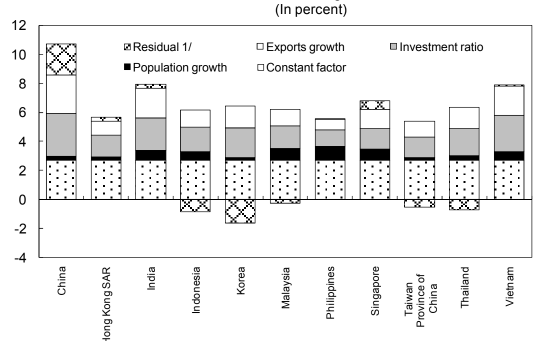
Incremental Capital Output Ratio
(Annual investment/annual increase in GDP)



Sources: CEIC Data Company Ltd: and IMF staff calculations.
1/ Annual average (1994–97) is used for Indonesia.

- ***Cross-country panel regression***: Panel regressions suggest that investment and exports have been the main contributors to growth in Asia, although somewhat less so in the case of the Philippines. Export is estimated to have contributed between 1-3 percentage points to growth during 2002 to 2007, and investments made a similar contribution. Based on this regression, a one percent drop in advanced economies' growth rate will reduce export growth in ASEAN economies (excluding Singapore) by almost four percentage points on average and GDP growth by ½ percentage point.

Growth Contribution: Annual Average between 2002 and 2007
(In percent)



Source: IMF staff estimates.
1/ Residual captures the contribution of other factors such as inflation rate.

A number of tentative conclusions can be drawn from these results. First, the improvement in TFP suggests that the economic reforms efforts in the Philippines since the Asian crisis may have lifted productivity and should be further enhanced to support growth over the medium term, including through a strengthening of the weak business climate (see below). Second, these reforms may also help raise the relatively low contribution from external demand to growth by strengthening competitiveness and the ability to tap into new export markets over the medium term. Finally, these reforms may also encourage higher investments in the Philippines, which according to the lower ICOR could result in a relatively high impact on growth.

over 2 percentage points of GDP higher than in 2008. The 2009 deficit outturn is estimated at about 4½ percent of GDP, overshooting the budgeted target primarily due to cyclical and legislative revenue-eroding measures such as increases in personal income tax exemptions and replacement of the VAT on power transmission with a franchise tax. Some progress was made, however, in tax compliance following stronger tax enforcement activities. This deficit implied an expansionary fiscal impulse of around 2¼ percent of GDP in 2009 and a growth impact of around 1 percentage points based on GIMF simulations (Box 2).

8. **The authorities have so far not faced financing constraints, but further fiscal slippage next year could raise concerns about sustainability**. Ample domestic liquidity and favorable international market conditions have so far allowed the government to easily finance the nonfinancial public sector borrowing need of 20 percent of GDP in 2009. Nonetheless, structural erosion of the tax base could raise investors' concerns about fiscal sustainability and increase financing costs as they demand higher risk premia.

9. **The government plans to target a deficit of 3 percent of GDP (IMF definition) in 2010 and to balance the budget by 2013**. The planned reduction in the deficit is expected to be achieved through (i) an ambitious revenue collection target well above the expected 2009 outturn in percent of GDP, and (ii) a sharp scale-back of infrastructure and maintenance spending. Combined, these are projected to more than offset the expected increase in personnel expenses due to the salary standardization law approved this year. With the onset of the global economic crisis, the government decided to delay the balancing of the budget by three years to 2013, but the concrete measures to underpin the planned consolidation efforts have yet to be identified.

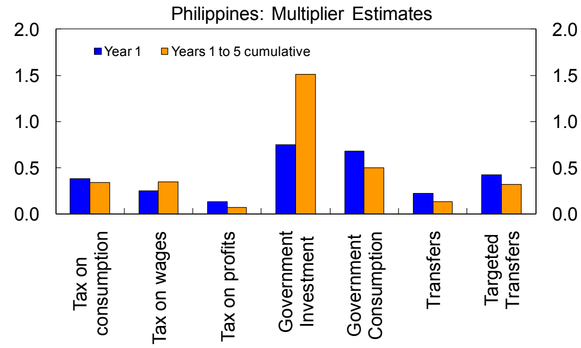
Policy Issues and Staff Views

10. **The fiscal policy easing in 2009 was appropriate and relatively effective, but the limited fiscal space would argue for a measured withdrawal in 2010**. The stimulus spending measures targeted at infrastructure and liquidity constrained households have likely been effective in supporting growth in 2009 (Box 2). However, despite the only moderate economic recovery expected in 2010, staff advised capping the deficit at 3½ percent of GDP to contain the high public debt level. This deficit would imply a negative fiscal impulse of about 1 percent of GDP. Yet, even this target is not achievable without new fiscal measures given that the erosion of the tax base has weakened the fiscal position and the growing proliferation of tax incentives suggests that revenue in 2010 will remain at best at the 2009 level. Staff, therefore, recommended (i) slowing the increase in the civil service wage bill and (ii) introducing new legislative and administrative revenue measures yielding about ½ percent of GDP. This will also help make room for public investment, including for post-typhoon rehabilitation and reconstruction.

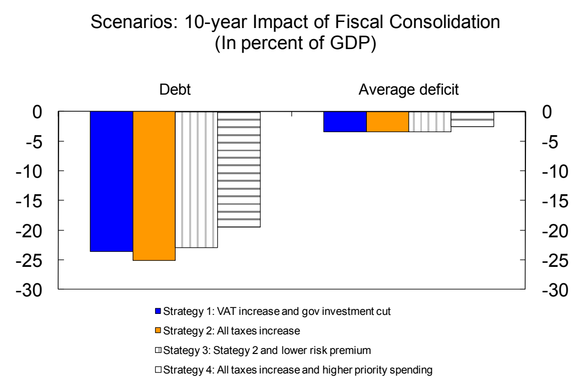
11. **To underscore the commitment to fiscal prudence, a credible medium-term consolidation plan should be announced in parallel with the 2010 budget**. This could help

Box 2. Effectiveness of Fiscal Policy in the Philippines

Public investment is found to be most effective in increasing growth in the Philippines. Simulations using the IMF's Global Integrated Monetary and Fiscal (GIMF) model calibrated for the Philippines show that the short-term (1-year) multipliers for expenditure measures range from 0.2 to 0.8 percent, with investment spending having the largest impact on growth. This is comparable to estimates of 0.4 to 1.1 percent found for emerging Asia [1]. The growth impact of general tax cuts, however, is smaller, ranging from 0.1 to 0.4 percent.



GIMF simulations also show that the government's stimulus package, the Economic Resiliency Plan, clearly helped support growth. Key components in the plan included transitory increases in infrastructure and targeted social benefits spending, along with permanent cuts in personal and corporate income taxes (with the latter approved before the onset of the crisis). If fully implemented, this package of around 2½ percent of GDP in 2009 could have increased output in the short term by an estimated 1¼ percent and in the medium term by 2¼ percent. However, only around ¾ has been implemented, implying a somewhat smaller fiscal impulse.



A revenue-based fiscal consolidation is most effective in supporting growth and containing public debt. Four strategies towards a balanced budget were simulated and are shown in the chart on the right. These simulations suggest that a consolidation strategy relying on higher investment and targeted social transfers (strategy 4)— financed by revenue-measures and a relaxation of the budget target by 1 percent of GDP—would have the largest positive impact on growth. This is consistent with other studies that found tax-based consolidations to have a stronger impact in countries with a low tax effort. Spending reforms that protect and increase investment are also found to have a more favorable growth impact. [2] Debt would also be contained as consolidation is partly achieved through revenue measures.

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[1] Freedman, Kumhof, Laxton, and Lee, 2009, "The Case for Global Fiscal Stimulus," IMF Staff Position Note No. 2009/03.

[2] Bania, Gray and Stone, 2007, "Growth, Taxes, and Government Expenditures: Growth Hills for U.S. States," National Tax Journal 193-204 (June 2007).

dampen investor concern about sustainability. The consolidation strategy should build on revenue-raising measures, which should also allow for more pro-poor spending and growth-enhancing investment. In this context, staff supports the authorities' plans to review the broader tax reform strategy with IMF technical support and encourage an early passage of the sin tax and incentives rationalization measures currently before Congress. Strengthening of revenue administration efforts, especially for large tax payers, is also crucial to bolster tax collections. The government's consolidation plans should also include steps to rationalize the National Food Authority (NFA) through full cost recovery and by limiting its role to food security. The finances of other government-owned and controlled corporations (GOCCs) should also be strengthened.

12. **A formalized fiscal framework would further underscore the credibility of the consolidation plans**. A good first step in this direction would be to submit a medium-term budget framework alongside the budget to the legislature. Consideration could also be given to adopt a Fiscal Responsibility Law, eventually supplemented with an explicit numerical rule to anchor fiscal policy. Such a rule would help reduce concerns about the public debt level, which while broadly sustainable, remains at a relatively high level and is sensitive to exchange rate and contingent liabilities shocks. Closer monitoring of contingent liabilities, including public-private partnership (PPP) guarantees, therefore, is key to enhance the management of fiscal risks.

The Authorities' Views

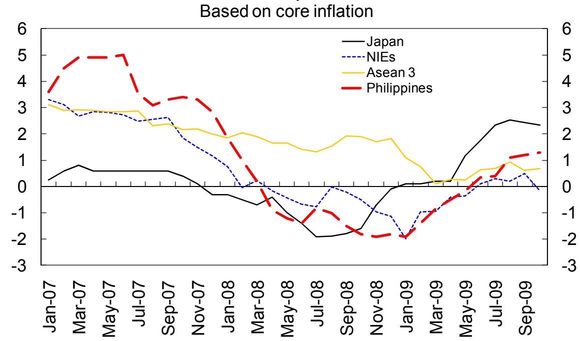
13. **As reflected in the 2010 budget, the authorities agreed on the need for a measured fiscal withdrawal next year to contain the deficit**. The authorities did not favor the revenue-eroding measures passed by Congress, and have been advocating a moratorium on such proposals. However, they cautioned that even in the event of lower-than-budgeted revenue performance, it would be very difficult to pass any of the revenue enhancing reforms currently before Congress in the run-up to the May elections. They agreed that the decline in public investment in the 2010 budget should be reviewed, especially considering the higher investment spending needed for post-typhoon reconstruction. They saw limited scope to compress the rapid rise in the civil service wage bill due to political constraints, but were hopeful that expenditures in other areas could be cut, especially unallocated reserves.

14. **The authorities agreed that it would be important to prepare a credible medium-term consolidation strategy**. With input from an FAD TA mission early next year, they will prepare a strategy to raise the tax effort for the new government taking office in July 2010. The authorities acknowledged that rationalizing the NFA and strengthening finances of other GOCCs is challenging. However, they also pointed out the considerable progress made on the privatization of the power companies and the stepped-up efforts to ensure cost recovery. The authorities saw merit in gradually introducing a more formalized medium-term fiscal framework and explained that they were currently working on strengthening the medium-term expenditure framework and budgeting procedures. Moreover, the authorities recognized the need for an integrated debt management framework, which could also help internalize the risks associated with the various guarantees extended.

B. Monetary Policy—Preparing Timely Exit

Background

Real Policy Rates
Based on core inflation

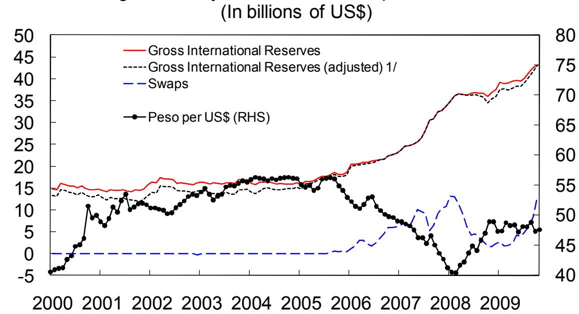


Sources: CEIC Data Company Ltd; and IMF staff calculations.

15. **The BSP took proactive and decisive steps to ease monetary policy to cushion the adverse spillovers from the global economic crisis.** The BSP lowered policy rates by 200 basis points since end-2008, bringing the reverse repo rate to 4 percent. Lending rates followed closely, thereby supporting growth (Box 3). Moreover, the reserve requirement rate on bank deposits and deposit substitutes was lowered by 2 percentage points (to 19 percent for universal/commercial banks) and the rediscount window was tripled to P60 billion, with eligibility of counterparts and collateral also expanded.

16. **Inflation expectations remain well-anchored and credit growth has decelerated in recent months**. As the economy slowed and inflation declined in response to the easing of food and fuel prices, inflation expectations followed suit and remain well-anchored at a level consistent with the BSP's inflation target. Credit growth has also decelerated due to key customers reaching the single borrower limits, some tightening in credit standards, and a substitution to corporate bond financing.

Foreign Currency Reserves and Swaps, and FX Rate
(In billions of US$)



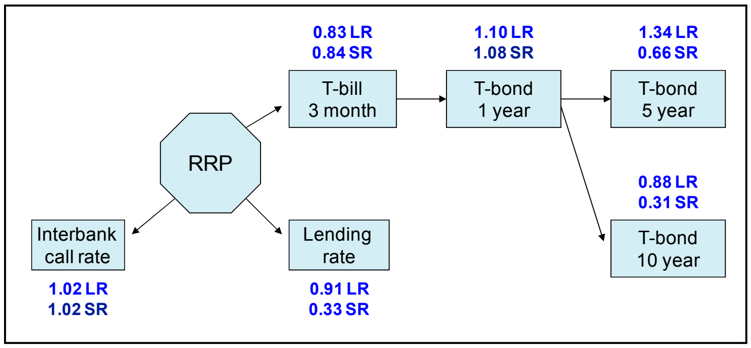
Sources: The Philippine Authorities; and CEIC Data Company Ltd.; and IMF staff calculations.
1/ Minus pledged assets.

17. **After being flat for most of the year, gross official reserves have risen in recent months**. Gross official reserves have risen by about US$6 billion since end-2008 to around US$44 billion as of November, and the forward book has increased by around US$11 billion over the same period. This has coincided with the appreciation of the exchange rate in recent months on the back of rising, yet modest, capital inflows and resilient remittances. The rise in the reserves largely reflects the IMF's SDR allocation, proceeds from government bond issuance, valuation gains, and AsDB loan disbursements.

Box 3. Monetary Policy Transmissions

The transmission mechanism in the Philippines works through the interest rate as well as indirectly through the exchange rate channels. The policy rate influences prices directly through the signaling effect, and various market rates which in turn affect asset prices and domestic demand. Monetary policy also works through the exchange rate, whereby prices are affected by the direct pass-through and, less plausibly, the indirect expectation channel as explained below.

The policy rate (RRP) is transmitted onto various market rates and maturities. To find the impact of rate *R* on rate *X,* a quarterly error-correction model (ECM) is estimated on the basis of a simple long-run relationship: $X_t = \beta_0 + \beta_R R_t + \varepsilon_t$ ($\beta_R > 0$) with ε being an error term. Evidence of strong pass-through for 2000Q2–2009Q2 is identified in the text charts.[1] The upper coefficients (LR) list the long-run relationship (β_R) and the lower coefficients (SR) list the short-run contemporaneous impact. This transmission mechanism has remained robust even during and after the global crisis.



The estimated long-run exchange rate pass-through to consumer prices is about 60 percent for 1989–2009. In recent years, financial integration has made the exchange rate more responsive to changes in domestic interest rates as balance-of-payment flows have become more sensitive to interest rate changes. In the former case, net foreign assets (NFAs) relative to M3 will rise, while in the latter case the exchange rate will move. A stable empirical link of prices with the exchange rate and NFA/M3 is identified for 1989Q1–2009Q2 using quarterly data.[2] A sub-sample analysis covering 2000Q1–2009Q2 suggests weaker direct exchange rate pass-through but a substantially stronger NFA/M3 impact on consumer prices. Also, the contemporaneous pass-through effect has increased significantly during this period. The rationale behind the impact of NFA/M3 on prices appears to be either a wealth effect-type pressure arising from the sterilized amount or future consumption expectation.

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[1] For example, the ECM for the interbank call rate (*IBC*) is:

$\Delta IBC_t = -\underset{(0.02)}{0.05}\Delta IBC_{t-1} + \underset{(0.06)}{1.01}\Delta RRP_t - \underset{(0.16)}{0.71}(IBC_{t-1} - \underset{(0.01)}{1.02} RRP_{t-1}) + u_t,$ (*Adjusted*- R^2 =0.94; Durbin-Watson statistic (*DW*) =1.98), where *u* is an error term, and heteroscedasticity-autocorrelation robust standard errors are in parentheses.

[2] An ECM for consumer prices based on a long-run relationship is estimated as:

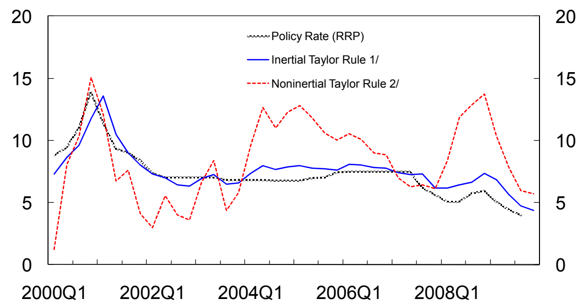
$\Delta p_t = -\underset{(0.05)}{0.13} + \underset{(0.09)}{0.33}\Delta p_{t-1} + \underset{(0.02)}{0.05}\Delta e_t + \underset{(0.06)}{0.10}\Delta p_t^* - \underset{(0.04)}{0.03}\Delta f_t$ (*Adjusted*- R^2 =0.58; *DW* =1.87), where *p*, *e*, and p^*, respectively,

$-\underset{(0.02)}{0.08}(p_{t-1} - \underset{(0.06)}{0.55} e_{t-1} - \underset{(0.14)}{0.91} p_{t-1}^* - \underset{(0.07)}{0.48} f_{t-1}) + w_t,$

are the logarithms of CPI, the exchange rate, and the foreign price measured by the world unit value of exports, f is the NFA/M3 ratio, and *w* an error term. Heteroscedasticity-autocorrelation robust standard errors are in parentheses.

Policy Issues and Staff Views

Policy Rates vs. Taylor-Rule Implied Rates



Sources: Philippines Authorities; and IMF staff calculations.
1/ Implied from the inertial Taylor-rule (with interest rate smoothing).
2/ Implied from the noninertial Taylor-rule.

18. **It would be premature to tighten monetary policy over the near-term in view of the negative output gap and limited fiscal space**. Inflation expectations remain well-anchored, credit growth has slowed, and the self-sustainability of the recovery is not yet assured. While the typhoons may temporarily raise food prices due to the damage to agriculture and the need to import more (expensive) food, the impact is not expected to persist. Also, there is currently no evidence of asset market bubbles and, according to a Taylor-rule based on the projected output gap and divergence of inflation from the central bank target, the current policy rates are assessed to be broadly appropriate.

19. **The exit from accommodative monetary policy should commence only when the recovery is on a solid footing**. A premature tightening might stall the recovery, especially once the fiscal stance becomes contractionary. Higher policy rates could also induce speculative inflows, leading to currency appreciation that could slow the recovery in exports. The mopping up of any excess liquidity as monetary policy is tightened will not be challenging as the expansion of the central bank balance sheet in the Philippines was very limited.

20. **Staff supports limiting foreign exchange market intervention to smoothing excessive movements**. Official international reserves accumulation in the Philippines has been pronounced, but the increase was only to a limited extent due to direct foreign exchange intervention. Instead, the BSP used foreign exchange swap to smooth the volatility in dollar liquidity from short-term capital inflows and a shift in residents' preference from dollar to peso holdings. With the exchange rate currently assessed to be broadly aligned with fundamentals, the authorities should continue to allow the exchange rate to adjust to market pressures. At the same, some further buildup in reserves could be allowed to continue to adequately cover short-term debt as well as foreign currency deposits.

Equilibrium Exchange Rate Estimates

	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/					
CGER	0.20	0.9	-0.1	-6.1	-4.7
Accounting for remittances	0.20	0.9	2.2	5.5	6.9
Equilibrium real exchange rate approach:					
CGER	—	—	—	9.9	9.0
External sustainability approach: 3/					
CGER	0.20	0.9	-1.3	-12.1	-12.7
Average	—	—	—	—	-0.4

Sources: CGER and mission team estimates.

Note: Reference period for the CGER and the mission team's assessments are September and November, 2009, respectively.

1/ Ratio of current account balance to GDP.
2/ Undervaluation="-".
3/ Based on medium-term projections through 2014.

The Authorities' Views

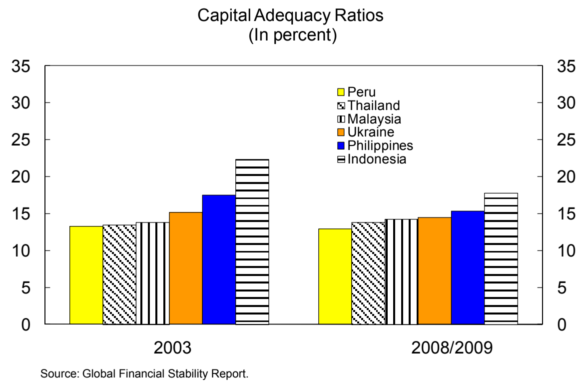
21. **The authorities saw no urgent need to raise policy rates over the near term**. While the latest inflation forecast suggests a slightly higher path, the BSP emphasized that it remained closer to the lower bound of the target range over the policy horizon. They further pointed out that demand-side pressures continue to be limited and inflation expectations are well anchored, while price pressures from typhoon-related crop losses would likely only prove temporary. The authorities would hold off exit from supportive monetary policies until there are clear signs that the economic recovery is self-sustainable and the downside risks to the inflation outlook have dissipated. In terms of sequencing, they would roll back liquidity enhancing measures before raising the policy rate.

22. **The authorities concurred with staff's assessment of the exchange rate**. They reiterated that the peso is market determined and foreign exchange market interventions are limited to smoothing excessive movements, while allowing for the adequate accumulation of reserves. Consistent with this, the authorities explained that they would allow the exchange rate to adjust to further upward pressures in the event of stronger balance of payments flows while allowing for a modest buildup in reserves for prudential reasons.

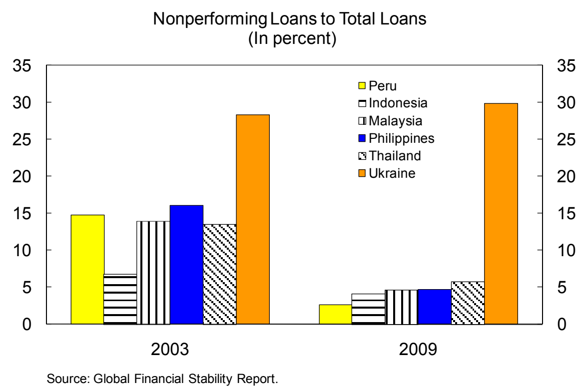
C. Financial Sector—Drawing Lessons from the Crisis

23. **The financial sector has weathered the global financial crisis relatively well, and balance sheet risks would appear manageable**.

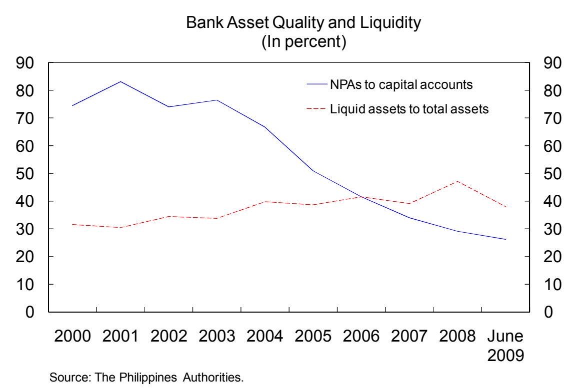
- *Bank earnings have improved during the first half of 2009 as global economic and financial conditions stabilized.* Operating income was up by 18½ percent (y/y) during the first six months led by widening net interest margins and solid credit growth despite the slowdown, partly reflecting a return to traditional banking following the global crisis. Moreover, first-half net profits were up by 33 percent over the same period last year.



- *Capitalization remains high with the capital adequacy ratio (CAR) at 15.3 percent as of March 2009.* Moreover, most capital is Tier 1 (12.4 percent), which remains above minimum requirements even after adjustment for deferred losses.[1]



- *Nonperforming loans (NPLs) also remain low on average, although not uniformly across institutions.* Thrift and rural banks, accounting only for about 10 percent of banking sector assets, have relatively higher NPLs. In addition, the NPL ratio on loans extended to households is elevated at around 9 percent as of June 2009, largely due to high delinquencies on credit card debt. However, household loans account for less than 20 percent of total bank loans. The large holdings of foreclosed properties, however, are assessed to pose less risk than previously thought. Total nonperforming assets (net of provisions) are relatively high at close to 30 percent of equity. But, they have declined in recent years and the properties are in many cases booked conservatively on the balance sheets.



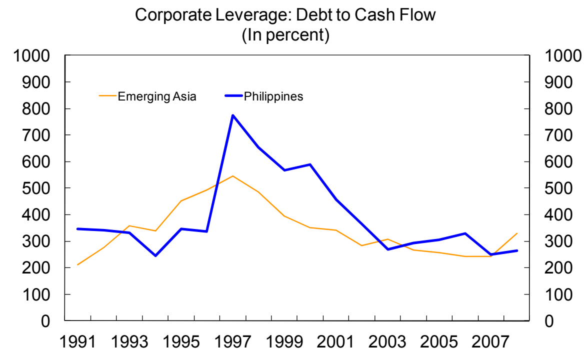
[1] These losses were realized when banks sold part of their stock of nonperforming loans generated during the late 1990s to special purpose vehicles (SPVs). The banks were allowed to defer these losses over 10 years.

- *A potential vulnerability stems from the relatively high concentration risk*. Given the presence of large conglomerates, some banks' exposures are concentrated on relatively few large corporate borrowers, making them vulnerable in case one or more of them defaults.

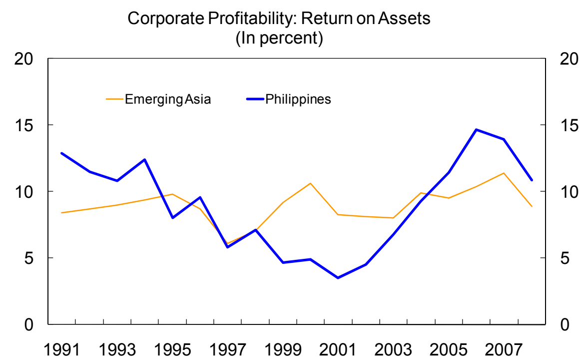
24. **Corporate balance sheets have improved noticeably in recent years**.

- *The corporate sector entered the global crisis from a stronger position than during the Asian crisis.* Leverage for nonfinancial corporates is considerably lower; the share of short-term debt has declined; liquidity risks have receded; and the interest coverage ratio (earnings to interest expenditures) has increased significantly.

- *Corporate profitability and earnings have recovered somewhat after dropping sharply during the global crisis*. Excluding financials, the net income of bourse listed companies rose by 50 percent during the first half of 2009 (year-on-year). However, the earnings jump was to a large extent driven by one-off gains for the industrial sector from the sales of ownership shares.[2]



Source: Corporate Vulnerability Utility, IMF.



Source: Corporate Vulnerability Utility, IMF.

Policy Issues and Staff Views

25. **The financial sector faces a number of vulnerabilities, but appears relatively resilient to potential downside risks**. While banks remain well capitalized and NPL ratios are low, the projected moderate economic growth may constrain bank earnings and could lead to a deterioration in asset quality. However, stress tests by IMF staff and rating agencies (Fitch Ratings and Moody's) suggest that the financial sector is quite robust to adverse shocks. Stress tests conducted during the November 2009 joint IMF-World Bank Financial Sector Assessment Program (FSSA) update mission showed that the largest banks were generally resilient to adverse shocks, including relatively severe macroeconomic shocks.[3] However, the tests showed that banks are vulnerable to the failure of one or more large conglomerates, due to the high

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[2] San Miguel Corporation in May 2009 sold a 43.25 percent share in its brewery to Japan's Kirin for around pesos 39 billion, accounting for more than 20 percent of the first half net income of all listed nonfinancials.

[3] Please see the FSSA – Update report on the Philippines for further details on financial sector assessment and policy recommendations.

concentration risks, and a permanent jump in interest rates given their significant holdings of government securities.

26. **The global financial crisis has brought a number of important lessons for future reform, which are also relevant for the Philippines**.

- *Micro-prudential regulation*: A more risk-based approach to capital requirements is desirable to better reflect institutional risk profiles. In this regard, staff welcomes the planned introduction in 2011 of the internal capital adequacy assessment process (ICAAP) under the Basle II, Pillar 2 framework as an important first steps. Continuing to strengthen banks' risk management capacities also remains key and staff welcomes the authorities continued efforts to enhance their own stress-testing capacities.

- *Macro-prudential regulation*: Current regulatory tools in the Philippines and elsewhere do not serve to dampen the potential pro-cyclicality of financial markets. As such, there may be scope for considering changes to required capital, collateral, liquidity, or loss provisioning requirements. However, these should be subject to the outturn of the ongoing international debate on the appropriate design of counter-cyclical frameworks.

27. **The authorities reacted promptly to the crisis, but there is still some scope to enhance the existing contingency framework**. The BSP enhanced monitoring and stress-testing, and provided liquidity support. Moreover, deposit insurance coverage was doubled. Looking ahead, there may be further scope to strengthen the prompt corrective action (PCA) framework by instituting earlier, faster, and increasingly severe action. The resolution framework could also be further enhanced, including through the elimination of the rehabilitation period for owners during receivership, the introduction of a bridge-bank facility, and a more flexible purchase and assumption facility. Moreover, restructuring decisions should be legally irreversible; and BSP and Philippine Deposit Insurance Corporation staff should be protected against litigation.

The Authorities' Views

28. **The authorities generally agreed with staff's assessment of the soundness of the financial sector.** The overall financial system is sound and resilient to the potential deterioration in earnings and asset quality, which had been confirmed through their own stress-testing exercises. While the authorities agreed that concentration risks are relatively high, they considered this inevitable given the dominance of the large conglomerates. Moreover, they emphasized that the large corporates were well-monitored and their financial positions were generally sound. The authorities noted that the large holdings of foreclosed properties did not present a risk to banks since the conservative book values would allow for a significant decline in property prices before it would impact capitalization.

29. **The authorities agreed with the basic contours of staff's policy recommendations**. They were keenly following the international efforts to address the gaps revealed in micro- and

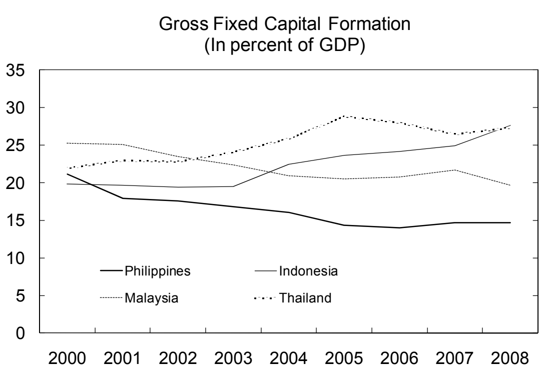
macro-prudential regulation by the recent crisis. In fact, they plan to introduce counter-cyclical liquidity measures, in line with steps taken in Australia and Hong Kong SAR. The authorities also explained that the passage of the NCBA amendments would provide them with adequate legal powers and protection to meet their core mandates by (i) lifting the remaining constraints imposed by bank secrecy laws on examiners, (ii) enhancing the scope for risk-based supervision, (iii) further strengthening the PCA and resolution framework, including by limiting shareholders' rights when capital falls below minimum requirements, and (iv) authorizing the BSP to issue its own debt securities to ensure more effective monetary management.

D. Structural Policies—Rebalancing and Strengthening Growth

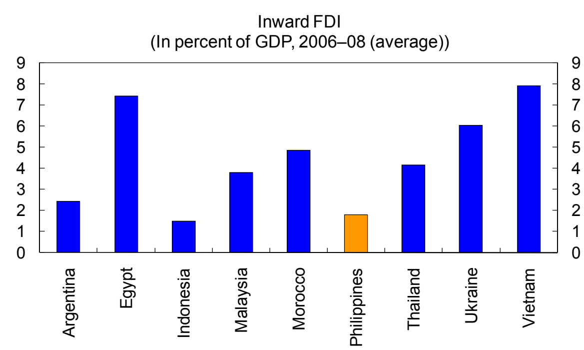
Background

30. **The global financial crisis will have a long-term impact on the global sources of growth, with clear implications for the Philippines**. Specifically, the Philippines could be impacted through slower growth in exports and remittances from workers in advanced economies (Box 4). At the same time, the new global economic landscape also provides opportunities for the Philippines. If the global rebalancing proves successful, increased domestic demand in emerging Asian economies could partly offset the decline in advanced economies' growth.

31. **However, the weak business climate will make it difficult to shift to new sources of growth and attract needed foreign investment.** The weak business climate reflects the lingering problems with corruption as identified by various surveys, including by Transparency International. It also reflects the high administrative burdens, including with respect to starting a business. In turn, the weak business climate is reflected in a relatively low investment-to-GDP ratio and foreign investment.



Sources: CEIC Data Company Ltd; and IMF staff calculations.



Source: IMF World Economic Outlook, and staff calculations.

Policy Issues and Staff Views

32. **To sustain the recovery and raise growth, it is key to take decisive steps to strengthen the business environment and improve basic infrastructure**.

Box 4. Macroeconomic Importance of Remittances

Similar to a number of Asian economies, remittances have remained resilient in the Philippines. Remittances currently amount to around 10 percent of GDP, which is high by international standards. Moreover, remittances have grown significantly over the last decade, led initially by the increasing share of skilled workers moving abroad, and more recently by the rising head-count of overseas workers. The resilience of remittances has proven to be key in sustaining consumption during the current crisis, although the growth rate did decline relatively more than for other countries dependent on these income flows.

Remittances for Selected Asian Countries

	In percent of GDP, 2008	Growth	
		2006–08	2009 1/
Bangladesh	11.0	28	16
India	4.2	29	9
Nepal	19.5	30	23
Pakistan	4.2	28	28
Sri Lanka	6.5	14	20
Philippines	9.7	15	5

Source: Almekinders, Geert, and Zeno Abenoja, "Remittances in South Asia and the Philippines: Determinants and Outlook, " IMF Working Paper (forthcoming).

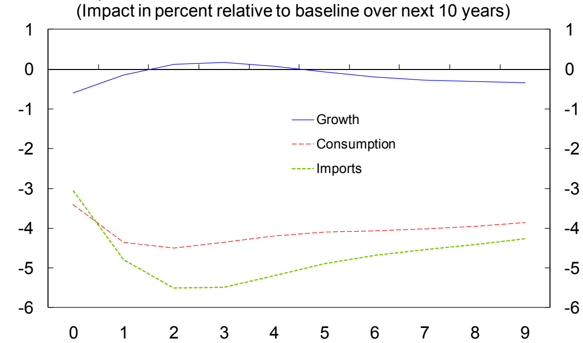
1/ Based on data available as of end-Oct. 2009

To analyze the macroeconomic implications of remittances, we extended the IMF's Global Integrated Monetary and Fiscal Model (GIMF).

- Specifically, remittances are introduced as (exogenous) lump-sum transfers to consumers and as lump-sum taxes on households (used as transfers to consumers) between countries. Net remittances received are added to human wealth for "optimizing consumers;" while for "liquidity-constrained consumers" they are added directly to consumption. Remittance flows are channeled through the balance of payments, which required an augmentation of the current account equation in GIMF. Obviously, the macroeconomic effects of remittances are sensitive to whether these flows are consumed or saved by the receiving households.

- The simulation result shows that a permanent decline in remittances brought on by weaker growth in advanced economies could have an impact on GDP growth and, in particular, on private consumption given the high share of liquidity constrained households in the Philippines (assumed at around 60 percent). This could have significant welfare consequences, which underscores the risks associated with relying so heavily on this income source.

GIMF Simulation:
Impact of Permanent 2.5 Percent Decline in Remittances
(Impact in percent relative to baseline over next 10 years)



- *Tackling corruption*: Continued and decisive measures are urgently needed to address this longstanding issue, which diverts resources away from productive use and adds additional costs of doing business.

- *Reduce administrative hurdles*: Steps could include: (i) cutting back on the number of procedures needed to start a business and speed up the processing; (ii) stepping efforts to strengthen corporate governance by raising disclosure requirements and director liabilities; and (iii) improving the existing bankruptcy law and administrative bottlenecks in the bankruptcy process.

- *Further develop capital markets*: Continue work to enhance capital markets to strengthen financial intermediation and transformation of savings into productive use.

- *Strengthen labor market flexibility*: Liberalize the use of fixed-term contracts, gradually reducing or phasing out minimum wages while strengthening social safety nets, and reducing redundancy notice periods and severance pay.

- *Improving the basic infrastructure*: Continued fiscal consolidation will be important to finance greater public investment, essential to solicit private sector investment.

The Authorities' Views

33. **The authorities broadly shared staff's view that reforms were needed to sustain and strengthen economic growth over the medium term**. To help achieve this, they would continue to push for the implementation of development strategies to improve competitiveness and investment in human capital. They also shared staff's views that governance reform would be crucial to strengthen the business climate and attract foreign investment. Making fiscal room for additional outlays on growth-enhancing government spending and continued power sector privatization was also considered a key pillar in the medium-term growth strategy.

IV. Staff Appraisal

34. **Following the initial adverse impact from the global crisis, the economy is now recovering**. Growth is projected to reach ¾ percent in 2009 and rise to about 3¼ percent in 2010. The deceleration in 2009 is broad based with expansionary macroeconomic policies and resilient remittances cushioning the slowdown. The recovery in 2010 will likely be led by consumption as confidence and remittances improve. Exports and investments are also likely to benefit from the global recovery. Risks to the outlook are broadly balanced.

35. **The expansionary fiscal stance in 2009 was appropriate, but a measured withdrawal would be desirable in 2010 given the limited fiscal space**. The fiscal stimulus proved an effective response to the weak economic environment at the height of the global crisis. However, the revenue target was breached due to a structural weakening of the tax base, well beyond cyclical factors. Despite the only moderate economic recovery expected in 2010, staff recommends capping the deficit at 3½ percent of GDP to avoid jeopardizing investor confidence. To achieve this, the authorities should introduce fiscal savings measures.

36. **A credible medium-term consolidation plan announced in parallel with the 2010 budget would demonstrate commitment to fiscal prudence**. Consolidation efforts should build on revenue-raising measures, which would also allow for more pro-poor spending and growth enhancing investment. Consolidation plans should also focus on improving the finances of GOCCs, including NFA.

37. **The eventual introduction of a formalized fiscal framework would further underscore the credibility of the consolidation plan**. A good first step would be to submit a medium-term budget framework alongside the budget to the legislature. This could be supplemented with an explicit numerical fiscal rule to help anchor fiscal policy. Closer monitoring of contingent liabilities, including PPPs, will also enhance the management of fiscal risks.

38. **The exit from accommodative monetary policy should await clear signs that a sustained recovery is underway**. BSP's proactive steps, including a 200 basis point cut in interest rates since end-2008, helped cushion the adverse spillovers from the global crisis. In view of the still negative output gap and the need to tighten fiscal policy, it is too early to tighten monetary policy at this stage. The exit should start with a rollback of liquidity-enhancing measures.

39. **Foreign exchange market interventions should remain limited to smoothing operations**. Currently, the exchange rate is assessed to be broadly aligned with fundamentals and should be allowed to adjust to market pressures, including from resurgence in capital inflows.

40. **The financial sector is broadly sound and appears relatively resilient to potential downside risks**. While banks remain well capitalized and NPL ratios are low, moderate economic growth will constrain bank earnings and potentially lead to a deterioration in asset quality. However, stress tests by IMF staff and rating agencies suggest that the financial sector is quite robust to adverse shocks, although the relatively high concentration of exposures makes banks vulnerable to tail-risk events.

41. **The financial sector is generally sound, but current BSP initiatives are expected to further strengthen bank supervision**. Capital requirements should be more risk-based and, in this respect, staff welcomes the planned introduction of the ICAAP in 2011. Early passage of the amendment to the NCBA currently in Congress is also important as it will lift the remaining constraints imposed by bank secrecy laws on examiners and enhance the scope for risk-based supervision. There is, however, scope to further strengthen the PCA framework by allowing for earlier, faster, and increasingly severe actions. The resolution framework should eliminate the rehabilitation period for owners during receivership, and allow the use of a bridge-bank and a more flexible purchase and assumption facility.

42. **To raise potential growth over the medium term, higher investment will be essential**. To achieve this, two bottlenecks will have to be overcome: enhancing basic infrastructure and improving the business environment. A substantial strengthening of the tax effort will be needed to finance essential public infrastructure investments. At the same time, it will be important to take significant steps to improve the weak business climate, including by reducing the high administrative burdens.

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

Table 1. Philippines: Selected Economic Indicators, 2005–10

Nominal GDP (2008): P7,423 billion ($166.9 billion)
Population (2008): 90.5 million
GDP per capita (2008): $1,845
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 (2008): 7.4 percent

					Proj.	
	2005	2006	2007	2008	2009	2010
GDP and prices (percent change)						
Real GDP	5.0	5.3	7.1	3.8	0.8	3.2
CPI (annual average)	7.7	6.2	2.8	9.3	3.1	4.3
CPI (end year)	6.7	4.3	3.9	8.0	3.0	4.3
Investment and saving (percent of GDP)						
Gross investment	14.6	14.5	15.4	15.2	13.7	14.7
National saving	16.6	19.1	20.3	17.6	18.3	17.7
Public finances (percent of GDP)						
National government balance (authorities definition)	-2.7	-1.1	-0.2	-0.9	-3.9	-3.3
National government balance (authorities definition, excl. privatization receipts)	-2.7	-1.2	-1.6	-1.3	-4.3	-3.4
National government balance 1/	-3.0	-1.4	-1.7	-1.5	-4.4	-3.6
Nonfinancial public sector balance 2/	-2.1	0.1	0.2	-0.3	-3.9	-3.0
Revenue and grants 3/	22.1	23.0	24.1	22.8	20.5	20.7
Expenditure	24.1	22.9	23.9	23.1	24.4	23.8
Nonfinancial public sector debt	85.9	73.9	61.1	60.9	63.7	62.7
Monetary sector (percent change, end of period)						
Broad money (M3)	10.3	22.7	10.6	15.6	11.6 5/	
Interest rate (91-day Treasury bill, end of period, in percent) 4/	6.4	5.1	4.2	5.8	4.1 6/	
Credit to the private sector	-0.3	6.7	8.5	16.8	7.9 5/	
External Sector						
Export value (percent change)	3.8	15.6	6.4	-2.5	-20.2	12.3
Import value (percent change)	8.0	10.9	8.7	5.6	-20.0	15.6
Current account (percent of GDP)	2.0	4.5	4.9	2.3	4.6	3.0
Capital and Financial account (US$ billions, excluding errors and omissions)	2.2	0.0	3.6	-1.9	0.8	1.4
Foreign direct investment (net)	1.7	2.8	-0.6	1.1	1.5	1.8
Other	0.6	-2.8	4.2	-3.0	-0.7	-0.4
Errors and omissions (US$ billions)	-1.8	-1.6	-2.1	-1.9	-1.9	-1.9
Overall balance (US$ billions)	2.4	3.8	8.6	0.1	6.3	4.8
Total external debt (percent of GDP) 7/	62.7	52.0	45.9	38.8	41.2	37.9
Debt-service ratio 8/	17.0	15.3	13.0	12.6	14.9	17.0
Reserves, adjusted (US$ billions) 9/	18.0	23.0	33.8	35.9	44.2	49.8
Reserves / Short-term liabilities, adjusted 10/	130.6	194.4	240.5	280.4	266.1	299.2
Exchange rate (period averages)						
Pesos per U.S. dollar	55.1	51.3	46.1	44.5	47.8 11/	...
Nominal effective exchange rate (2000 =100)	76.9	82.0	89.3	89.5	...	...
Real effective exchange rate (2000 =100)	92.3	102.5	112.3	118.7	...	...

Sources: Philippine authorities; and IMF staff projections.

1/ Fund definition. Excludes privatization receipts and includes deficit from restructuring of the central bank (Central Bank-Board of Liquidators).
2/ Includes the national government, Central Bank-Board of Liquidators, 14 monitored government-owned enterprises, social security institutions, and local governments.
3/ Excludes public financial institutions and privatization receipts.
4/ Secondary market rate.
5/ September 2009 (year-on-year).
6/ November 2009.
7/ Includes 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.
8/ In percent of exports of goods and nonfactor services.
9/ Adjusted for gold and securities pledged as collateral against short-term liabilities.
10/ Short-term liabilities include medium- and long-term debt due in the following year.
11/ Average for January to October 2009.

Table 2. Philippines: National Government Cash Accounts, 2006–10

(In percent of GDP; unless otherwise noted)

	2006	2007	2008	2009		2010	
				Budget	Proj.	Budget	Proj. 1/
Revenue and grants	16.2	15.8	15.8	15.5	14.6	15.9	14.9
Tax revenue	14.3	14.0	14.1	13.9	12.7	14.3	13.0
Net income and profits	6.3	6.4	6.5	6.0	5.7	...	5.5
Excises	1.1	1.0	1.0	...	1.0	...	1.0
VAT	4.3	4.1	4.0	...	3.8	...	3.8
Tariffs	1.1	1.0	1.2	...	0.9	...	0.8
Other 2/	1.4	1.4	1.4	...	1.3	...	1.8
Nontax revenue	1.9	1.7	1.7	1.7	1.9	1.6	1.9
Measures	...	...	...	...	...	...	0.5
Expenditure and net lending	17.5	17.4	17.3	19.3	19.1	19.0	18.5
Current expenditures	15.2	14.4	14.0	15.6	15.4	15.7	14.9
Personnel services	5.4	5.3	5.0	5.5	5.5	6.1	5.3
Maintenance and operations	1.7	1.9	1.9	2.4	2.2	2.1	2.0
Allotments to local government units	2.3	2.3	2.3	2.6	2.7	2.6	2.7
Subsidies	0.2	0.3	0.2	0.1	0.2	0.2	0.2
Tax expenditure	0.3	0.5	0.8	0.7	0.7	0.5	0.5
Interest	5.4	4.2	3.8	4.2	4.0	4.3	4.3
National government	5.1	4.0	3.7	4.0	3.8	4.1	4.0
Central Bank-Board of Liquidators	0.2	0.1	0.1	0.2	0.2	0.2	0.2
Capital and equity expenditure 3/	2.3	2.9	3.0	3.5	3.5	3.2	3.5
Net lending	0.0	0.1	0.2	0.2	0.2	0.2	0.2
Balance	-1.4	-1.7	-1.5	-3.8	-4.4	-3.1	-3.6
On the authorities' presentation 4/	-1.1	-0.2	-0.9	-3.2	-3.9	-2.8	-3.3
Financing	1.4	1.7	1.5	3.2	4.4	2.8	3.6
Net external financing	2.0	0.8	-0.1	0.9	1.4	-0.3	0.6
Net domestic financing	-0.6	0.8	1.6	2.3	3.0	3.1	3.0
Privatization	0.1	1.4	0.4	0.4	0.4	0.1	0.2
Memorandum Items:							
Nonfinancial public sector balance 5/	0.1	0.2	-0.3	…	-3.9	…	-3.0
Consolidated public sector balance 5/	0.2	0.3	0.0	…	-3.8	…	-2.9
Primary national government balance	4.0	2.5	2.3	0.5	-0.4	1.2	0.7
National government debt 6/	55.4	47.8	48.6	…	51.2	…	50.5
(percent of NG revenues)	342.4	303.4	307.4	…	349.8	…	338.5
Nonfinancial public sector debt 7/	73.9	61.1	60.9	…	63.7	…	62.7
(percent of NFPS revenues)	321.5	253.5	266.5	…	310.5	…	302.2
National government gross financing requirements 8/	22.0	17.8	15.0	…	18.9	…	18.6
Health and education spending (current and capital; commit. basis)	2.2	2.2	2.2		…	…	…
GDP (in billions of pesos) 9/	6,031	6,647	7,423	7,795	7,612	8,337	8,190

Sources: Philippine authorities; and IMF staff projections.

1/ Measures assume gains from sin tax reform and rationalization of tax incentives, and expenditure compression relative to the budget through delays in wage bill increases, and higher reconstruction spending.
2/ Includes other percentage taxes, documentary stamp tax, and noncash collections. Tax expenditure includes noncash transfers to the National Food Authority for payment of import taxes, which is also reflected under revenues.
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.
6/ Net of national government debt held by the sinking fund, and excludes contingent/guaranteed debt.
7/ Includes the national government, CB-BOL, 14 monitored government-owned enterprises, social security institutions, and local governments.
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/ The GDP growth assumed in the budget is the lower bound of the range of the official GDP projections.

Table 3. Philippines: Balance of Payments, 2005–10

(In billions of U.S. dollars)

	2005	2006	2007	2008	Proj. 2009	Proj. 2010
Current account balance	**2.0**	**5.3**	**7.1**	**3.9**	**7.3**	**5.4**
Trade balance	-7.8	-6.7	-8.4	-12.9	-10.4	-13.3
Exports, f.o.b.	40.3	46.5	49.5	48.3	38.5	43.2
Imports, f.o.b.	48.0	53.3	57.9	61.1	48.9	56.6
Of which: oil and related products	6.3	8.1	9.6	12.4	8.2	11.9
Services (net)	-1.3	0.1	2.2	1.4	1.6	1.8
Receipts	4.5	6.4	9.8	10.2	9.5	10.7
Payments	5.9	6.3	7.5	8.8	7.9	9.0
Income	-0.3	-1.3	-0.9	0.1	0.4	0.2
Receipts, of which:	3.9	4.4	5.4	6.0	6.1	6.3
Remittances of resident workers abroad	2.9	2.8	3.0	4.1	4.3	4.4
Payments	4.2	5.6	6.2	5.8	5.7	6.1
Interest payments	2.8	3.3	3.6	3.3	3.2	3.3
Transfers (net)	11.4	13.2	14.2	15.2	15.8	16.8
Receipts	11.7	13.5	14.6	15.8	16.4	17.5
Of which: nonresident workers remittances	10.7	12.5	13.3	14.5	15.1	16.1
Payments	0.3	0.3	0.4	0.6	0.6	0.7
Capital and financial account	**2.2**	**0.0**	**3.6**	**-1.9**	**0.8**	**1.4**
Capital account	0.0	0.1	0.1	0.1	0.1	0.1
Financial account	2.2	-0.1	3.5	-2.0	0.8	1.3
Direct investment	1.7	2.8	-0.6	1.1	1.5	1.8
Portfolio investment	3.5	3.0	4.6	-3.8	2.5	1.2
Equity	1.5	2.5	3.1	-1.2	-1.0	-0.5
Debt	2.0	0.5	1.5	-2.6	3.5	1.7
Financial Derivatives	0.0	-0.1	-0.3	-0.1	0.1	0.1
Other investment	-2.9	-5.8	-0.2	0.8	-3.3	-1.8
Errors and omissions	**-1.8**	**-1.6**	**-2.1**	**-1.9**	**-1.9**	**-1.9**
Overall balance	**2.4**	**3.8**	**8.6**	**0.1**	**6.3**	**4.8**
Overall financing	**-2.4**	**-3.8**	**-8.6**	**-0.1**	**-6.3**	**-4.8**
Monetization of gold and revaluation	0.6	1.5	2.2	2.2	0.9	0.7
Change in net international reserves (increase =-)	-3.1	-5.3	-10.8	-2.3	-7.2	-5.6
Memorandum items:						
Current account/GDP	2.0	4.5	4.9	2.3	4.6	3.0
Short-term debt (original maturity)	9.4	7.7	9.9	10.0	10.4	10.8
Short-term debt (residual maturity)	14.3	11.8	14.0	14.4	16.8	16.8
Gross reserves	18.5	23.0	33.8	37.6	44.4	49.9
Adjusted gross reserves 1/	18.0	23.0	33.8	35.9	44.2	49.8
(in percent of short-term debt by residual maturity) 2/	130.6	194.4	240.5	280.4	266.1	299.2
Net international reserves	17.7	23.0	33.7	36.0	44.3	49.9
Monitored external debt (in billions) 3/	62.0	61.1	66.2	64.8	65.9	67.3
(in percent of GDP)	62.7	52.0	45.9	38.8	41.2	37.9
Debt service ratio 4/	17.0	15.3	13.0	12.6	14.9	17.0
Export value (percent change)	3.8	15.6	6.4	-2.5	-20.2	12.3
Import value (percent change)	8.0	10.9	8.7	5.6	-20.0	15.6
Gross external financing needs	10.5	8.9	4.7	10.1	7.1	11.4
GDP	98.8	117.5	144.0	166.9	159.8	177.7

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/ 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 nonfactor services.

Table 4. Philippines: Depository Survey, 2006–09

(In billions of pesos; unless otherwise noted)

	2006	2007 1/	2008 1/	2009 1/		
	Dec	Dec	Dec	Mar	Jun	Sep
Net foreign assets	1,366	1,659	1,931	2,113	2,190	2,336
Central bank	1,077	1,365	1,686	1,786	1,823	1,959
Net international reserves	1,128	1,397	1,717	1,816	1,852	1,987
Medium- and long-term foreign liabilities	51	32	31	30	29	28
Deposit money banks	289	294	245	327	367	377
Net domestic assets	2,445	2,422	2,738	2,471	2,476	2,401
Net domestic credit	3,007	3,162	3,691	3,684	3,787	3,780
Public sector credit	1,040	1,027	1,199	1,244	1,252	1,257
National Government	762	767	891	956	972	974
Credits	986	1,082	1,223	1,252	1,241	1,319
Foreign exchange receivables	4	0	0	0	0	0
Treasury IMF Accounts	-58	-51	-58	-57	-59	-60
Deposits	-170	-265	-274	-239	-210	-285
Local government and others	278	261	308	288	280	284
Private sector credit	1,967	2,134	2,492	2,440	2,535	2,523
Other items net	-562	-740	-953	-1,214	-1,311	-1,380
Total liquidity	3,811	4,081	4,669	4,584	4,666	4,736
M4	3,722	3,925	4,610	4,509	4,604	4,680
M3 (peso liquidity)	2,870	3,174	3,668	3,531	3,600	3,668
Foreign currency deposits, residents	853	751	942	978	1,004	1,012
Other liabilities	89	155	58	75	62	56
			Annual percent change			
Net foreign assets	49.9	21.4	16.4	21.7	17.6	24.1
Net domestic assets	6.3	-1.0	13.1	9.7	3.2	-0.2
Net domestic credit	7.2	5.2	16.8	16.0	15.2	8.8
Public sector	8.3	-1.2	16.7	12.2	15.2	10.8
Private sector	6.7	8.5	16.8	18.0	15.1	7.9
M4	19.0	5.5	17.5	17.7	12.5	11.0
M3	22.7	10.6	15.6	15.6	12.6	11.6

Sources: Philippine authorities; and CEIC Data Company Ltd.

1/ Based on New Depository Corporation Survey.

Table 5. Philippines: Baseline Medium-Term Outlook, 2007–14
(In percent of GDP, unless otherwise indicated)

	2007	2008	Proj. 2009	2010	2011	2012	2013	2014
GDP and prices								
Real GDP (percent change)	7.1	3.8	0.8	3.2	3.8	4.0	4.0	4.0
GDP per capita (US$)	1,624	1,845	1,733	1,891	1,948	2,011	2,076	2,142
CPI (percent change, average)	2.8	9.3	3.1	4.3	4.5	4.5	4.5	4.5
Investment and saving								
Gross investment	15.4	15.2	13.7	14.7	15.2	15.4	15.4	15.4
Private	12.8	12.2	10.7	11.6	12.3	12.7	12.5	12.5
Public	2.6	3.0	3.0	3.1	2.9	2.7	2.9	2.9
National saving 1/	20.3	17.6	18.3	17.7	17.7	17.1	16.5	15.6
Private	17.4	14.6	19.1	17.6	16.6	15.8	14.5	13.0
Public	2.9	3.0	-0.8	0.1	1.1	1.4	2.0	2.6
Foreign saving	-4.9	-2.3	-4.6	-3.0	-2.5	-1.7	-1.1	-0.2
Public finances								
Nonfinancial public sector balance 2/	0.2	-0.3	-3.9	-3.0	-2.0	-1.5	-1.0	-0.4
Primary balance	4.8	3.8	0.5	1.5	2.3	2.7	3.1	3.4
Revenue and grants 3/	24.1	22.8	20.5	20.7	21.3	21.4	22.1	22.7
Expenditure (primary) 4/	19.3	19.0	20.0	19.2	19.0	18.6	19.0	19.3
Interest	4.6	4.1	4.4	4.5	4.2	4.2	4.0	3.8
Nonfinancial public sector gross financing	18.1	14.9	19.4	19.1	17.5	16.5	15.6	14.6
Domestic	16.2	13.9	15.7	16.4	15.3	14.4	13.6	12.7
Foreign currency	1.9	1.0	3.8	2.7	2.2	2.1	2.0	1.9
National government balance (authorities definition)	-0.2	-0.9	-3.9	-3.3	-2.3	-1.4	-0.6	0.1
National government balance 5/	-1.7	-1.5	-4.4	-3.6	-2.5	-1.5	-0.8	-0.1
Nonfinancial public sector debt 6/	61.1	60.9	63.7	62.7	62.9	61.0	58.5	54.6
External sector								
Export value (percent change)	6.4	-2.5	-20.2	12.3	6.7	5.6	5.6	5.4
Import value (percent change)	8.7	5.6	-20.0	15.6	8.2	7.7	7.1	6.9
Trade balance	-5.8	-7.7	-6.5	-7.5	-8.1	-8.7	-9.2	-9.7
Current account	4.9	2.3	4.6	3.0	2.5	1.7	1.1	0.2
FDI (net, US$ billions)	-0.6	1.1	1.5	1.8	1.9	1.9	2.0	2.1
Reserves, adjusted (US$ billions) 7/	33.8	35.9	44.2	49.8	54.8	59.2	62.8	64.9
Reserves / Short-term liabilities, adjusted 8/	240.5	280.4	266.1	299.2	324.9	337.0	357.7	365.7
Gross external financing requirements (US$ billions) 9/	4.7	10.1	7.1	11.4	12.2	13.6	15.4	17.2
Total external debt 10/	45.9	38.8	41.2	37.9	36.5	35.4	34.2	33.1
Debt service ratio (in percent of exports of G&S)	13.0	12.6	14.9	17.0	15.2	14.3	14.1	12.7

Sources: Philippine authorities; and IMF staff projections.

1/ Defined as the difference between gross investment and external 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 the 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/ 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/ 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, 2004–09

(End of year; unless otherwise indicated)

	2004	2005	2006	2007	2008	2009 Q2
Capital adequacy						
Total capital accounts to total assets	12.5	11.8	11.7	11.7	10.6	11.3
Capital adequacy ratio (consolidated basis)	18.4	17.7	17.6	15.7	15.5	15.3 1/
Asset quality						
NPL ratio 2/	14.4	10.0	7.5	5.8	4.5	4.5
NPA ratio 3/	11.8	8.8	6.9	5.9	5.1	5.0
Distressed asset ratio 4/	24.9	19.1	15.1	12.5	10.7	10.3
NPL coverage ratio 5/	58.0	72.9	75.0	81.5	86.0	86.7
NPA coverage ratio 6/	33.2	38.4	37.3	39.8	44.4	45.4
Profitability						
Return on assets	0.9	1.1	1.3	1.3	0.8	0.9
Return on equity	7.1	8.8	10.6	10.8	6.9	8.1
Cost-to-income ratio	68.1	65.5	64.0	65.2	73.9	71.0
Liquidity						
Liquid assets to deposits	53.3	53.1	52.1	51.9	52.3	51.8
Loans (gross) to deposits	73.3	72.4	69.3	70.9	69.7	68.6

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

1/ As of 2009 Q1.
2/ Nonperforming loans (NPL) over total loan portfolio excluding interbank loans (TL).
3/ (Nonperforming loans + ROPA) over total gross assets.
4/ Ratio of (NPLs + Gross ROPA + current restructed loans) to (Gross total loan portfolio + Gross ROPA).
5/ Ratio of loan loss reserves to NPLs.
6/ Ratio of valuation reserves (for loans and ROPA) to NPAs.

Table 7. Philippines: Indicators of External Vulnerability, 2005–10
(In percent of GDP, unless otherwise indicated)

	2005	2006	2007	2008	Proj. 2009	2010
External indicators (including external liquidity):						
Gross international reserves, adjusted (in billions US dollars) 1/	18.0	23.0	33.8	35.9	44.2	49.8
Maturing short-term debt (in billions US dollars)	9.4	7.7	9.9	10.0	10.4	10.8
Amortization of medium and long-term debt (in billions US dollars)	4.9	4.8	4.1	4.1	4.5	6.4
Net FDI inflows (in billions of US dollars)	1.7	2.8	-0.6	1.1	1.5	1.8
FX deposits residents (in billions of US dollars) 2/	16.7	18.9	19.5	20.6	21.8	...
Total gross external debt	62.7	52.0	45.9	38.8	41.2	37.9
Public sector indicators:						
Overall balance	-2.1	0.1	0.2	-0.3	-3.9	-3.0
Primary balance	4.3	5.8	4.8	3.8	0.5	1.5
Nonfinancial public sector debt (NFPSD)	85.9	73.9	61.1	60.9	63.7	62.7
NFPSD denominated in FX or linked to the exchange rate (in percent of NFPSD)	60.9	61.2	57.2	58.2	56.5	52.4
Short-term general government debt (original maturity, in percent of NFPSD)	16.6	17.7	17.2	19.0	15.3	17.4
Average effective interest rate of government debt (in percent)	7.4	7.8	7.5	6.8	6.9	7.3
Amortization of total debt	22.2	24.2	18.3	14.6	15.5	16.0

Sources: Philippine authorities; and IMF staff projections.

1/ Gross reserves less gold and securities pledged as collateral against short-term liabilities.
2/ As of June, 2009.

APPENDIX I. DEBT SUSTAINABILITY ANALYSIS

The Philippines' public sector debt is broadly sustainable. Fiscal reforms, strong growth and an appreciating exchange rate have contributed to a rapid decline in nonfinancial public sector (NFPS) debt over recent years. In staff's baseline scenario, an uptick in debt levels is expected in 2009–10 as the impact from the global financial crisis reverses these trends. Moreover, assuming in this scenario that revenue reforms are implemented with the goal of achieving a 1 percent of GDP National Government deficit by 2013, the NFPS debt is expected to decline gradually to the pre-crisis level by then. In the absence of reforms, however, debt is expected to remain at an elevated level of 60 percent of GDP in 2013. Public debt dynamics remains most vulnerable to shocks to the exchange rate and contingent liabilities.

Projected external debt dynamics are generally benign. In recent years, external debt has steadily declined—from nearly 80 percent of GDP in 2002 to around 40 percent at end-2008. Under the staff's baseline scenario, the external debt ratio would fall gradually over the medium term to just over 33 percent in 2014. However, the debt dynamics are still vulnerable to exchange rate volatility. Indeed, a one-time real depreciation of 30 percent is estimated to entail a 22 percentage point jump in the external debt ratio from its 2008 level, which would exceed 60 percent in the medium term. However, the debt dynamics are more resilient to interest rate and growth shocks, and are only moderately affected by noninterest shocks to the current account.

Table A1. Philippines: Public Sector Debt Sustainability Framework, 2004-2014
(In percent of GDP, unless otherwise indicated)

	Actual					Projections						
	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	**Debt-stabilizing primary balance 9/**
1 **Baseline: Public sector debt 1/**	95.2	85.9	73.9	61.1	60.9	**63.7**	**62.7**	**62.9**	**61.0**	**58.5**	**54.6**	**0.4**
Of which foreign-currency denominated	62.7	52.3	45.3	34.9	35.4	36.0	32.8	32.3	31.5	30.6	29.3	
2 Change in public sector debt	-5.6	-9.3	-11.9	-12.9	-0.2	2.9	-1.0	0.2	-1.8	-2.6	-3.9	
3 Identified debt-creating flows (4+7+12)	-6.1	-10.9	-12.1	-13.6	-1.1	2.1	-1.3	-2.6	-3.2	-3.6	-3.9	
4 Primary deficit	-1.6	-4.3	-5.8	-4.8	-3.8	-0.5	-1.5	-2.3	-2.7	-3.1	-3.4	
5 Revenue and grants	20.5	22.1	23.0	24.1	22.8	20.5	20.7	21.3	21.4	22.1	22.7	
6 Primary (noninterest) expenditure	19.0	17.8	17.2	19.3	19.0	20.0	19.2	19.0	18.6	19.0	19.3	
7 Automatic debt dynamics 2/	-4.2	-6.9	-6.2	-9.1	2.6	2.9	0.0	-0.6	-0.8	-0.8	-0.8	
8 Contribution from interest rate/growth differential 3/	-5.0	-3.6	-2.6	-2.3	-2.3	2.9	0.0	-0.6	-0.8	-0.8	-0.8	
9 Of which contribution from real interest rate	0.7	0.6	1.6	2.5	-0.2	3.4	1.9	1.5	1.5	1.4	1.3	
10 Of which contribution from real GDP growth	-5.7	-4.2	-4.2	-4.7	-2.1	-0.5	-1.9	-2.2	-2.3	-2.2	-2.2	
11 Contribution from exchange rate depreciation 4/	0.8	-3.3	-3.7	-6.8	4.8	...	...	...	...	...	...	
12 Other identified debt-creating flows	-0.4	0.4	0.0	0.2	0.2	-0.3	0.1	0.3	0.3	0.3	0.3	
13 Privatization receipts (negative)	0.0	0.0	-0.1	-1.4	-0.4	-0.4	-0.2	0.0	0.0	0.0	0.0	
14 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	
15 Other (specify, e.g. bank recapitalization)	-0.4	0.4	0.1	1.6	0.6	0.1	0.3	0.3	0.3	0.3	0.3	
16 Residual, including asset changes (2–3) 5/	0.6	1.6	0.1	0.7	0.9	0.8	0.3	2.8	1.4	1.0	0.0	
Public sector debt-to-revenue ratio 1/	463.6	389.5	321.5	253.5	266.5	310.5	302.2	295.5	285.5	264.7	240.7	
Gross financing need 6/	28.0	24.3	24.2	18.1	14.9	19.4	19.1	17.5	16.5	15.6	14.6	
in billions of U.S. dollars	24.4	24.0	28.4	26.1	24.9	31.0	33.9	32.7	32.5	32.3	31.9	
Scenario with key variables at their historical averages 7/						**63.7**	**59.7**	**58.4**	**55.7**	**52.7**	**48.9**	**-0.4**
Scenario with no policy change (constant primary balance) in 2009-2014						**63.7**	**66.7**	**67.7**	**68.1**	**68.1**	**67.2**	**0.5**
Key Macroeconomic and Fiscal Assumptions Underlying Baseline												
Real GDP growth (in percent)	6.4	5.0	5.3	7.1	3.8	0.8	3.2	3.8	4.0	4.0	4.0	
Average nominal interest rate on public debt (in percent) 8/	7.3	7.5	7.5	6.8	7.5	7.4	7.7	7.4	7.3	7.2	7.1	
Average real interest rate (nominal rate minus change in GDP deflator, in percent)	1.2	1.0	2.3	3.9	0.0	5.7	3.4	2.9	2.8	2.7	2.6	
Nominal appreciation (increase in U.S. dollar value of local currency, in percent)	-1.2	6.0	8.0	18.7	-12.8	...	...	...	...	...	...	
Inflation rate (GDP deflator, in percent)	6.1	6.5	5.2	2.9	7.5	1.7	4.3	4.5	4.5	4.5	4.5	
Growth of real primary spending (deflated by GDP deflator, in percent)	0.6	-1.7	1.8	20.6	2.0	6.3	-0.8	2.4	2.1	6.2	5.4	
Primary deficit	-1.6	-4.3	-5.8	-4.8	-3.8	-0.5	-1.5	-2.3	-2.7	-3.1	-3.4	

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/ Derived as $[(r - \pi(1+g) - g + \alpha\varepsilon(1+r)]/(1+g+\pi+g\pi))$ times previous period debt ratio, with r = interest rate; π = growth rate of GDP deflator; g = real GDP growth rate; α = share of foreign-currency denominated debt; and ε = nominal exchange rate depreciation (measured by increase in local currency value of U.S. dollar).

3/ The real interest rate contribution is derived from the denominator in footnote 2/ as $r - \pi(1+g)$ and the real growth contribution as -g.

4/ The exchange rate contribution is derived from the numerator in footnote 2/ as $\alpha\varepsilon(1+r)$.

5/ For projections, this line includes exchange rate changes.

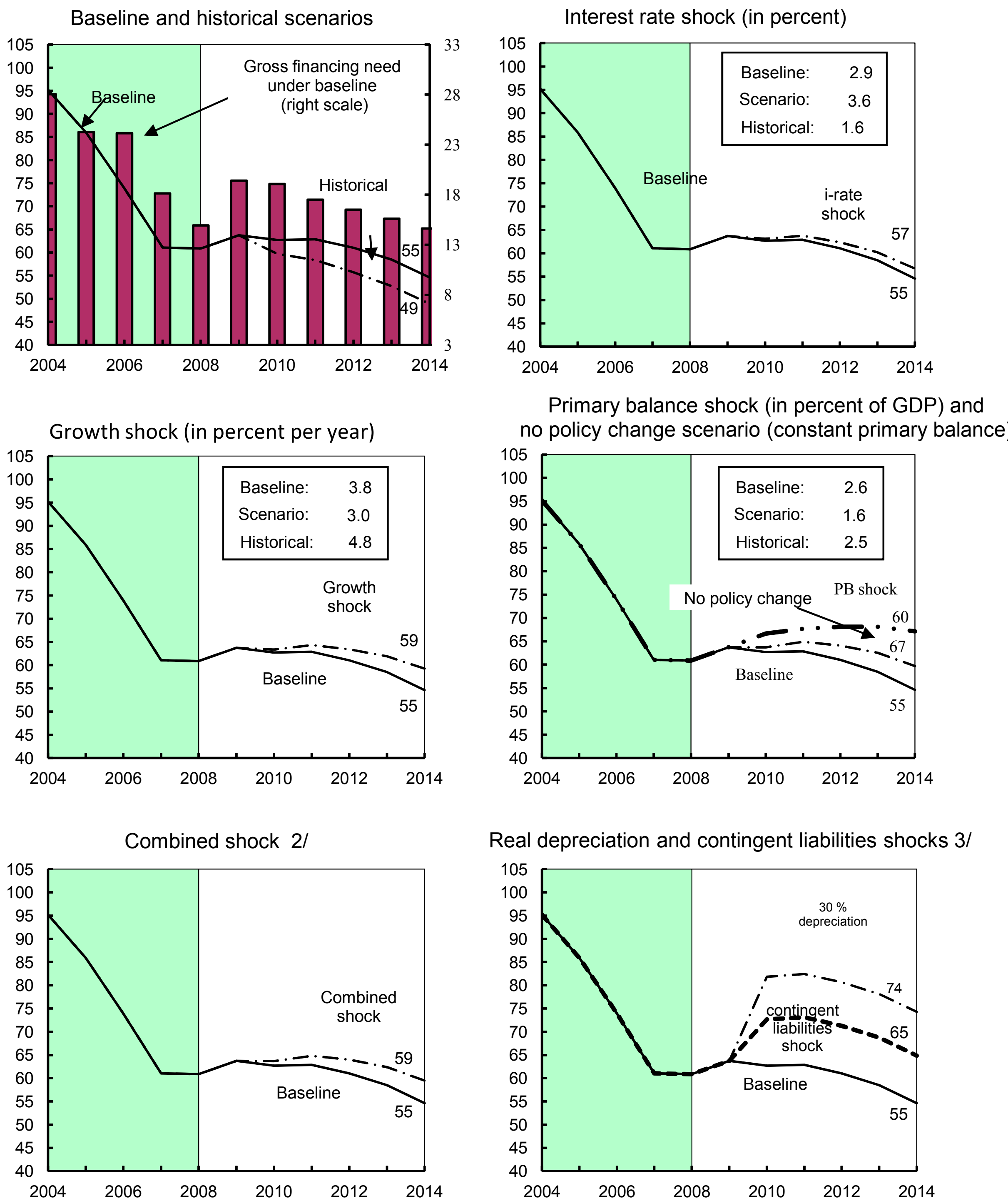
6/ Defined as public sector deficit, plus amortization of medium and long-term public sector debt, plus short-term debt at end of previous period.

7/ The key variables include real GDP growth; real interest rate; and primary balance in percent of GDP.

8/ Derived as nominal interest expenditure divided by previous period debt stock.

9/ 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. Philippines: 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 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 2009, 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 A2. Philippines: External Debt Sustainability Framework, 2004-2014
(In percent of GDP, unless otherwise indicated)

		Actual					Projections						
		2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	**Debt-stabilizing non-interest current account 6/**
1	**Baseline: External debt**	70.7	62.7	52.0	45.9	38.8	**41.2**	**37.9**	**36.5**	**35.4**	**34.2**	**33.1**	**-1.7**
2	Change in external debt	-8.5	-8.0	-10.7	-6.1	-7.1	2.4	-3.4	-1.3	-1.1	-1.2	-1.2	
3	Identified external debt-creating flows (4+8+9)	-9.2	-13.7	-19.1	-16.2	-8.6	-5.2	-4.9	-4.9	-4.2	-3.7	-2.9	
4	Current account deficit, excluding interest payments	-4.6	-5.2	-7.3	-7.4	-4.3	-6.3	-4.6	-4.0	-3.2	-2.5	-1.6	
5	Deficit in balance of goods and services	8.6	9.2	5.6	4.3	6.9	5.6	6.5	7.0	7.8	8.3	8.9	
6	Exports	49.3	45.3	45.1	41.2	35.0	30.0	30.4	30.9	31.1	31.2	31.3	
7	Imports	57.9	54.5	50.7	45.4	41.9	35.6	36.9	38.0	38.8	39.6	40.2	
8	Net nondebt creating capital inflows (negative)	-0.7	-3.2	-4.5	-1.7	0.0	-0.3	-0.7	-1.1	-1.1	-1.2	-1.3	
9	Automatic debt dynamics 1/	-3.9	-5.4	-7.2	-7.1	-4.4	1.4	0.4	0.1	0.1	0.1	0.1	
10	Contribution from nominal interest rate	2.7	3.2	2.8	2.5	1.9	1.7	1.6	1.5	1.5	1.4	1.4	
11	Contribution from real GDP growth	-4.6	-3.1	-2.8	-3.0	-1.5	-0.3	-1.2	-1.4	-1.4	-1.3	-1.3	
12	Contribution from price and exchange rate changes 2/	-2.0	-5.4	-7.2	-6.6	-4.8	...	...	...	...	...	...	
13	Residual, incl. change in gross foreign assets (2–3) 3/	0.7	5.7	8.4	10.2	1.5	7.7	1.5	3.6	3.1	2.5	1.7	
	External debt-to-exports ratio (in percent)	143.5	138.4	115.4	111.6	110.9	137.4	124.6	118.2	113.9	109.5	105.5	
	Gross external financing need (in billions of U.S. dollars) 4/	11.4	10.5	8.9	4.7	10.1	7.1	11.4	12.2	13.6	15.4	17.2	
	in percent of GDP	13.2	10.7	7.6	3.3	6.1	4.5	6.4	6.5	6.9	7.4	7.9	
	Scenario with key variables at their historical averages 5/						**41.2**	**38.2**	**34.7**	**30.7**	**26.2**	**21.1**	**-2.8**
	Key Macroeconomic Assumptions Underlying Baseline												
	Real GDP growth (in percent)	6.4	5.0	5.3	7.1	3.8	0.8	3.2	3.8	4.0	4.0	4.0	
	GDP deflator in U.S. dollars (change in percent)	2.6	8.3	12.9	14.5	11.6	-5.0	7.8	1.2	1.2	1.2	1.2	
	Nominal external interest rate (in percent)	3.7	5.1	5.2	5.8	4.9	4.2	4.2	4.2	4.2	4.2	4.2	
	Growth of exports (U.S. dollar terms, in percent)	10.6	4.6	18.3	11.9	-1.4	-18.0	12.6	7.0	5.8	5.9	5.6	
	Growth of imports (U.S. dollar terms, in percent)	8.1	7.2	10.5	9.8	6.9	-18.7	15.4	8.1	7.8	7.2	7.1	
	Current account balance, excluding interest payments	4.6	5.2	7.3	7.4	4.3	6.3	4.6	4.0	3.2	2.5	1.6	
	Net nondebt-creating capital inflows	0.7	3.2	4.5	1.7	0.0	0.3	0.7	1.1	1.1	1.2	1.3	

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).

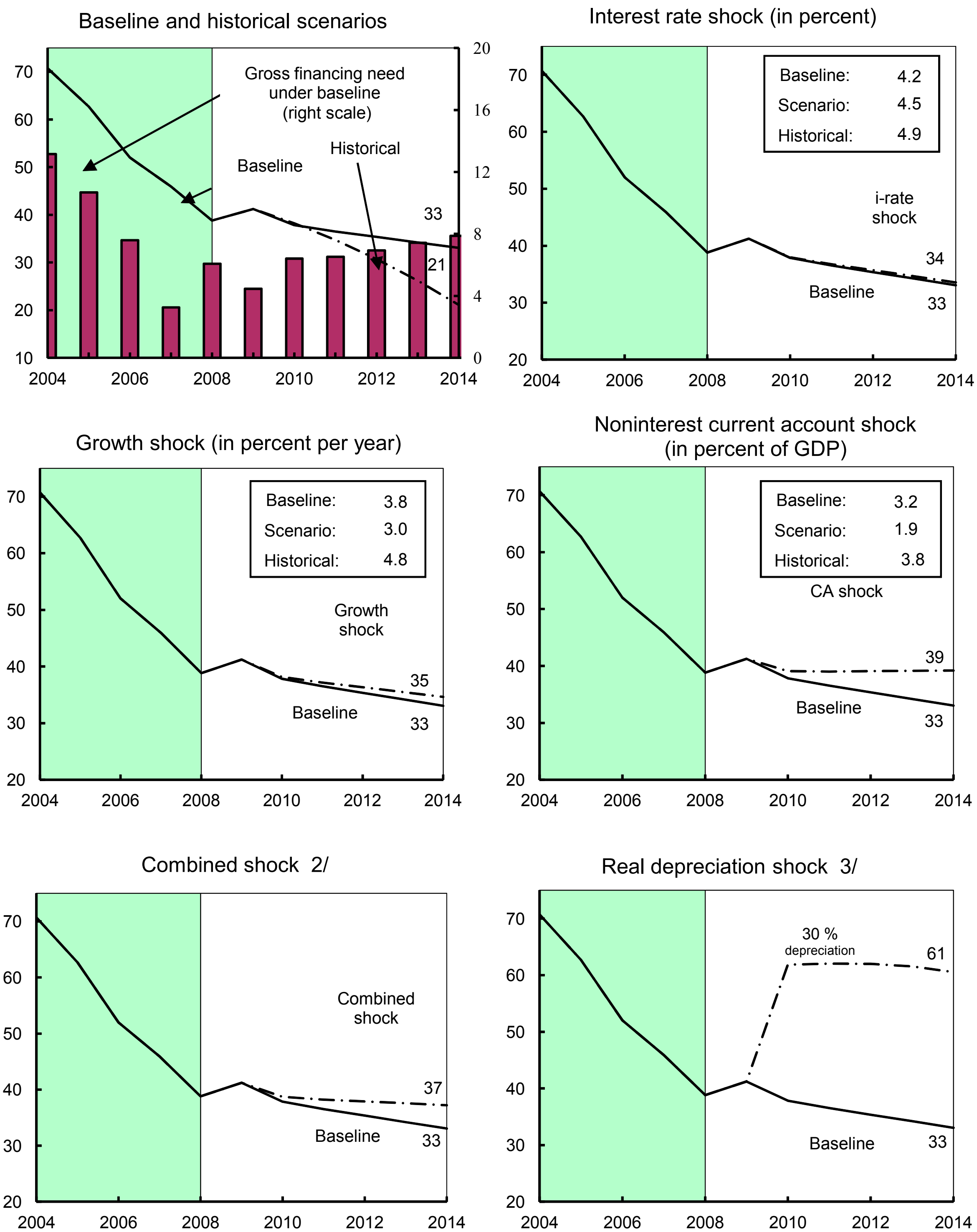
3/ For projection, line includes the impact of price and exchange rate changes.

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 nondebt 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 A2. 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 2009.

INTERNATIONAL MONETARY FUND

PHILIPPINES

Staff Report for the 2009 Article IV Consultation—Informational Annex

Prepared by the Asia and Pacific Department

January 4, 2010

Contents | Page

ANNEX I. PHILIPPINES: FUND RELATIONS

(As of November 30, 2009)

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	792.19	90.03
Reserve position in Fund	87.71	9.97

III. **SDR Department**:

	SDR Million	% Allocation
Net cumulative allocation	837.96	100.00
Holdings	727.93	86.87

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			
	2010	2011	2012	2013
Principal	...	...	...	...
Charges/Interest	0.33	0.33	0.33	0.33
Total	0.33	0.33	0.33	0.33

VII. **Exchange Arrangement**:

The de jure exchange rate arrangement is *free floating*, while the de facto exchange arrangement is classified as *floating*. 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 2008 Article IV Consultation was discussed by the Executive Board on January 16, 2009.

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. The FSAP update mission took place in November 2009.

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 advisers have visited Manila six times (June and September 2006, January, March, May, and July 2007).

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 mission visited Manila in November 2006 to advise on liberalization of the foreign exchange market. MCM TA in the area of problem bank identification, management, and resolution took place in March 2009 and a TA mission on stress testing visited Manila in June 2009.

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. A STA mission took place in August 2009 to finalize a monetary statistics compilation system based on the Standardized Report Forms.

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 and 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. A mission reviewing progress in tax administration reforms and VAT performance took place in March 2009. A TA mission in October–November 2009 were part of a joint mission with the Millenium Challenge Corporation (MCC) to (i) identify critical institutional, procedural and functional reform priorities; and (ii) review of the ETIS tax administration computer system and tax reform program. FAD's peripatetic advisor on cash management reforms visited Manila in February and June 2009.

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. Dennis Botman assumed the post of Resident Representative in January 2009.

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

The World Bank Program

Strategy

The current Philippines Country Assistance Strategy (CAS) covers the period July 1, 2009 to June 30, 2012 (FY10-12). It is anchored in the country's Medium-Term Philippine Development Plan, and carries the theme of *Making Growth Work for the Poor*. Its overall goal is to achieve inclusive growth through five Strategic Objectives: (i) Stable Macro Economy; (ii) Improved Investment Climate; (iii) Better Public Service Delivery; (iv) Reduced Vulnerabilities; and (v) Good Governance, which is also a cross-cutting theme. Shifts in strategy from the previous CAS include increased focus on direct poverty reduction; operationalized focus on governance; expanded and re-focused knowledge agenda; and strengthened linkages to global issues—climate change and disaster risk management.

Lending Program

Since the World Bank started operations in the Philippines, it has committed approximately $13 billion under IBRD loans and $244 million under IDA credits. As of October 31, 2009, the Philippine portfolio consisted of 24 projects, amounting to $1.4 billion with undisbursed balance of $908 million. Four operations amounting to $320 million were approved in FY09: Food Crisis Response Development Policy Operation ($200 million); Participatory Irrigation Development Project ($70.4 million); Additional Financing for Rural Power Project ($40 million); and Additional Financing for Agrarian Reform and Community Development Project ($10 million). Based on net commitments by sector, the current portfolio can be broken down as follows: infrastructure ($532 million, 38 percent); human development ($372 million, 26 percent); rural development and environment ($332 million, 24 percent); social development ($139 million, 10 percent); and others ($33 million, 2 percent). For FY10, the Social Welfare and Development Reform Project ($405 million) was approved on November 17, 2009.

Under the CAS, IBRD anticipated lending program is in the order of US$700 million-US$1 billion per year, with lower commitments expected for FY10 due to the May 2010 elections. The IFC investment program is expected to be in the order of US$250–300 million per year, while advisory services will be supported by funding of approximately US$3 million per year.

Non-Lending Program

An important aspect of World Bank support to the Philippines is in the form of analytical and advisory activities (AAA) leveraged through partnerships with other organizations, administration of trust funds, and policy dialogue. Examples of AAA outputs in FY09 include the Quarterly Economic Updates, the Philippine Development Report, and the Public Expenditure Report for the Transport Sector.

The Bank has an extensive outreach program in the Philippines to promote knowledge sharing. Currently, there are 12 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.

Partnerships

Strategic partnerships, supported by large bilateral and multi-donor trust funds administered by the World Bank, form a significant part of the country program. Large trust funds in the health and education sectors are supported by the European Commission and AusAID respectively. In addition, partnerships are facilitated through global funds such as the Global Environmental Facility, Public-Private Infrastructure Advisory Facility, Carbon Finance Funds, Cities Alliance, Water and Sanitation Program, and others. Important recently approved trust funds include the Australian=funded umbrella Trust Fund, the Global Partnership Fund (GPF), and the State and Peace-Building Fund (SPF).

The Philippines Development Forum (PDF) 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 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, which facilitate the policy dialogue throughout the year related to the working groups' specific themes. Partnerships with the Government, other development partners, and other stakeholders on the policy reform agenda are facilitated through the PDF process.

Table 1. IBRD Loans Approved by the Board of Executive Directors between July 1, 2000 and October 31, 2009
(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	19.0	10/11/05
Manila Third Sewerage	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 2	83.8	7/03/07
National Program Support for Env. and Nat. Resources Management	50.0	11/27/07
Bicol Power Restoration	12.9	5/21/08
National Roads Improvement and Management 2	232.0	4/22/09
Food Crisis Response Development Policy Operation	200.0	2/23/09
Participatory Irrigation Development	70.4	11/03/09
Additional Financing for Rural Power	40.0	9/25/09
Additional Financing for Agrarian Reform and Community Development	10.0	7/31/09

Table 2. IBRD/IDA Lending Operations as of October 31, 2009
(In millions of U.S. dollars)

	IBRD	IDA	TOTAL
Total disbursed 1/	10,005.4	244.0	10,249.4
Total commitments 1/	10,843.7	239.5	11,083.2
Total undisbursed	871.9	0	871.9
Total repaid	7,516.5	77.4	7,593.9

[1/] Net of cancellations.

Table 3. IFC investments as of October 31, 2009
(In millions of U.S. dollars)

Total commitments held by IFC and participants	948.46	
Total commitments held by IFC alone		945.73
Approvals pending commitments:		
IFC		70.00
Participants		0.00

ANNEX III. PHILIPPINES: RELATIONS WITH THE ASIAN DEVELOPMENT BANK

From January 2005 to September 30, 2009, the Asian Development Bank (AsDB) approved fourteen public sector loans totaling $2.86 billion,[1] including $2.65 billion for nine policy-based loans[2] and $41.64 million for 39 technical assistance and grant-financed projects; generated $559 million in co-financing; approved $224.4 million for private sector operations; and supported two peso bond issues totaling pesos 7.5 billion to finance local currency operations.[3]

Since joining the AsDB in 1966, the Philippines has received 192 loans for a total of $11 billion, and 354 technical assistance grants amounting to $162.37 million. Energy and agriculture account for the largest proportion of lending (Table 1). Since 1998, 80 percent of lending has been for policy-based operations and 20 percent for investment projects.

Table 1. Philippines: Cumulative AsDB Lending to the Philippines
(As of September 30, 2009)

	No. of Loans	Amount of Loans ($ million)	Percent (by amount)
Energy	26	2,688.2	24.4
Agriculture and Natural Resources	59	1,909.0	17.3
Public Sector Management	8	1,853.0	16.8
Transport and ICT	26	1,292.9	11.7
Finance	19	1,128.0	10.2
Water and Other Municipal Infrastructure and Services	27	1,042.9	9.5
Health and Social Protection	7	367.4	3.3
Multisector	7	301.2	2.7
Education	8	252.1	2.3
Industry and Trade	5	174.0	1.6
Total	**192**	**11,008.6**	**100.0**

AsDB's private sector operations in the Philippines, which are made without government guarantee, began in 1986. As of 30 June 2009, cumulative approvals for 25 private sector projects amounted to $648.1 million. The Philippines is among the largest recipients of private sector operations support from AsDB, receiving 28 percent of its total 2008 private sector loan and equity disbursements. AsDB's private sector operations in the Philippines

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[1] Five project loans for $210 million were among these.

[2] In 2009, two policy-based loans totaling $750 million (90 percent of all lending) and two project loans 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.

included financing for power plants, and investments in banks and private equity funds. In 2000, AsDB approved a direct loan of up to $45 million and $25 million in loans under AsDB's complementary financing scheme for the rehabilitation of the expressway that links Metro Manila, the national capital, to the central and northern provinces of the Philippines. Completed in February 2005, the expansion and improvement of the road to world standards spurred development in other regions and decentralized economic activities from congested Metro Manila. In 2004, AsDB approved a loan and equity investment totaling $34 million for a project that will help fund the purchase of a portfolio of nonperforming mortgage loans secured by single-family homes located throughout the Philippines. In 2008, a $200 million loan was approved and disbursed for the acquisition, rehabilitation, and operation of an existing coal-fired thermal power plant in the Philippines.

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, 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 operations with Philippine priorities. Given the strategic continuous relevance of CSP and AsDB intention to synchronize the next five-year CPS with the Mid-Term Philippines Development Plan 2011-2016, the 2005-07 CPS was extended three times through Country Operations Business Plans for 2007–08, 2009–2010, and 2010–2012, respectively. Through its annual lending allocation of around $620 million/year during 2010–2012, AsDB would continue its support for medium-term reforms via the Financial Market Regulation and Intermediation, Justice Reform, Investment Climate, and Power Distribution Sector Reform programs. The share of policy-based loans in total loans is expected to be 40 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 and 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

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

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.

ANNEX IV. PHILIPPINES—STATISTICAL ISSUES

As of December 4, 2009

I. Assessment of Data Adequacy for Surveillance	
General: Data provision has some shortcomings, but is broadly adequate for surveillance.	
National Accounts: Despite the authorities' efforts to improve quality, weaknesses remain in the national accounts. These include large statistical 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. First, 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. Second, 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. Finally, 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. **Price Statistics:** 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 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.	
External Sector Statistics: Steps have been taken to improve the quality of balance of payment statistics. In 2005, the 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 and improvements in the classification of remittances. The revisions to imports have narrowed the gap between national trade data and those of partner countries on a net basis. However, 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.	
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.	
Government Finance Statistics: While the Philippines meet 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 obligation 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. 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.	
II. Data Standards and Quality	
The Philippines subscribed to the Special Data Dissemination Standards (SDDS) in August 1996.	A data ROSC was published in August 2004.

PHILIPPINES: TABLE OF COMMON INDICATORS REQUIRED FOR SURVEILLANCE

(As of December 4, 2009)

	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 09	Dec 4/09	D	D	D		
International Reserve Assets and Reserve Liabilities of the Monetary Authorities[1]	Oct 09	Nov 6/09	D	D	M		
Reserve Money Base Money	Oct 09 Sep 09	Nov 13/09 Nov 10/09	D	W	W	O, LO, LO, LNO	LO, O, O, O, LO
Broad Money	Sep 09	Nov 10/09	M	M	M		
Central Bank Balance Sheet	Aug 09	Oct 15/09	M	M	M		
Consolidated Balance Sheet of the Banking System	Sep 09	Nov 10/09	M	M	M		
Interest Rates[2]	Dec 09	Dec 4/09	D	D	D		
Consumer Price Index	Nov 09	Dec 4/09	M	M	M	O, O, O, O	O, LO, O, LO, LO
Revenue, Expenditure, Balance and Composition of Financing[3] – General Government[4]	Q1/09	Jul 09	Q	Q	Q	LO, LO, O, O	LO, LO, LO, LO, LO
Revenue, Expenditure, Balance and Composition of Financing[3]– Central Government	Oct 09	Nov 18/09	M	M	M		
Stocks of Central Government and Central Government-Guaranteed Debt[5]	Q2/09	Sep 09	Q	Q	Q		
External Current Account Balance	Q2/09	Sep 24/09	Q	Q	Q	O, LO, LO, LO	LNO, LO, O, LO, LO
Exports and Imports of Goods and Services	Q2/09	Sep 24/09	Q	Q	Q		
GDP/GNP	Q3/08	Nov 26/09	Q	Q	Q	LO, LO, O, LO	LNO, LNO, O, LO, O
Gross External Debt	Q2/08	Sep 30/09	Q	Q	Q		
International Investment Position[6]	2008	Sep 30/09	A	A	A		

[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

Public Information Notice

EXTERNAL RELATIONS DEPARTMENT

Public Information Notice (PIN) No. 10/26
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International Monetary Fund
700 19th Street, NW
Washington, D. C. 20431 USA

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IMF Executive Board Concludes 2009 Article IV Consultation with the Philippines

On January 29, 2010 the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with the Philippines.[1]

Background

Following the adverse impact from the global economic and financial crisis, there are signs of a nascent recovery. The Philippine economy avoided a technical recession as second and third quarter GDP in 2009 rebounded by 1.7 percent and 1.0 percent (quarter-on-quarter), respectively, following the 2.1 percent contraction during the first quarter. Inflation has trended down during the year, reaching 3¼ percent during January–November, in the middle of the Bangko Sentral ng Pilipinas (BSP's) target range. Following the post-Lehman financial market stress in late 2008, market conditions are normalizing and equity prices have returned to pre-crisis levels. The current account has held up well, with the decline in exports cushioned by waning imports of commodities and resilient remittances. With the return of risk appetite, the exchange rate has appreciated and capital inflows have resumed, although so far primarily into the corporate and government bond market.

Growth is expected at ¾ percent in 2009 and to recover to around 3¼ percent in 2010. The recovery will likely be led by private consumption as confidence strengthens and remittances pick up further. Investments and exports are also expected to benefit from the

[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. An explanation of any qualifiers used in summings up can be found here: http://www.imf.org/external/np/sec/misc/qualifiers.htm..

global recovery. Risks to the near-term outlook are broadly balanced and sensitive to the global growth outturn. On the domestic side, the output losses from the devastation caused by the two recent typhoons could turn out to be larger than currently estimated, and fiscal slippage could raise investor concerns. On the upside, the post-typhoon rebuilding efforts could spur higher investment.

The financial sector has weathered the global financial crisis relatively well and generally remains sound. Bank earnings have improved during the first half of 2009 as global economic and financial conditions have stabilized. The capital adequacy ratio remains high at around 15 percent and nonperforming loans are also generally low (around 4 percent of loans), although they are relatively high for thrift and rural banks. Bank exposures are often concentrated on few large corporate borrowers due to the prevalence of big conglomerates. However, they are reportedly well monitored and financially sound.

Fiscal policy was loosened in response to the crisis, but poor revenue performance will likely lead to a breach of the widened deficit target in 2009. The deficit is now estimated at 4½ percent, overshooting the budget target of 3¾ percent of GDP (IMF definition). This deficit implies a positive fiscal impulse of around 2¼ percent of GDP and an estimated growth impact of around 1 percentage point.

The BSP took proactive steps to lessen the adverse impact of the global financial crisis. Policy rates have been cut by 200 basis points since end–2008, which had a significant impact on lending rates. Moreover, the reserve requirement rate on bank deposits and deposit substitutes was lowered by 2 percentage points (to 19 percent for universal/ commercial banks) in late 2008 and the rediscount window was tripled to pesos 60 billion.

Executive Board Assessment

Executive Directors commended the authorities for their implementation of sound economic policies in recent years. Supportive macroeconomic policies, together with resilient remittances, cushioned the impact in 2009 of the global economic crisis. Recovery is expected in 2010, led by private demand as confidence and remittances improve. A timely return toward a sustainable fiscal path while avoiding a premature exit from a supportive monetary policy will be important, along with continued reforms to ensure sustained growth in the medium-term.

Directors concurred that the fiscal stimulus in 2009 proved to be an effective response to the weak economic environment. Given the limited fiscal space, they supported a measured fiscal withdrawal in 2010. Public debt remains relatively high, and tax collections have weakened beyond cyclical factors. Directors welcomed the authorities' commitment to fiscal deficit reduction starting this year. They stressed that this will require new revenue measures as well as expenditure restraint focused on non-priority current spending.

To further strengthen public finances, bolster market confidence, and create fiscal space for pro-poor spending and growth-enhancing public investment, Directors encouraged the authorities to introduce a credible medium-term consolidation plan, building on revenue raising measures. They supported the authorities' request for technical assistance in this area. The introduction of a formalized fiscal framework would further underscore the commitment to fiscal prudence.

Directors welcomed the BSP's proactive easing steps in response to the crisis. In view of the still negative output gap and the planned tightening of fiscal policy, they concurred that monetary policy should remain accommodative until a sustained economic recovery is assured, while ensuring that inflation expectations remain well-anchored. Directors noted the staff's assessment that the exchange rate appears aligned with fundamentals. They recommended that foreign exchange interventions remain limited to smoothing operations, while allowing the exchange rate to adjust to market pressures.

Directors commended the authorities' good progress in implementing the recommendations of the 2002 Financial Sector Assessment Program (FSAP), noting that the financial sector weathered the crisis well, with banks remaining well capitalized and nonperforming loan (NPL) ratios low. While the moderate economic growth expected over the near term could dampen the banks' earnings and potentially lead to a deterioration in asset quality, stress tests conducted in the context of the FSAP update suggest that banks are quite resilient to adverse shocks. At the same time, concentration risks are more elevated due to the exposure to large conglomerates.

Directors supported additional steps to further strengthen financial sector supervision and the regulatory framework, including through early adoption of the proposed amendments to the New Central Banking Act. The latter would also provide supervisory staff with adequate protection from litigation. Directors suggested that capital requirements could be more risk-based, and welcomed the authorities' planned introduction in 2011 of the internal capital adequacy assessment process as an important first step. Directors also recommended further steps to strengthen the prompt corrective action and resolution frameworks.

To sustain the recovery and raise growth, Directors encouraged the authorities to make further efforts to strengthen governance and the business environment and improve basic infrastructure. This will be important to raise domestic demand, including through increased investment, and allow businesses to tap into new export markets.

Philippines: Selected Economic Indicators, 2005–10

					Proj.		
Growth and prices	2005	2006	2007	2008	2009		2010
Real GDP	5.0	5.3	7.1	3.8	0.8		3.2
CPI (annual average)	7.7	6.2	2.8	9.3	3.1		4.3
Public finances (percent of GDP)							
National government balance (authorities' definition)	-2.7	-1.1	-0.2	-0.9	-3.9		-3.3
National government balance 1/	-3.0	-1.4	-1.7	-1.5	-4.4		-3.6
Nonfinancial public sector balance 2/	-2.1	0.1	0.2	-0.3	-3.9		-3.0
Revenue and grants 3/	22.1	23.0	24.1	22.8	20.5		20.7
Expenditure	24.1	22.9	23.9	23.1	24.4		23.8
Nonfinancial public sector debt	85.9	73.9	61.1	60.9	63.7		62.7
Monetary sector (percent change, end of period)							
Broad money (M3)	10.3	22.7	10.6	15.6	11.6	5/	
Interest rate (91-day Treasury bill, end of period, in percent) 4/	6.4	5.1	4.2	5.8	4.1	6/	
Credit to the private sector	-0.3	6.7	8.5	16.8	7.9	5/	
External Sector							
Current account (percent of GDP)	2.0	4.5	4.9	2.3	4.6		3.0
Reserves, adjusted (US$ billions) 7/	18.0	23.0	33.8	35.9	44.2		49.8
Reserves/Short-term liabilities, adjusted 8/	130.6	194.4	240.5	280.4	266.1		299.2
Pesos per U.S. dollar	55.1	51.3	46.1	44.5	47.8	9/	…

Sources: Philippines authorities; and IMF staff projections.

1/ Fund's definition. Excludes privatization receipts and includes deficit from restructuring of the central bank (Central Bank-Board of Liquidators
2/ Includes the national government, Central Bank-Board of Liquidators, 14 monitored government-owned enterprises, social security institutions, and local governments.
3/ Excludes public financial institutions and privatization receipts.
4/ Secondary market rate.
5/ September 2009 (year-on-year).
6/ November 2009.
7/ Adjusted for gold and securities pledged as collateral against short-term liabilities.
8/ Short-term liabilities include medium- and long-term debt due in the following year.
9/ Average for January to October 2009.

Statement by Ms. Vongpradhip and Ms. Sicat on Philippines
Executive Board Meeting 10/10
January 29, 2010

Introduction

The Philippine authorities welcome the comprehensive review by staff as well as the productive exchange of views which paved the way for a candid assessment of the country's economic performance, policy considerations, and the challenges that lie ahead. The discussions which focused on the policies needed to reduce vulnerabilities to support growth over the medium-term were appropriate and constructive. Overall, the authorities broadly agree with the staff appraisal and appreciate the policy recommendations.

Recent Economic Trends

The Philippine economy held up relatively well from the global crisis as signs of stabilization emerged. Despite the global economic downturn and severe contractions elsewhere in the region, the economy managed to post a modest growth of 0.7 percent for the first three quarters of 2009, supported by a package of monetary and fiscal stimulus measures, continued strength of overseas remittances, marked easing of inflation and stable interest rate.

Headline inflation averaged 3.2 percent in 2009, considerably lower than the 9.3 percent level in 2008 and well within the government's target range. Meanwhile, the critical flow of credit, particularly during the height of the global credit crunch, was enabled by liquidity-enhancing measures of the central bank through a fundamentally sound banking system.

On the external front, the overall balance of payments surplus in 2009 amounted toUS$5.3 billion bolstered mainly by the strong performance of the current account. The substantial surplus gave the authorities the opportunity to further build up the country's international reserves (to US$44.2 billion as of end December 2009, equivalent to finance 9.0 months imports of goods and services), and improve the external debt structure. However, despite the substantial inflows, the modest peso movement reflected the concerns on the widening fiscal deficit. In the stock market, the local bourse showed signs of recovery beginning July 2009 buoyed by renewed investors' risk appetite, positive macroeconomic data and improving corporate earnings. Philippine credit spreads have narrowed as market perception on the country's credit risk improved, evidenced by the stable/positive outlook given by Fitch Ratings, Moody's and Standards and Poors credit rating agencies.

Outlook, Challenges and Policy Thrusts

While there have been definitive signs of recovery in some sectors, there remain some vulnerabilities that need to be addressed. The immediate challenge is to safeguard the gains achieved so far and ensure that growth is sustained. For 2010, the economy is projected to grow by 3-4 percent. To support this, the fiscal authorities envisage to continue the stimulus spending without undermining fiscal consolidation. The authorities will continue to monitor the risks to the inflation outlook, which include rising commodity prices, and will adjust policy settings if needed to achieve the price stability objective. Consistent with the inflation-targeting framework, the authorities remain committed to a market-determined exchange rate. In the financial sector, focus will be given to assessing the vulnerabilities of the financial system and implementing measures to ensure that the latter remains strong to support recovery. Structural reforms addressing the constraints to growth will be also pursued.

Fiscal Policy
Over the past five years prior to the crisis, the fiscal authorities have made significant strides in fiscal consolidation and in strengthening debt management. If not for the global economic crisis, the country could have attained its goal of a balanced budget by 2010. Fiscal deficit, as a percent of GDP, declined from 5.3 percent in 2002 to 0.2 percent in 2007. Despite the onset of the global crisis in the latter part of 2008, the fiscal authorities managed to contain the deficit at 0.9 percent of GDP during the year. However, in 2009 fiscal pressures from economic stimulus and post-calamity restructuring program coupled by weak revenue collections resulted in the deficit climbing to 4.3 percent of GDP for the period January to September.

The higher fiscal deficit is expected to increase the public sector debt which has been successfully brought down from 110 percent of GDP in 2002 to 71 percent in 2008.

For 2010, the fiscal authorities are proposing a fiscal deficit of 2.8 percent of GDP to sustain the needed capital expenditures and accommodate an increase in pro-poor spending. The authorities believe that such a fiscal policy stance may strike the appropriate balance between the need to continue a supportive recovery and fiscal consolidation. To achieve the programmed deficit, they expect that tax revenues would be increased to 16 percent of GDP while expenditures would be kept at about 19 percent of GDP. Nonetheless, in the event of a shortfall in tax revenues, expenditures will be adjusted in order to contain the possible fiscal slippage. Over the medium-term, the authorities are committed to balance the budget, and reduce the debt burden to below 50 percent by 2013.

With the view of increasing tax revenues, the implementation of tax administrative measures to improve compliance and strengthen enforcement will be intensified. Tax compliance programs will be enhanced, including monitoring of compliance by large tax payers. The authorities are also strongly supporting Congress to enact revenue enhancement and simplification measures to bring in more sustainable sources of revenues. Government will also pursue privatization of some assets to augment its resources. On the expenditure side, priority capital outlays will be given to high impact infrastructure projects. Operations of some public corporate entities will be rationalized to increase cost-recovery and reduce government's subsidies. Government will continue to restructure its debt portfolio to manage debt payments and lengthen the maturity profile of both domestic and foreign debt. Payment of adjustment in civil service wages which has already been passed into law is planned to be implemented over four years (2009-2012) to ease potential pressure on the budget.

To support medium-term fiscal consolidation, the Department of Finance has recently requested technical assistance from the IMF to assist the agency in mapping out a credible medium-term strategy to raise tax effort for the incoming administration. On the aspect of enhancing fiscal risk management, the Development Budget Coordinating Committee (DBCC),[1] recently approved a framework to improve contingent liability management by introducing value analysis in the assessment of projects, especially those that will involve government guarantees. The government is also moving to review the effectiveness of present joint venture guidelines to mitigate the fiscal risks to public-private partnerships.

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[1] The DBCC comprises of heads of government economic institutions who oversee the implementation of economic and financial programs of Government.

Monetary and External Policies

With inflation pressures subdued and domestic demand conditions relatively weak, the BSP promptly adopted an accommodative monetary policy stance during the onset of the crisis. The monetary policy setting allowed the substantial monetary stimulus to counter the effect of the negative feedback loop on the real sector. As a result, the series of monetary policy actions allowed domestic credit to flow.

For 2010, the monetary authorities target inflation to stay within the range of 3.5 – 5.5 percent to support the country's growth objectives. Toward this end, the monetary policy stance will continue to focus on achieving price stability over the policy horizon while remaining supportive of sustained and broad-based economic growth. A challenge to monetary policy is the risk posed by the uneven pace of global recovery. Thus, the timing and speed of the shift to a tighter or less accommodative monetary policy stance will be guided by the outlook on inflation and the balance of risks between the inflation forecasts and economic growth. This implies that monetary policy will continue to be flexible to support domestic demand and economic activity in the near term as long as inflation remains anchored toward the target over the policy horizon. The authorities will be mindful of domestic conditions, particularly with regard to inflation and output, when it gradually exits from its accommodative monetary policy stance.

The authorities welcome the staff's assessment that the Philippines' exchange rate is broadly aligned with fundamentals. The exchange rate policy will continue to remain market-determined with the BSP's participation in the foreign exchange market aimed only at smoothing observed volatilities to promote more orderly market movements and to seize the opportunity to increase reserves as a precautionary measure to provide policy space should there be a reversal of market sentiments.

Financial Sector Policy

Financial stability, along with monetary stability, is another key policy objective of the authorities to support recovery. A stable and well functioning banking system will efficiently mobilize funds and channel these to productive uses. As such, authorities will continue to implement key reforms that will further improve the regulatory and supervisory framework, enhance risk management, improve corporate governance structure, and strengthen disclosure practices for better consumer protection.

So far, the banking system has weathered the global financial crisis relatively well because of its limited exposure to troubled US assets, and low exposures to securitization and off-balance sheet activities. Moreover, the financial reforms instituted over the years had created a sound banking system with stronger capital base. The banks' capital adequacy ratio of 15.7 percent (as of June 2009) is well above the Bangko Sentral ng Pilipinas' (BSP) minimum capital ratio (at 10 percent) and the BASEL Accord's standard ratio (8 percent). Likewise, Tier 1 capital ratio of the banking system remain significantly higher than the prudential minimum ratio. The banking system's asset quality also continued to improve with the non-performing loan ratio as of November 2009 easing further to 3.3 percent from 3.8 percent a year ago.

The results of the stress tests conducted by the BSP indicated that the financial sector is quite robust to adverse shocks, even under relatively severe macroeconomic shocks. These findings were validated by the Fund staff's and the rating agencies' (Fitch and Moodys) own stress-test exercises.

Staff raised a potential vulnerability issue stemming from the relatively high concentration risk involving banks' exposure to large conglomerates. We would like to note that conglomerates are an important feature of the Philippine economy, where a majority of which are in the banking industry. Failure of more than one large economic group would reduce the CARs of most of the top 10 banks and could wipe out Tier 1 capital for some of the largest banks. However, stress test simulations show that the impact of this type of failure would actually be <u>less</u> than that of the impact of the sharp rise in NPLs from 3 percent to 20 percent.

Staff also raised an issue of vulnerability of banks to interest rate movements. The BSP is aware of the increasing importance of banks' investment portfolio, which has been growing in double digits since 2000 (except for 2005-2007). In recognition of the importance of this concern, the BSP implemented the market risk amendments to Basel I in 2003. In addition, the BSP formed a Capital Markets Specialist Group (CMSG) in 2006. The CMSG is a specialist on-site examination team that focuses on banks' trading activities. Shortly after the creation of the CMSG, guidelines on market risk and liquidity risk were issued.

Structural reforms

Staff has rightfully pointed out the need to further improve the business environment and address the growth constraints. Aware of these negative factors that constrain the inflow and the build-up of the much needed investments into the country, the government is focusing on improving the business environment.

In line with the objectives of the Economic Resiliency Plan in 2009, much of the pump-priming activities of the government in response to the global economic crisis were channeled towards the upgrading/rehabilitation of existing infrastructures such as repairs of irrigation facilities, farm-to-market roads, and road widening, as well as initial ground works for large scale multi-year projects like the construction of airports, expressways, and linking of railway systems for an efficient transport. The increased fiscal spending aims to prepare the country for the eventual recovery by addressing its lack of competitiveness primarily through infrastructure development. For 2010, given the budget constraints, the government will push for large-scale infrastructure projects with participation of the private sector through partnerships, joint ventures, and/or Build-Operate-Transfer programs, but taking in due consideration the risks these entail to ensure that such strategy will not compromise macroeconomic stability in the medium term.

On governance, several laws to curb corruption are already in place such as the Procurement Law and the Anti-Red-Tape Act. The government is determined to properly implement these measures in order to improve the efficiency in the delivery of government services and lower transaction costs.

The government is aware that much still needs to be done to address the issues and concerns that could potentially discourage prospective investors. Addressing the country’s lack of competitiveness and other factors that contribute to a weak business climate in the country is one of the primary objectives of development policies in the near to medium term.

Concluding Remarks

The Philippine economy has been holding up relatively well under the global economic downturn. While economic growth has moderated, as external demand weakened, overall macroeconomic and financial stability has remained. The authorities are fully cognizant of the vulnerabilities and challenges facing the economy. As such, they are firmly committed to continue pursuing sound macroeconomic management and structural reforms to strengthen the economy in addressing the challenges and allowing growth to revert to a sustained path. The authorities value the Fund’s views and intend to continue working closely with it through the regular Article IV consultations and technical assistance programs.