October 2006
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Philippines: Mid-2006 Post-Program Monitoring Discussions—Staff Report; Public Information Notice on the Executive Board Discussion; and Statement by the Executive Director for the Philippines

In the context of the Mid-2006 post-program monitoring discussions with the Philippines, the following documents have been released and are included in this package:

- the staff report for the Mid-2006 Post-Program Monitoring Discussions, prepared by a staff team of the IMF, following discussions that ended on August 2, 2006, with the officials of the Philippines on economic developments and policies. Based on information available at the time of these discussions, the staff report was completed on September 27, 2006. 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 October 11, 2006 discussion of the staff report that concluded the post-program monitoring discussions.

- 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.

To assist the IMF in evaluating the publication policy, reader comments are invited and may be sent by e-mail to publicationpolicy@imf.org.

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INTERNATIONAL MONETARY FUND

PHILIPPINES

Report for the Mid-2006 Post-Program Monitoring Discussions

Prepared by the Asia and Pacific Department

Approved by Masahiko Takeda and Michael Hadjimichael

September 27, 2006

- Post-Program Monitoring (PPM) discussions were held in Manila during July 21-August 2. The team comprised Messrs. Gordon (Head), Brooks, Singh, Ms. Fujita (all APD), Mr. Seshadri (PDR), Ms. Zakharova (FAD) and Mr. Baqir (Resident Representative). Ms. Amador (OED) also joined the discussions.

- The mission met with senior government officials including Finance Secretary Teves, Bangko Sentral ng Pilipinas (BSP) Governor Tetangco, Budget and Management Secretary Andaya, Energy Secretary Lotilla, and Trade and Industry Secretary Favila, as well as with financial market participants and business representatives.

- Executive Directors' views and comments at the 2005 Article IV and PPM discussions can be found on http://www.imf.org/np/sec/pn/2006/pn0625.htm.

- The Philippines has accepted the obligations under Article VIII, Sections 2, 3, and 4 of the Fund's Articles of Agreement and maintains an exchange system free of restrictions on payments and transfers for current international transactions.

- The authorities are attempting to strengthen the statistical base, which suffers from several deficiencies that hamper surveillance. With STA assistance, the authorities have made progress in improving the nonfinancial public sector debt and balance of payments data.

- In light of the need to strengthen the fiscal position, the Philippines is expected to engage in PPM through April 2007 even though outstanding borrowing from the Fund has dropped well below 100 percent of quota. By April 2007, outstanding credit to the Fund will fall to 10 percent of quota.

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GLOSSARY OF ABBREVIATIONS AND TERMS

AML/CFT ....Anti-Money Laundering/Combating the Financing of Terrorism
BIR.......................Bureau of Internal Revenue
BOL......................Board of Liquidators
BSP ....Bangko Sentral ng Pilipinas
CTF ....Common Trust Fund
FATF....................Financial Action Task Force
FSSA....................Financial System Stability Assessment
Gencos..................NPC's generation assets
GSIS.....................Government Service Insurance System
GOCCs.................Government-Owned and Controlled Corporations
IFRS.....................International Financial Reporting Standards
IRRs ....Implementing Rules and Regulations
LGU ....Local Government Units
NDC ....National Development Company
NDF......................Nondeliverable Forwards
NFA......................National Food Authority
NFPS....................Nonfinancial Public Sector
NG........................National Government
NPA......................Nonperforming Assets
NPC......................National Power Corporation
NPL......................Nonperforming Loans
NSO......................National Statistics Office
OFWs...................Overseas Filipino Workers
PCA......................Prompt Corrective Action
PIT........................Personal Income Tax
PDIC ....Philippine Deposit Insurance Corporation
PPM......................Post-Program Monitoring
PSALM ....Power Sector Assets and Liabilities Management Corporation
ROP......................Republic of the Philippines
ROPOA ....Real and Other Properties Owned or Acquired
SPV ....Special Purpose Vehicle
SSIs ....Social Security Institutions
SSS.......................Social Security System
Transco.................National Transmission Corporation
UITFs...................Unit Investment Trust Funds
WESM..................Wholesale Electricity Spot Market
y/y ....Year-on-year

EXECUTIVE SUMMARY

Macroeconomic performance has been relatively strong and the large fiscal adjustment in 2005 and the recent VAT reform represent significant progress in strengthening the fiscal position. For the first time in a decade, tax collections in 2006 are growing significantly faster than GDP, while pressures to roll back the expansion of VAT to energy products have been successfully resisted. Yet vulnerabilities remain high as a result of the still-sizeable public debt and large external commercial borrowing requirements. Sustaining the reform momentum will therefore be essential to maintain the confidence of markets.

The 2006 budget targets further adjustment, but also contains a much-needed expansion in capital and social spending financed by a portion of the proceeds from the VAT reform. However, the budget has not been approved by Congress and this has constrained spending. The authorities are attempting to increase infrastructure and social spending through a supplemental budget and the public enterprises. While there is a need to increase priority spending, any off-budget expenditures should be transparent and well-contained.

The authorities plan to balance the public sector budget by 2008, as well as to significantly increase capital spending over the medium-term. To achieve both objectives will require a further increase in revenue. Strengthening tax administration has the potential to deliver part of the needed additional resources. But further tax measures will also likely be necessary over the medium-term for sustainable fiscal consolidation.

Inflation remains above target as a result of the oil shock and the VAT reform, but prospects are good that inflation will return to target in 2007 once base effects drop out. A further surge in oil prices might threaten the inflation outlook, while continued appreciation of the peso associated with improving market sentiment could bring inflation down even faster. On balance, monetary policy settings seem appropriate for the moment.

Important steps are being taken by the authorities to strengthen the banking sector, including through resolving the NPA problem, but some banks remain weak and short of capital given new accounting standards and the pending introduction of Basel II. Recent consolidation in the industry and efforts by banks to raise new capital are welcome, but approval of long-delayed changes to the BSP Charter remain necessary to make the strengthening of banking regulations fully effective. Capital market development is also a priority.

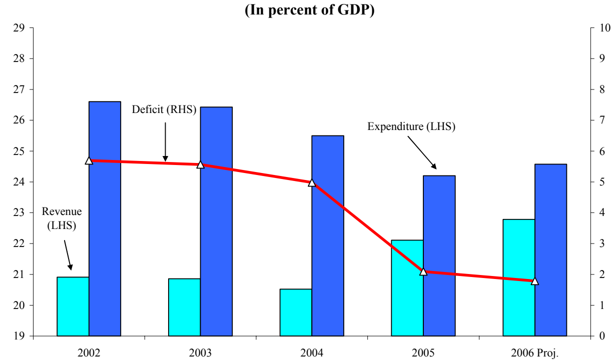
The sharp reduction in power sector losses since 2004 is a key achievement and close monitoring of NPC's finances is essential to ensure that this improvement is maintained. The authorities should also accelerate the much-delayed sale of power sector assets.

I. Background

1. **Reforms have advanced despite significant obstacles.** The Philippines experienced a period of policy drift in 2002-2004, during which mushrooming public debt and large external financing requirements placed the economy in a highly vulnerable condition. Upon taking office two years ago, the administration launched a major package of economic reforms. Implementation was initially slow due in part to political developments, while surging international oil prices threatened to derail the extension of VAT to energy products, a key component of the fiscal reforms. However, the authorities have persevered with reforms and considerable progress has been made.

2. **A number of major milestones have been achieved, but important challenges remain.** The non-financial public sector (NFPS) deficit was cut to 2 percent of GDP in 2005, 3½ percentage points below the 2003 level through tight controls on government spending and a marked turnaround in the finances of the National Power Corporation (NPC). The VAT reform, which took full effect in February 2006, looks set to further reduce the deficit, while potentially allowing much-needed increases in priority spending. Steps have also been taken to strengthen the banking system. Economic vulnerabilities have thus declined and financial markets have taken note. However, the reform momentum will need to be sustained for there to be a significant improvement in economic performance.

NFPS Fiscal Adjustment, 2002-2006 1/
(In percent of GDP)

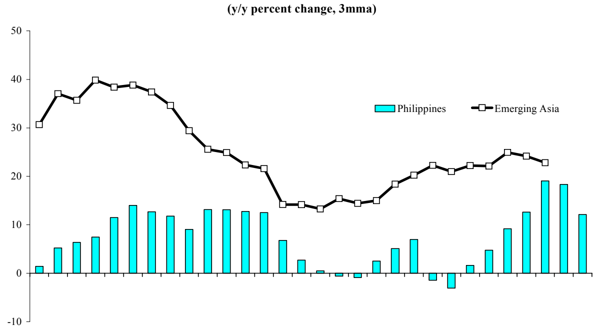


1/ Excludes non-cash collections and tax expenditure.
Sources: Philippine authorities and IMF staff calculations.

II. Recent Economic Developments

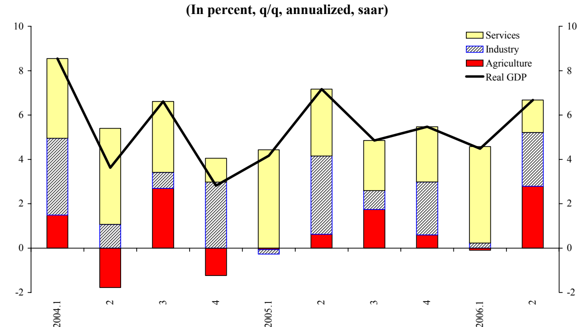
3. **Private consumption has been the main growth driver, although exports have shown new vigor.** Despite higher oil prices and the VAT reform, private consumption has remained resilient, buoyed by rapid growth in remittances. Investment has continued to be weak, with durable equipment investment contracting in real terms. Exports, by contrast, have rebounded from last year's poor showing, largely reflecting a recovery in electronics

Electronics Export Growth in the Philippines and Emerging Asia
(y/y percent change, 3mma)



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

GDP Growth and Contributions by Sector
(In percent, q/q, annualized, saar)

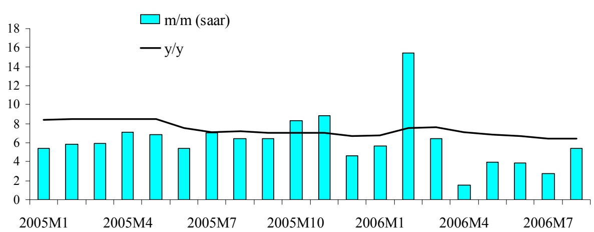


Sources: CEIC Data Company Ltd; and IMF staff calculations.

exports, although textiles and clothing and services exports have also picked up. GDP growth in the first half of the year was 5½ percent, with growth boosted by a jump in agriculture. Meanwhile, the services sector has continued to grow more rapidly than industry.

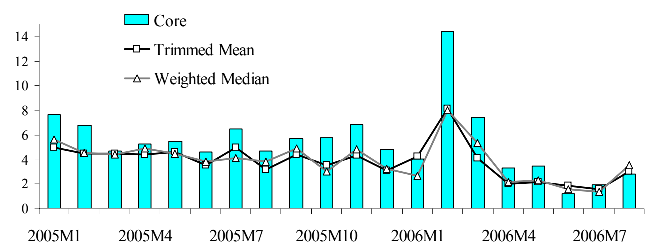
4. **Inflation remains above target, but momentum is slowing.** Headline inflation measured 6.3 percent (y/y) in August, above the Bangko Sentral ng Pilipinas (BSP)'s inflation target of 4–5 percent for 2006. Continued high inflation is largely attributable to base effects from the oil price shock, as well as the VAT rate hike which pushed seasonally adjusted month-on-month inflation up sharply in February. In contrast, measures of core inflation have resumed their downward trend over the past few months, and there are few signs that inflation is becoming more generalized.

Headline Inflation.
(Jan. 2005 - Aug. 2006, in percent)



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

Measures of Core Inflation
(Jan. 2005 - Aug. 2006, m/m saar, in percent)



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

5. **The government is on track to further reduce the deficit in 2006.** The national government deficit (authorities' definition) fell to P 147 billion (2.7 percent of GDP) in 2005, from 3.8 percent of GDP in 2004. Through August this year, the cumulative deficit was P 34.2 billion, P 46.6 billion lower than in the corresponding period in 2005 and substantially below the full year target of P 125 billion (2.1 percent of GDP). With revenue collection broadly on target, the faster pace of adjustment stems from deadlock between the President and Senate over the 2006 Budget, which has yet to be passed; as a result, the 2005 Budget has been re-enacted and spending has been constrained to 2005 levels.

6. **External vulnerabilities remain high, but are coming down.** The strong performance of remittances and exports has helped to insulate the current account from surging oil prices. There has also been a pick-up this year in FDI. The peso sold off during the emerging market turbulence in mid-May, but has since recovered strongly. This has allowed the BSP to resume its accumulation of reserves, which adjusted for pledged assets reached $21.0 billion at end-July, up from $18.0 billion at end-2005. The authorities have also used the greater availability of foreign exchange to repay short-term external debt.[1]

[1] The authorities redeemed $411 million worth of Brady bonds in May 2006 as they became callable. The authorities have an option to retire a further $364 million worth of Brady bonds later in the year. In April 2006, the BSP pre-paid $500 million of a term loan facility due in October without rolling it over.

Philippines. Summary of External Borrowings 2003-06
(In millions of U.S. dollars)

	Actual Borrowings			Staff Proj.	Completed 1/
	2003	2004	2005	2006	2006
Commercial	**4,406**	**4,556**	**4,150**	**4,010**	**2,850**
National Government	2,875	4,056	3,250	2,850	2,850
Other Public Sector	1,531	500	900	1,160	0
Official	**578**	**294**	**800**	**977**	**305**
Total	**4,984**	**4,850**	**4,950**	**4,987**	**3,155**

Sources: Philippine Authorities; Fund staff projections.
1/ As of September 1, 2006.

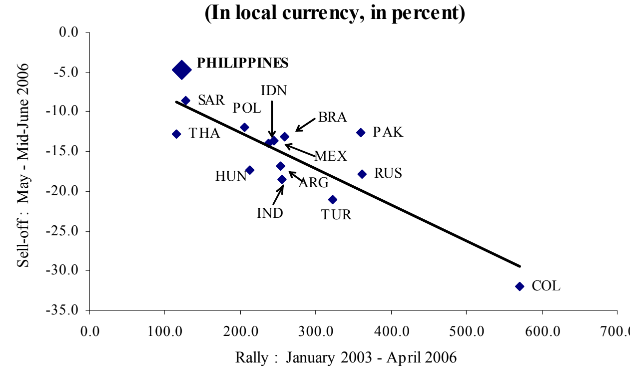
7. **The debt profile looks more favorable.** As a result of the lower fiscal deficit, continued robust growth and the more appreciated exchange rate, NFPS debt declined to 86 percent of GDP at end-2005, compared to 100 percent at end-2003. External debt has declined by a similar order of magnitude. To create more liquid instruments, while smoothing the debt repayment profile, the authorities have undertaken domestic and external debt swaps, most recently in early September when they swapped $1 billion of external bonds and notes into a smaller number of issues with longer maturity.

III. Report on the Discussions

A. Viewing Recent Developments Through a Cross-Country Lens

8. **In common with the asset class, Philippine markets sold off in May and June.** Staff presented evidence suggesting an initial lack of investor discrimination between emerging markets during the instability that recently roiled markets. For example, across equity markets, the extent of the sell-off was broadly proportional to the size of the run-up over the past few years. That said, Philippine assets sold off quite sharply in May. The correction was particularly dramatic in the domestic bond market, where the rapid growth of unit investment trust funds (UITFs) had caused a sharp run-up in peso bond prices earlier in the year (Box 1). During the turbulence in May, 10-year bond yields rose by almost 400 basis points.

EM Equities - The Rally and the Sell-off
(In local currency, in percent)



Sources: Bloomberg and IMF staff calculations.

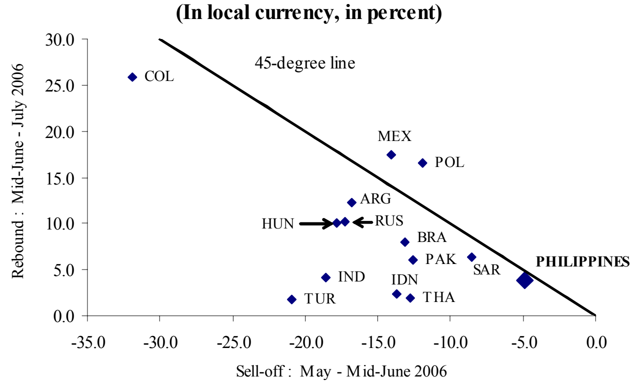
Philippines. Financial Market Developments Year-to-Date

	Pre Sell-off Jan. 1 - Apr 30	**Sell-off** May 1 - Jun 9	**Post Sell-off** Jun 10 - Sep 27
Peso/USD (percent change, + depreciation)	-2.5	2.7	-5.6
Regional currencies (percent change, average, + depreciation)	-5.0	2.5	-1.3
EMBI+ PHL (change, bps)	-94.0	61.0	-35.0
EMBI+ Global (change,bps)	-67.0	45.0	-11.0
91-day T-Bill (change, secondary market rate, bps)	-96	320	-247
10-year Gov't Bond (change, secondary market rate, bps)	-274	396	-385
Manila Stock Exchange (percent change, in local currency)	8.3	-4.9	18.4
MSCI Asia excl. Japan (percent change)	11.7	-10.3	7.4

Sources: Bloomberg, Philippine authorities, and IMF staff calculations.

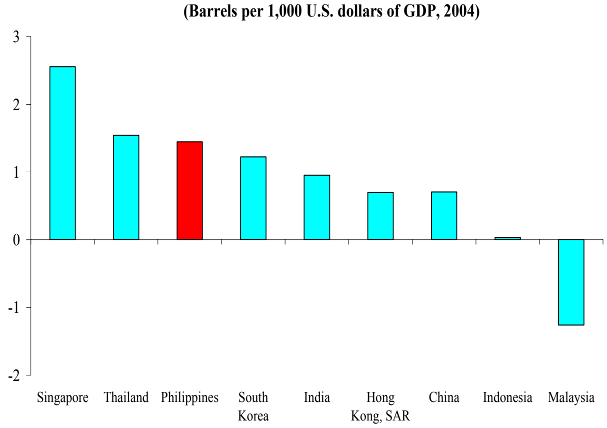
9. **Progress with fiscal consolidation appears to have helped markets rebound.** Staff observed that Philippine markets had recovered quite strongly once investors re-established risk positions after the sell-off. In fact, the Philippine stock market was one of the quickest to regain the ground lost in the sell-off. This relatively favorable performance could be attributed to the recent improvement in fundamentals. The authorities took a similar view, noting that progress with reforms was now being recognized by markets. There was agreement that sustaining the reform momentum would help insure against further volatility.

EM Equities - The Sell-off and the Rebound
(In local currency, in percent)



Sources: Bloomberg and IMF staff calculations.

Net Oil Consumption
(Barrels per 1,000 U.S. dollars of GDP, 2004)



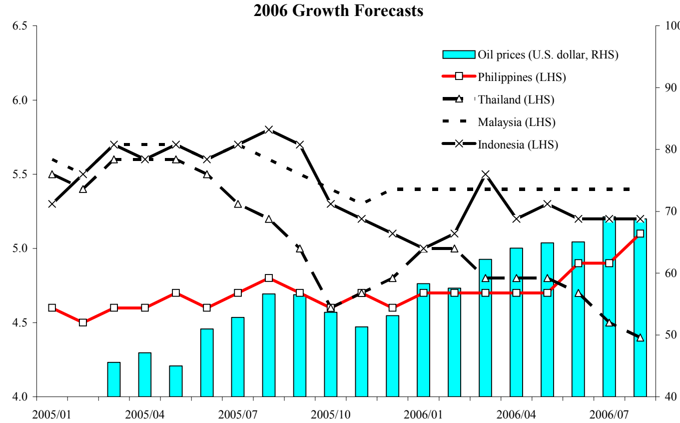
Source: BP Statistical Review of World Energy, June 2006

10. **Growth has remained robust in the face of higher oil prices.** Staff observed that growth had held up well in the Philippines even though oil consumption is relatively high. In many oil-importing countries, growth had been supported during the recent oil price shock by strong global demand and high non-fuel commodity prices. In the Philippines, while exports had helped prop up growth, the more important offset had come from remittances, which have tended to act as a consumption hedge (Box 2).

11. **The jump in oil prices had raised various policy issues**. As in many countries, higher oil prices had led to calls for fiscal relief. The authorities had resisted pressures to roll back the expansion of VAT to energy products, and had introduced instead a mechanism to adjust oil import tariffs.[2] They had also continued to avoid fuel subsidies, which have been a drain on the budget in other countries. Higher domestic petroleum prices, combined with conservation efforts, had led to oil consumption falling by about 8 percent in 2005, and a further decline was expected this year. The authorities were now facing pressure to grant income tax incentives to the biofuels industry. Staff cautioned that the existing list of tax incentives should be substantially pared down before new incentives could be considered, particularly as the rationalization of existing fiscal incentives was a promising revenue-raising measure for the medium term.[3]

12. **Medium-term prospects hinge on further progress with reforms.** Staff noted that in contrast to other countries in the region, the consensus forecast for growth in 2006 had been revised up since oil prices began to rise, perhaps reflecting the brighter outlook for investment following the fiscal reforms. Indeed, assuming the recent fiscal improvement can be maintained, and that there is some pick-up in investment as confidence improves (*Currently Identified Measures Scenario*), staff project growth to increase from 5.0 percent in 2006 to 5.4 percent in 2007, and to remain at similar levels over the medium term (Table 5). On the basis of currently identified measures, the NFPS deficit is projected to settle at the current level of about 2 percent of GDP over the medium term while public investment increases modestly. On the other hand, with an additional revenue effort that allows the authorities to eliminate the NFPS deficit altogether while substantially increasing infrastructure investment (*Additional Reforms Scenario*), the outlook for private investment and growth would be even more favorable (Table 6). Under both scenarios, public debt would decline significantly, but would still remain sizable by 2011 (Annex I).

2006 Growth Forecasts



Source: Asia Pacific consensus forecasts (January 2005-August 2006).

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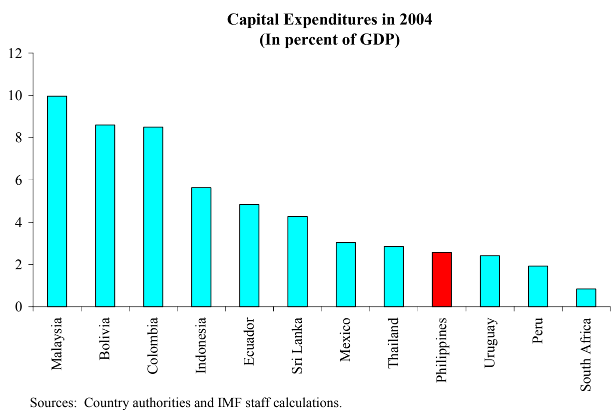
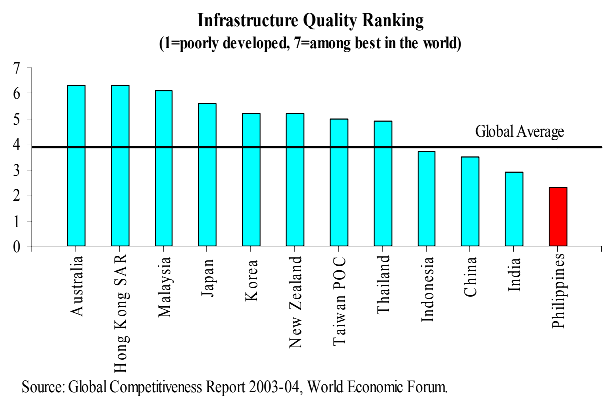
[2] The adjustment mechanism links the tariff on oil and oil-product imports to the oil price: the tariff (3 percent prior to the measure) is automatically reduced (increased) by 1 percentage point within a 0-3 percent range, once the monthly average price of Dubai crude falls above (below) a certain trigger level.

[3] A bill currently in the Senate consolidates the large number of incentives and could form a basis for eventually eliminating tax holidays. Nevertheless, the list of special incentives remains long and tax concessions are widely applied and are not time bound. These factors could undermine the expected revenue gains.

B. Taking Stock of the Fiscal and Power Sector Reforms

13. **Revenues have performed strongly in 2006 to date, creating room for higher social spending.** Staff viewed the 24 percent growth in tax revenues through July (y/y) as evidence that the hoped-for revenue boost from the VAT reform was materializing. Tax revenues looked set to rise by about 1 percentage point of GDP in 2006, the first increase of any significance in a decade. The authorities intended to channel 30 percent of the additional revenues generated by the VAT reform into social services and infrastructure, areas where the Philippines has large unfulfilled needs. As a result, a 17 percent increase in primary spending was targeted in the 2006 Budget. The authorities attached considerable importance to explaining to the public that the VAT reform not only facilitated debt reduction, but also increased the ability to spend on priority areas. Staff agreed with this emphasis, as well as with the pressing need to upgrade infrastructure.[4]





14. **Efforts are being made to accelerate spending.** The implementation of the higher spending planned for 2006 is being frustrated by the impasse over the budget, as well as by apparent procurement delays. In response, the authorities have proposed a P 46 billion (0.8 percent of GDP) supplemental budget that was recently approved by Congress. The authorities are also attempting to increase infrastructure spending through a special P 10 billion National Development Company (NDC) bond issue, the proceeds of which would be on-lent to Government Owned and Controlled Corporations (GOCCs). Staff questioned whether such off-budget activities might detract from the quality of expenditure, but the authorities indicated that all new projects were part of their medium-term public investment plan. Despite these efforts, staff estimated that national government spending was likely to fall short of program by about ½ percent of GDP in 2006, while the increase in GOCC spending would probably be fairly limited. The authorities were more confident that spending could catch up with the original plans.

[4] In addition, the Philippines is in danger of not meeting some MDG targets, particularly that on reducing the rate of maternal mortality.

15. **The public sector deficit should decline further this year.** Staff projected the NFPS deficit to fall to 1.8 percent of GDP in 2006, aided by the greater-than-expected decline in the national government deficit as a result of the underspending. This would be partially offset by a slightly less favorable outturn at the GOCCs. Surpluses by social security institutions (SSIs) were expected to continue, but there might be a deterioration in LGU finances as spending increased ahead of the 2007 elections.

Philippines: Sectoral Breakdown of the NFPS Deficit, 2003-06
(In percent of GDP)

	2003	2004	2005	2006
NFPS	5.6	5.0	2.1	1.8
NG (IMF definition)	4.9	4.2	3.0	2.1
SSIs	-0.4	-0.5	-0.9	-0.8
LGUs	-0.4	-0.3	-0.4	-0.1
GOCCs (incl. NPC)	1.5	1.8	0.4	0.8
Other	-0.1	-0.1	0.0	-0.2

Sources: Philippine authorities; and Fund staff calculations.

16. **Budget balance remains the medium-term goal.** The authorities described their plans to eliminate both the national government and public sector deficits by 2008, two years earlier than previously envisaged. Staff supported the plans to balance the budget, but underscored the importance of the adjustment being sustainable. A durable fiscal adjustment would require raising revenue rather than compressing expenditure, which until the recent NPC tariff hikes and VAT reform, had been the principal means used to contain the fiscal deficit.

17. **The other medium-term objective is to boost capital spending.** In her state of the nation address at end-July, President Arroyo outlined plans for a substantial increase in spending on transportation, irrigation, and energy infrastructure over the next few years. Staff noted that this would require an additional revenue effort. By staff calculations, increasing capital spending by 1½ percentage points of GDP over the medium term (Table 6), while balancing the NFPS budget, would require revenues to rise by about 3 percentage points of GDP.[5] The authorities were hopeful that this could come from better tax compliance and attached considerable importance to current efforts to improve tax administration. These include the reform program for the Bureau of Internal Revenue (BIR) that is being formulated with technical assistance from the Fund, World Bank and other donors. The authorities indicated that if revenues were to fall short, expenditures would be adjusted or additional revenue measures taken to contain the deficit.

18. **Various tax reforms are under consideration.** In addition to the tax incentives bill, there are two versions of amendments to the personal income tax (PIT) law before Congress. Staff noted that there were revenue concerns about the PIT bills, since in their present form

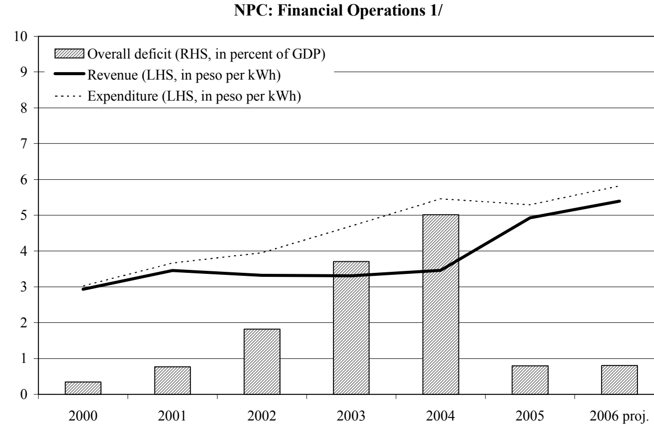
[5] This estimate factors in expected interest rate savings (about 2 percentage points of GDP) and a number of pre-programmed tax decreases (1½ percentage points of GDP) including the planned cut in the corporate income tax rate (which was raised to 35 percent from 32 percent as part of the VAT reform, but will fall back to 30 percent in 2009).

they would serve to narrow the tax base. The discussions also focused on one provision of the VAT reform, the 70 percent cap on input credit, that has attracted considerable opposition from business. The authorities are considering administrative solutions to make this provision less onerous for firms. As another step necessary to strengthen the revenue base over the medium term, staff recommended that excises be indexed to inflation.

19. **Other fiscal reforms could complement the revenue effort.** The authorities reported progress with the government rationalization plan, which while primarily geared to improving efficiency, may lead to expenditure savings over time. They also described their intention to introduce a rolling three-year medium-term expenditure framework, as well as plans to establish performance contracts for GOCCs, beginning with the National Food Authority (NFA). Staff supported these efforts and hoped that the performance contracts would pave the way for setting up monitorable targets for the larger public enterprises. Staff also welcomed the efforts being made by the Social Security System (SSS) to reduce fraudulent claims and to improve collection efficiency by increasing coverage, including of Overseas Filipino Workers (OFWs).

20. **NPC's finances have been placed on a more solid footing.** NPC's cash deficit ballooned to 1½ percent of GDP in 2004, but has since been reduced sharply as a result of increases in generation tariffs. The Wholesale Electricity Spot Market (WESM) commenced operations in June with the aim of strengthening incentives for power producers to be more efficient and bringing down the cost of electricity through competition over time. Since NPC may have to accept lower prices for power supplied to the WESM, staff questioned whether the price reductions that might accrue to consumers might be at the cost of NPC's bottom line, and hence be at the expense of the public purse. However, the authorities saw limited scope for price reductions in the short run.

NPC: Financial Operations 1/



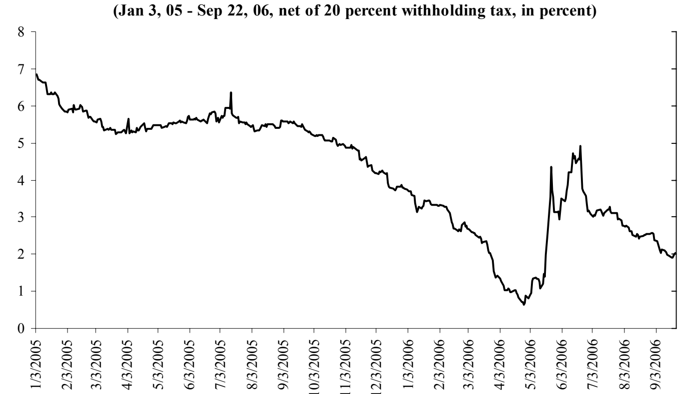
1/ Includes NPC, Transco, and PSALM. Excludes privatization revenues.
Sources: Philippine authorities and IMF staff projections.

21. **Privatization has encountered repeated delays.** The authorities explained that uncertainty about supply contracts continued to limit investor interest in power sector assets. They noted that many countries had found power sector privatization to be a difficult process, and that the delays being experienced in the Philippines reflected the difficulty of the exercise, rather than any lack of commitment on the authorities' part. Staff recognized that there were many obstacles to privatization, but hoped that the rebidding of NPC's transmission assets (Transco) planned for November would be successful. Concluding this deal had the potential to unlock the sales of generation assets and set the stage for the private investment needed to avoid long-term power shortages.

C. Assessing the Prospects for Inflation Returning to Target

22. **Current monetary policy settings appear consistent with inflation returning within target over the next twelve months.** After successive rounds of tightening last year, the BSP has left rates unchanged to date in 2006, arguing that the absence of near-term demand pressures will allow inflation to return to the 4-5 percent target in 2007. Staff concurred with this assessment, noting that core inflation was edging down, while the recent round of private sector wage increases was fairly contained. Moreover, the benchmark 91-day treasury bill rate remains 70 bps higher than before the sell-off in May and real interest rates and interest rate differentials have increased substantially. Staff expect inflation to average 5 percent in 2007, but to fall within target in the second half of the year once base effects from the oil shock and the VAT rate hike have dropped out.

Yield Differential Between Philippine and U.S. 10-Year Government Bonds (Jan 3, 05 - Sep 22, 06, net of 20 percent withholding tax, in percent)



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

23. **The exchange rate has shrugged off recent volatility and resumed its appreciating trend.** The authorities have intervened in the foreign exchange market to maintain orderly conditions, while building foreign reserves to more comfortable levels. There was intervention to support the peso during the emerging market sell-off in May, but this has since been more than recouped. The authorities' assessment at that time was that the downward pressure on the peso did not threaten inflation sufficiently to justify raising interest rates, a judgment that has been borne out by subsequent events. Over the past twelve months, the peso has risen by 10 percent in nominal effective terms. Nonetheless, exports have performed strongly.

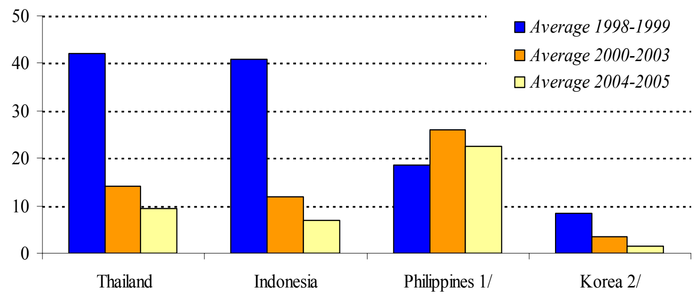
24. **The discussions focused on the risks to inflation.** One question considered was whether there were upside risks to inflation from rapid growth of monetary aggregates. The upward trend in domestic liquidity over the past two years has been largely due to the build up in foreign assets, with some offset provided by BSP sterilization including through foreign exchange swaps. There had been a recent acceleration in M3 growth, but this reflected a shift back into deposits once UITFs were redeemed rather than a change in money supply. It was agreed that possible additional increases in oil prices posed greater upside risks to the inflation outlook. There were also downside risks to the inflation forecast, notably from additional peso appreciation should sentiment improve further as reforms continue. The appreciation of the exchange rate to almost P 50 to the U.S. dollar during September attests to this possibility.

D. Reviewing Progress with Strengthening the Financial Sector

25. **Strengthening the banking sector is an important challenge.** The Philippine banking system is fragmented and saddled with high NPAs, with some banks under-provisioned and lacking capital. Previous staff analysis has indicated that deficiencies in accounting and loan classification practices cause capital adequacy to be overstated, and particularly so for some banks. Profitability improved in 2005, with strong securities and foreign exchange trading gains boosting net operating income, which allowed banks to increase their provisioning and debt write-offs. Profit growth remained positive in the first semester of 2006 despite losses on bond and foreign exchange trading in the second quarter as a result of the market sell-off.

26. **After a slow start, NPA resolution is moving ahead.** The authorities recognized that the NPA problem had been tackled relatively slowly in the Philippines, a result of the Special Purpose Vehicle (SPV) framework being market-driven with use of public money limited to providing tax incentives. But progress had been made with sales of P 100 billion of NPAs (one fifth of the stock) under the SPV framework that expired in April 2005. The authorities expected the recent two-year extension of the SPV law to lead to a further P 50-100 billion in NPA sales. The BSP had also authorized banks to enter into joint ventures with real estate firms to develop foreclosed assets (ROPOAs), the sale of which had tended to lag other NPAs.

Non performing loans
(Ratio to total loans)

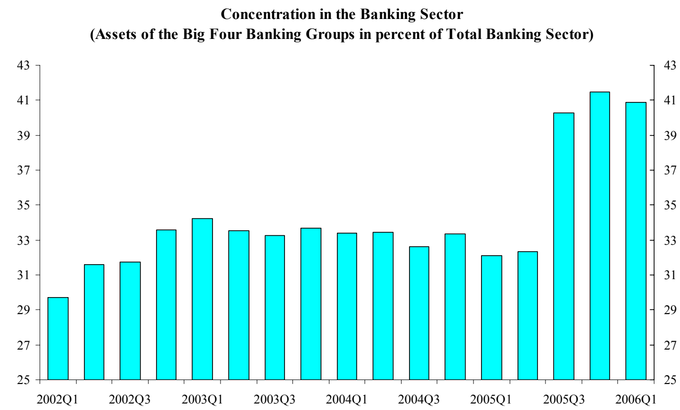


1/ NPL plus "real and other properties owned or acquired" (ROPOA) over TL plus ROPOA.
2/ Average 1998-1999 only contains 1999 data

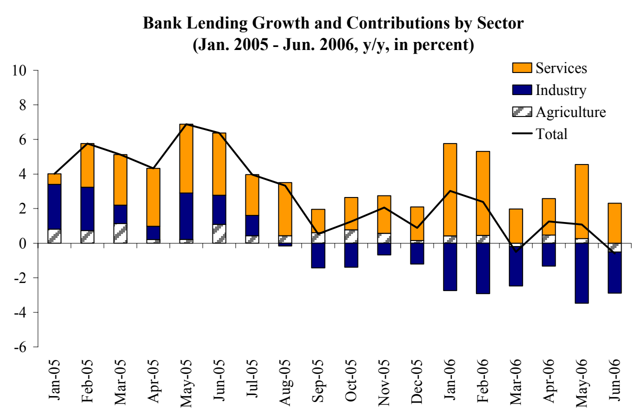
Sources: CEIC Data Company Ltd; and IMF staff calculations.

27. **Legislative amendments that would strengthen bank supervision, however, remain mired in Congress.** Bank supervision would be given added teeth by amendments to the BSP Charter that would provide legal protection for bank supervisors and allow them to increase pressure on banks to raise capital and facilitate prompt closure of problem banks. However, the authorities considered the near-term prospects for Congress passing these amendments to be poor. In the absence of the amendments, the authorities were attempting to engage banks facing difficulties at an early stage including through a new Prompt Corrective Action (PCA) framework.

28. **Regulatory changes are encouraging banks to raise capital, although some banks may require time to adjust.** Beginning with the period ending December 2005, the financial statements of banks were required to comply with international accounting standards (IFRS), which imply more rigorous valuation requirements. In addition, higher risk-weightings on NPLs have been introduced as a first step towards Basel II. If effectively implemented, these changes, as well as further measures in prospect under Basel II, should induce weaker banks to raise capital or merge with other banks.[6] The authorities were therefore encouraged by several recent mergers between banks and by a number of banks issuing new capital. Even so, the regulatory changes underway were likely to be onerous for the weakest banks. A clearer picture of the impact of IFRS, and the extent to which some banks will require forbearance, would emerge once the BSP has reviewed the IFRS-consistent financial accounts for 2005. As in the past, staff underscored the importance of any regulatory relief provided by the BSP being transparent and conditional on a clear bank recapitalization plan.



29. **Bank lending remains sluggish, perhaps in part due to measures to strengthen the banking system.** Staff observed that there had been little pick-up to date in bank lending, even though banks were now disposing of their NPAs. On the other hand, attempts to strengthen the regulatory environment were still ongoing. While the strengthening of risk management would lay the foundation for solid lending growth over the medium term, the authorities also pointed to the demand for bank credit being weak, especially from the manufacturing sector.



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

[6] Basel II will be introduced in two stages. On July 1, 2007, banks will be required to implement the standardized approach for credit risk and operational risks. In particular, risk weighting for NPAs will be increased from the current 100 percent to 150 percent, a capital charge equivalent to 15 percent of operating revenues will be introduced to cover operational risk, and a 100 percent weighting on Philippines external sovereign bonds (ROPs) will be phased in over three years. In the second stage, effective in 2010, banks will be allowed to move to the advanced internal ratings based approach.

30. **Recent events in the trust industry may prove salutary.** The rapid expansion of the UITFs appears to have swept in investors that were not fully conversant with the risks. Once financial markets began to decline in May, investors pressed for redemption and exacerbated the market decline. The authorities viewed these developments as a learning experience for investors. There were also lessons for the industry including the need to improve sale practices, customer profiling, and risk disclosure. The current regulatory framework might also need review.

31. **Capital market development more generally is a priority.** The authorities noted that recent peso bond exchanges had helped to increase liquidity in domestic markets. The authorities also planned to stimulate the domestic market by shifting the mix of funding for the budget from external to domestic sources.[7] Various legislative initiatives are intended to foster financial market development, including the Personal Equity and Retirement Account (PERA) bill which was approved by the Senate Banking Committee in August. Other bills pending in Congress are the Credit Information Systems Act, the Corporate Recovery Act, the Pre-Need Code, and amendments to the Investment Company Act (the Mutual Fund Bill) and to the Corporation Code.

IV. Staff Appraisal

32. **Progress with reforms sets the stage for resolving longstanding economic problems**. The fiscal position has shown a marked improvement over the past two years, with the nonfinancial public sector deficit reduced by more than half. Initially, the adjustment reflected tight control on spending and increases in power generation tariffs. Higher tax revenues from the VAT reform have now begun to play a role. Steps have also been taken to strengthen bank balance sheets. However, while the macroeconomic environment has become more stable, further reforms are needed before the economy can break free from its long-standing exposure to market risks and shift to a higher growth path.

33. **Fiscal reforms appear to have paid an early dividend, but vulnerabilities remain relatively high.** Philippine markets have rebounded decisively from the recent emerging market sell-off, a welcome sign that investors have taken note of recent reforms. Yet while public debt has been placed on a clearly declining path, the level remains high, with external commercial borrowing requirements still sizeable. Maintaining the confidence of markets will require that the reform momentum is sustained. Building a longer track record should help to attract the attention of long-term investors and boost foreign direct investment.

34. **Fall-out from the oil price shock has so far been limited.** Buoyant remittances and resurgent exports have provided a valuable prop to growth in the face of higher oil prices, and have also served to limit the impact on the external current account. On the policy side,

[7] The Fund is currently providing technical assistance on the regulation and infrastructure of the domestic debt market, as well as on regulatory and legal issues in the foreign exchange market.

the oil shock has been well-handled. Despite pressures for fiscal relief, the VAT reform has emerged intact and the authorities have avoided incurring subsidies for the budget. Downside risks to growth going forward include a renewed surge in oil prices, as well as a possible slowing of the global economy.

35. **Tax collections are growing strongly this year.** For the first time in a decade, tax collections in 2006 are outstripping GDP growth, and by a considerable margin. The growth in tax revenues primarily reflects the boost from the VAT reform. Tax administration reforms can also make a key contribution to balancing the budget. The authorities are rightly attempting to strengthen collection efforts and full operationalization of the BIR reform program being developed with donor assistance is essential.

36. **Priority spending should also be allowed to grow.** Higher revenues not only allow public debt to be reduced, but can also finance increases in spending on social services and infrastructure. However, the government is currently spending less than planned in these areas as a result of the re-enactment of the 2005 Budget. Efforts are appropriately being made to increase priority spending in the second half of the year, but care should be taken that any off-budget spending is transparent and contained.

37. **Over the medium-term, sustainable fiscal consolidation will require a further revenue effort.** Staff support the authorities' plans to balance the budget by 2008, as well as to significantly increase capital spending over the medium term. Upgrading the quality of infrastructure will contribute to improving the investment climate, but to achieve this while balancing the budget is likely to require further tax measures for which preparations should begin now. A particular priority is to ensure that current efforts to rationalize fiscal incentives are made significantly revenue positive.

38. **NPC's finances are much improved, but privatization of power sector assets should move ahead.** The sharp reduction in NPC losses achieved since 2004 is a key component of the fiscal consolidation to date. Ensuring that this improvement is preserved will require that NPC's finances be closely monitored. The performance contracts being contemplated for the larger public enterprises should assist in this regard, as well as permit closer scrutiny of the GOCCs more generally. Over the long-run, privatization of power assets will permit needed investment in the power sector. The authorities should therefore proceed with the sale of power sector assets including Transco as soon as possible.

39. **Risks to inflation seem fairly evenly-balanced.** Inflation remains above target as a result of recent oil price rises and the VAT reform. However, with little evidence that supply shocks are having second-round effects, prospects are good that inflation will return to target in 2007. Monetary policy settings thus seem appropriate for the time being. Staff are confident that the authorities will remain vigilant against new developments such as an upward spike in oil prices that might threaten the inflation outlook. On the other hand, a more pronounced appreciation of the peso associated with improving sentiment might bring inflation down even faster.

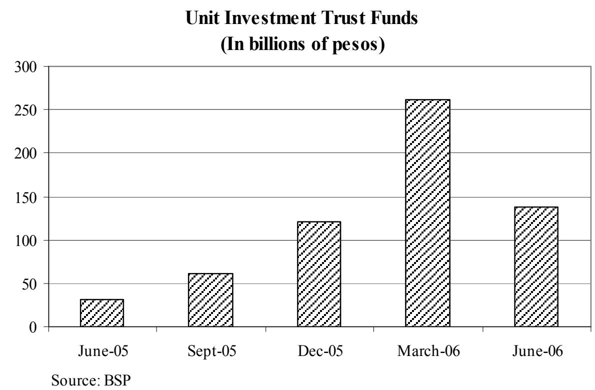
40. **Although important challenges remain, steps are being taken to strengthen the banking sector.** Resolution of the NPA problem is finally underway, with the extension of the SPV framework promising to facilitate significant additional NPA sales. Nonetheless, new accounting standards, as well as the pending introduction of Basel II, will bring shortfalls in capital adequacy at some banks into sharp relief. While recent consolidation in the banking industry and efforts by banks to raise new capital are welcome, the BSP should maintain pressure on banks to raise capital. Any regulatory relief provided to banks that require time to comply with the new regulatory standards should be tied closely to a clear and transparent recapitalization plan.

41. **Long-delayed changes to the BSP Charter remain essential.** Congress continues to show little interest in passing BSP Charter amendments that would strengthen legal protection for supervisors and increase their leverage over problem banks. The authorities should continue to press for passage of these amendments so as to allow the steps they have taken to strengthen the regulatory framework to become fully effective.

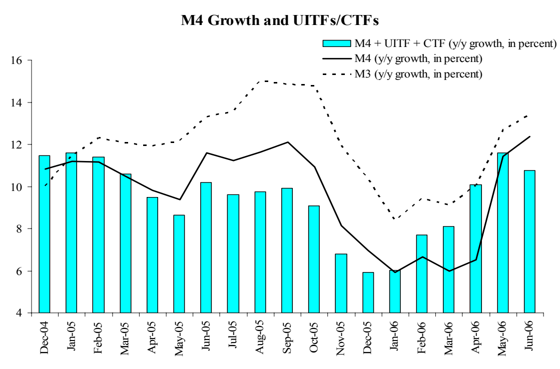
42. **Capital market development is appropriately a priority.** The recent fall-out in the trust industry carries lessons for investors, but also for the industry in terms of the need to improve disclosure of risks and take better account of customer risk appetites. Through their management of public debt, the authorities are striving to promote the development of domestic debt markets. Important legislative initiatives, including bills to create credit information bureaus and promote retirement saving vehicles, have also been launched to foster domestic financial market development.

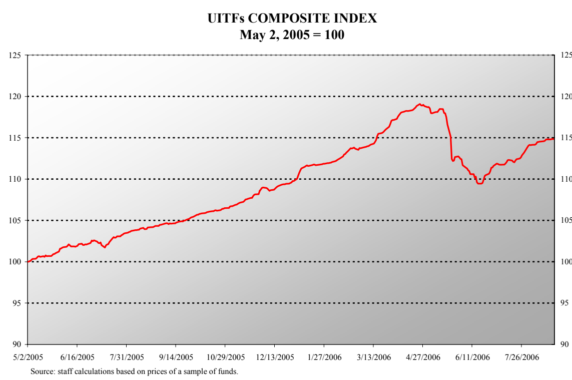
Box 1. Unit Investment Trust Funds

Unit Investment Trust Funds (UITFs) were created to reduce risks to bank balance sheets. Up until recently, Common Trust Funds (CTFs) represented about 40 percent of the entire trust business. They were sometimes perceived as a substitute for deposits with a guaranteed return, exposing banks to losses in their trust departments. The BSP issued regulations in September 2004 governing the creation, administration and investments of UITFs, which were to completely replace CTFs over time. Unlike CTFs, these open-ended funds are marked to market and invest exclusively in tradable and liquid securities. To stimulate the migration, the BSP made UITFs exempt from reserve requirements.



UITFs have emerged as an important savings vehicle for retail investors. Aggressive marketing triggered significant inflows into UITFs in the last quarter of 2005 and the first quarter of 2006. The new instruments had attracted P 260 billion by end-March 2006, two thirds from CTFs and the remainder from new inflows. As liquidity moved from bank deposits into UITFs, M4 growth dropped below 7 percent in late 2005. Meanwhile, bond purchases by the UITFs in conjunction with the improving fiscal news caused yields to experience a dramatic compression. By end-April, 91-day T-bills and 10-year government bonds were trading at yields 230 basis points and 30 basis points below the overnight rate, respectively. However, the rise in market volatility in mid-May led investors to redeem their UITF holdings and shift back into bank deposits. Against this background, M4 growth rose to 12.4 percent (y/y) in June, [1/] and the yield curve steepened.





Recent events highlight the need for further development of the capital market. During the recent period of rapid expansion, the BSP warned banks from "overselling" their new product and voiced concerns that investors were not fully aware of the risks, attracted only by the high past returns of these funds. To provide additional protection to investors, the trust industry is working on improving sale practices, customer profiling, and risk disclosure.

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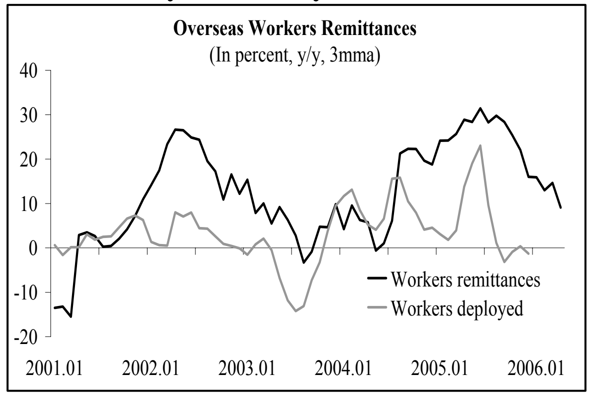
[1] According to the Depository Corporations Survey data.

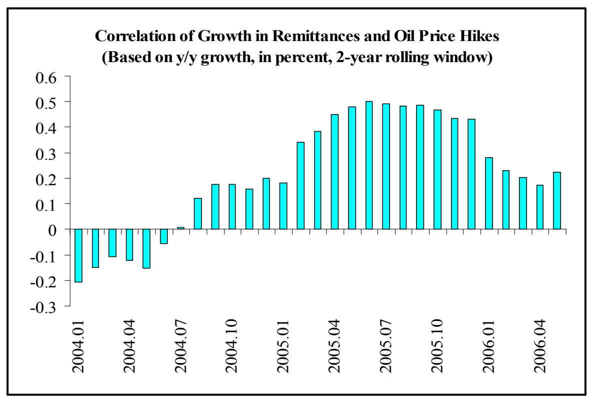
Box 2. Remittance Inflows to the Philippines[1]

Remittance flows to the Philippines have increased substantially in recent years. Remittances grew by 25 percent in 2005, reaching over 10 percent of GDP, after growing by 10 and 13 percent in 2003 and 2004, respectively. In 2004, over 8 million Filipinos were recorded as being overseas, including nearly five million overseas Filipino workers (OFWs)—about one quarter of the domestic labor force—mainly in the Middle East (32 percent of total), Asia (30 percent), the Americas (17 percent) and Europe (13 percent).

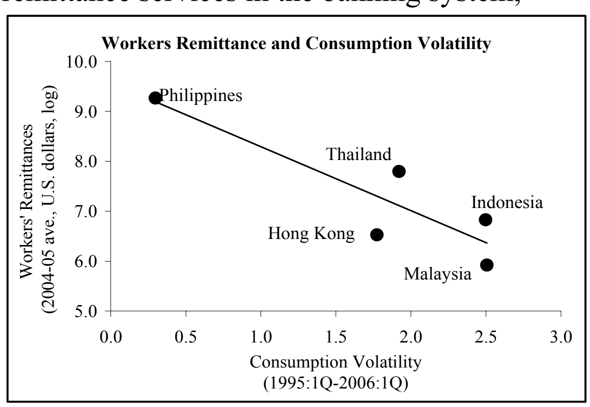


In addition to the steady increase in numbers of OFWs, several factors account for the increase in remittances:

- Remittance growth has become positively correlated with changes in oil prices in recent years, possibly reflecting the increasing fraction of OFWs deployed to the Middle East, with the result that remittances have acted as a consumption hedge.



- The proportion of skilled workers among OFWs has increased. With strong demand for professional and technical workers in host countries such as the U.S., OFWs are increasingly taking high-skilled jobs, including jobs in the medical field such as nursing.
- The amount of remittances routed through the banking system has grown. In conjunction with enforcing AML/CFT, efforts have been made to reduce the costs of remittance services in the banking system, enhancing OFW access to formal channels.



The importance of remittances may be a contributing factor to the lower volatility of private consumption in the Philippines. Private consumption over the long-term has been less volatile in the Philippines than elsewhere in the region, with remittance inflows providing a hedge to economic shocks.

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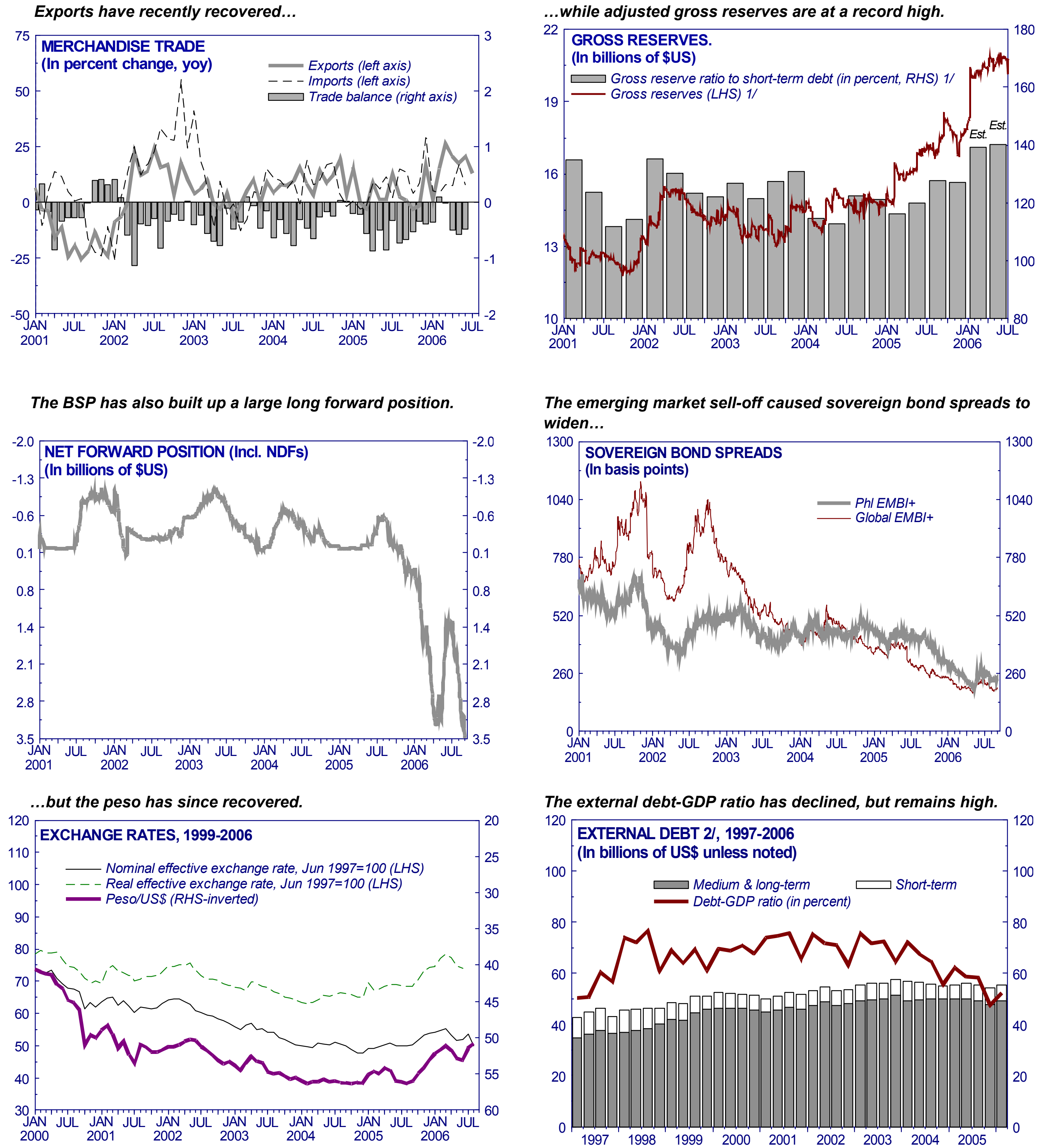
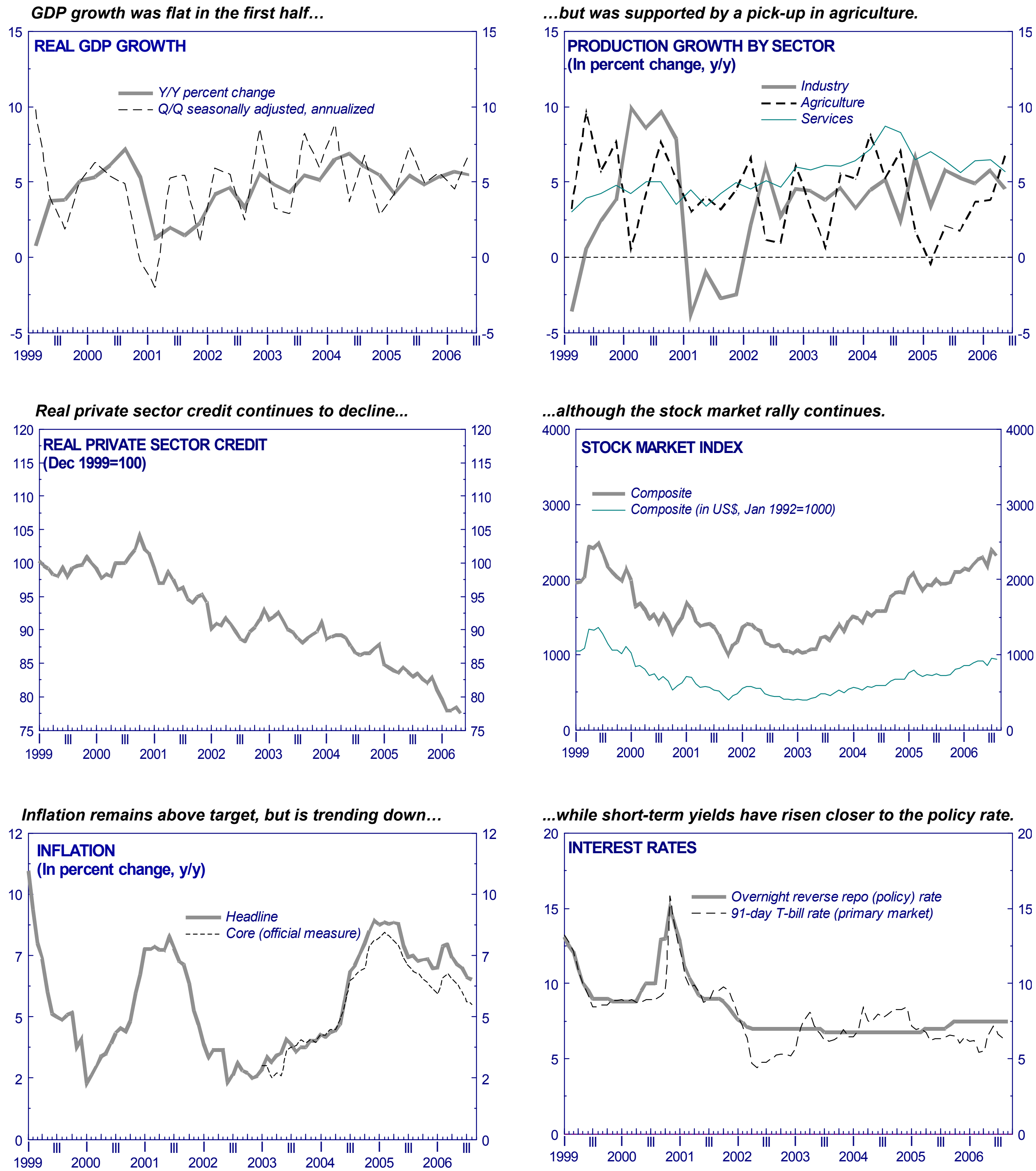
[1] The remittance data used cover remittances sent through the banking system. The BSP estimates that about 15-20 percent is sent through other channels. In addition, a part of remittances recorded as coming from the U.S. may have originated elsewhere.

Figure 1. Philippines: External Developments, 2001–06



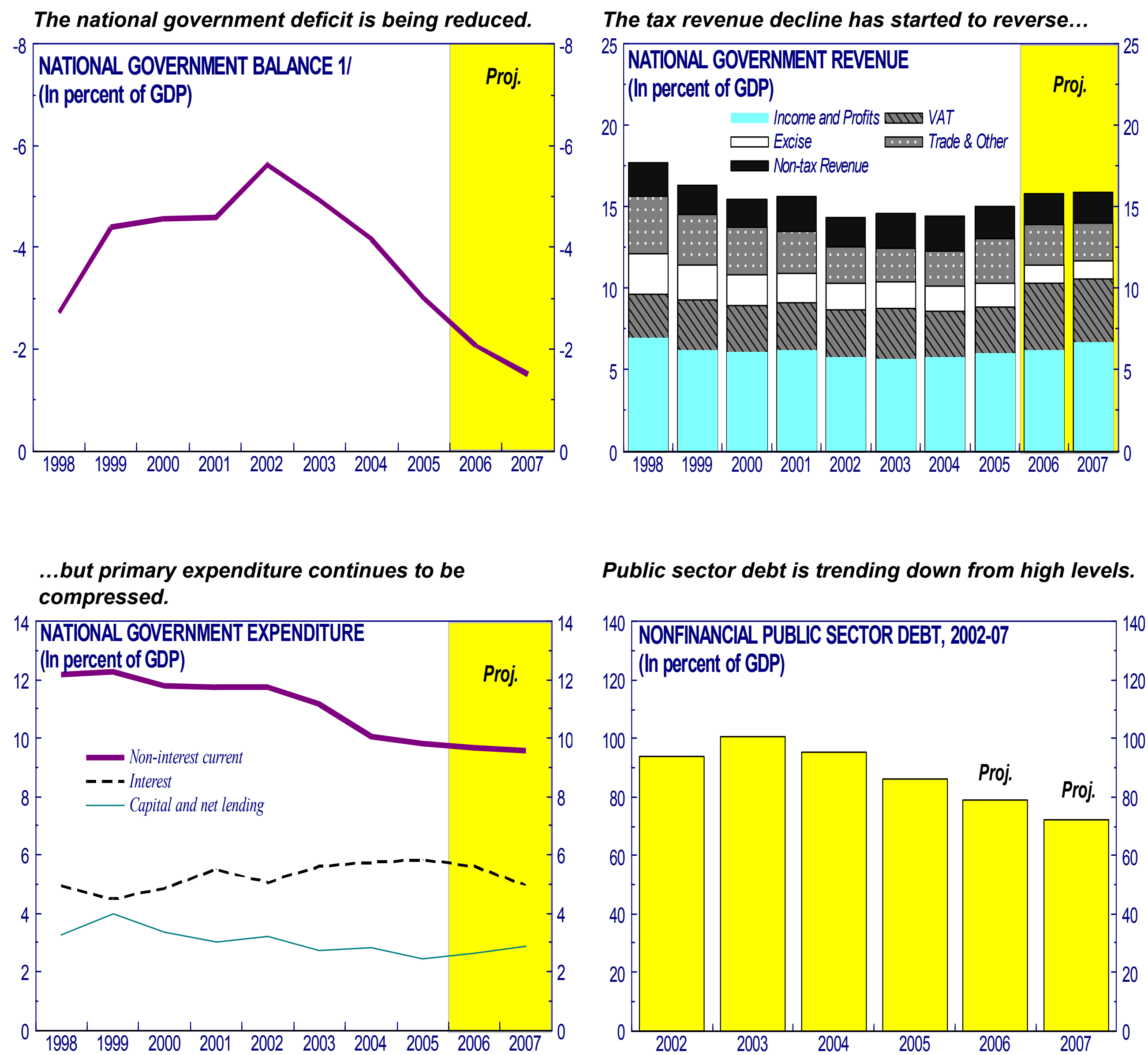
Sources: Data provided by the Philippine authorities; CEIC; and Fund staff estimates.
1/ Adjusted for pledged assets; staff estimates.
2/ Includes private sector inter-company accounts, loans without BSP approval, and obligations under capital lease.

Figure 2. Philippines: Domestic Developments, 1999–2006



Sources: Data provided by the Philippine authorities; CEIC; and Fund staff estimates.

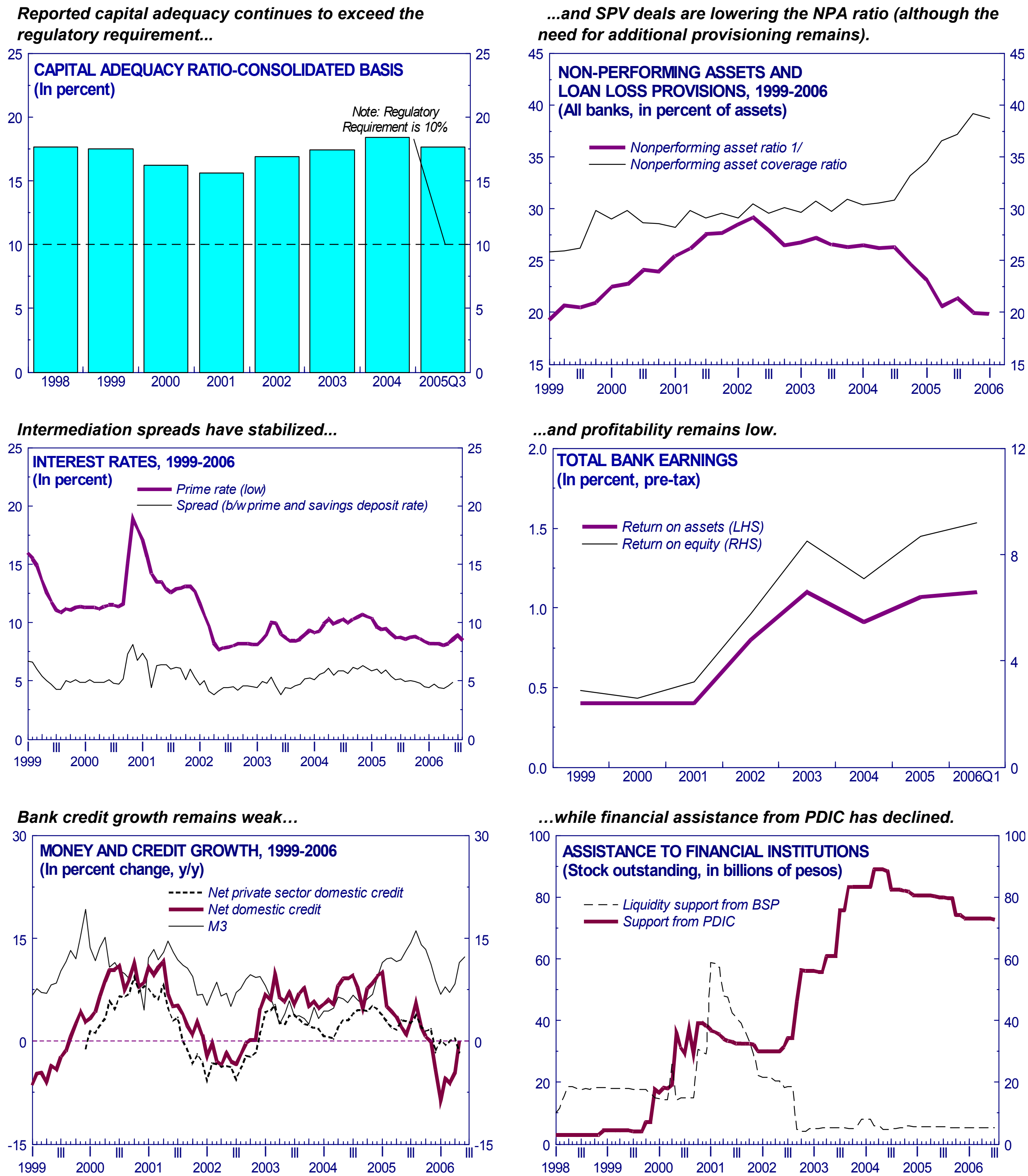
Figure 3. Philippines: Fiscal Sector, 1998–2007



Source: Data provided by the Philippine authorities; and Fund staff estimates and projections.

1/ Fund staff definition. Excludes privatization receipts of the national government and includes operations of the Central Bank-Board of Liquidators.

Figure 4. Philippines: Banking Sector, 1998–2006



Sources: Data provided by the Philippine authorities; CEIC; and Fund staff estimates.
1/ Nonperforming loans plus foreclosed assets over total loans plus foreclosed assets.

Table 1. Philippines: Selected Economic Indicators, 2002–07

Nominal GDP (2005): P5,419 billion ($ 98.4 billion)
Population (2005): 84.2 million
GDP per capita (2005): $1,168
IMF quota: SDR 879.9 million

	2002	2003	2004	2005	2006	2007 1/
				Est.	Staff Proj.	
GDP and prices (percentage change)						
Real GDP	4.4	4.9	6.2	5.0	5.0	5.4
CPI (annual average)	3.0	3.5	6.0	7.6	6.7	5.0
CPI (end year)	2.5	3.9	8.6	6.7	6.1	4.1
Investment and saving (percent of GDP)						
Gross investment	17.7	16.8	16.8	15.1	15.2	15.6
National saving 2/	17.2	17.2	18.7	17.5	17.6	17.4
Public finances (percent of GDP)						
National government balance (authorities definition)	-5.3	-4.6	-3.8	-2.7	-1.7	-1.9
National government balance 3/	-5.6	-4.9	-4.2	-3.0	-2.1	-2.3
Nonfinancial public sector balance 4/	-5.7	-5.6	-5.0	-2.1	-1.8	-2.3
Revenue and grants 5/	20.9	20.9	20.5	22.1	22.8	22.4
Expenditure 6/	26.6	26.4	25.5	24.2	24.6	24.6
Nonfinancial public sector debt 7/	93.7	100.8	95.4	86.3	78.7	73.3
Monetary sector (percentage change, end of period)						
Broad money (M3)	9.5	3.3	9.2	9.0	12.3 9/	...
Interest rate (91-day Treasury bill, end of period, in percent) 8/	5.9	6.5	8.4	6.4	6.2 10/	...
Credit to the private sector	1.2	1.8	4.6	-1.5	-1.0 9/	...
External sector						
Export value (percent change)	9.9	2.7	9.8	3.7	10.0	5.2
Import value (percent change)	6.3	3.1	8.0	7.4	9.4	5.3
Current account (percent of GDP)	-0.5	0.4	1.9	2.4	2.4	1.7
Capital and financial account (US$ billions, excluding errors and omissions)	1.1	0.6	-1.6	1.0	1.1	0.0
Foreign direct investment (net)	1.5	0.2	0.1	1.0	1.2	0.8
Other	-0.4	0.4	-1.7	0.0	-0.1	-0.8
Errors and omissions and trade credit (US$ billions)	-0.8	-1.7	0.6	-1.0	-0.2	-0.2
Overall balance (US$ billions)	-0.1	-0.7	0.6	2.4	3.7	2.2
Monitored external debt (percent of GDP) 11/	77.7	78.8	69.6	63.8	55.9	50.4
Debt-service ratio (percent of exports)	19.7	20.6	19.7	18.5	19.8	19.6
Reserves, adjusted (US$ billions) 12/	14.3	14.7	15.2	18.0	21.9	24.1
Reserves / Short-term liabilities, adjusted 13/	123.9	122.9	122.9	133.0	160.7	161.6
Exchange rate (period averages)						
Pesos per U.S. dollar	51.6	54.2	56.0	55.1	50.4 10/	...
Nominal effective exchange rate (1990 =100)	89.7	81.3	75.7	76.9	81.2 9/	...
Real effective exchange rate (1990 =100)	96.2	89.1	86.2	92.3	100.9 9/	...

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

1/ "Currently-identified measures" scenario.
2/ Defined as difference between gross investment and current account. There is a statistical break in national saving and balance of payments data in 2003.
3/ Fund definition. Excludes privatization receipts of the national government, and includes net deficit from restructuring the central bank.
4/ Includes the national government, Central Bank-Board of Liquidators, 14 monitored government-owned enterprises, social security institutions, and local governments.
5/ 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.
6/ Defined as difference between nonfinancial public sector revenue and balance.
7/ Debt is consolidated (net of intra-nonfinancial public sector holdings of debt). Data on local government debt are not available for 2001; it is assumed that these debts were the same as a share of GDP as in 2002.
8/ Secondary market rate.
9/ June 2006.
10/ September 2006.
11/ 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.
12/ Gross reserves less gold and securities pledged as collateral against short-term liabilities.
13/ 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 pledged assets.

Table 2. Philippines: National Government Cash Accounts, 2002–07
(In percent of GDP; unless otherwise indicated)

	2002	2003	2004	2005	2006		2007
				Prel. Est.	Proposed Budget	Staff Proj.	Staff Proj. 1/
Revenue and grants	14.4	14.6	14.4	15.1	16.2	15.8	15.3
Tax revenue	12.5	12.4	12.3	13.0	14.6	13.9	13.5
Net income and profits	5.7	5.6	5.7	6.0	...	6.1	6.1
Excises	1.7	1.6	1.6	1.4	...	1.1	1.1
VAT	2.9	3.1	2.9	2.9	...	4.1	4.0
Tariffs	0.9	1.0	1.0	1.1	...	0.8	0.6
Other 2/	1.3	1.1	1.2	1.7	...	1.7	1.7
Nontax revenue	1.8	2.1	2.1	2.0	1.6	1.9	1.8
Of which: Central Bank-Board of Liquidators	0.1	0.1	0.1	0.0	...	0.0	0.0
Of which: Recovery of Marcos wealth	...	...	0.2	0.0	...	0.0	0.0
Expenditure and net lending	20.0	19.5	18.6	18.1	18.6	17.9	17.6
Current expenditures	16.8	16.8	15.8	15.6	15.8	15.3	14.7
Personnel services	6.7	6.4	5.8	5.5	5.5	5.4	5.5
Maintenance and operations	2.1	1.8	1.7	1.6	1.8	1.7	1.7
Allotments to local government units	2.8	2.7	2.3	2.3	2.2	2.2	2.2
Subsidies	0.1	0.3	0.1	0.1	0.1	0.1	0.1
Tax expenditure		...	...	0.4	...	0.2	0.2
Interest	5.1	5.6	5.7	5.8	6.0	5.6	5.0
National government	4.7	5.2	5.4	5.5	5.7	5.2	4.6
Central Bank-Board of Liquidators	0.4	0.4	0.4	0.3	0.4	0.4	0.3
Capital and equity expenditure 3/	3.1	2.6	2.7	2.4	2.7	2.5	2.8
Net lending	0.1	0.1	0.1	0.0	0.1	0.1	0.0
Balance	-5.6	-4.9	-4.2	-3.0	-2.4	-2.1	-2.3
On the authorities' presentation 4/	-5.3	-4.6	-3.8	-2.7	-2.1	-1.7	-1.9
Financing	5.6	4.9	4.2	3.0	2.4	2.1	2.3
Net external financing	2.8	3.3	1.7	1.7	1.7	0.5	1.1
Net domestic financing	2.9	1.6	2.5	1.3	0.7	1.5	1.2
Memorandum Items:							
Nonfinancial public sector balance 5/	-5.7	-5.6	-5.0	-2.1	…	-1.8	-2.3
Consolidated public sector balance 5/	-5.6	-5.2	-4.8	-1.8	…	-1.6	-2.1
Primary national government balance	-0.6	0.7	1.6	2.8	3.6	3.5	2.7
National government debt 6/	66.5	71.4	69.9	63.1	…	59.0	55.1
(percent of NG revenues)	462.6	490.1	483.9	419.4	…	373.2	359.6
Nonfinancial public sector debt 7/	93.7	100.8	95.4	86.3	…	78.7	73.3
(percent of NFPS revenues)	448.1	483.0	465.1	390.3	…	345.2	327.7
National government gross financing requirements 8/	23.2	23.6	24.4	21.2	…	22.1	18.3
GDP (in billions of pesos)	3,964	4,316	4,859	5,419	5,999	6,042	6,679

Sources: Philippine authorities; and Fund staff projections.

1/ "Currently identified measures" scenario assumes no new measures starting in 2007, but higher capital spending.
2/ Includes other percentage taxes and documentary stamp tax. Beginning in 2005, includes non-cash collections (P 20.5 bln, or 0.4 percent of GDP in 2005). These collections are also reflected as tax expenditures under current expenditures.
3/ Excludes purchase of NPC securities and other onlending; includes capital transfers to LGUs. May exceed public investment in years when capital transfers to LGUs exceed their reported capital spending.
4/ Includes privatization receipts as revenue and excludes the operations of the Central Bank-Board of Liquidators (CB-BOL).
5/ Excludes privatization receipts from revenue.
6/ Consolidated (net of national government debt held by the sinking fund) and excludes contingent/guaranteed debt.
7/ Nonfinancial public sector includes the national government, CB-BOL, 14 monitored government-owned enterprises, social security institutions, and local governments. Debt is consolidated (net of intra-nonfinancial public sector holdings of debt). Data on local government debt are not available for 2001; it is assumed that these debts were the same as a share of GDP as in 2002.
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.

Table 3. Philippines: Balance of Payments, 2002–07
(In billions of U.S. dollars)

	2002	2003 1/	2004 1/	2005 1/	2006	2007
					Staff Proj.	
CURRENT ACCOUNT BALANCE	**-0.4**	**0.3**	**1.6**	**2.4**	**2.8**	**2.3**
Trade Balance	-5.5	-5.9	-5.7	-7.5	-8.0	-8.4
Exports, f.o.b.	34.4	35.3	38.8	40.2	44.3	46.6
Imports, f.o.b.	39.9	41.2	44.5	47.8	52.2	55.0
of which: oil and related products	3.3	3.8	4.7	6.3	8.2	9.6
Services (net)	-2.0	-2.0	-1.8	-1.4	-0.6	-0.7
Receipts	3.4	3.4	4.0	4.5	5.5	5.9
Payments	5.4	5.4	5.8	5.9	6.2	6.6
Income	-0.5	-0.3	-0.1	-0.1	-0.9	-1.5
Receipts, of which:	3.3	3.3	3.7	3.9	4.4	4.7
Remittances of resident workers abroad 2/	2.6	2.6	2.9	2.9	3.1	3.2
Payments	3.8	3.6	3.6	4.0	5.2	6.2
Interest payments	2.5	0.1	2.9	3.3	3.7	4.4
Transfers (net)	7.7	8.4	9.2	11.4	12.3	12.9
Receipts, of which:	7.9	8.6	9.4	11.7	12.6	13.3
Non-resident workers remittances 2/	...	8.2	9.0	10.7	11.7	12.4
Payments	0.3	0.2	0.3	0.3	0.3	0.4
CAPITAL AND FINANCIAL ACCOUNT	**1.1**	**0.6**	**-1.6**	**1.0**	**1.1**	**0.0**
Capital Account	0.0	0.0	0.0	0.0	0.0	0.0
Financial Account	1.1	0.6	-1.6	1.0	1.1	0.1
Direct Investment	1.5	0.2	0.1	1.0	1.2	0.8
Portfolio Investment	0.7	0.6	-1.7	2.9	2.8	2.2
Equity	0.2	0.5	0.5	1.5	1.1	0.8
Debt	0.5	0.1	-2.2	1.4	1.8	1.3
Other Investment (excluding trade credit)	-1.1	-0.1	0.0	-2.8	-2.9	-2.9
ERRORS AND OMISSIONS (incl. trade credit)	**-0.8**	**-1.7**	**0.6**	**-1.0**	**-0.2**	**-0.2**
OVERALL BALANCE	**-0.1**	**-0.7**	**0.6**	**2.4**	**3.7**	**2.2**
OVERALL FINANCING	**0.1**	**0.7**	**-0.6**	**-2.4**	**-3.7**	**-2.2**
Monetization of gold and revaluation	1.7	1.9	0.5	0.2	0.2	0.2
Change in Net international reserves (increase =-)	-1.6	-1.2	-1.1	-2.6	-4.0	-2.4
BSP Gross Reserves (increase =-)	-0.5	-0.7	0.4	-2.3	-3.8	-2.2
Fund credit (net)	-0.4	-0.6	-0.5	-0.3	-0.2	-0.2
Change in other BSP liabilities	-0.7	0.1	-1.1	0.0	0.0	0.0
Memorandum items:						
Current account/GDP	-0.5	0.4	1.9	2.4	2.4	1.7
Short-term debt (original maturity)	8.0	8.2	7.9	8.0	8.4	8.8
Short-term debt (residual maturity)	13.4	14.1	13.4	14.1	14.0	15.4
Gross reserves	16.2	16.9	16.2	18.5	22.3	24.6
Adjusted gross reserves 3/	14.3	14.7	15.2	18.0	21.9	24.1
(in percent of st. debt by res. maturity) 4/	123.9	122.9	122.9	133.0	160.7	161.6
Net international reserves	12.8	13.9	15.1	17.7	21.4	23.8
Monitored external debt (in billions) 5/	59.7	62.8	60.3	62.8	65.3	67.7
(in percent of GDP)	77.7	78.8	69.6	63.8	55.9	50.4
Debt service ratio 4/	19.7	20.6	19.7	18.5	19.8	19.6
Export value (percent change)	9.9	2.7	9.8	3.7	10.0	5.2
Import value (percent change)	6.3	3.1	8.0	7.4	9.4	5.3
Gross external financing needs 6/,7/	14.3	13.1	12.5	11.0	11.2	11.7
GDP (in billions)	76.8	79.6	86.7	98.4	116.9	134.3

Sources: Philippine authorities and Fund staff projections.

1/ Based on revisions to the data, made March 2006.
2/ The 2003–04 revisions to the data separate remittances made by Filipino residents working abroad (income), and non-resident workers' remittances (transfers).
3/ Gross reserves less gold and securities pledged as collateral against short term liabilities.
4/ As a percent of short-term debt excluding pledged assets of the central bank.
5/ Monitored external liabilities are defined as external debt plus liabilities of foreign banks in the Philippines to their headquarters, branches and agencies, some external debt not registered with the central bank and private capital lease agreements.
6/ In percent of goods and non-factor services.
7/ Defined as the current account deficit, plus amortization on medium- and long-term debt, plus short-term debt at the end of the previous period.

Table 4. Philippines: Monetary Survey, 2002–06

	2002 Dec.	2003 Dec.	2004 Dec.	2005 Dec.	2006 Mar.	2006 Jun.
			(In billions of pesos)			
Net foreign assets	551	673	727	961	1,102	1,239
Central bank	547	637	690	846	938	1,013
Net international reserves	693	782	820	937	1,024	1,091
Medium and long-term foreign liabilities	146	145	130	91	86	78
Deposit money banks	4	37	37	115	164	226
Net domestic assets	1,799	1,801	1,985	1,925	1,779	1,863
Net domestic credit	2,207	2,314	2,533	2,428	2,292	2,434
Public sector credit	727	807	956	875	765	898
National Government	590	620	764	652	536	665
Credits	749	807	923	852	797	915
Foreign exchange receivables	7	7	15	18	17	4
Treasury IMF Accounts	-50	-58	-65	-66	-66	-60
Deposits	-117	-137	-109	-152	-213	-194
Local government and others	132	184	191	222	229	233
Claims on CB-BOL 1/	6	4	1	0	0	0
Private sector credit	1,480	1,507	1,577	1,553	1,526	1,536
Other items net	-407	-513	-548	-503	-513	-571
Total liquidity	2,351	2,474	2,711	2,886	2,882	3,102
M4	2,298	2,401	2,649	2,814	2,801	3,031
M3 (peso liquidity)	1,670	1,725	1,884	2,053	2,058	2,212
Foreign currency deposits, residents	628	676	766	762	744	818
Other liabilities	53	73	62	72	80	71
			(12-month percent change)			
Net foreign assets	36.0	22.1	7.9	34.3	31.4	31.7
Net domestic assets	2.3	0.1	10.2	-3.6	-7.4	0.5
Net domestic credit	4.8	4.8	9.5	-3.9	-6.1	1.1
Public sector	12.8	11.0	18.5	-7.8	-16.4	5.0
Private sector	1.2	1.8	4.6	-1.5	0.0	-1.0
M4	8.9	4.5	10.3	6.2	4.1	11.1
M3	9.5	3.3	9.2	9.0	7.1	12.3
			(In billions of pesos; unless otherwise indicated)			
Memorandum items:						
Gross domestic credit from deposit money banks	2,151	2,322	2,558	2,527	2,445	2,582
Private sector	1,470	1,498	1,566	1,543	1,516	1,526
(12-month percent change)	1.3	1.9	4.6	-1.5	0.0	-1.1
Public sector	681	824	992	985	929	1,057
(In percent of total gross credit)	31.6	35.5	38.9	39.0	38.0	40.9
			(In billions of U.S. dollars)			
Net foreign assets	10.2	11.9	12.7	18.1	21.5	23.1
Central bank	10.1	11.3	12.1	15.9	18.3	18.9
Deposit money banks	0.1	0.7	0.6	2.2	3.2	4.2
Foreign currency deposits residents	11.8	12.2	13.6	14.4	14.5	15.3
Dollar-denominated credit to residents	9.9	9.9	11.2	10.0	10.1	10.9
Public sector	4.8	6.6	6.7	6.1	6.2	6.8
Private sector	5.2	3.3	4.5	3.9	3.9	4.1
			(In percent; unless otherwise indicated)			
Dollar denominated credit / dollar deposits	84.0	81.0	82.5	70.0	69.8	71.4
Dollar denominated credit to public sector / dollar deposits	40.3	53.9	49.4	42.7	42.9	44.7
Exchange rate (peso per dollar; end-period)	53.1	55.6	56.3	53.1	51.3	53.6

Sources: Philippine authorities; CEIC, and Fund staff estimates.

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

Table 5. Philippines: Medium-Term Outlook, 2004–11
(Currently identified measures scenario)

	2004	2005	2006	2007	2008	2009	2010	2011
		Est.			Staff Proj.			
	(Percentage change; unless otherwise indicated)							
GDP and prices								
Real GDP	6.2	5.0	5.0	5.4	5.6	5.7	5.8	5.7
GDP per capita (US$)	1,049	1,168	1,361	1,532	1,689	1,820	1,963	2,075
CPI (average)	6.0	7.6	6.7	5.0	4.5	4.0	4.0	4.0
Labor								
Employment (average, million)	31.6	32.3	33.3	34.4	35.5	36.7	38.0	39.3
Employment (average)	3.7	2.2	3.0	3.2	3.4	3.4	3.5	3.4
Unemployment rate (old definition, average, percent)	11.8	11.3	10.5	10.1	9.7	9.3	8.8	8.3
	(In percent of GDP, unless otherwise indicated)							
Investment and saving								
Gross investment	16.8	15.1	15.2	15.6	16.1	16.5	17.2	17.5
Private	14.5	12.9	12.8	12.9	13.3	13.8	14.5	14.8
Public	2.3	2.3	2.4	2.8	2.8	2.7	2.7	2.7
National saving 1/	18.7	17.5	17.6	17.4	17.4	17.4	17.8	18.0
Private 1/	21.2	17.1	16.8	16.7	16.7	16.8	17.1	17.4
Public	-2.5	0.4	0.8	0.7	0.8	0.6	0.7	0.6
Foreign saving	-1.9	-2.4	-2.4	-1.7	-1.3	-0.9	-0.6	-0.5
Public finances								
Nonfinancial public sector balance 2/	-5.0	-2.1	-1.8	-2.3	-2.2	-2.2	-2.2	-2.2
Primary balance	1.6	4.3	4.2	3.4	3.1	2.9	2.7	2.5
Revenue and grants 3/	20.5	22.1	22.8	22.4	22.3	22.0	21.9	21.7
Expenditure (primary) 4/	19.0	17.8	18.5	19.0	19.2	19.1	19.2	19.2
Interest	6.5	6.4	6.0	5.6	5.3	5.2	4.9	4.7
Nonfinancial public sector gross financing	28.1	24.4	24.3	21.0	21.3	20.4	20.9	20.5
Domestic	25.1	19.7	20.5	17.0	17.7	16.6	17.6	17.5
Foreign currency	3.0	4.6	3.8	4.0	3.6	3.8	3.3	3.0
National government balance (authorities definition)	-3.8	-2.7	-1.7	-1.9	-1.9	-2.0	-2.0	-2.0
National government balance 5/	-4.2	-3.0	-2.1	-2.3	-2.2	-2.3	-2.2	-2.2
Nonfinancial public sector debt 6/	95.4	86.3	78.7	73.3	69.8	67.2	64.7	63.0
External sector								
Export value (percent change)	9.8	3.7	10.0	5.2	5.8	5.1	4.6	4.2
Import value (percent change)	8.0	7.4	9.4	5.3	6.0	5.3	4.9	4.8
Trade balance	-6.6	-7.7	-6.8	-6.3	-6.0	-5.8	-5.6	-5.6
Current account	1.9	2.4	2.4	1.7	1.3	1.0	0.6	0.5
FDI (net, US$ billions)	0.1	1.0	1.2	0.8	0.8	0.8	0.8	0.8
Reserves, adjusted (US$ billions) 7/	15.2	18.0	21.9	24.1	26.2	27.8	28.7	29.5
Reserves / Short-term liabilities, adjusted 8/	122.9	133.0	160.7	161.6	168.9	167.2	150.5	158.6
Gross external financing requirements (US$ billions) 9/	12.5	11.0	11.2	11.7	13.4	14.3	15.7	17.5
Monitored external debt 10/	69.6	63.8	55.9	50.4	46.2	43.3	41.1	39.5
Debt service ratio (in percent of exports of G&S)	19.7	18.5	19.8	19.6	20.9	20.6	20.5	23.0

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

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

Table 6. Philippines: Medium-Term Outlook, 2004–11
(Additional reforms scenario) 1/

	2004	2005	2006	2007	2008	2009	2010	2011
		Est.			Staff Proj.			
	(Percentage change; unless otherwise indicated)							
GDP and prices								
Real GDP	6.2	5.0	5.0	5.6	5.8	6.2	6.5	6.8
GDP per capita (US$)	1,049	1,168	1,361	1,557	1,723	1,848	1,987	2,123
CPI (average)	6.0	7.6	6.7	4.5	3.7	3.0	3.0	3.0
Labor								
Employment (average, million)	31.6	32.3	33.3	34.4	35.6	36.9	38.4	39.9
Employment (average)	3.7	2.2	3.0	3.4	3.5	3.7	3.9	4.1
Unemployment rate (old definition, average, percent)	11.8	11.3	10.5	10.0	9.5	8.8	7.9	6.9
	(In percent of GDP, unless otherwise indicated)							
Investment and saving								
Gross investment	16.8	15.1	15.2	16.0	16.6	17.4	18.3	19.4
Private	14.5	12.9	12.8	13.0	13.5	14.1	14.8	15.6
Public	2.3	2.3	2.4	3.0	3.1	3.3	3.5	3.8
National saving 2/	18.7	17.5	17.6	17.6	18.1	18.8	19.6	20.5
Private 2/	21.2	17.1	16.8	15.8	15.2	15.4	15.7	16.4
Public	-2.5	0.4	0.8	1.8	2.8	3.4	3.9	4.1
Foreign saving	-1.9	-2.4	-2.4	-1.6	-1.5	-1.4	-1.3	-1.1
Public finances								
Nonfinancial public sector balance 3/	-5.0	-2.1	-1.8	-1.4	-0.4	-0.1	0.2	0.2
Primary balance	1.6	4.3	4.2	3.8	4.2	4.1	4.0	3.6
Revenue and grants 4/	20.5	22.1	22.8	22.8	23.3	23.6	23.8	24.0
Expenditure (primary) 5/	19.0	17.8	18.5	19.0	19.2	19.5	19.8	20.3
Interest	6.5	6.4	6.0	5.1	4.6	4.2	3.8	3.5
Nonfinancial public sector gross financing	28.1	24.4	24.3	19.8	18.4	16.7	15.9	14.7
Domestic	25.1	19.7	20.5	16.6	15.7	13.6	13.4	12.4
Foreign currency	3.0	4.6	3.8	3.1	2.7	3.1	2.6	2.4
National government balance (authorities definition)	-3.8	-2.7	-1.7	-1.3	-0.5	-0.3	0.0	0.0
National government balance 6/	-4.2	-3.0	-2.1	-1.6	-0.8	-0.5	-0.2	-0.2
Nonfinancial public sector debt 7/	95.4	86.3	78.7	71.4	66.5	62.5	58.3	54.5
External sector								
Export value (percent change)	9.8	3.7	10.0	7.0	6.8	6.8	6.0	4.9
Import value (percent change)	8.0	7.4	9.4	7.0	6.5	6.3	5.5	5.5
Trade balance	-6.6	-7.7	-6.8	-6.3	-5.8	-5.5	-5.2	-5.1
Current account	1.9	2.4	2.4	1.6	1.5	1.4	1.3	1.1
FDI (net, US$ billions)	0.1	1.0	1.2	1.3	1.2	1.2	1.2	1.2
Reserves, adjusted (US$ billions) 8/	15.2	18.0	21.9	24.0	26.3	28.7	31.3	33.6
Reserves / Short-term liabilities, adjusted 9/	122.9	133.0	160.7	162.2	172.6	180.2	188.5	193.7
Gross external financing requirements (US$ billions) 10/	12.5	11.0	11.2	11.8	12.9	13.3	14.0	15.8
Monitored external debt 11/	69.6	63.8	55.9	48.9	44.1	41.0	38.7	36.4
Debt service ratio (in percent of exports of G&S)	19.7	18.5	19.8	19.4	20.4	19.9	19.5	21.7

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

1/ "Additional reforms" scenario allows for higher capital spending, financed by additional revenue measures, including rationalization of tax incentives, indexation of excises to inflation, and stronger tax administration.
2/ Defined as difference between gross investment and current account.
3/ Nonfinancial public sector includes the national government, CB-BOL, 14 monitored government-owned enterprises, social security institutions, and local governments.
4/ The sum of all nonfinancial public sector revenue net of intra-public sector payments. It is assumed that 80 percent of Bureau of Treasury revenue represents interest and dividends from other parts of the nonfinancial public sector. Privatization receipts are excluded.
5/ Defined as difference between nonfinancial public sector revenue and primary balance.
6/ Fund definition. Excludes privatization receipts of the national government, and includes net deficit from restructuring the central bank.
7/ Debt is consolidated (net of intra-nonfinancial public sector holdings of debt).
8/ Gross reserves less gold and securities pledged as collateral against short-term liabilities.
9/ 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.
10/ Defined as the current account deficit, plus amortization on medium- and long-term debt, plus short-term debt at the end of the previous period.
11/ 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 7. Philippines: Banking Sector Indicators, 1999–2006

(End of year unless otherwise indicated)

	1999	2000	2001	2002	2003	2004	2005	2006 Q1 Prel.
Capital adequacy								
Total capital accounts to total assets	14.5	13.6	13.6	13.4	13.1	12.6	12.0	12.5
Net worth-to-risk assets ratio	17.5	16.2	15.8	16.7	16.7	16.5	18.2	18.2
Capital adequacy ratio (solo basis) 1/	...	...	14.5	15.5	16.0	17.4	16.7	...
Capital adequacy ratio (consolidated basis) 1/	...	...	15.6	16.9	17.4	18.4	17.6	...
Asset quality								
NPL ratio 2/	14.6	16.6	19.0	16.6 9/	16.1	14.4	10.3	10.0
NPA ratio 3/	21.0	24.0	27.7	26.5 9/	26.1	24.7	20.0	19.9
Distressed asset ratio 4/	24.4	27.7	31.7	31.0 9/	30.9	28.6	23.5	23.2
NPL coverage ratio 5/	45.2	43.7	45.3	50.2 9/	51.5	58.0	73.8	73.3
NPA coverage ratio 6/	29.8	28.6	29.6	30.1 9/	30.9	33.2	39.2	38.7
Net NPL to total capital 7/	28.3	34.5	37.7	28.9 9/	27.4	21.0	9.4	9.2
Net NPA to total capital 8/	56.3	69.6	78.9	73.3 9/	72.4	65.4	47.6	47.4
Profitability								
Net interest income to average earning assets	4.5	3.9	3.8	3.8	3.7	4.2	4.6	4.5
Return on assets	0.4	0.4	0.4	0.8	1.1	0.9	1.1	1.1
Return on equity	2.9	2.6	3.2	5.8	8.5	7.1	8.7	9.2
Cost-to-income ratio 10/	72.2	81.8	80.7	71.4	68.9	69.8	66.8	66.8
Liquidity								
Liquid assets to total assets	26.4	29.0	30.0	32.3	32.3	36.6	36.3	35.2

Sources: Philippine authorities; and Fund staff calculations.

1/ Q3 data for 2005.
2/ Nonperforming loans (NPL) over total loan portfolio excluding interbank loans (TL).
3/ NPL plus "real and other properties owned or acquired" (ROPOA) over TL plus ROPOA.
4/ NPL plus ROPOA plus current restructured loans over TL plus ROPOA. Starting July 2004, performing restructured loans was usec
5/ Loan loss reserves over NPLs.
6/ Allowances for probable losses on NPAs over NPAs.
7/ NPL minus loan loss reserves over capital.
8/ NPA minus allowances for probable loss on NPAs over capital.
9/ Change in series largely due to new NPL definition in 2002.
10/ Operating expenses (net of bad debts and provisions) to total operating income.

Table 8. Philippines: Indicators of External Vulnerability, 2001–06
(In percent of GDP, unless otherwise indicated)

	2001	2002	2003	2004	2005	2006 Staff Proj.
External indicators (including external liquidity):						
Gross international reserves, adjusted (in billions U.S. dollars) 1/	13.2	14.3	14.7	15.2	18.0	21.9
Short-term debt (original maturity, in billions U.S. dollars)	9.1	8.0	8.2	7.9	8.0	8.4
Amortization of medium and long-term debt (in billions U.S. dollars)	4.9	5.4	5.9	5.4	6.0	5.6
Net FDI inflows (in billions of U.S. dollars)	0.3	1.5	0.2	0.1	1.0	1.2
FX deposits residents (in billions of U.S. dollars)	11.4	11.8	12.2	13.6	14.4	15.3 2/
Total gross external debt	81.6	77.7	78.8	69.6	63.8	55.9
Public sector indicators:						
Overall balance	-4.9	-5.7	-5.6	-5.0	-2.1	-1.8
Primary balance	1.3	0.1	0.7	1.6	4.3	4.2
Nonfinancial public sector debt (NFPSD)	87.4	93.7	100.8	95.4	86.3	78.7
NFPSD denominated in FX or linked to the exchange rate (in percent of NFPSD)	65.8	65.9	67.8	65.9	60.9	57.5
Short-term general government debt (original maturity, in percent of NFPSD)	17.5	14.1	14.5	15.4	16.6	17.5
Average effective interest rate of government debt (in percent)	7.1	6.2	6.3	6.9	7.4	7.7
Amortization of total debt	22.3	21.6	23.2	23.1	22.3	22.5

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

1/ Gross reserves less gold and securities pledged as collateral against short-term liabilities.
2/ As of June, 2006.

Table 9. Philippines: Indicators of Financial Obligations to the Fund, 2002–09

	2002	2003	2004	2005	2006	2007	2008	2009
					Projections			
Fund repurchases and charges								
In millions of U.S. dollars	461.8	653.0	502.3	347.9	205.0	198.2	32.0	0.0
In percent of exports of goods and services	1.2	1.7	1.2	0.8	0.4	0.4	0.1	0.0
In percent of total debt service due	6.2	8.2	5.9	4.2	2.2	1.9	0.3	0.0
In percent of quota	40.5	53.0	38.5	26.8	15.8	15.1	2.4	0.0
In percent of adjusted gross official reserves	3.2	4.4	3.3	1.9	0.9	0.8	0.1	0.0
Fund credit outstanding								
In millions of U.S. dollars	1606.4	1128.8	721.2	402.1	223.9	31.4	0.0	0.0
In percent of quota	140.9	91.6	55.3	30.9	17.2	2.4	0.0	0.0
In percent of GNP	2.0	1.3	0.8	0.4	0.2	0.0	0.0	0.0
In percent of total external debt	2.7	1.8	1.2	0.7	0.3	0.0	0.0	0.0
Memorandum item:								
US$/SDR Period average	1.295	1.401	1.481	1.478	1.475	1.497	1.502	1.507

Source: Fund staff projections.

ANNEX I. PHILIPPINES: DEBT SUSTAINABILITY ANALYSIS

The sustainability of the Philippines' public sector debt depends largely on the strength of future reforms:

- **Currently identified measures.** The "currently identified measures" scenario (Table 5) is considered the baseline for the Debt Sustainability Analysis (Table A1). This scenario assumes that the recent fiscal gains are sustained, but no new measures are introduced over the medium term. In this scenario, the nonfinancial public sector (NFPS) debt will decline, but will remain high at 63 percent of GDP in 2011. The scenario assumes average real GDP growth of 5.5 percent over 2006-11 and a gradual deterioration of the primary surplus. While the debt dynamics are favorable overall, they remain vulnerable to shocks, especially to the exchange rate and, to a lesser extent, growth.

- **Additional reforms.** Under staff's recommended scenario (Table 6), reforms are assumed to continue after 2006, including full implementation of tax administration reform, indexation of excises to inflation, and a revenue-positive rationalization of tax incentives. In such a world, public sector debt would be placed on a steeper downward path. This scenario assumes that primary surpluses will remain high, improving the debt dynamics both directly and indirectly, with improved confidence and higher private sector investment raising average real GDP growth to 6 percent.

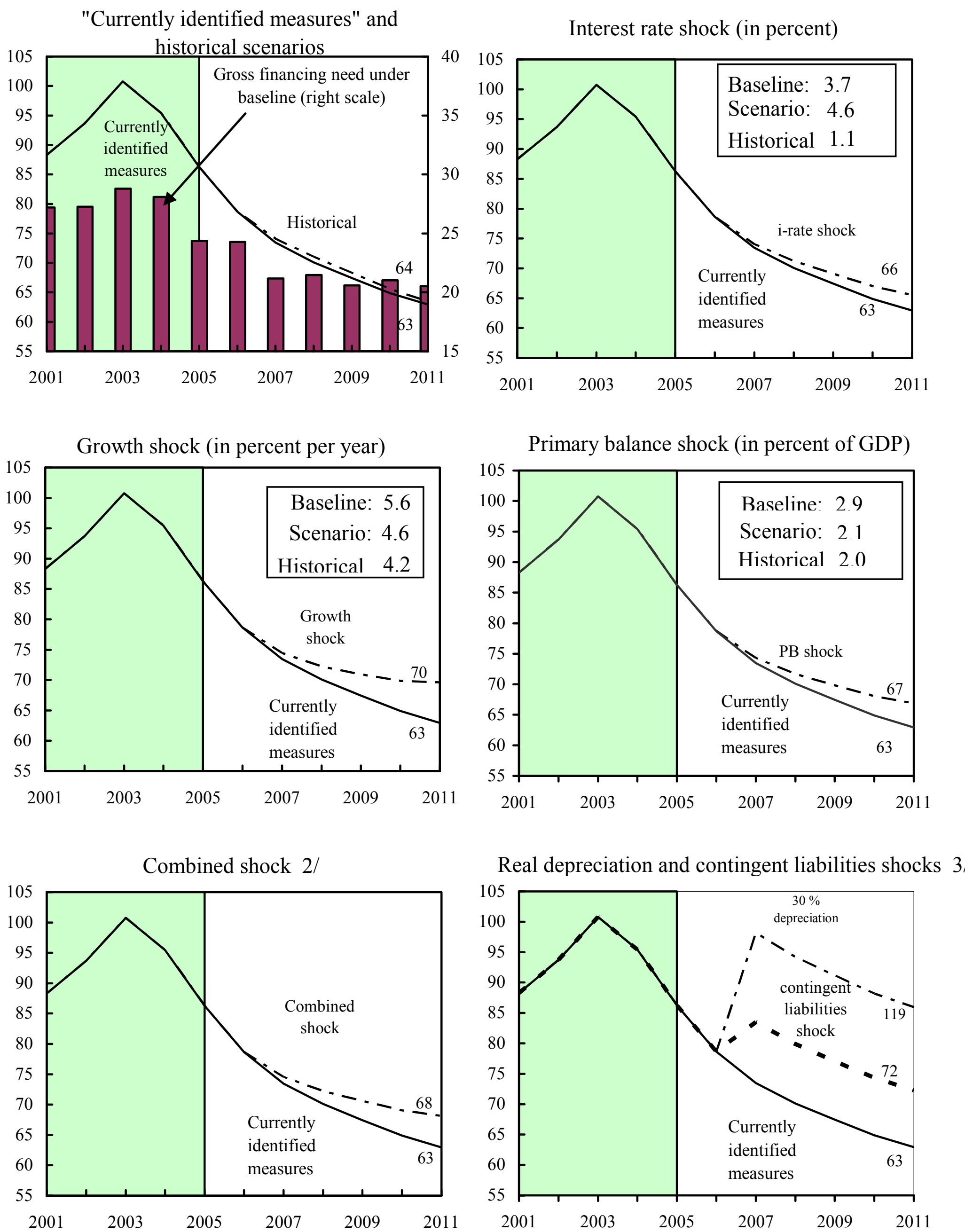
The reduction in external vulnerabilities is largely driven by the extent to which the National Government reduces its dependence on external financing. In the "currently-identified measures" scenario, external debt is envisaged to fall to about 40 percent of GDP by 2011, compared with 36.4 percent of GDP in the "additional reforms" scenario, where the deficit reduction envisaged is greater. As the stress tests show, the external debt trajectory is most sensitive to a sharp one-time nominal depreciation in the exchange rate (for example, if there were a shock similar to the period in 2000-2001). Furthermore, if: (1) the current account reverts to a deficit (for example, due to a strong shock to global growth that slows export growth and remittances), and/or (2) the economy experiences a growth shock stronger than the standard stress tests envisage, the external debt dynamics would look considerably less favorable.

Table A1. Philippines: Public Sector Debt Sustainability Framework, 2001-2011
(In percent of GDP, unless otherwise indicated)

		Actual					Projections						
		2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	**Debt-stabilizing primary balance 10/**
1	**Currently identified measures scenario: Public sector debt 1/**	88.3	93.7	100.8	95.4	86.3	**78.7**	**73.3**	**69.8**	**67.2**	**64.7**	**63.0**	**-0.4**
	o/w foreign-currency denominated	57.5	61.7	68.3	62.9	52.6	45.3	41.6	38.4	36.1	32.8	29.9	
2	Change in public sector debt	-0.7	5.4	7.1	-5.3	-9.2	-7.6	-5.4	-3.5	-2.6	-2.5	-1.7	
3	Identified debt-creating flows (4+7+12)	-1.3	0.0	1.2	-5.9	-10.7	-6.9	-5.0	-4.5	-3.9	-3.7	-3.4	
4	Primary deficit	-1.3	-0.1	-0.7	-1.6	-4.3	-4.2	-3.4	-3.1	-2.9	-2.7	-2.5	
5	Revenue and grants 2/	23.0	20.9	20.9	20.5	22.1	22.8	22.4	22.3	22.0	21.9	21.7	
6	Primary (noninterest) expenditure	21.7	20.8	20.1	19.0	17.8	18.5	19.0	19.2	19.1	19.2	19.2	
7	Automatic debt dynamics 3/	0.6	0.2	1.4	-3.9	-6.8	-2.9	-1.9	-1.6	-1.1	-1.2	-1.1	
8	Contribution from interest rate/growth differential 4/	-0.6	-1.6	-1.3	-4.7	-3.4	-2.9	-1.9	-1.6	-1.1	-1.2	-1.1	
9	Of which contribution from real interest rate	0.9	2.0	2.9	0.8	0.8	1.0	2.0	2.1	2.5	2.4	2.2	
10	Of which contribution from real GDP growth	-1.4	-3.6	-4.2	-5.5	-4.3	-3.9	-3.8	-3.7	-3.6	-3.5	-3.4	
11	Contribution from exchange rate depreciation 5/	1.2	1.8	2.7	0.8	-3.3	...	...	...	...	...	...	
12	Other identified debt-creating flows	-0.6	-0.1	0.6	-0.4	0.4	0.2	0.2	0.2	0.2	0.2	0.2	
13	Privatization receipts (negative)	0.0	0.0	0.0	0.0	0.0	0.0	0.0	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)	-0.6	0.0	0.6	-0.4	0.4	0.2	0.2	0.2	0.2	0.2	0.2	
16	Residual, including asset changes (2-3) 6/	0.6	5.4	5.8	0.6	1.6	-0.7	-0.3	1.0	1.3	1.2	1.7	
	Public sector debt-to-revenue ratio 1/	383.5	448.1	483.0	465.1	390.3	345.2	327.7	313.8	305.6	295.3	289.8	
	Gross financing need 7/	27.2	27.3	28.8	28.1	24.4	24.3	21.0	21.3	20.4	20.9	20.5	
	in billions of U.S. dollars	19.4	20.9	22.9	24.4	24.0	28.4	28.2	32.1	33.9	38.2	40.5	
	Scenario with key variables at their historical averages 8/						**78.7**	**74.1**	**71.0**	**68.4**	**65.7**	**63.6**	**-1.2**
	Additional reforms scenario						**78.7**	**71.4**	**66.5**	**62.5**	**58.3**	**54.5**	
	Key Macroeconomic and Fiscal Assumptions Underlying Baseline												
	Real GDP growth (in percent)	1.8	4.4	4.9	6.2	5.0	5.0	5.4	5.6	5.7	5.8	5.7	5.5
	Average nominal interest rate on public debt (in percent) 9/	7.6	7.2	7.3	7.3	7.5	7.8	7.9	8.0	8.1	8.1	8.0	
	Average real interest rate (nominal rate minus change in GDP deflator, in percent)	1.2	2.7	3.6	1.3	1.3	1.6	3.1	3.5	4.1	4.1	4.0	
	Nominal appreciation (increase in US dollar value of local currency, in percent)	-2.7	-3.2	-4.5	-1.2	6.0	...	...	...	...	...	...	
	Inflation rate (GDP deflator, in percent)	6.4	4.5	3.8	6.0	6.2	6.2	4.9	4.5	4.0	4.0	4.0	
	Growth of real primary spending (deflated by GDP deflator, in percent)	-0.9	0.0	1.5	0.1	-1.5	9.4	8.1	6.5	5.2	6.4	6.1	
	Primary deficit	-1.3	-0.1	-0.7	-1.6	-4.3	-4.2	-3.4	-3.1	-2.9	-2.7	-2.5	

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). Data on local government debt are not available for 2001; it is assumed that these debts were the same as a share of GDP as in 2002.
2/ Revenue is the sum of all nonfinancial public sector revenue net of intra-public sector payments. It is assumed that 80 percent of Bureau of Treasury revenue represents interest and dividends from other parts of the nonfinancial public sector.
3/ Derived as $[(r - \pi(1+g) - g + \alpha\varepsilon(1+r)]/(1+g+\pi+g\pi))$ 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).
4/ 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.
5/ The exchange rate contribution is derived from the numerator in footnote 2/ as $\alpha\varepsilon(1+r)$.
6/ For projections, this line includes exchange rate changes.
7/ Defined as public sector deficit, plus amortization of medium and long-term public sector debt, plus short-term debt at end of previous period.
8/ The key variables include real GDP growth; real interest rate; and primary balance in percent of GDP.
9/ Derived as nominal interest expenditure divided by previous period debt stock.
10/ Assumes that key variables (real GDP growth, real interest rate, and other identified debt-creating flows) remain at the level of the last projection year.

Figure A1. 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 "currently identified measures" 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 2006, 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, 2001-2011
(In percent of GDP, unless otherwise indicated)

	Actual					Projections						
	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	**Debt-stabilizing non-interest current account 6/**
Currently identified measures: External debt	81.6	77.7	78.8	69.6	63.8	**55.9**	**50.4**	**46.2**	**43.3**	**41.1**	**39.5**	**-0.4**
Change in external debt	6.0	-3.9	1.1	-9.3	-5.7	-7.9	-5.5	-4.2	-2.9	-2.2	-1.6	
Identified external debt-creating flows (4+8+9)	6.8	-7.7	-3.9	-9.0	-13.1	-7.0	-5.6	-4.9	-4.3	-3.6	-3.4	
Current account deficit, excluding interest payments	-1.6	-2.8	-3.6	-4.8	-5.7	-5.7	-5.2	-4.6	-4.1	-3.5	-3.8	
Deficit in balance of goods and services	12.0	9.8	9.8	8.6	9.1	7.4	6.8	6.5	6.2	6.0	5.9	
Exports	48.3	49.3	48.6	49.4	45.4	42.6	39.1	36.7	35.1	33.4	32.4	
Imports	60.3	59.1	58.4	58.0	54.5	50.0	45.9	43.2	41.3	39.4	38.3	
Net non-debt creating capital inflows (negative)	-0.7	-2.2	-0.8	-0.7	-2.5	-1.9	-1.2	-1.1	-0.9	-0.8	-0.7	
Automatic debt dynamics 1/	9.0	-2.7	0.5	-3.5	-5.0	0.6	0.9	0.8	0.8	0.7	1.1	
Contribution from nominal interest rate	4.0	3.3	3.2	2.9	3.3	3.3	3.5	3.3	3.2	3.0	3.3	
Contribution from real GDP growth	-1.4	-3.4	-3.7	-4.5	-3.0	-2.7	-2.6	-2.5	-2.4	-2.3	-2.2	
Contribution from price and exchange rate changes 2/	6.4	-2.6	0.9	-2.0	-5.2	...	...	...	...	...	...	
Residual, incl. change in gross foreign assets (2-3) 3/	-0.7	3.8	5.1	-0.3	7.4	-0.9	0.1	0.7	1.4	1.5	1.7	
External debt-to-exports ratio (in percent)	169.1	157.8	162.1	140.8	140.4	131.2	128.9	125.7	123.3	123.1	122.0	
Gross external financing need (in billions of US dollars) 4/	13.8	14.3	13.1	12.5	11.0	11.2	11.7	13.4	14.3	15.7	17.5	
in percent of GDP	19.4	18.7	16.5	14.4	11.2	9.6	8.7	8.9	8.6	8.6	8.9	
Scenario with key variables at their historical averages 5/						**55.9**	**55.4**	**54.2**	**52.5**	**51.0**	**48.9**	**-1.3**
Additional reforms scenario						**55.9**	**48.9**	**44.1**	**41.0**	**38.7**	**36.4**	
Key Macroeconomic Assumptions Underlying Baseline												
Real GDP growth (in percent)	1.8	4.4	4.9	6.2	5.0	5.0	5.4	5.6	5.7	5.8	5.7	
GDP deflator in US dollars (change in percent)	-7.8	3.3	-1.2	2.5	8.1	13.2	8.9	6.5	4.0	4.0	2.0	
Nominal external interest rate (in percent)	5.0	4.3	4.3	4.1	5.4	6.1	7.2	7.4	7.6	7.6	8.6	
Growth of exports of G&S (US dollar terms, in percent)	-16.7	10.0	2.4	10.6	4.3	11.4	5.5	5.6	5.0	4.7	4.5	
Growth of imports of G&S (US dollar terms, in percent)	7.7	5.7	2.6	8.1	6.6	8.9	5.4	5.9	5.1	4.9	4.8	
Current account balance, excluding interest payments	1.6	2.8	3.6	4.8	5.7	5.7	5.2	4.6	4.1	3.5	3.8	
Net non-debt creating capital inflows	0.7	2.2	0.8	0.7	2.5	1.9	1.2	1.1	0.9	0.8	0.7	

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 US 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).

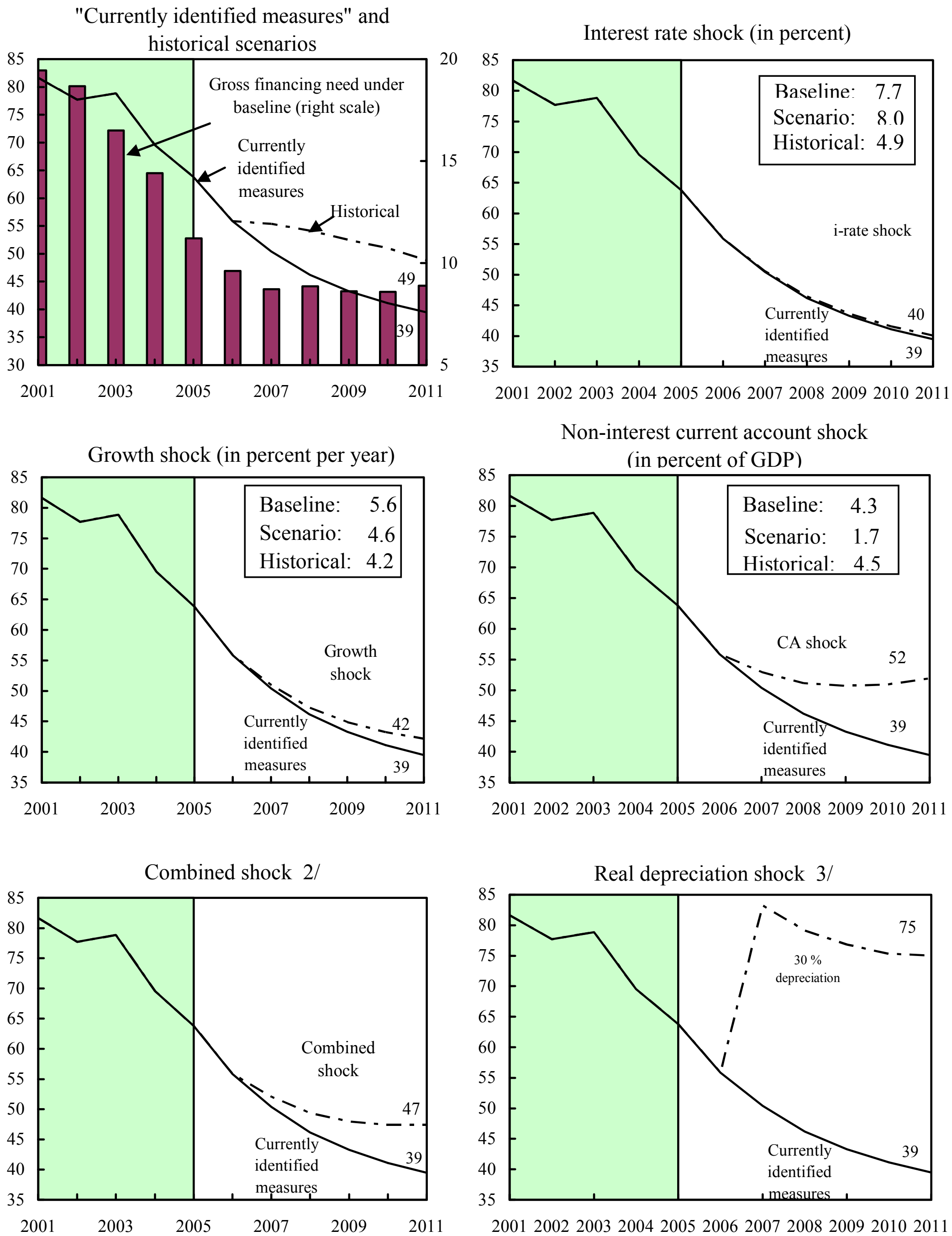
3/ For projection, line includes the impact of price and exchange rate changes.

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 non-interest current account and non-debt inflows in percent of GDP.

6/ Long-run, constant balance that stabilizes the debt ratio assuming that key variables (real GDP growth, nominal interest rate, dollar deflator growth, and non-debt 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 "currently identified measures" 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 2006.

ANNEX II. PHILIPPINES: FUND RELATIONS
(As of August 31, 2006)

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	959.14	109.01
Reserve position in Fund	87.55	9.95

III. **SDR Department:**	SDR Million	% Allocation
Net cumulative allocation	116.60	100.00
Holdings	0.37	0.32

IV. **Outstanding Purchases and Loans:**	SDR Million	% Quota
Extended arrangements	166.78	18.95

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

The Philippines is expected to continue to engage in post-program monitoring with the Fund until April 30, 2007.

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

	Forthcoming				
	2006	2007	2008	2009	2010
Principal	20.50	125.78	20.50	...	...
Charges/Interest	3.23	9.11	5.00	4.54	4.54
Total	23.72	134.90	25.49	4.54	4.54

VII. **Exchange Arrangement:**

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

VIII. **Article IV Consultation:**

The Philippines is on the standard 12-month cycle. The 2005 Article IV Consultation was discussed by the Executive Board on February 13, 2006. At that time, Directors commended the authorities for steadying the economic ship after the political turbulence in mid-2005 and for regaining momentum on their reform agenda – as evidenced by the sharp reduction in power sector losses and the full implementation of the landmark VAT reform law. They welcomed the large reduction in the public sector fiscal deficit in 2005. These policies have helped to turn around investor sentiment, boost market confidence, and strengthen the peso.

IX. **FSAP and ROSC Participation:**

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

FAD: Discussions on fiscal transparency were held in Manila in September 2001. The ROSC report was discussed by the Executive Board in September 2002 together with the Article IV staff report, and published in October 2002. The update to the ROSC report was published in June 2004.

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

X. **Technical Assistance:**

An MFD 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 MFD mission visited Manila in February 2005 to review the payment systems, central bank accounting, and government bond market development. Another mission took place in July 2006 to review the regulation and infrastructure of the domestic debt market.

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

An FAD mission to provide a briefing to the new tax commissioner took place in April–May 2001. An FAD mission reviewed VAT and excise administration in December 2001. An FAD staff member participated in the July 2004 PPM mission to evaluate and advise 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 in June-July 2006, the first in a program of 8 or 9 visits to help the Tax Reform Administration Group to implement the reform agenda.

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

XI. **Resident Representative:**

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

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

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

Statement by Jong Nam Oh, Executive Director for the Philippines and Cyd Amador, Senior Advisor to the Executive Director October 11, 2006

Our authorities appreciate the comprehensive report of the staff, which draws upon the robust policy dialogues between them. Of particular value to our authorities are the lessons from cross-country experiences that the Fund staff brings to the discussions, which leverage on the Fund's expertise as a multilateral institution. The IMF has been fully engaged in the Philippines, with interactions ranging from regular consultations to highly valued technical assistance and visits by Fund management. Fund advice has contributed to more informed policy discussions and has heightened the public's appreciation of the benefits of reform, helping to strengthen the buy-in for sound policies.

Economic resilience is due to disciplined policies and sound reforms.

The economy has continued to grow briskly, expanding by 5.6 percent in the first half of 2006. Inflation is declining and inflation expectations are well-contained. The fiscal deficit reduction strategy remains on track, with palpable gains in revenue collection. The stronger external payments position provides a cushion to transitory shocks and downside risks. The peso has strengthened to its highest level since 2002 and sovereign bond spreads have tightened. Positive market sentiment has helped boost capital inflows. The authorities have taken advantage of these favorable conditions to build international reserves and improve the debt structure.

This encouraging performance testifies to the authorities' pursuit of disciplined and stability-oriented macroeconomic policies as well as much-needed structural reforms. Yet, for the authorities, the steady stream of positive news has underscored that more needs to be done to solidify recent economic gains and spread out their benefits for a more-inclusive and participatory development. They continue to move on a broad front to build a strong track record of sound macroeconomic management and reinforce this with reforms that would, among other things, advance power sector restructuring, strengthen the financial system, as well as reduce the large debt stock and external borrowing requirements, which are potentially critical pressure points.

Sustaining prudent monetary and external sector policies is key to continued strong growth.

Inflation has moderated to 5.7 percent in September from this year's high of 7.6 percent. It is seen to slow over the course of the year given the cumulative effects of past monetary policy actions, still-restrained domestic demand, the peso appreciation and well-anchored inflation expectations. Headline inflation is expected to be within target in 2007. The obvious inflation risk comes from high oil prices as there is full pass-through of global prices into domestic prices. The impact is expected, however, to be partly absorbed by the stronger peso.

After a round of policy-tightening in 2005, the BSP has kept so far this year a steady hand in monetary policy while maintaining a watchful eye on potential inflationary pressures to pre-emptively forestall a rise in inflation. The authorities are well aware that containing inflation is critical to economic growth and poverty reduction.

The external sector is a source of strength for the economy. Remittances have been robust, exports have been performing well and capital inflows have been strong, driven in part by upbeat market sentiment. The external position is well-supported by the flexible exchange rate policy, with the appreciation of the peso over the past year reflecting the strong macroeconomic fundamentals.

The favorable external position has allowed the authorities to be opportunistic in building international reserves, thus reducing the economy's sensitivity to the moods and swings of global markets. As of end-August, foreign reserves rose to US$21.5 billion. This level is a new high for the Philippines and compares comfortably when viewed against international reserve adequacy benchmarks. The authorities have also used the favorable global financing conditions to refinance more expensive debt and retire some short-term debt, including more than half of the outstanding Brady bonds. As a result, outstanding external debt has declined and the external debt service ratio has improved.

Fiscal policy is focused on achieving fiscal consolidation and strengthening the quality of adjustment.

Efforts to improve the fiscal health have continued to deliver positive results. This is evident in the rise in the revenue effort to 15.1 percent in 2005, reversing the previous trend. This is expected to rise further, given the 20 percent increase in revenues for the first eight months of 2006 compared to the level a year ago. Revenue from the recent VAT reform has exceeded expectations thus far, a welcome proof of its successful implementation. These developments come in the wake of the better-than-expected 2005 National Government (NG) deficit outturn.

For 2006, the target for the NG deficit is 2.1 percent of GDP, but an overperformance is likely as revenue targets will probably be exceeded due to strong VAT receipts and tax administration reforms as well as because of continued spending restraint, in part as the government is working with a re-enacted budget. All eyes continue to be on the deficit meter and the target is to achieve a balanced budget for the NG by 2008. A balanced consolidated public sector position is also envisaged in the medium term on the back of improved performance by government-owned and controlled corporations (GOCCs), social security institutions and local governments. Over time, this is expected to lead to a material reduction in the public debt burden. Already, at end-2005, the public sector debt dropped to 93.4 percent of GDP, the first time since 1998 that the ratio has been below 100 percent. It has further declined to 89 percent at end-March this year. The authorities are well aware that this ratio is still high, and they remain committed to fiscal discipline and sound debt management for the long haul.

Fiscal consolidation will require further decisive actions to strengthen tax administration, contain the deficits of public enterprises, and broaden the tax base. The authorities intend to build on their efforts to improve the efficiency of tax administration. This year, the government has implemented the lateral attrition law, which provides a mechanism to dismiss underperforming revenue officials and grant incentives to those who overperform. The performance of revenue agencies is under stringent review, and the crackdown on tax leakages and evasion is ongoing. Measures in train include the use of benchmarking, tax mapping, third party information, and computer-assisted audits. A reform administration group has been established at the Bureau of Internal Revenue to assist in the identification, prioritization and implementation of tax reforms. Nation-wide information campaigns are helping to inculcate the benefits of tax reforms. Technical assistance from the Fund, the World Bank and other donors is helping the Philippines draw on international best practices to strengthen tax collection.

Stronger fiscal oversight is being exercised over GOCCs, including through close review of their financial performance and operations as well as strengthening of management. Performance contracts, which will contain clear and measurable deliverables for public enterprises, are being considered. The reform of GOCCs is an integral part of the strategy to achieve fiscal consolidation and strengthen debt sustainability.

The government is keen to get the most value for money from the resources generated from the fiscal reforms. It continues to pursue prudent spending while improving the efficiency of public service delivery. Higher revenues also enable deeper fiscal adjustment and a pick-up in developmental spending. The Department of Finance has reported that for the first half of 2006 about a quarter of the incremental revenue from the VAT reform was used to fund social services and infrastructure projects. The authorities are hopeful that greater transparency and accountability in the use of VAT receipts will raise taxpayer confidence in the government, leading to higher compliance and improved tax take.

Looking ahead, the authorities plan to ratchet up public investment in infrastructure and funnel more funds to social programs such as housing, social services, health and education so that all segments of the population can benefit in lock step from the economy’s growth. Better infrastructures will make the economy more competitive, create job opportunities and lift growth. Well-targeted increases in social spending will help reduce marginalization, allowing broader-based and more meaningful participation in the economy. To help improve program implementation, the government is considering the adoption of multi-year budgeting for the efficient and predictable allocation of public funds.

A fundamental improvement in the government’s long-term revenue-mobilizing capacity is also contingent on expanding the tax base. In this regard, the government is considering the rationalization of fiscal incentives, which seeks to harmonize various incentive laws with a view to ensuring that incentives are fiscally sustainable as well as economically justifiable.

Putting public finances on a sustainable footing and improving the country's debt dynamics are at the heart of the authorities' fiscal consolidation strategy. They continue to strengthen cash flow and liability management, including through bond exchanges, to reduce borrowing costs, stretch debt maturity, build a more diversified institutional base and further develop the capital market. Greater reliance is being placed on domestic borrowing relative to foreign borrowing, enhancing resilience in withstanding external shocks.

To foster growth, the authorities are keeping the ground fertile with structural reforms.

Structural reforms are key to enhancing efficiency, increasing flexibility, and strengthening the foundations for long-term vibrant growth. The authorities recognize that it is particularly important to push reforms aimed at strengthening the business climate, improving financial intermediation, and restructuring the energy sector. Well aware of the centrality of good governance in investment decisions, the authorities are taking steps to improve the investment environment and reduce the regulatory burden. A comprehensive anti-corruption strategy is in place, which includes better standards for public tendering and procurement and a stronger Office of the Ombudsman.

Financial reforms are at the center of efforts to promote development. The financial system remains sound, with the banking sector posting modest expansion in assets and deposits, and a rise in profitability. Lending growth, however, remains weak, in part because of low corporate demand and banks' aversion to credit risk due to the overhang of non-performing loans (NPL). The authorities are hopeful that the strengthening of risk management and the reduction in the stock of bad debts will promote stronger lending growth over the medium term. Efforts to compel banks to take more aggressive steps to offload impaired assets have helped reduce the NPL ratio to 7.5 percent as of end-July 2006 compared to the peak of 18.3 percent in 2002. With the recent two-year extension of the incentives offered by the SPV law, the expectation is that asset quality ratios will be brought closer to pre-crisis levels. Other important reforms involve the realignment of local regulations with international standards, particularly those pertaining to corporate governance, financial reporting, risk management and capital adequacy. The BSP is also steadily progressing with its Basel II implementation roadmap. It also continues to bolster the prudential framework to ensure that risks are well-monitored and contained, including by continuing to push for the passage of amendments to its charter that would, among other things, provide legal protection for bank supervisors.

Enhancing the efficiency of saving and investment decisions also requires deepening the capital market. Some important measures have been taken to create a sound market infrastructure, enhance transparency and market discipline, and promote greater investor protection. In March last year, the Fixed Income Exchange, which paves the way for a more transparent system of trading bonds and other securities in the secondary market, was launched. The third party custodianship for securities, which is aimed at proper delivery, accounting and monitoring of all purchased securities, was also implemented last year. Reforms will also be directed at enhancing capital market development, including through the creation of a centralized credit information bureau, establishment of retirement saving vehicles, and passage of the Corporate Recovery Act. As in tax administration, capital market reform in the Philippines is benefiting considerably from technical assistance from the Fund.

Measurable progress has been achieved in power sector restructuring through the adjustment of electricity tariffs, removal of cross subsidies and recently the launch of the wholesale electricity spot market. Advances have also been made in achieving greater energy independence, with the further development of alternative and renewable energy sources. The National Power Corporation (NPC), the power utility, has emerged from seven years of losses, posting a small profit in 2005 as a result of rate adjustments, lower interest expense, and the stronger peso. Our authorities accord high priority to sustaining NPC's good financial performance in 2006 and beyond.

The government continues to press ahead with the challenging task of privatizing its power assets, and it is hopeful that faster progress can be made this year as it works to resolve issues on supply contracts and other related concerns. Looking ahead, the implementation of the wholesale electricity spot market and the successful sale of the National Transmission Co. (Transco)—with bidding expected next month—would help spur reforms in the energy sector and make it more efficient. Interest in Transco assets has risen with the determination by the Energy Regulatory Commission of the basis for the transmission cost that can be passed on to end-users, allowing bidders to forecast better their prospective revenue streams. Before the year ends, the government is also eyeing the sale of some subtransmission assets as well as a number of hydroelectric and geothermal plants.

Concluding remarks

Sound monetary, fiscal and structural policies have had a salutary effect on the economy. The key challenge will be to lock in the recent gains while moving the economy to a higher growth path to reduce poverty and improve living standards. The authorities are committed to fiscal prudence and supportive monetary policies. They also intend to tackle policy challenges boldly through purposeful reforms to strengthen the institutional underpinnings of policies, improve productivity and boost international competitiveness.

INTERNATIONAL MONETARY FUND
Public Information Notice
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International Monetary Fund
700 19th Street, NW
Washington, D. C. 20431 USA

IMF Executive Board Concludes Mid-2006 Post-Program Monitoring Discussions with the Philippines

On October 11, 2006, the Executive Board of the International Monetary Fund (IMF) concluded the Mid-2006 Post-Program Monitoring discussions on the Philippines based on the information available through that date.[1]

Background

Considerable progress has been made with reforms, despite significant obstacles. Implementation of the far-reaching package of economic reforms launched in 2004 was initially slow due in part to political events. At the same time, surging international oil prices threatened to derail the extension of VAT to energy products, a key component of the fiscal reforms. Nevertheless, the non-financial public sector deficit was cut to 2 percent of GDP in 2005, 3½ percentage points below the 2003 level, reflecting tight controls on government spending and a marked turnaround in the finances of the National Power Corporation following a series of tariff hikes. The VAT reform, which took full effect in February 2006, looks set to further reduce the deficit this year, and has the potential to permit much-needed increases in spending on social services and infrastructure. Steps have also been taken to strengthen the banking system.

GDP growth in the first half of the year was 5.6 percent, with growth in agriculture particularly strong. Despite higher oil prices and the VAT reform, private consumption has been the main growth driver, buoyed by rapid growth in remittances. While investment has remained weak, exports have rebounded from last year's poor showing. Inflation remains above the Bangko Sentral ng Pilipinas (BSP)'s inflation target of 4–5 percent for 2006, but this is due largely to base effects from oil shocks and the VAT rate hike, and inflation has been easing in recent months.

The national government deficit fell to P 147 billion (2.7 percent of GDP) in 2005, from 3.8 percent of GDP in 2004. Through August this year, the cumulative deficit was P 34.2 billion, P 46.6 billion lower than in the corresponding period in 2005 and substantially below the full year target of P 125 billion (2.1 percent of GDP). With revenue collection broadly on target, the faster-than-expected pace of adjustment stems from the deadlock over the 2006 Budget,

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[1] Post-Program Monitoring provides for frequent consultations between the Fund and members whose arrangements have expired but who continue to have Fund credit outstanding. Particular focus is placed in these consultations on policies that have a bearing on external viability.

which was not passed by Congress; as a result, the 2005 Budget has been re-enacted which has constrained spending. The authorities are making efforts to increase social and infrastructure spending, including through the supplemental budget.

The strong performance of remittances and exports has helped to insulate the current account from surging oil prices. There has also been a pick-up this year in foreign direct investment. The Philippine peso was negatively affected by the emerging market sell-off in mid-May, but has since recovered strongly. This has allowed the BSP to resume its accumulation of reserves, which adjusted for pledged assets reached $21.5 billion at end-August, up from $18.0 billion at end-2005. The authorities have also used the greater availability of foreign exchange to prepay short-term external debt.

A key challenge for the Philippine economy will be to sustain the reform momentum, which will help maintain the confidence of markets and insure against market volatility. On current policies, growth is expected to increase to 5½ percent in 2007, but could be significantly higher over the medium term on the back of additional reforms that put public debt on a steeper downward path and boost investor confidence and investment. The main downside risks to the outlook are a renewed surge in oil prices and a slowdown in the global economy.

Executive Board Assessment

Executive Directors commended the Philippine authorities for the strong macroeconomic performance—including robust growth, moderating inflation, and an improved external position—as well as the progress made in structural reforms. In particular, they welcomed the large fiscal adjustment in 2005 and the further decline in the fiscal deficit in prospect this year, aided by the VAT reform, which has also contributed to improving market confidence.
In addition, the oil price shock had been well-handled, and important steps are being taken to strengthen the banking sector.

While stronger fundamentals have made the Philippines more resilient and less vulnerable to shocks, Directors cautioned that important vulnerabilities remain. Although on a declining path, the public debt is still high, with external commercial borrowing requirements continuing to be sizeable. Against this backdrop, Directors encouraged the authorities to sustain fiscal consolidation and other reform efforts to ensure debt sustainability, maintain the confidence of markets, and spur investment and the rate of economic growth.

Directors were encouraged to see tax revenues this year running significantly ahead of GDP growth for the first time in a decade, due primarily to the VAT reform. They looked forward to further improvements in tax administration, in particular through full operationalization of the Bureau of Internal Revenue reform program that is being developed with donor assistance.

Directors judged the authorities' fiscal plans for the current year to strike a good balance between further adjustment and much-needed expansion in capital and social spending, financed by a portion of the proceeds from the VAT reform. Given that the 2006 budget was not passed by Congress, the authorities' efforts to increase priority infrastructure and social spending through a supplemental budget and the public enterprises are understandable. However, Directors emphasized that any off-budget expenditures should be transparent and well-contained.

Directors welcomed the authorities' plans to balance the budget by 2008, as well as to significantly increase social services and capital spending over the medium term. They observed, however, that achieving both objectives will require further increases in revenue. While strengthening tax administration has the potential to yield part of the needed additional resources, Directors were of the view that additional tax measures will also be needed for sustainable fiscal consolidation.

Directors considered the monetary policy stance to be appropriate, with risks to the inflation outlook being evenly balanced. While inflation is above target due to past oil price hikes and the VAT reform, there appears to be little evidence that supply shocks are having second-round effects, and inflation is expected to return to target in 2007. However, Directors concurred that the BSP should remain vigilant against possible price pressures.

In the banking sector, Directors were encouraged by progress made toward resolving the non-performing assets (NPA) problem, and looked forward to significant additional NPA sales facilitated by the extension of the Special Purpose Vehicle (SPV) framework. Directors also welcomed the recent consolidation in the banking industry and efforts by banks to raise new capital. Nonetheless, they urged the BSP to maintain pressure on banks to strengthen capital and pursue sound risk assessment practices. Raising capital will be particularly important for those banks that are shown to be undercapitalized based on new accounting standards, and in light of the pending introduction of Basel II. Directors stressed that any regulatory relief provided to banks that require time to comply with the new regulatory standards should be tied closely to clear and transparent recapitalization plans. To ensure full effectiveness of the strengthened regulatory framework, Directors encouraged the authorities to continue pressing for the passage of long-delayed amendments to the BSP Charter that would strengthen the legal protection for supervisors and increase their leverage over problem banks.

Directors supported the priority which the authorities are assigning to promoting financial market development. While the recent disruption in the trust industry carries lessons for investors, it has also highlighted the need to improve disclosure of risks and take better account of customer risk appetite. Directors considered recent debt swaps to be important for the development of the domestic debt market. They looked forward to progress with legislative initiatives designed to foster domestic financial market development, including measures to create a credit information bureau and promote retirement saving vehicles.

Directors regarded the sharp reduction in power sector losses since 2004 as a key achievement in the authorities' reforms. They emphasized that close monitoring of the National Power Corporation's (NPC) finances going forward will be essential to ensure that this improvement is maintained. While recognizing the challenges involved in power sector privatization, Directors underscored the importance of pressing ahead with the sale of power sector assets.

Public Information Notices (PINs) are issued, (i) at the request of a member country, following the conclusion of the Article IV consultation for countries seeking to make known the views of the IMF to the public. This action is intended to strengthen IMF surveillance over the economic policies of member countries by increasing the transparency of the IMF's assessment of these policies; and (ii) following policy discussions in the Executive Board at the decision of the Board. The Staff Report for the 2006 Article IV Consultation with Philippines is also available.

Philippines: Selected Economic Indicators, 2002-07

	2002	2003	2004	2005	2006	2007
					Staff proj. 1/	
Growth and prices (in percent change)						
GDP growth	4.4	4.9	6.2	5.0	5.0	5.4
CPI inflation (average)	3.0	3.5	6.0	7.6	6.7	5.0
Public finances (in percent of GDP)						
National government balance (authorities' definition)	-5.3	-4.6	-3.8	-2.7	-1.7	-1.9
National government balance 2/	-5.6	-4.9	-4.2	-3.0	-2.1	-2.3
Nonfinancial public sector balance 3/	-5.7	-5.6	-5.0	-2.1	-1.8	-2.3
Revenue and grants 4/	20.9	20.9	20.5	22.1	22.8	22.4
Expenditure 5/	26.6	26.4	25.5	24.2	24.6	24.6
Money and credit (in percent change)						
Broad money (M3)	9.5	3.3	9.2	9.0	12.3 6/	...
Interest rate (91-day Treasury bill, secondary market, end period, in percent)	5.9	6.5	8.4	6.4	6.2 7/	...
Credit to the private sector (net)	1.2	1.8	4.6	-1.5	-1.0 6/	...
Balance of payments (in percent of GDP)						
Trade balance	-7.2	-7.3	-6.6	-7.7	-6.8	-6.3
Current account balance	-0.5	0.4	1.9	2.4	2.4	1.7
Gross international reserves						
In billions of U.S. dollars	16.2	16.9	16.2	18.5	21.5 8/	...
Adjusted, in billions of U.S. dollars 9/	14.3	14.7	15.2	18.0	21.5 8/	...
Adjusted, in percent of short-term liabilities 10/	123.9	122.9	122.9	133.0	...	...

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

1/ Projections are based on currently identified measures.

2/ IMF definition. Excludes privatization receipts of the national government, and includes net deficit from restructuring the central bank.

3/ Includes the national government, Central Bank-Board of Liquidators, 14 monitored government-owned enterprises, social security institutions, and local governments.

4/ The sum of all nonfinancial public sector revenue net of intra-public sector payments. It is assumed that 80 percent of Bureau of Treasury revenue represents interest and dividends from other parts of the nonfinancial public sector. Privatization receipts are excluded.

5/ Defined as difference between nonfinancial public sector revenue and balance.

6/ As of June 2006.

7/ As of September 2006.

8/ At end-August 2006.

9/ In addition to monitoring the level of gross international reserves (GIR), the IMF also monitors Adjusted Reserves, which are calculated by subtracting from GIR the value of the BSP's foreign assets that have been pledged as collateral for short-term liabilities. These pledged assets (gold and other securities) remain foreign reserve assets of the BSP and so are considered part of GIR. However, they are not as readily usable as other components of GIR since pledged assets must be set aside while the short-term liabilities they secure remain outstanding.

10/ Short-term liabilities include medium- and long-term debt due in the following year, exclude loans backed by gold and securities pledged as collateral and include estimates of non-monitored debt.