

**Philippines: 2005 Article IV Consultation and Post-Program Monitoring Discussions—  
Staff Report; Staff Statement; Public Information Notice on the Executive Board  
Discussion; and Statement by the Executive Director for the Philippines**

Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. In the context of the 2005 Article IV Consultation and post-program monitoring discussions with the Philippines, the following documents have been released and are included in this package:

- the staff report for the 2005 Article IV consultation and post-program monitoring discussions, prepared by a staff team of the IMF, following discussions that ended on November 22, 2005, 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 January 19, 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 staff statement of February 13, 2006 updating information on recent developments.
- a Public Information Notice (PIN) summarizing the views of the Executive Board as expressed during its February 13, 2006 discussion of the staff report that concluded the Article IV consultation.
- a statement by the Executive Director for the Philippines.

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

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INTERNATIONAL MONETARY FUND

PHILIPPINES

**Staff Report for the 2005 Article IV Consultation and  
Post-Program Monitoring Discussions**

Prepared by the Asia and Pacific Department

(In consultation with other departments)

Approved by Masahiko Takeda and Michael Hadjimichael

January 19, 2006

- **The Article IV and Post-Program Monitoring (PPM) discussions were held in Manila during November 10-22.** The staff team comprised Messrs. Takeda (Head), Gordon, Singh, Brooks, Baqir (Resident Representative), Ishi (all APD), Seshadri (PDR), and Ms. Zakharova (FAD). Ms. Amador (OED) 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 Neri, Energy Secretary Lotilla, Socioeconomic Planning Secretary Santos, and several legislators including Senate President Drilon and House Speaker de Venecia, as well as with academics, financial market participants, and business representatives.
- **The 2004 Article IV Consultation discussions were concluded on March 7, 2005.** Executive Directors' views and comments can be found on <http://www.imf.org/np/sec/pn/2005/pn0535.htm>.
- **The Philippines has accepted the obligations of Article VIII**, Sections 2, 3 and 4 of the Fund's Articles of Agreement and maintains an exchange system free of restrictions on the making of payments and transfers for current international transactions.
- **The authorities are attempting to strengthen the statistical base, which suffers from several deficiencies that hamper surveillance.** The data ROSC published in August 2004 identified national accounts and balance of payments statistics as particularly weak. With STA assistance, the authorities have made progress in improving the nonfinancial public sector debt and balance of payments data.
- **The exchange arrangement is classified as an independent float.** The BSP intervenes on occasion in the spot and forward markets in order to smooth undue short-term fluctuations in the exchange rate and to build reserves for strategic purposes.
- **The Philippines is expected to engage in PPM through April 30, 2007.** The authorities see benefits from continuing PPM until the fiscal position strengthens further, even though outstanding borrowing from the Fund is down to 30 percent of quota. The next PPM mission is expected to take place in June 2006.

Contents		Page
Glossary of Abbreviations and Terms .....		3
Executive Summary.....		4
I. Introduction and Background .....		5
II. Recent Economic Developments .....		5
III. Report on the Policy Discussions .....		7
A. Managing Short-Term Vulnerabilities .....		8
B. Laying the Foundations for Higher Investment and Growth .....		9
IV. Staff Appraisal .....		15
Boxes		
1. The Status of Fiscal Reforms .....		18
2. The Pre-Need Industry .....		19
3. Assessing the Monetary Policy Stance .....		20
4. The Status of Power Sector Reforms .....		21
Figures		
1. External Developments, 2001-06.....		22
2. Domestic Developments, 1999-2006.....		23
3. Fiscal Sector, 1997-2006.. ..		24
4. Banking Sector, 1998-2005.. ..		25
Tables		
1. Selected Economic Indicators, 2002–06.....		26
2. National Government Cash Accounts, 2001–06.....		27
3. Balance of Payments, 2001–06.....		28
4. Monetary Survey, 2000–05.....		29
5. Medium-Term Outlook, 2003-10 (Reforms Proceed Scenario).....		30
6. Medium-Term Outlook, 2003–10 (Reform Stall Scenario).....		31
7. Banking Sector Indicators, 2000–05.....		32
8. Indicators of External Vulnerability 2000–05 .....		33
9. Indicators of Financial Obligations to the Fund, 2002-09 .....		34
Annexes		
I. Debt Sustainability Analysis.....		35
II. Fund Relations .....		40
III. Relations with the World Bank Group.....		43
IV. Relations with the Asian Development Bank .....		46
V. Statistical Issues .....		47
VI. Millennium Development Goals.....		51

## GLOSSARY OF ABBREVIATIONS AND TERMS

AML/CFT .....	Anti-Money Laundering/Combating Financing of Terrorism
BIR.....	Bureau of Internal Revenue
BOC .....	Bureau of Customs
BPO.....	Business Process Outsourcing
BSP .....	Bangko Sentral ng Pilipinas
CB-BOL.....	Central Bank-Board of Liquidators
ERC.....	Energy Regulatory Commission
EPIRA .....	Electric Power Industry Reform Act
FATF.....	Financial Action Task Force
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
MTPDP .....	Medium-Term Philippine Development Plan
NCCTs .....	Non-Cooperative Countries or Territories
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
PDIC .....	Philippine Deposit Insurance Corporation
PNB .....	Philippine National Bank
PPM.....	Post-Program Monitoring
SEC .....	Securities and Exchange Commission
SNIT.....	Simplified Net Income Taxation
SPV .....	Special Purpose Vehicle
SSIs .....	Social Security Institutions
SSS.....	Social Security System
TI.....	Transparency International
Transco.....	National Transmission Corporation
WESM.....	Wholesale Electricity Spot Market
y/y .....	Year-on-year

## EXECUTIVE SUMMARY

**Economic reforms have moved ahead.** The authorities have made important progress with reforms, most notably with a sharp reduction in power sector losses following large increases in generation tariffs, and with the passage of a landmark VAT reform law in May 2005. The reform momentum was interrupted in mid-2005 amid political turbulence. Since then, however, political uncertainties have receded and the reform momentum has been regained. A large reduction in the public sector fiscal deficit appears to have been achieved in 2005 and a further reduction is being targeted for 2006. Meanwhile, important steps have been taken to strengthen bank balance sheets, although power sector privatization has been delayed.

**The discussions took stock of the progress made in reducing short-term vulnerabilities and in laying the foundations for higher investment and growth.** The economy has displayed considerable resilience to the recent oil price shock and foreign reserves have been built up to a more comfortable level. However, the investment climate remains weak and the transition to a higher growth path is not yet assured.

### **The staff report makes the following recommendations:**

- the next critical milestone is to raise the VAT rate on schedule in February and to ensure that tax administration is strong enough to collect the new higher VAT liability;
- after the VAT reform, further fiscal measures will be needed to achieve the authorities' goal of balancing the budget over the medium term;
- recent increases in policy rates are welcome and monetary policy should remain vigilant against possible second-round effects of supply shocks;
- power sector privatization needs to be accelerated;
- priority should be given to passing long-overdue legislative amendments necessary to strengthen bank supervision.

**In sum, the challenge is to maintain the reform momentum.** Further financial and other structural reforms are needed to increase the low rate of domestic investment. If reforms were to stall, the adverse effects of a downward revision by markets of the Philippines' economic prospects could be substantial, and the opportunity to undertake fundamental economic reforms created by President Arroyo's 2004 election victory could close.

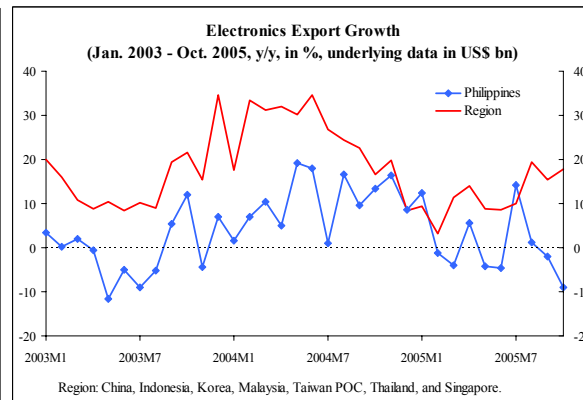
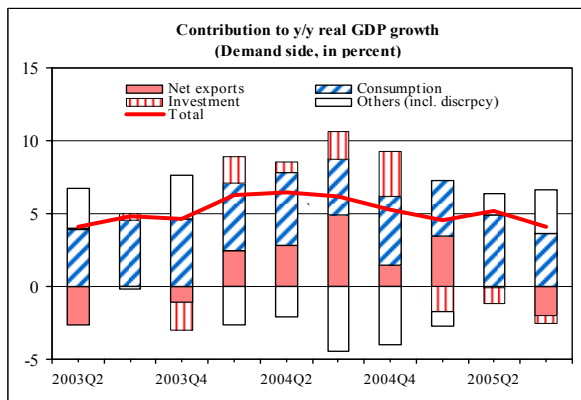
## I. INTRODUCTION AND BACKGROUND

1. **Since mid-2004, when the administration took office, economic reforms have moved ahead.** Two reforms stand out as particularly significant. First, power generation tariffs were raised so as to substantially cut the National Power Corporation (NPC)'s losses. Second, the VAT reform law was passed, with the first phase coming into effect in November 2005. Aided by tight curbs on government spending, the nonfinancial public sector (NFPS) deficit has been reduced from 5½ percent of GDP in 2003 to an expected 3¼ percent of GDP in 2005. If the second phase of the VAT reform, an increase in the VAT rate, occurs as scheduled in February, the NFPS deficit should fall further to 2¼ percent of GDP in 2006. In other sectors, important steps have been taken to strengthen bank balance sheets, but power sector privatization has been delayed.

2. **The challenge going forward will be to maintain the economic reform momentum.** Economic reforms were temporarily blown off course in mid-2005 by political turbulence following allegations of wrongdoing against the President. During this period, key members of the economic team resigned and the VAT reform was suspended by the Supreme Court. The authorities quickly regrouped and succeeded in keeping fiscal consolidation on track. Impeachment charges were dismissed by Congress in September, and political uncertainties have since receded. However, political events such as possible constitutional change are likely to absorb the attention of legislators during 2006. With vulnerabilities still high and the investment climate still weak, the remaining reforms should be pursued vigorously and without delay.

## II. RECENT ECONOMIC DEVELOPMENTS

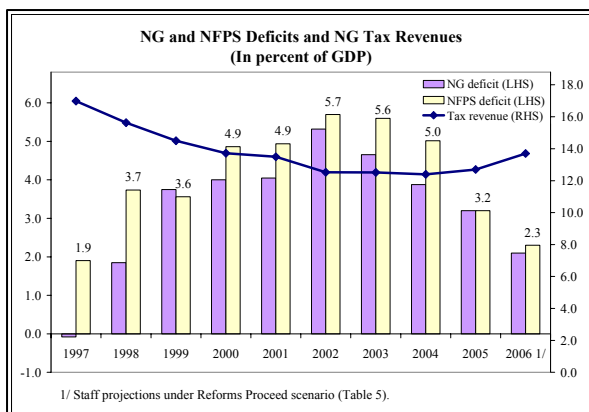
3. **Growth has slowed in 2005.** GDP grew by 4.6 percent y/y in the first three quarters of 2005, down from 6 percent in 2004. Weak exports and a decline in investment served as a drag on activity. Private consumption has been supported by surging remittances and, to date, has shrugged off the effects of high petroleum prices. On the production side, services such as business process outsourcing (BPO), telecommunication, and tourism remain key growth drivers. Job growth was limited to 2¼ percent in 2005, insufficient to substantially reduce unemployment, which remained high at 10.3 percent in the fourth quarter.



4. **The balance of payments has been in surplus.** Exports grew by only 2½ percent in the first 11 months of 2005 (y/y), weighed down by anemic electronics exports which are not benefiting from the regional recovery (Chart). Oil-related imports are estimated to have been

\$1.3 billion higher in 2005 than in 2004; however, this was offset by a decline in non-oil imports and a jump in remittances from overseas Filipino workers (OFWs). There have also been sizable equity inflows, while the government has successfully tapped sovereign bond markets, most recently with a \$2.1 billion issue in early January. Foreign reserves (adjusted for pledged assets) were \$18.0 billion at end-2005, \$2.8 billion above the end-2004 level.

5. **A sharp reduction in the fiscal deficit seems assured.** The National Government budget deficit is expected to have easily achieved the 2005 target of 3.4 percent of GDP. Tax revenues through November were up 15 percent (y/y), which, if sustained, will imply an increase in the tax to GDP ratio in 2005 after seven years of decline. By contrast, expenditure, especially on the capital budget, declined in real terms. The deficit of the 14 monitored Government Owned and Controlled Corporations (GOCCs) fell sharply, led by NPC, which is estimated to have cut its losses to ½ percent of GDP in 2005, a third of the 2004 level. Meanwhile, larger surpluses are expected for the social security institutions (SSIs) reflecting lower net lending and increased contributions, including from overseas workers. Taken together, these projections would imply an NFPS deficit of 3.2 percent of GDP in 2005, compared to 5.0 percent of GDP in 2004.



	2003	2004	2005	2006 1/
(In percent of GDP)				
<b>NFPS</b>	<b>5.6</b>	<b>5.0</b>	<b>3.2</b>	<b>2.3</b>
NG	4.7	3.9	3.2	2.1
SSIs	-0.4	-0.5	-0.7	-0.6
LGUs	-0.4	-0.3	-0.4	-0.2
GOCCs	1.5	1.8	0.8	0.8
Other	0.2	0.2	0.3	0.2

Source: Fund staff calculations.  
1/ Staff projections under Reforms Proceed scenario (Table 5).

6. **Markets have been volatile, but have reacted positively to the better fiscal news.** The stock market has risen by 8 percent in peso terms, and the peso has strengthened by 4 percent against the U.S. dollar, since the November 1 implementation of the first stage of the VAT reform.

7. **Inflation has risen, and monetary policy has been tightened.** Due in large part to the oil price shock, inflation rose to 8.5 percent in April 2005 y/y, but with base effects coming off, declined to 6.6 percent by December. Nonetheless, inflation averaged 7.6 percent in 2005, well above the target range of 5-6 percent. Monetary aggregates have grown at annual rates of 14 percent, driven primarily by the accumulation of net foreign assets. The authorities raised policy rates in April, September, and October (25 bps each to 7.50 percent), and also increased reserve requirements in July.

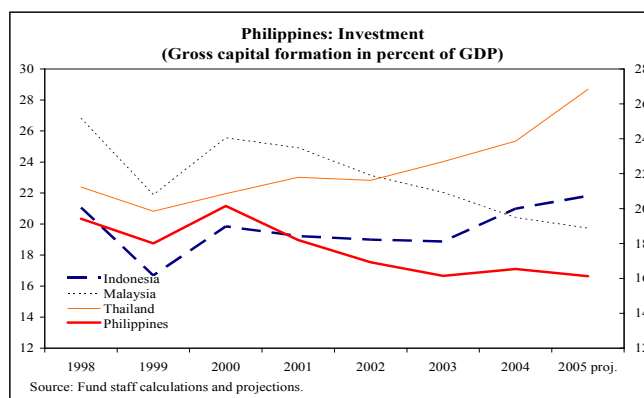


### III. REPORT ON THE POLICY DISCUSSIONS

8. Upon beginning its term in mid-2004, the administration faced critical economic problems. The

unchecked fiscal deficit and build-up of external debt since the Asian Crisis had left the economy dependent on external borrowing and vulnerable to changes in market sentiment. In particular, NFPS debt stood at around 100 percent of GDP; the interest burden was 30 percent of government revenue; and the gross public sector borrowing requirement was almost 25 percent of GDP. Meanwhile, the economy had underperformed, with per capita GDP growth averaging 1 percent per annum from 1998-2003, and almost half the population living on less than \$2 a day.<sup>1</sup> Much of the relatively modest growth performance can be attributed to weak investment (Chart). To spur economic growth and reduce poverty, the new administration embarked on a comprehensive reform program in 2004, the Medium-Term Philippine Development Plan (MTPDP).

Review of Past Fund Surveillance		
Fund Policy Advice in 2002-03	Status	
	2003 Article IV Consultation	2005 Article IV Consultation
<ul style="list-style-type: none"> <li>Bring budget back under control in 2003 and preserve credibility of medium-term framework.</li> </ul>	<ul style="list-style-type: none"> <li>NG deficit reduced to 4.7 percent of GDP, but NFPS deficit remained above 5½ percent of GDP. Date to balance budget moved from 2006 to 2009.</li> </ul>	<ul style="list-style-type: none"> <li>NG deficit set to fall to 3¼ percent of GDP in 2005, and, if VAT reform fully implemented, to 2¼ percent of GDP in 2006. Similar decline projected for NFPS deficit.</li> </ul>
<ul style="list-style-type: none"> <li>Strengthen tax administration and introduce new tax measures.</li> </ul>	<ul style="list-style-type: none"> <li>Some improvement in tax administration, but no major revenue-boosting reforms.</li> </ul>	<ul style="list-style-type: none"> <li>VAT reform law passed; excises on alcohol and cigarettes increased.</li> </ul>
<ul style="list-style-type: none"> <li>Improve PCA framework, compel banks to raise capital, and strengthen legal protection for supervisors.</li> </ul>	<ul style="list-style-type: none"> <li>Second tier capital raised. Otherwise, little progress made.</li> </ul>	<ul style="list-style-type: none"> <li>Significant NPA sales, but amendments to strengthen PCA framework and legal protection for supervisors still pending in Congress.</li> </ul>
<ul style="list-style-type: none"> <li>Depoliticize electricity pricing and limit NPC's external borrowing.</li> </ul>	<ul style="list-style-type: none"> <li>Tariff increases continued to encounter obstacles. NPC borrowing much higher.</li> </ul>	<ul style="list-style-type: none"> <li>Generation tariffs increased by more than 50 percent, sharply cutting NPC losses.</li> </ul>
<ul style="list-style-type: none"> <li>Strengthen AML legislation.</li> </ul>	<ul style="list-style-type: none"> <li>AML law amended to correct deficiencies.</li> </ul>	<ul style="list-style-type: none"> <li>AML/CFT being effectively implemented.</li> </ul>



*The mission presented an opportunity to take stock of progress made in (a) reducing short-term vulnerabilities, and (b) laying the foundations for higher investment and growth:*

<sup>1</sup> Such modest growth in living standards has jeopardized the achievement of some Millennium Development Goals, especially those related to child malnutrition and maternal mortality (Annex VI).

## A. Managing Short-Term Vulnerabilities

9. **Soaring oil prices presented a major challenge for the VAT reform.** With the petroleum sector deregulated since 1998, the jump in oil prices immediately translated into higher domestic prices. This complicated the VAT reform, since a central component was to extend VAT to energy products. However, the authorities resisted attempts by Congress to re-exempt power and petroleum products from the VAT for fear that the whole VAT reform package would unravel. Nonetheless, to mitigate the impact on the poor, the authorities introduced measures such as a reduction in oil import duties and lower petroleum excises. The authorities regarded these measures as critical to maintaining political support for the reform. The VAT base expansion was made easier by the softening of international oil prices in November and the appreciation of the peso.

10. **Staff welcomed the progress made with reducing vulnerabilities.** The relatively smooth introduction of the VAT reform to date owed much to the authorities' communication efforts to explain the mitigating measures that were being taken. The authorities' commitment to increasing the VAT rate from February 1, 2006 was also welcome (Box 1). Markets had already responded positively, and, if the VAT reform was fully implemented and delivered the envisaged revenue, sentiment could improve further. Staff noted that the more comfortable level of reserves would allow the government to tilt its borrowing mix more toward domestic financing. The authorities agreed, noting that the BSP was already reducing its foreign borrowing, and there might be scope for the government to do likewise in 2006.

11. **Higher oil prices had also posed challenges for the monetary authorities.** Inflation, already above target on account of supply shocks in 2004, stayed high during 2005 as a result of the further rise in oil prices. The authorities tightened monetary policy out of concern that continued above-target inflation would increase inflation expectations at a time when liquidity was growing rapidly and interest differentials had narrowed. With regard to liquidity growth, staff questioned whether one-off factors related to regulatory changes might be overstating M3 growth in 2005. However, the authorities considered such factors to be a relatively minor explanation of high liquidity growth compared to the increase in net foreign assets.

12. **Steps have been taken to reduce vulnerabilities in the financial system.** Some banks in the Philippines are weak and undercapitalized, while others have been intervened and are being rehabilitated. The authorities have strengthened prudential regulations, but continue to be hamstrung by the lack of legal protection for bank supervisors. Amendments to remedy this weakness were tabled in Congress in 2004, but have yet to achieve any traction. Nonetheless, solid progress has been made under the Special Purpose Vehicle (SPV) framework, with banks selling one fifth of their stock of NPAs. Consolidation of the banking system has also moved ahead, with a number of deals recently concluded, while one large intervened bank, the Philippine National Bank (PNB), has been privatized. A new soft spot has recently emerged in the pre-need sector, with several firms experiencing financial distress (Box 2). However, with only one such firm having a direct link with a bank, the authorities did not perceive this as a systemic risk.

13. **The vulnerabilities that remain weigh on the outlook.** Staff expected growth to be little changed at about 5 percent in 2006. There was upside to this projection if private investment was to respond strongly to continued progress with reforms and the better

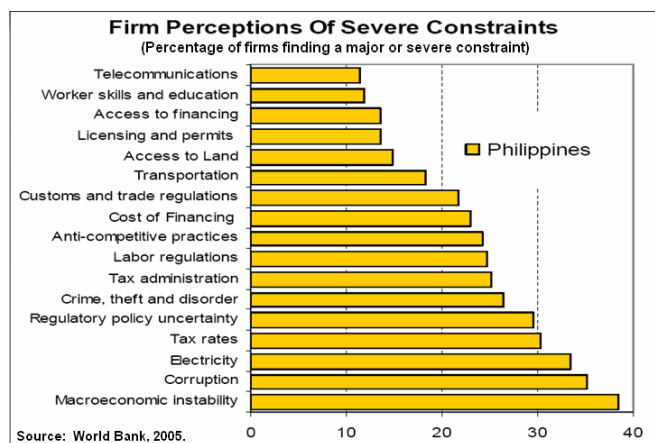
macroeconomic environment. On the other hand, growth might be lower if the negative effects of the VAT reform on consumption were larger than expected and oil price effects were still to come. The heavy reliance on external commercial borrowing also put the Philippines at risk should there be a reversal of the currently benign financing environment in emerging markets, perhaps reflecting higher risk aversion or a disorderly resolution of global imbalances. Avian flu posed another risk and although there had yet to be a case in the Philippines, the authorities indicated that they had developed a contingency plan.

14. **Extension of Post-Program Monitoring (PPM) was discussed against this background.** The Philippines is currently expected to engage in PPM through April 30, 2006. Even though outstanding Fund credit is down to 30 percent of quota, and the fiscal position has improved, the authorities see benefits from continuing PPM for a further year through April 30, 2007.

### B. Laying the Foundations for Higher Investment and Growth

15. **The medium-term outlook depends on the pace of reforms.** Higher economic growth will require increases in investment and productivity. Foreign direct investment, currently at very low levels, can play an important role in achieving both objectives. Staff have prepared two scenarios for the medium term that differ depending on the pace of reform. In the first scenario (Table 5), which is the staff's recommended scenario, reforms proceed beyond the VAT reform and include tax measures additional to those the authorities are currently contemplating, as well as bold measures to improve the investment climate. In such a world, investment increases by 5½ percentage points of GDP, raising growth to 6½ percent and pushing the unemployment rate down to single digits. The authorities achieve their objective of balancing the budget over the medium term and the debt dynamics become highly favorable. On the other hand, if reforms were to stall—the VAT reform is not fully implemented and the deficit is reduced no further than the 2005 level—the outlook for investment and growth would be less rosy. Table 6 shows a scenario where growth declines, unemployment increases over time, and debt sustainability is far from assured. So as to illustrate that vulnerabilities would remain very high if reforms were to stall, the Debt Sustainability Analysis is presented for this scenario (Annex I).

16. **Improving the investment climate is critical.** The authorities recognized that competition from China and the region explained some of the recent weakness in export growth, particularly in the electronics sector. This situation does not seem to primarily reflect an overvalued exchange rate, as this is rarely cited as a factor impeding investment in the Philippines (Chart). Rather, in explaining the relative unattractiveness of the Philippines as an investment destination, investors tend to emphasize: (i) macro-instability and the unsustainable fiscal position; (ii) poor infrastructure and power sector problems; (iii) financial market constraints;



and (iv) corruption and governance.<sup>2</sup> The discussions covered each of these impediments to investment:

*(i) ensuring fiscal sustainability and macro stability*

17. **The fiscal position will be strengthened further in 2006.** Provided that the VAT rate is increased as planned, the NFPS deficit is projected to fall to 2.3 percent of GDP in 2006. While applauding this adjustment, which would amount to over 3 percentage points of GDP since 2003, staff noted that the outlook was subject to several risks. First, VAT collections may be lower than expected, particularly if there is a delay in raising the rate, or there are administrative difficulties in collecting the new tax. Second, the food subsidy provided by the National Food Authority (NFA) might increase substantially if prices of imported rice continue to rise and the prices at which NFA sells imported rice to consumers are not adjusted.<sup>3</sup> Third, the financial position of local government units (LGUs) may weaken in the run up to the 2007 local elections. In response, the authorities agreed that NFA's finances required close scrutiny, but considered local governments to be a low fiscal risk.

18. **The authorities plan to eliminate the remaining fiscal deficit over time.** While welcoming the authorities' intention to balance the budget during the term of the administration, staff cautioned that this would require additional fiscal measures. Possible options included the rationalization of tax incentives and raising and indexing excise taxes. The authorities noted that a fiscal incentive bill was already before Congress, although they recognized that this would yield limited revenue in its present form. In any case, their strategy was to first strengthen tax administration before going to Congress with requests for more tax measures.

19. **The authorities' strategy to rely primarily on tax administration to close the remaining fiscal gap highlights the pressing need to increase collection efficiency.** Improving tax compliance is particularly important in the Philippines because tax policy measures have often been strongly opposed as inequitable because they imply collecting more from those who are already paying tax. It is therefore critical for the Bureau of Internal Revenue (BIR) to broaden the tax net by strengthening taxpayer registration, addressing stop filer problems, and formulating better audit strategies. The Bureau of Customs (BOC) needs to make better use of information and communication technologies to improve efficiency and reduce discretion. But going beyond these technical changes, what is needed, both for BIR and BOC, is to institute better management and incentive systems, so that tax officers will be

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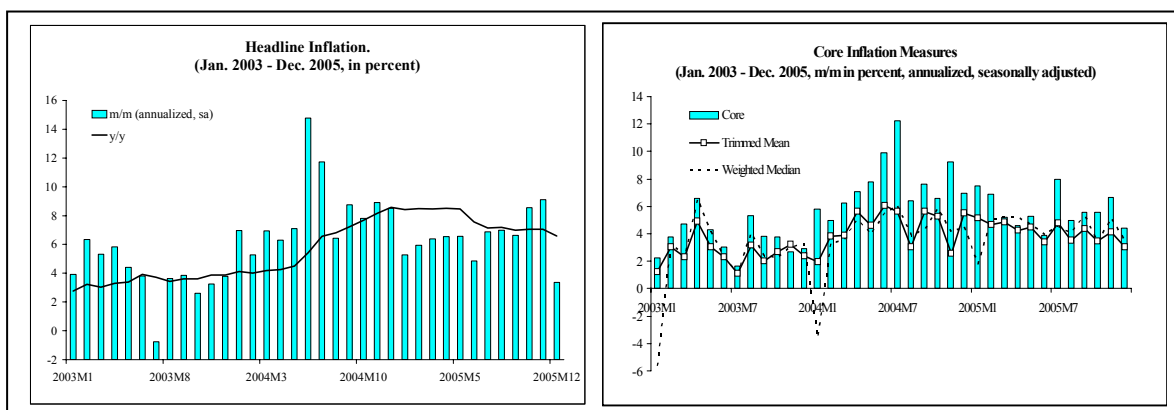
<sup>2</sup> These factors are also recognized as constraints on investment in the MTPDP (see Box 2 in IMF Country Report No. 05/105). A recent survey by McKinsey shows that similar factors account for the Philippines being ranked below India and Vietnam as a destination for BPO operations.

<sup>3</sup> The NFA is expected to have made a loss of 0.4 percent of GDP in 2005, although this is only half as large when customs duties payable by NFA are excluded.

properly motivated to pursue sustainable and equitable tax collection, instead of short-term revenue gains.<sup>4</sup>

20. **The discussions covered other medium-term fiscal issues.** One challenge was to ensure that the GOCCs do not undermine the fiscal consolidation effort. To this end, staff argued for the development of medium-term deficit targets for individual enterprises. The authorities' preferred strategy was to closely monitor the most important enterprises, including NPC and NFA, and then to extend the process to all 14 GOCCs.<sup>5</sup> With regard to the pension funds, preliminary estimates from an actuarial review show that the Social Security System (SSS) may run out of assets in 2027, which is later than previously estimated. Nevertheless, to ensure long term solvency, the contribution rate will need to be gradually increased over time. Staff welcomed SSS's plans to strengthen its investment strategy and improve collection efficiency including by intensifying audits and reducing fraudulent claims.

21. **The inflation targeting framework is key to maintaining macroeconomic stability.** Staff welcomed recent policy rate increases. The absence of strong signs that inflation had become more generalized suggested that monetary policy had so far been effective in limiting the inflation caused by supply shocks to first round effects.<sup>6</sup> Assuming that there were no further shocks, and that the recent strengthening of the exchange rate is sustained, staff expect that inflation will return to the target range in 2007 (4-5 percent). Upside risks to this forecast include second-round effects from the VAT reform, further increases in international oil prices, or a delay in reforms that serves to weaken the exchange rate. By contrast, in the event of full implementation of the VAT reform, a more pronounced rally in the peso could bring inflation back within target more quickly.



<sup>4</sup> A joint Fund/World Bank mission recently provided technical assistance in the areas of tax and customs administration. The authorities are studying the mission's recommendations, including those listed above, with a view to developing a comprehensive plan for improving collection efficiency.

<sup>5</sup> Staff discussed with the authorities the scope for improving the coverage of public enterprises in the fiscal statistics. The authorities were of the view that the current coverage is adequate and that all public enterprises that present fiscal risks are currently covered among the 14 monitored GOCCs.

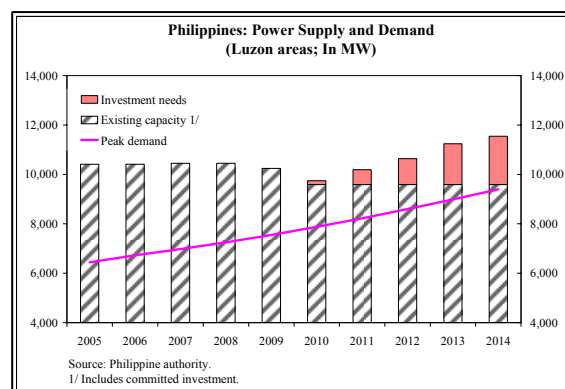
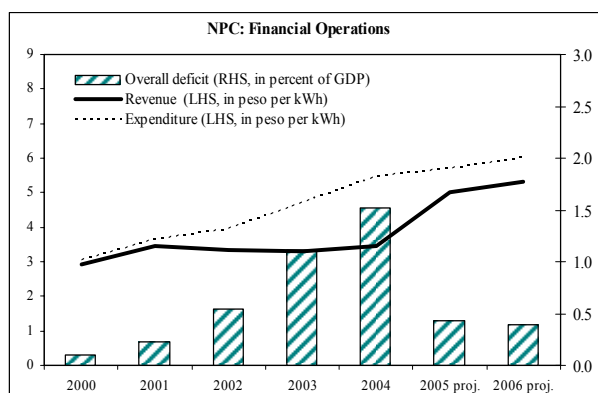
<sup>6</sup> See Box 3.

22. **The authorities indicated that monetary policy would remain vigilant.** Continued rapid liquidity growth and narrow interest differentials were viewed as risks to the inflation outlook, although the authorities noted that some offset was being provided by the existing slack in the economy. Staff observed that interest differentials would be a particular concern if reforms were to stall, since in such a scenario the risk premium was likely to rise. More generally, the authorities assured staff that they stood ready to raise rates again should the inflation forecast look less favorable.

*(ii) improving infrastructure and power sector reform*

23. **Fiscal reforms should create space within the budget for increased infrastructure spending.** Pressure on the budget has led to public investment falling sharply in recent years, and the poor quality of infrastructure is cited as a deterrent by investors. Infrastructure investment is likely to have high returns, particularly in tourism, as well as in mining (where a Supreme Court ruling in early 2005 allowing foreign control of projects has opened the way for foreign investment). The authorities are appropriately allocating a portion of the proceeds from the VAT reform to boosting capital expenditure as well as social spending and the Reforms Proceed scenario considered by staff envisages public investment rising from 2.3 percent of GDP in 2003 to 3.1 percent of GDP by 2007.

24. **Progress with power sector reform had been mixed.** Given the importance of sustaining the turn-around in NPC's finances, staff welcomed the proposal for a new generation rate adjustment mechanism to recover fluctuations of fuel costs in a timely way. Privatization remained key to ensuring adequate investment in the power sector and thus to avoiding future supply shortages. However, the authorities have made little headway in selling power sector assets (Box 4). The deadline for rebidding the concession for the transmission company (Transco) has been postponed to the second quarter of 2006, and the deadline for the sale of 70 percent of generation assets (Gencos) has been pushed out by six months to June 2006. The recent decline in electricity demand (in response to the hikes in tariffs) has provided the authorities with some respite since it now appears that power supply shortages will not re-emerge until the early 2010s. Nonetheless, given that power projects have long gestation periods, staff argued that privatization should remain a top priority.



25. **The prospects for power sector reform are uncertain.** The authorities plan to introduce the wholesale electricity spot market (WESM) in early 2006, followed by open access (retail competition), although under the Electric Power Industry Reform Act (EPIRA), this is contingent on 70 percent of Gencos being privatized. The authorities explained that

slow progress with Gencos privatization partly reflected difficulties in concluding power supply contracts between NPC and distributors, as well as uncertainty about the prospects for market reforms such as WESM and open access. As a measure to accelerate privatization the authorities were considering selling Gencos contingent on the implementation of open access. Staff, however, argued that a successful Transco sale might break the current deadlock.

*(iii) strengthening and deepening financial markets*

**26. The cost and availability of financing are additional constraints on investment.**

The banking system has a high cost-to-income ratio and low profitability, which hampers the needed provisioning for the large holdings of NPAs and keeps spreads fairly high. The significant level of NPAs also tends to inhibit bank lending. As a result, loans have only grown in nominal terms by about 3 percent on average annually over the last five years, implying limited private sector access to bank financing. The authorities have undertaken a number of initiatives to strengthen bank balance sheets, notably by reinforcing the supervisory framework and by granting regulatory and tax advantages through the Special Purpose Vehicle (SPV) framework to banks disposing of their NPAs. To stimulate nonbank financing, the authorities have drawn up a legislative agenda to develop domestic capital markets.

**27. The SPV framework has reduced NPAs, but some banks remain weak.** Sales of distressed assets to SPVs have amounted to P 97 billion to date, leading to a decline in the NPA ratio from 26.2 percent in June 2004 to 20.6 percent in June 2005. The authorities regarded the expiration of the SPV framework in April 2005 as a factor behind the surge in transactions in early 2005 and noted that the prospective implementation of International Financial Reporting Standards (IFRS) had also encouraged deals. Extending the SPV framework was therefore important.<sup>7</sup> However, discounts on NPA sales have averaged 76 percent to date, and as provided for under the SPV framework, banks can stagger loss recognition over ten years for the purpose of complying with regulatory capital requirements. Staff stressed the importance of deferred losses being shown transparently in financial statements.

**28. More substantial progress in fortifying the banking system will require strengthening the powers of supervisors.** Staff expressed concern about the lack of speed with which amendments to the BSP charter to strengthen legal protection for supervisors and the PCA framework were moving in Congress. The authorities acknowledged that it might still take some time for the amendments to be passed. They were therefore trying to strengthen supervisory procedures and evidence gathering to maximize the chances of winning any lawsuits that were filed against bank supervisors.

**29. Effective enforcement of the IFRS provides an opportunity for bank recapitalization.** With effect from the period beginning January 2005, the annual financial statements of banks are required to comply with IFRS. The authorities noted that the rules

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<sup>7</sup> The Lower House passed a bill extending the SPV framework for an additional two years in December.

governing loan loss reserves, deferred tax assets and more rigorous valuation of foreclosed real estate properties were likely to have significant implications for certain banks. At the time of the mission, banks were carrying out simulations to assess the likely impact on reported earnings and capital. The BSP was considering whether to provide regulatory relief to any banks that need time to comply. Staff stressed that any such relief should be conditional on a clear recapitalization plan and again should be transparent to markets.

30. **Steps are being taken to develop the domestic capital market.** A centralized electronic marketplace for domestic fixed income securities was opened in March 2005. The authorities have given high priority to passing the Corporate Recovery Act, which aims to rationalize the rules guiding the recovery of financially distressed enterprises and allows for the appointment of a conservator. A Credit Information System Act is under discussion in Congress and would create a credit information bureau to help foster transparency in the market. A Personal Equity and Retirement Account Bill, which would promote retirement savings, is also pending before Congress. But greater efforts are needed to develop nonbank channels of financial intermediation and thereby facilitate investment.

*(iv) improving governance*

31. **The authorities have taken a number of anti-corruption steps.** Transparency International (TI) has consistently ranked the Philippines in the worst one third of countries in terms of perceived corruption. Moreover, a deterioration in tax administration is regarded by many analysts as a major cause of the decline in the tax/GDP ratio over the last seven years, and hence of the current fiscal problems. The MTPDP recognizes that the Philippines' ability to attract investment requires building an effective government free of corruption. Indeed, a system of lifestyle checks on government officials was introduced in 2003 to reduce opportunities for misconduct by revenue collecting agencies. In addition, the Government Procurement Reform Act was passed in 2003 with the aim of promoting competitive bidding and transparency and accountability in government procurement.

32. **Progress, however, is difficult to measure.** There may have been some gains in reducing procurement costs over the past year, but how large is unclear. There is also some evidence suggesting that bribe taking has become less prevalent in recent years, although this is yet to be confirmed by the TI indicators of perceived corruption. With regard to tax administration, staff encouraged the authorities to recreate the atmosphere of heightened enforcement that had existed in the second quarter of 2005, but which seemed to have dissipated during the political turbulence in mid year.

33. **Civil service reform has been initiated.** A Government Rationalization Program was launched in 2005 to improve the efficiency and effectiveness of government. Eight government agencies and one GOCC have submitted their rationalization plans for review by the Department of Budget and Management and other relevant agencies, and two of these plans were approved in September. Separated personnel will be given an option of reassignment to other agencies or availing of separation benefits. Over the medium term, if all identified employees choose to separate from the civil service, the government expects to realize annual savings of about 0.1 percent of GDP.

34. **Progress has been made with AML/CFT.** The Philippines continues to be monitored by the Financial Action Task Force (FATF) as part of its standard monitoring



procedure for delisted Non-Cooperative Countries or Territories (NCCTs). Staff welcomed the progress made in two areas of concern for the FATF, namely streamlining the reporting of suspicious transactions and accelerating the processing of cases.

#### IV. STAFF APPRAISAL

35. **Recent events have lifted sentiment.** The authorities deserve credit for steadying the economic ship after the political turbulence experienced in mid-2005. With the first phase of the VAT reform now implemented, and a clear commitment made to raising the VAT rate in February 2006, the reform momentum has been regained for now.

36. **But the momentum needs to be sustained in the period ahead.** Progress with reforms appears to have already been priced in to some extent by markets. There might thus be a significant correction if reforms were to be interrupted again. Other near-term risks to the economy arise from possible further spikes in oil prices or an outbreak of Avian flu. In light of continued high debt levels, the Philippines is also especially vulnerable to a sudden end to the current benign external financing environment. Completing the agenda for fiscal and other structural reforms should make a material difference to the economy's ability to absorb such shocks.

37. **A significant improvement in the investment climate is essential to set the stage for higher economic growth and substantial reductions in poverty.** Staff do not view the level of the exchange rate as a threat to medium-term competitiveness. Rather, what is needed to improve the investment climate is a stable macroeconomic environment, increased infrastructure investment, a strengthened financial system, and improved governance. Immediate priorities are to raise the VAT rate in February, accelerate power sector privatization, and pass legislation strengthening bank supervision.

38. **Sizable fiscal consolidation is underway.** Tight control was maintained over expenditure in 2005 and the tax-GDP ratio looks set to rise after many years of decline. With the financial position of NPC and the SSIs also much improved, the NFPS deficit is estimated to have declined to 3¼ percent of GDP in 2005, an adjustment of 2½ percentage of points of GDP over the past two years. After raising the VAT rate in February, the authorities need to ensure that tax administration is strong enough to collect commensurately higher VAT revenue. Providing that this happens, the NFPS deficit is set to fall further to 2¼ percent of GDP in 2006.

39. **Balancing the budget over the medium-term will require additional measures.** Gains from improved tax administration and interest savings are unlikely to eliminate the NFPS deficit of 2-2½ percent of GDP that will remain after the VAT reform is implemented. While strengthening tax administration remains a pressing need, additional tax policy measures will also be necessary, such as a more ambitious rationalization of tax incentives than is currently being considered.

40. **Other parts of the public sector should support fiscal consolidation.** The authorities are planning to closely monitor important GOCCs: priorities will be to ensure that the turn around in NPC's finances is sustained, and that poorly targeted food subsidies do not lead to large losses at NFA. The solvency of the pension funds will be enhanced by strengthened investment strategies and improved collections of contributions.

41. **Inflation risks remain.** In the absence of further shocks, inflation is projected to return to target by 2007, but this outcome is far from assured. Risks to the outlook include possible second-round effects from current shocks such as the VAT reform. However, the recent rate actions by the BSP inspire confidence that rates will be raised again should the inflation forecast look less favorable. On the other hand, if sentiment continues to improve, higher capital inflows may put upward pressure on the peso and inflation could return to target more rapidly. Given the improved foreign reserve cover, the authorities can offset incipient peso strength by using dollars bought from the market to substitute for external borrowing.

42. **Power sector privatization should be accelerated.** Re-bidding for the Transco concession has been postponed, while far fewer Gencos have been sold by this stage than was planned. If needed investment in the power sector is to be made, the challenge is to shift sufficient power sector assets into private hands. This will require reducing the uncertainties that are deterring potential deals. Successful bidding of Transco might break this deadlock.

43. **There have been positive developments in the banking system.** The SPV framework has induced banks to take steps to resolve a portion of the stock of bad assets and bank consolidation is underway. However, the banking sector remains fragmented with some banks undercapitalized, and the level of NPAs continues to be high. While an extension to the SPV framework is warranted, greater pressure needs to be exerted on weak banks to raise capital and encourage mergers.

44. **Passage of the amendments to the BSP Charter remains critical.** The proposed amendments would strengthen the PCA framework and legal protections for bank supervisors, thus fortifying the BSP's ability to deal with distressed banks. However, these proposals have made little progress through Congress over the last few years. Greater efforts must be made to pass these amendments so as to permit a durable strengthening of the banking system.

45. **Effective implementation of IFRS should promote bank recapitalization.** The BSP should clarify the conditions under which regulatory relief might be granted to banks significantly affected by the introduction of IFRS. Such relief should be granted transparently and conditional on a clear recapitalization plan. Certain banks will also be carrying large deferred losses from NPA sales under the SPV framework. IFRS will make these losses transparent to investors, which underscores the urgency of banks raising fresh capital.

46. **There is a need for further financial market development.** The authorities should give priority to advancing the various legislative initiatives to develop domestic capital markets. The financial difficulties being experienced by pre-need firms are probably not a systemic concern, but illustrate the need to strengthen the supervisory and regulatory framework for the industry. On AML/CFT, while noting the FATF's continued monitoring of the Philippines, staff welcomes the progress being made with streamlining the reporting of suspicious transactions and accelerating the processing of cases.

47. **Data provision for surveillance purposes is adequate overall, although staff's analysis continues to be affected by certain deficiencies in the data.** Staff welcomes the authorities' efforts to address these shortcomings, particularly those in the balance of payments data.

48. **It is recommended that the next Article IV Consultation with the Philippines be held on the standard 12-month cycle.** Continuation of PPM is recommended for an additional year in light of the still vulnerable fiscal position.

### Box 1. The Status of Fiscal Reforms

**Over the past year, the Philippine authorities have made commendable progress in advancing fiscal reforms.** Since September 2004, power generation tariffs have been raised by over 50 percent. In December 2004, excises on alcohol and tobacco products were increased by 30 percent on average, while duties on imports of oil products were raised from 3 to 5 percent.<sup>1</sup> Congress also passed the Lateral Attrition Bill intended to provide financial incentives for tax collectors to meet revenue targets. The centerpiece of the authorities' reform agenda is the VAT reform law. Implementation of the first stage (extending the VAT base to power and petroleum products) began on November 1, 2005 a few weeks after the Supreme Court declared the law to be constitutional.

**When fully implemented, the VAT reform is expected to yield 1.4 percent of GDP in revenue annually.** In addition to base broadening measures, the law gives the President authority to raise the VAT rate from 10 to 12 percent in 2006; the authorities are planning to implement this increase on February 1.<sup>2</sup> The law also increases the corporate income tax (CIT) rate from 32 to 35 percent. To protect the poor from the impact of the base broadening

The Philippines: Annualized Revenue Yield and the Status of the Proposed Measures 1/

Measure	Status	Revenue yield (in percent of GDP)
Increasing power generation tariffs	Implemented	1.0
Increasing and indexing excises on "sin products"	Partially implemented	0.2
Broadening the VAT base	Implemented	0.5
Increasing the CIT rate	Implemented	0.3
Reducing excises on petroleum products	Implemented	-0.2
Changing VAT refund procedures	Implemented	0.3
Raising the VAT rate from 10 to 12 percent	Pending	0.5
Lateral attrition bill	Implemented	?
Consolidating fiscal incentives	Pending	?
Simplified net income tax for self-employed	Pending	?
Fiscal Responsibility Bill	Pending	...

measures, the law eliminates excises on kerosene, and reduces excises on diesel and gasoline. In addition, the law includes a limit on input VAT credit (at 70 percent of the VAT paid on output), and a provision for staggering VAT refunds on investment over a five-year period. The last two provisions have met with resistance from segments of the business community because they increase costs of conducting business, discourage investment, and complicate tax compliance.

**The remaining near-term fiscal reform agenda includes the passage of three pieces of legislation.** The first piece, a bill tackling the proliferation of fiscal incentives, has the highest revenue potential. However, the version before Congress has only a limited revenue impact; while the bill reduces the scope of some incentives, it also appears to extend existing incentives to cover a broader range of activities. The second bill proposes simplified (net income) taxation of the self-employed (SNITs) and contains a number of useful provisions that could simplify tax compliance and limit abuse, although they are unlikely to result in a significant revenue gain. Finally, a fiscal responsibility bill introduces measures to reduce unfunded expenditures and imposes public debt limits.

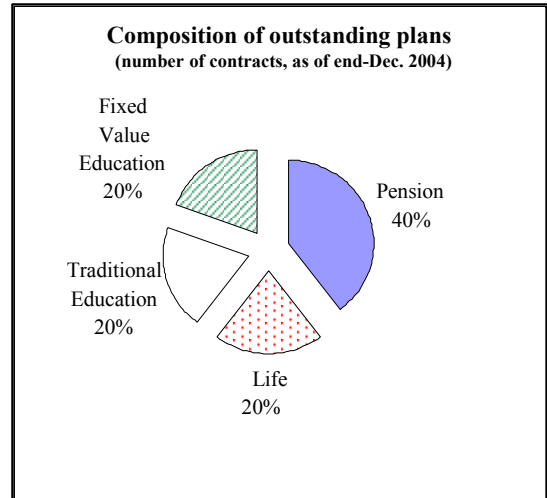
<sup>1</sup> This measure was subsequently reversed to mitigate the impact of the VAT reform on fuel prices.

<sup>2</sup> The VAT reform law provides for a VAT rate increase from January 2006 if VAT collections as a percentage of GDP exceed 2.8 percent, or if the fiscal deficit exceeds 1.5 percent of GDP. Both conditions already look likely to have been met in 2005. However, the authorities have chosen to wait until February to raise the rate so as to minimize the chances of legal challenges that the data are too preliminary to tell whether the conditions in fact hold.

## Box 2. The Pre-Need Industry

**The pre-need industry in the Philippines offers a popular saving instrument.** The sector consists of nonbank financial institutions that cater for households who want to pre-finance future expenditure such as their children's education. First introduced in 1966, pre-need plans have become a particularly popular savings instrument. As of end-December 2004, the sector's assets amounted to 3.3 percent of GDP (equivalent to 4 percent of banking sector assets), with 4 million plans outstanding.

**The industry is facing financial difficulties.** The sector as a whole is running an actuarial deficit (estimated at 0.2 percent of GDP) and several pre-need companies have encountered difficulties meeting payment obligations. The problems apparently stem from poor investment decisions and significant increases in tuition fees following deregulation in the mid-1990s. Many companies had been selling "open-ended" education plans (the "traditional" plan), where the company promised to pay whatever the tuition is at the time of delivery. Some companies seem to have tried to cover their growing liabilities by using the proceeds from the sale of new plans to service maturing obligations. The sale of "traditional" contracts has been discontinued and some firms have been denied licenses to sell new plans, but existing obligations still need to be met.



**The regulatory framework and supervision have been strengthened.** The Security and Exchange Commission (SEC), which is responsible for regulating the sector, has issued guidelines to improve actuarial assumptions and has imposed tighter accounting standards. Restrictions were introduced on the investments made by pre-need companies and minimum paid-up capital was increased. In addition, on-site inspections were initiated and stricter compliance with reporting requirements was sought.

**Further steps, however, are necessary.** According to some observers, plan holders need greater protection, and restrictions on investments should be further tightened, with connected lending forbidden. The high commissions and operational costs—up to 49 percent of a plan holder's contribution—also need to be reviewed. A proposed Pre-Need Code is under consideration in Congress and would provide a specific legal framework for the sector, rationalizing its current regulatory environment. Furthermore, SEC's resources and enforcement powers probably need to be strengthened.

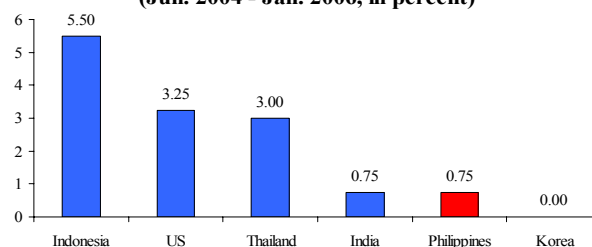
### Box 3. Assessing the Monetary Policy Stance

**The BSP has been less aggressive than other central banks in the region in raising policy rates.** Since the start of the current tightening cycle—the Fed began its series of rate hikes in June 2004—the BSP has raised policy rates by a cumulative 0.75 percent, compared with 5.50 percent in Indonesia and 3.00 percent in Thailand (Figure 1). This might be interpreted as implying that the BSP is behind the curve in the current tightening cycle, especially given the surge in oil prices during 2005.

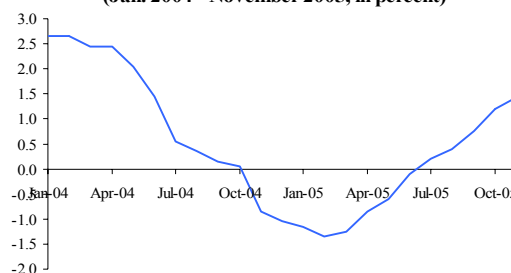
**However, several considerations suggest that the BSP’s policy stance is appropriate for now.** One measure of whether the policy stance is appropriate is the real interest rate, measured as the overnight borrowing rate minus core inflation. This indicator suggests that the policy stance tightened substantially in the course of 2005, due to falling core inflation and recent rate hikes (Figure 2). In addition, domestic demand in the Philippines has weakened (Figure 3), largely due to a fall in investment (excluding inventories). Going forward, weak electronics exports suggest investment may stay weak, while implementation of the VAT reform may also weaken private consumption. Demand-led inflation is thus unlikely to be a factor in the near-term.

**Nonetheless, the interest differential versus the U.S. has narrowed, a risk factor if the reform momentum stalls.** Up until September 2004, the BSP’s overnight borrowing rate exceeded the Federal Funds rate by more than 5 percent (Figure 4). As of December 2005, this differential measured 3.25 percent. This decline may be sustainable if ongoing fiscal consolidation results in a lower risk premium for the Philippines. If reforms stall, however, the narrow interest differential could become a risk factor, if it leads to a rise in inflation expectations via anticipated weakening of the exchange rate. A further risk is the possible emergence of second-round effects from past supply shocks and the implementation of the VAT reform.

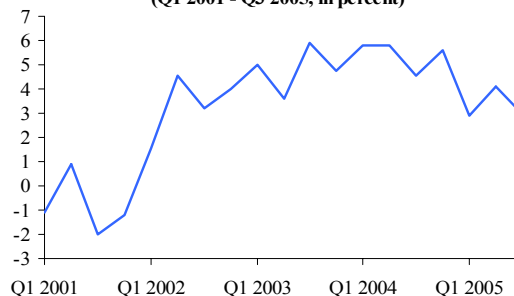
**Figure 1. Cumulative Increase in Policy Rates (Jun. 2004 - Jan. 2006, in percent)**



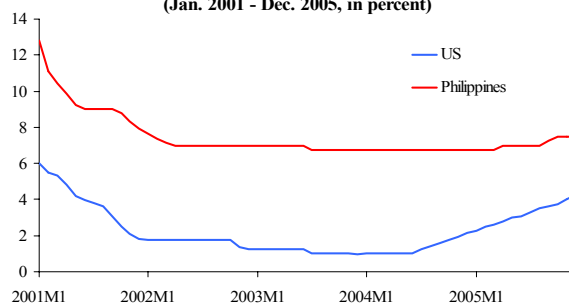
**Figure 2. Overnight Rate Minus Core Inflation (Jan. 2004 - November 2005, in percent)**



**Figure 3. Domestic Demand Growth Contributions (Q1 2001 - Q3 2005, in percent)**



**Figure 4. Policy Rates in the Philippines and the US (Jan. 2001 - Dec. 2005, in percent)**



### Box 4. The Status of Power Sector Reforms

**The Philippines has embarked upon comprehensive power sector reform.** Given the government's limited fiscal resources, a private-sector-led reform strategy was chosen to expand power generation and transmission capacity and avoid power shortage in the medium term. The Electricity Power Industry Reform Act (EPIRA) enacted in 2001 envisages both the privatization of power sector assets and the introduction of competitive power markets, one of the most ambitious power sector reform programs in the region.

**Progress has been mixed.** Positive developments include putting in place a new institutional framework and raising generation tariffs to close to full-cost recovery levels. Moreover, the Wholesale Electricity Spot Market (WESM) is ready for operation beginning early 2006. However, the privatization program has been delayed. Bidding for the transmission assets (Transco) concession has been continuously postponed over the last year with repeated changes made to the bidding strategy, while the delays in selling generation assets (Gencos) apparently reflect limited investor interest.

**Several factors may explain the difficulty in advancing privatization.** First, global investment in the power sector has remained subdued since 1997. Second, the transition of the Philippine power sector to a competitive market structure is raising concerns among investors about risks such as a possible malfunctioning of the prospective spot market. The signing of power supply contracts, which are intended to help mitigate transition risks, has been delayed, because distribution utilities are concerned about the effects of market reform on their business. Third, the investment climate in the Philippines is perceived to be relatively inhospitable. Market analysts partly attribute the limited investor interest to the heightened political noise during 2005.

**Demonstration of the government's commitment to reform might break the current deadlock.** For example, successful bidding for the Transco concession might send a signal to investors about the government's commitment to greater private sector participation in the power sector. Smooth introduction of WESM could raise investor confidence and resolve some uncertainties associated with market reform. More generally, steady progress toward the establishment of a competitive market structure—which itself requires an improvement in the regulatory environment—might be viewed by investors as a factor that strengthens the investment climate in the power sector.

Selected Asian Countries: Plan and Status of Power Sector Reform

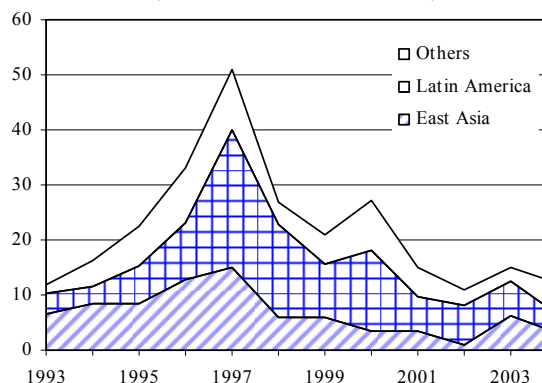
	Reform plan includes:		Status
	Privatization (or private ownership)	Market liberalization	
Philippines	Yes	Yes	See table below.
Indonesia	Yes	No	New legislation allowing full private ownership of generation assets was enacted in 2005.
Korea	Yes	No	Privatization program has moved forward, but at a slower pace than planned.
Malaysia	Yes	Under study	Reform is still at an early stage.
Singapore	Yes	Yes	Privatization and introduction of retail competition have been delayed.
Thailand	Yes	No	Privatization plan is still under study.

Source: Energy Information Administration, Country Analysis Brief.

Philippines: Status of Power Sector Reform Program

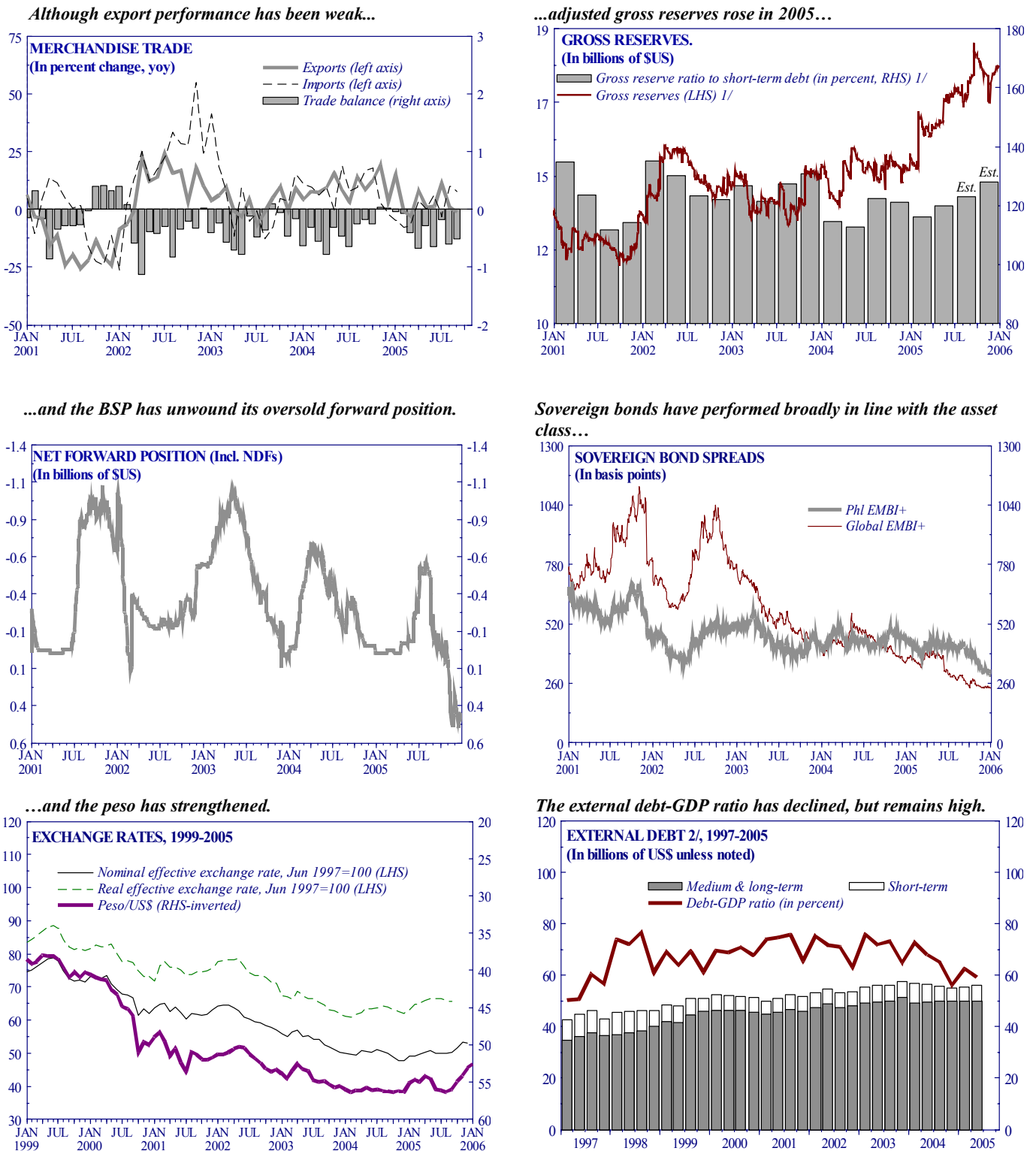
Major developments	Status
Creation of Energy Regulatory Commission	Done in 2001.
Creation of Transco	Done in 2001.
Unbundling of tariff setting mechanism	Completed in 2005.
Transco privatization	Delayed (targeted by end-2005). Bidding attempts failed twice due to limited investors' interest.
70 percent Genco privatization	Delayed (targeted by end 2005). Less than 15 percent of assets sold.
Creation of WESM	Scheduled for early 2006.
Creation of a retail competitive market	Scheduled for mid-2006 contingent on 70 percent Genco privatization.

Private Investment in Power Sector  
(In billions of 2004 U.S. dollars)



Source: World Bank, Private Participation in Infrastructure Projects Database.

Figure 1. Philippines: External Developments, 2001–06



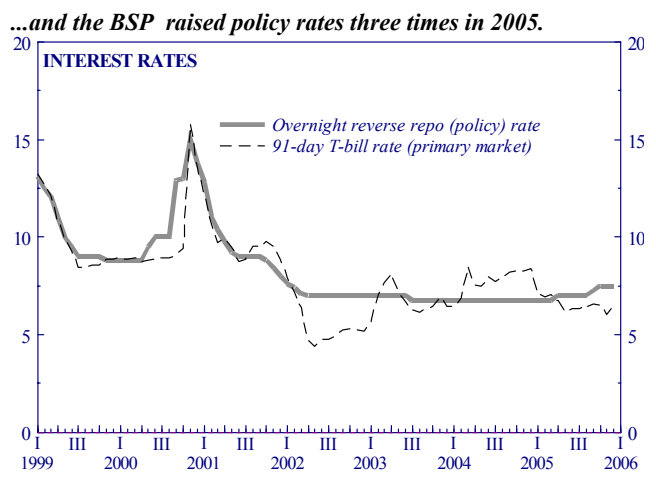
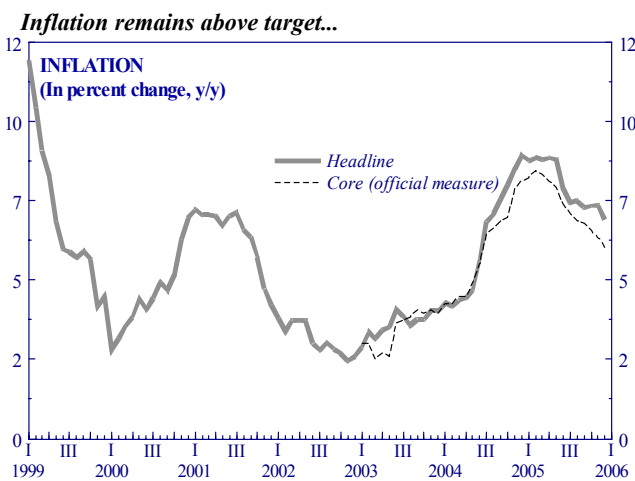
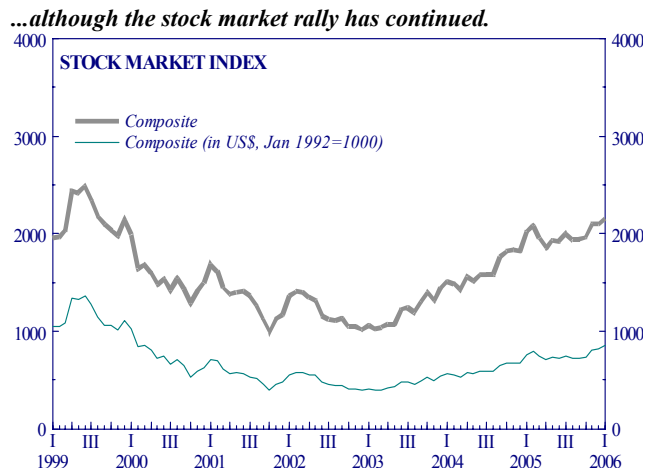
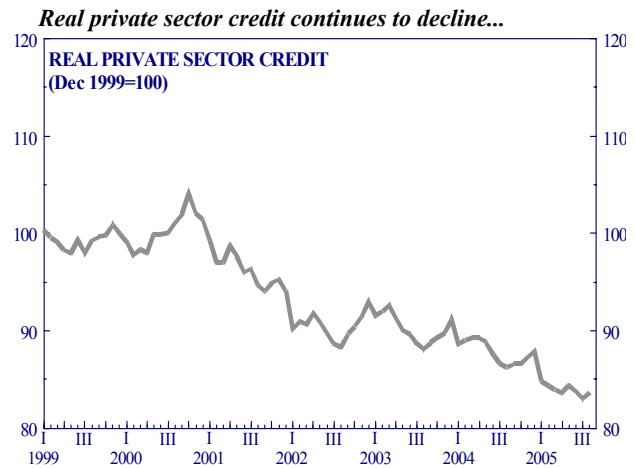
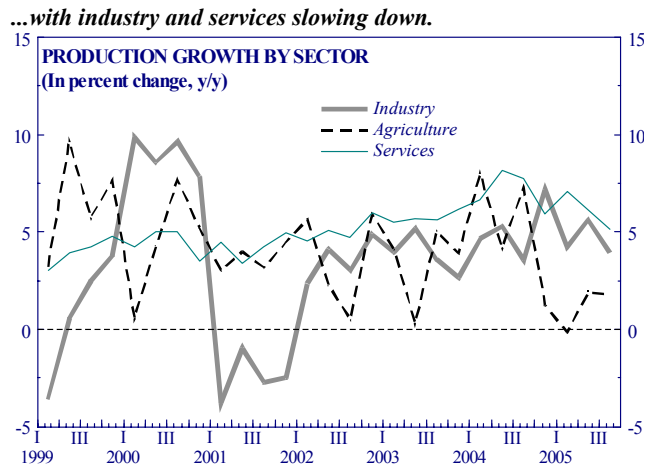
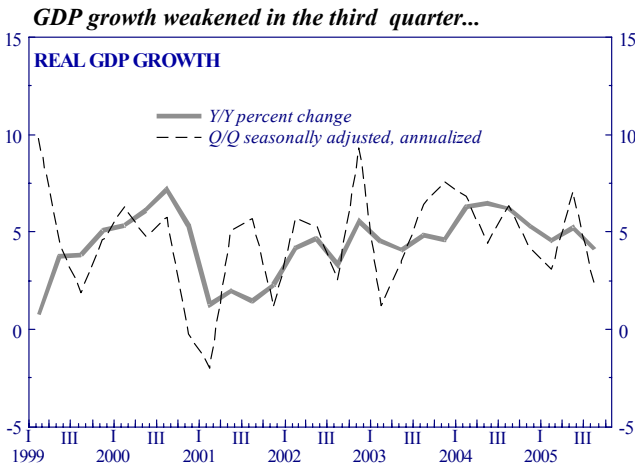
Sources: Data provided by the Philippine authorities; CEIC; and Fund staff estimates.

1/ Adjusted for pledged assets; staff estimates.

2/ Includes private sector inter-company accounts, loans without BSP approval, and obligations under capital lease.



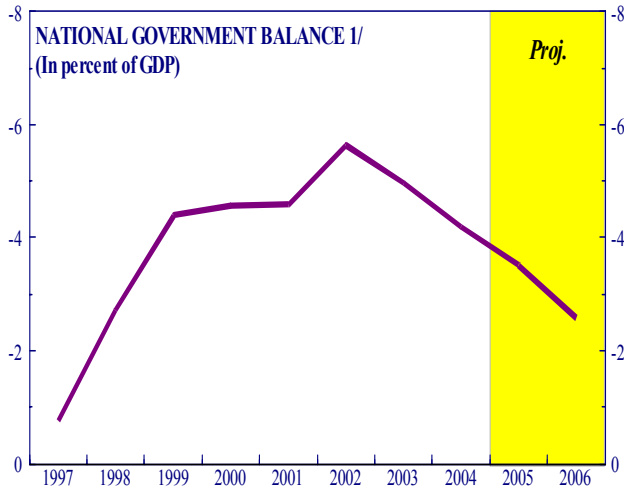
Figure 2. Philippines: Domestic Developments, 1999–2006



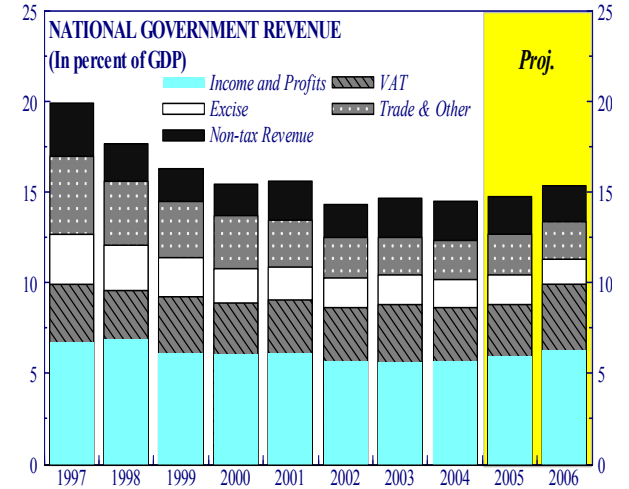
Sources: Data provided by the Philippine authorities; CEIC; and Fund staff estimates.

Figure 3. Philippines: Fiscal Sector, 1997–2006

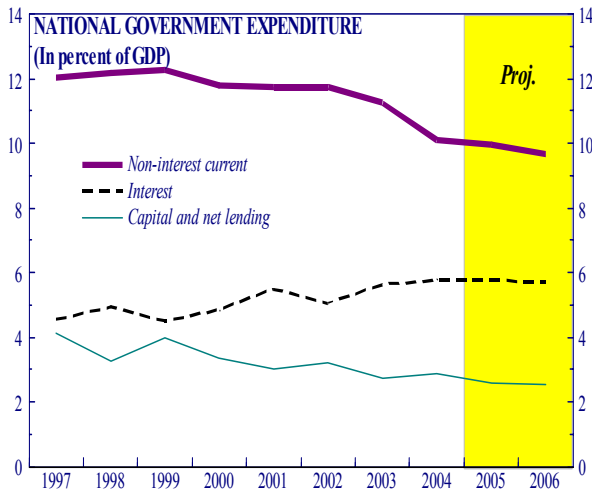
*The national government deficit is being reduced.*



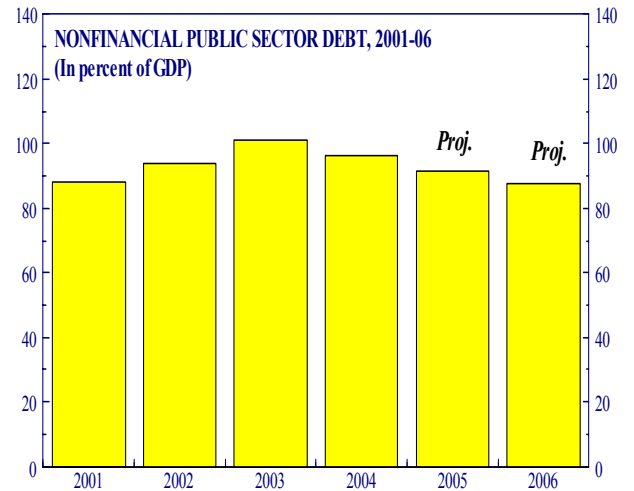
*The decline in revenue has been arrested, and promises to be reversed...*



*...while primary expenditure continues to be compressed.*



*Public sector debt has trended down since 2003, but continues to be high.*

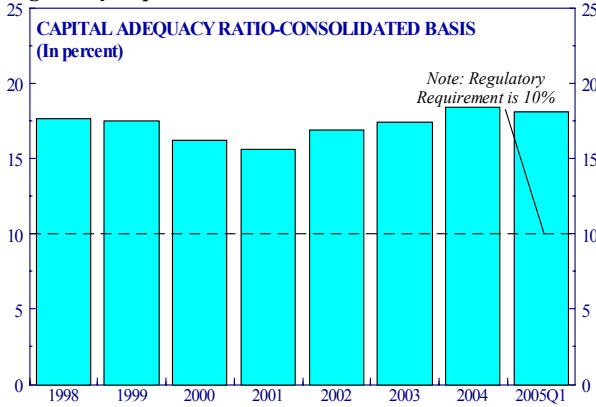


Source: Data provided by the Philippine authorities; and Fund staff estimates and projections.

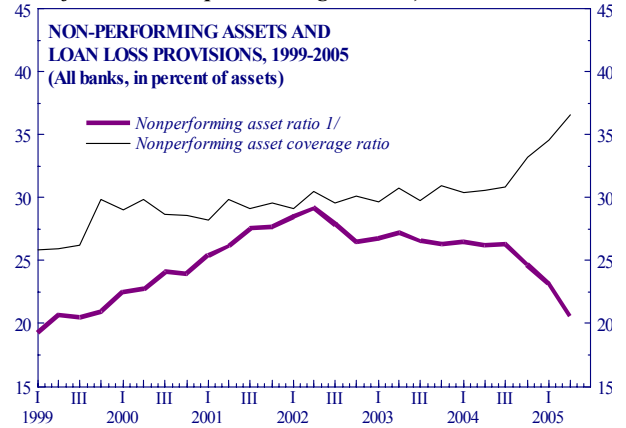
1/ Fund staff definition. Excludes privatization receipts of the national government and includes operations of the Central Bank-Board of Liquidators.

Figure 4. Philippines: Banking Sector, 1998–2005

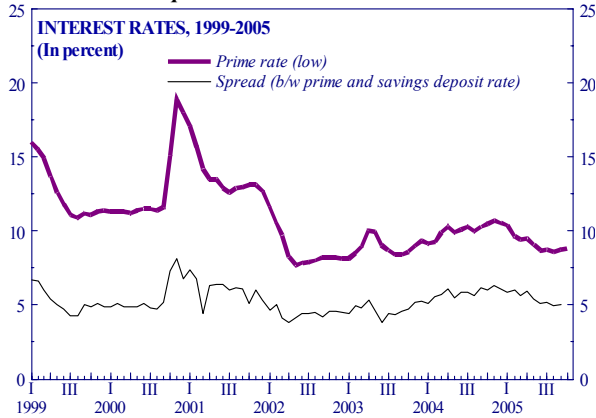
*Reported capital adequacy continues to exceed the regulatory requirement...*



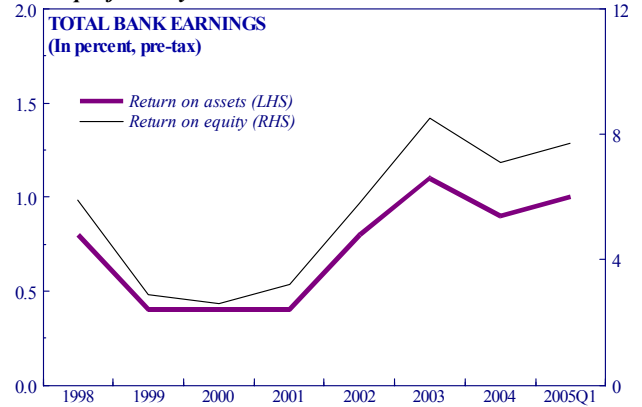
*...and SPV deals are lowering the NPA ratio (although the need for additional provisioning remains).*



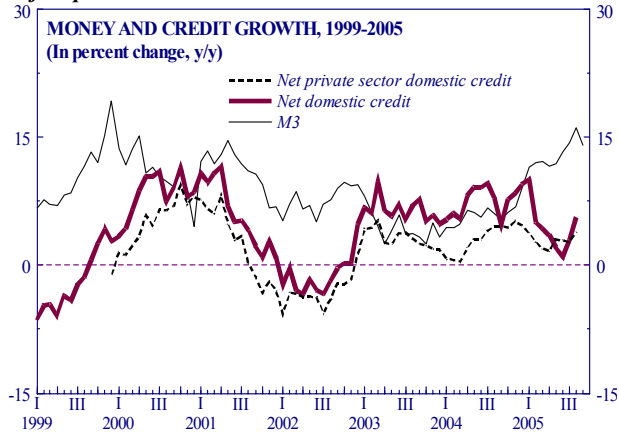
*Intermediation spreads have stabilized...*



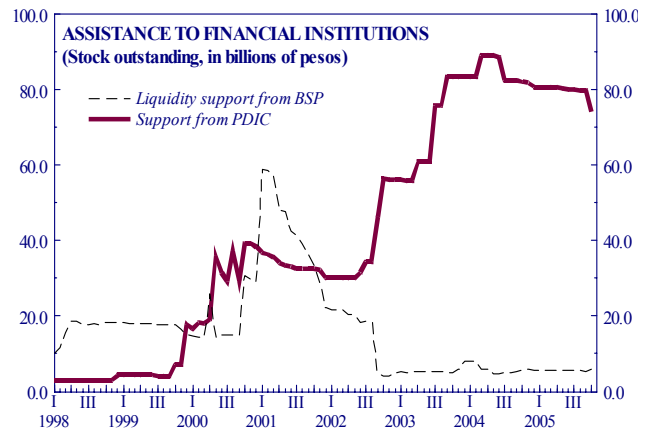
*...and profitability remains low.*



*Bank credit growth has remained low despite rapid growth of deposits.*



*Financial assistance from PDIC has declined.*



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, 2002–06

Nominal GDP (2004): P 4,826 billion (\$86.1 billion)

Population (2004): 83.5 million

GDP per capita (2004): \$1,031

IMF quota: SDR 879.9 million

	2002	2003	2004	2005 Staff Est.	2006 1/ Staff Proj.
<b>GDP and prices (percentage change)</b>					
Real GDP	4.4	4.5	6.0	4.9	5.0
CPI (annual average)	3.0	3.5	6.0	7.7	7.5
CPI (end year)	2.5	3.9	8.6	7.1	6.6
<b>Investment and saving (percent of GDP)</b>					
Gross investment	17.7	16.7	17.1	16.0	17.3
National saving 2/	23.4	18.4	19.8	19.0	19.4
<b>Public finances (percent of GDP)</b>					
National government balance (authorities definition)	-5.3	-4.7	-3.9	-3.2	-2.1
National government balance 3/	-5.6	-5.0	-4.2	-3.6	-2.5
Nonfinancial public sector balance 4/	-5.7	-5.6	-5.0	-3.2	-2.3
Revenue and grants 5/	20.9	21.0	20.7	21.8	22.9
Expenditure 6/	26.6	26.6	25.7	25.0	25.2
Nonfinancial public sector debt 7/	93.7	101.3	96.1	90.0	83.7
<b>Monetary sector (percentage change, end of period)</b>					
Broad money (M3)	9.5	3.3	9.2	14.1 8/	...
Interest rate (91-day Treasury bill, end of period, in percent)	5.9	6.5	8.4	6.4 9/	...
Credit to the private sector	1.2	1.8	4.6	2.1 8/	...
<b>External Sector</b>					
Export value (percent change)	10.0	2.8	9.6	2.3	5.6
Import value (percent change)	6.2	20.1	10.6	2.0	7.8
Current account (percent of GDP)	5.7	1.8	2.7	3.0	2.1
Capital and Financial account (US\$ billions, excluding errors and omissions)	1.2	-2.2	-2.1	-0.4	-1.0
Foreign direct investment (net)	1.7	0.2	0.1	0.9	0.9
Other	-0.5	-2.4	-2.2	-1.2	-1.9
Errors and omissions and trade credit (US\$ billions)	-4.9	-0.8	0.4	-0.2	0.4
Overall balance (US\$ billions)	0.7	-1.7	0.6	2.3	1.8
Monitored external debt (percent of GDP) 10/	77.7	79.3	71.5	65.7	59.7
Debt-service ratio (percent of exports)	19.9	20.6	19.7	18.8	20.1
Reserves, adjusted (US\$ billions) 11/	14.3	14.7	15.2	18.0	19.9
Reserves / Short-term liabilities, adjusted 12/	123.9	122.9	121.2	130.5	138.4
<b>Exchange rate (period averages)</b>					
Pesos per U.S. dollar	51.6	54.2	56.0	55.1	...
Nominal effective exchange rate (1990 =100)	66.1	58.7	54.0	54.8 13/	...
Real effective exchange rate (1990 =100)	102.2	89.0	85.2	91.8 13/	...

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

1/ "Reforms proceed" scenario assumes VAT rate increase on February 1, 2006.

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/ As of September, 2005.

9/ Secondary market rate.

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.

11/ Gross reserves less gold and securities pledged as collateral against short-term liabilities.

12/ Reserves as a percent of short-term debt (including medium- and long-term debt due in the following year). Both reserves and debt were adjusted for pledged assets.

13/ October 2005.

Table 2. Philippines: National Government Cash Accounts, 2001-06  
(In percent of GDP; unless otherwise noted)

	2001	2002	2003	2004	2005	2006	
						Proposed Budget	Staff Proj. 1/
Revenue and grants	15.7	14.4	14.6	14.5	14.7	16.2	15.6
Tax revenue	13.5	12.5	12.5	12.4	12.7	14.6	13.7
Net Income and Profits	6.2	5.7	5.7	5.8	6.0	...	6.3
Excises	1.8	1.7	1.6	1.6	1.7	...	1.4
VAT	2.9	2.9	3.1	2.9	2.8	...	4.0
Tariffs	1.1	0.9	1.0	1.0	1.0	...	0.8
Other 2/	1.6	1.3	1.1	1.2	1.2	...	1.2
Nontax revenue	2.2	1.8	2.1	2.2	2.0	1.6	1.9
Of which: Central Bank-Board of Liquidators	0.2	0.1	0.1	0.1	0.1	...	0.1
Of which: Recovery of Marcos wealth	...	...	...	0.2	0.2	...	0.0
Expenditure and net lending	20.3	20.0	19.6	18.7	18.2	18.6	18.1
Current expenditures	17.3	16.8	16.9	15.9	15.5	15.8	15.1
Personnel services	6.6	6.7	6.4	5.9	5.7	5.5	5.5
Maintenance and operations	2.4	2.1	1.8	1.7	1.7	1.8	1.8
Allotments to local government units	2.5	2.8	2.7	2.4	2.3	2.2	2.2
Subsidies	0.2	0.1	0.3	0.1	0.0	0.1	0.1
Interest	5.5	5.1	5.6	5.8	5.7	6.0	5.5
National government	4.8	4.7	5.3	5.4	5.3	5.7	5.1
Central Bank-Board of Liquidators	0.7	0.4	0.4	0.4	0.4	0.4	0.4
Capital and equity expenditure 3/	2.9	3.1	2.6	2.7	2.6	2.7	2.8
Net lending	0.1	0.1	0.1	0.1	0.1	0.1	0.1
Balance	-4.6	-5.6	-5.0	-4.2	-3.6	-2.4	-2.5
On the authorities' presentation 4/	-4.0	-5.3	-4.7	-3.9	-3.2	-2.1	-2.1
Financing	4.6	5.6	5.0	4.2	3.6	2.4	2.5
Net external financing	0.6	2.8	3.4	1.7	1.4	1.7	0.7
Net domestic financing	4.0	2.9	1.6	2.5	2.1	0.7	1.7
Memorandum Items:							
Nonfinancial public sector balance 5/	-4.9	-5.7	-5.6	-5.0	-3.2	...	-2.3
Consolidated public sector balance 5/	-4.8	-5.6	-5.3	-4.8	-3.1	...	-2.2
Primary national government balance	0.9	-0.6	0.7	1.6	2.2	3.6	3.0
National government debt 6/	62.8	66.5	71.8	70.4	67.0	...	63.6
(percent of NG revenues)	400.6	462.6	490.1	483.9	456.3	...	407.7
Nonfinancial public sector debt 7/	87.4	93.7	101.3	96.1	90.0	...	83.7
(percent of NFPS revenues)	379.8	448.1	483.0	465.1	412.1	...	365.4
National government gross financing requirements 8/	21.4	23.2	23.8	24.5	22.4	...	21.9
GDP (in billions of pesos)	3,631	3,964	4,293	4,826	5,384	5,999	6,048

Sources: Philippine authorities; and Fund staff projections.

1/ "Reforms proceed" scenario assumes VAT rate increase on February 1, 2006.

2/ Includes other percentage taxes and documentary stamp tax.

3/ Excludes purchase of NPC securities and other onlending; includes capital transfers to LGUs that may be used to finance current expenditures.

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, 2001–06  
(In billions of U.S. dollars)

	2001	2002	2003 1/	2004 1/	2005 Staff Est.	2006 2/ Staff Proj.
<b>CURRENT ACCOUNT BALANCE</b>	<b>1.3</b>	<b>4.4</b>	<b>1.4</b>	<b>2.3</b>	<b>2.9</b>	<b>2.3</b>
Trade Balance	-0.7	0.4	-5.5	-6.4	-6.4	-7.7
Exports, f.o.b.	31.2	34.4	35.3	38.7	39.6	41.9
Imports, f.o.b.	32.0	34.0	40.8	45.1	46.0	49.6
o/w: oil and related products	3.4	3.3	3.8	4.7	6.0	7.9
Services (net)	-2.1	-1.0	-1.7	-1.3	-1.4	-0.7
Receipts	3.1	3.1	3.3	4.1	4.5	5.3
Payments	5.2	4.1	5.0	5.4	5.9	6.0
Income	3.7	4.5	-0.2	0.4	-0.3	-0.5
Receipts, of which:	7.2	7.9	3.3	3.8	4.1	4.5
Remittances of resident workers abroad 2/	6.0	7.2	2.6	2.9	3.1	3.3
Payments	3.5	3.5	3.6	3.4	4.4	5.0
Interest payments	2.9	2.5	1.4	2.9	3.3	3.2
Transfers (net)	0.4	0.5	8.8	9.6	11.0	11.3
Receipts, of which:	0.5	0.6	9.0	9.9	11.3	11.6
Non-resident workers remittances 3/	...	...	8.2	9.0	10.4	10.7
Payments	0.1	0.1	0.2	0.3	0.3	0.4
<b>CAPITAL AND FINANCIAL ACCOUNT</b>	<b>1.7</b>	<b>1.2</b>	<b>-2.2</b>	<b>-2.1</b>	<b>-0.4</b>	<b>-1.0</b>
Capital Account	0.0	0.0	0.0	0.0	0.0	0.0
Financial Account	1.7	1.2	-2.3	-2.1	-0.4	-1.0
Direct Investment	1.1	1.7	0.2	0.1	0.9	0.9
Portfolio Investment	1.1	1.1	-1.3	-1.4	2.5	1.6
Equity	0.4	0.4	0.4	0.3	1.3	1.1
Debt	0.7	0.7	-1.7	-1.7	1.2	0.5
Other Investment (excluding trade credit)	-0.5	-1.6	-1.1	-0.7	-3.7	-3.5
<b>ERRORS AND OMISSIONS (incl. trade credit)</b>	<b>-3.2</b>	<b>-4.9</b>	<b>-0.8</b>	<b>0.4</b>	<b>-0.2</b>	<b>0.4</b>
<b>OVERALL BALANCE</b>	<b>-0.2</b>	<b>0.7</b>	<b>-1.7</b>	<b>0.6</b>	<b>2.3</b>	<b>1.8</b>
<b>OVERALL FINANCING</b>	<b>0.2</b>	<b>-0.7</b>	<b>1.7</b>	<b>-0.6</b>	<b>-2.3</b>	<b>-1.8</b>
Monetization of gold and revaluation	-1.1	0.9	2.8	0.5	0.2	0.2
Change in Net international reserves (increase =-)	1.3	-1.6	-1.2	-1.1	-2.6	-2.0
BSP Gross Reserves (increase =-)	0.6	-0.5	-0.7	0.4	-2.2	-1.8
Fund credit (net)	0.0	-0.4	-0.6	-0.5	-0.3	-0.2
Change in other BSP liabilities	0.7	-0.7	0.1	-1.1	0.0	0.0
<b>Memorandum items:</b>						
Current account/GDP	1.9	5.7	1.8	2.7	3.0	2.1
Short-term debt (original maturity)	9.1	8.0	8.2	8.1	8.2	8.4
Short-term debt (residual maturity)	14.0	13.4	14.1	13.6	14.3	14.8
Gross reserves	15.6	16.2	16.9	16.2	18.5	20.3
Adjusted gross reserves 4/	13.2	14.3	14.7	15.2	18.0	19.9
(in percent of st. debt by res. maturity) 5/	114.3	123.9	122.9	121.2	130.5	138.4
Net international reserves	11.4	12.8	13.9	15.1	17.6	19.3
Monitored external debt (in billions) 6/	58.1	59.7	62.8	61.6	64.1	65.6
(in percent of GDP)	81.6	77.7	79.3	71.5	65.7	59.7
Debt service ratio 5/	19.1	19.9	20.6	19.7	18.8	20.1
Export value (percent change)	-16.2	10.0	2.8	9.6	2.3	5.6
Import value (percent change)	-4.5	6.2	20.1	10.6	2.0	7.8
Gross external financing needs 7,8/	10.8	9.6	12.0	11.8	10.6	12.0
GDP (in billions)	71.2	76.8	79.2	86.1	97.5	109.8

Sources: Philippine authorities and Fund staff projections

1/ Based on revisions to the data, made April 2005; do not include further pending data changes commenced August 2005.

2/ "Reforms proceed" scenario assumes VAT rate increase on February 1, 2006.

3/ The 2003-04 revisions to the data separate remittances made by Filipino residents working abroad (income), and non-resident workers' remittances (transfers).

4/ Gross reserves less gold and securities pledged as collateral against short term liabilities.

5/ As a percent of short-term debt excluding pledged assets of the central bank.

6/ 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.

7/ In percent of goods and non-factor services.

8/ 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, 2000–05

	2000	2001	2002	2003	2004				2005		
	Dec.	Dec.	Dec.	Dec.	Mar.	Jun.	Sep.	Dec.	Mar.	Jun.	Sep.
(In billions of pesos)											
Net foreign assets	343	405	551	673	682	615	693	727	839	941	956
Central bank	430	449	547	637	631	635	661	690	724	816	873
Net international reserves	567	586	693	782	775	791	801	820	842	937	991
Medium and long-term foreign liabilities	138	136	146	145	143	156	140	130	119	121	118
Deposit money banks	-87	-44	4	37	51	-20	32	37	116	126	83
Net domestic assets	1,737	1,760	1,799	1,801	1,826	1,906	1,834	1,985	1,921	1,852	1,851
Net domestic credit	2,088	2,106	2,207	2,314	2,341	2,382	2,360	2,533	2,442	2,407	2,409
Public sector credit	581	645	727	807	845	874	836	956	916	855	853
National Government	426	532	590	620	649	673	635	764	725	643	637
Credits	575	690	749	807	849	866	878	923	951	899	916
Foreign exchange receivables	13	12	7	7	7	7	7	15	14	15	14
Treasury IMF Accounts	-41	-50	-50	-58	-58	-65	-65	-65	-65	-66	-66
Deposits	-121	-120	-117	-137	-150	-136	-185	-109	-175	-205	-226
Local government and others	104	97	132	184	195	199	199	191	190	212	215
Claims on CB-BOL 1/	51	15	6	4	2	2	1	1	0	0	0
Private sector credit	1,507	1,462	1,480	1,507	1,496	1,508	1,524	1,577	1,526	1,552	1,556
Other items net	-351	-347	-407	-513	-515	-476	-526	-548	-520	-554	-558
Total liquidity	2,079	2,165	2,351	2,474	2,509	2,521	2,527	2,711	2,761	2,794	2,807
M4	2,013	2,111	2,298	2,401	2,435	2,447	2,463	2,649	2,691	2,729	2,743
M3 (peso liquidity)	1,427	1,525	1,670	1,725	1,713	1,740	1,728	1,884	1,922	1,970	1,973
Foreign currency deposits, residents	586	586	628	676	722	707	735	766	770	759	770
Other liabilities	66	54	53	73	74	74	64	62	69	65	65
(12-month percent change)											
Net foreign assets	4.2	18.1	36.0	22.1	28.3	2.3	12.0	7.9	23.0	53.1	37.9
Net domestic assets	8.0	1.3	2.2	0.1	1.4	8.2	4.0	10.2	5.2	-2.8	1.0
Net domestic credit	8.6	0.9	4.8	4.8	5.4	9.1	4.8	9.5	4.3	1.0	2.1
Public sector	9.9	11.0	12.7	11.0	15.5	21.6	5.3	18.5	8.4	-2.2	2.0
<i>Idem, adjusted 2/</i>	4.4	10.7	11.5	9.9	14.1	19.7	4.9	17.0	9.6	-2.4	2.1
Private sector	8.1	-3.0	1.2	1.8	0.4	3.0	4.5	4.6	2.0	2.9	2.1
<i>Idem, adjusted 2/</i>	2.4	-3.5	0.6	1.7	-0.2	2.1	3.9	4.1	2.5	2.8	2.4
M4	6.7	4.9	8.9	4.5	6.8	6.4	6.6	10.3	10.5	11.5	11.3
M3	4.6	6.9	9.5	3.3	4.8	5.6	5.3	9.2	12.2	13.2	14.1
Memorandum items:											
(In billions of pesos; unless otherwise stated)											
Gross domestic credit from deposit money banks	1,999	2,085	2,151	2,322	2,386	2,444	2,476	2,558	2,544	2,544	2,574
Private sector	1,492	1,451	1,470	1,498	1,487	1,499	1,514	1,566	1,516	1,542	1,548
(12-month percent change)	8.1	-2.7	1.3	1.9	0.4	3.1	4.5	4.6	2.0	2.9	2.1
Public sector	507	634	681	824	899	945	962	992	1,028	1,002	1,028
(In percent of total gross credit)	25.4	30.4	31.6	35.5	37.7	38.7	38.8	38.8	40.4	39.4	39.9
(In billions of US dollars)											
Net foreign assets	6.9	7.9	10.4	12.1	12.1	10.9	12.3	12.9	15.3	16.8	17.0
Central bank	8.6	8.7	10.3	11.5	11.2	11.3	11.7	12.3	13.2	14.6	15.6
Deposit money banks	-1.7	-0.9	0.1	0.7	0.9	-0.4	0.6	0.7	2.1	2.2	1.5
Foreign currency deposits residents	11.7	11.4	11.8	12.2	12.8	12.6	13.1	13.1	14.1	13.5	13.8
Dollar-denominated credit to residents	10.8	10.2	9.9	9.7	11.1	11.7	11.5	11.2	11.0	10.8	10.8
Public sector	4.0	4.4	4.8	6.4	6.7	7.2	7.0	6.7	6.5	6.1	6.6
Private sector	6.8	5.8	5.2	3.3	4.3	4.5	4.5	4.5	4.5	4.7	4.2
(In percent; unless otherwise stated)											
Dollar denominated credit / dollar deposits	92.3	89.5	84.0	79.5	86.7	92.8	88.8	85.5	78.0	80.0	78.3
Dollar denominated credit to public sector / dollar deposits	34.2	38.6	40.7	52.5	52.3	57.1	53.4	51.1	46.1	45.2	47.8
Exchange rate (peso per dollar; end-period)	50.0	51.4	53.1	55.6	56.4	56.2	56.3	56.3	54.8	55.9	56.1

Source: 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.

2/ Adjusted for exchange rate valuation effects.

Table 5. Philippines: Medium-Term Outlook, 2003-10  
(Reforms proceed scenario)

	2003	2004	2005	2006	2007	2008	2009	2010
			Staff Est.			Staff Proj.		
(Percentage change; unless otherwise indicated)								
GDP and prices								
Real GDP	4.5	6.0	4.9	5.0	5.6	6.0	6.5	6.4
GDP per capita (US\$)	968	1,031	1,157	1,278	1,404	1,525	1,640	1,762
CPI (average)	3.5	6.0	7.7	7.5	4.8	4.1	3.5	3.5
Labor								
Employment (average, million)	30.6	31.6	32.3	33.3	34.3	35.5	36.9	38.2
Employment (average)	1.9	3.2	2.2	2.9	3.2	3.5	3.8	3.7
Unemployment rate (old definition, average, percent)	11.4	11.8	11.3	10.5	10.2	9.7	8.9	8.2
(In percent of GDP, unless otherwise indicated)								
Investment and saving								
Gross investment	16.7	17.1	16.0	17.3	20.0	20.8	21.5	21.7
Private	14.2	14.8	13.7	14.5	16.9	17.7	18.4	18.7
Public	2.5	2.3	2.4	2.8	3.1	3.1	3.1	3.0
National saving 1/	18.4	19.8	19.0	19.4	21.9	22.6	22.6	22.6
Foreign saving	-1.8	-2.7	-3.0	-2.1	-1.9	-1.8	-1.1	-0.9
Public finances								
Nonfinancial public sector balance 2/	-5.6	-5.0	-3.2	-2.3	-1.6	-0.9	-0.6	-0.2
Primary balance	0.7	1.6	3.2	3.8	4.2	4.4	4.4	4.5
Revenue and grants 3/	21.0	20.7	21.8	22.9	23.7	24.1	24.2	24.3
Expenditure (primary) 4/	20.2	19.1	18.6	19.1	19.5	19.7	19.8	19.8
Interest	6.3	6.6	6.4	6.1	5.8	5.4	5.0	4.7
Nonfinancial public sector gross financing	29.0	28.3	25.3	24.0	21.0	19.6	17.1	16.2
Domestic	22.2	25.2	21.3	19.9	15.8	14.7	11.9	11.6
Foreign currency	6.8	3.1	4.0	4.1	5.3	5.0	5.2	4.6
National government balance (authorities definition)	-4.7	-3.9	-3.2	-2.1	-1.4	-0.8	-0.5	0.0
National government balance 5/	-5.0	-4.2	-3.6	-2.5	-1.7	-1.0	-0.8	-0.2
Nonfinancial public sector debt 6/	101.3	96.1	90.0	83.7	77.8	73.0	68.5	63.9
External sector								
Export value (percent change)	2.8	9.6	2.3	5.6	7.9	8.1	6.9	7.1
Import value (percent change)	20.1	10.6	2.0	7.8	6.9	6.6	6.8	6.2
Trade balance	-6.9	-7.4	-6.6	-7.0	-6.4	-5.7	-5.5	-5.0
Current account	1.8	2.7	3.0	2.1	1.9	1.8	1.1	0.9
FDI (net, US\$ billions)	0.2	0.1	0.9	0.9	1.4	1.5	1.7	1.9
Reserves, adjusted (US\$ billions) 7/	14.7	15.2	18.0	19.9	22.1	24.7	27.1	29.6
Reserves / Short-term liabilities, adjusted 8/	122.9	121.2	130.5	138.4	151.0	157.5	163.8	172.2
Gross external financing requirements (US\$ billions) 9/	12.0	11.8	10.6	12.0	12.4	12.6	14.4	15.4
Monitored external debt 10/	79.3	71.5	65.7	59.7	54.9	51.8	49.7	47.5
Debt service ratio (in percent of exports of G&S)	20.6	19.7	18.8	20.1	20.2	19.2	19.4	18.6

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). 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.

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, 2003-10  
(Reforms stall scenario) 1/

	2003	2004	2005	2006	2007	2008	2009	2010
			Staff Est.			Staff Proj.		
(Percentage change; unless otherwise indicated)								
GDP and prices								
Real GDP	4.5	6.0	4.9	4.7	4.4	4.2	4.0	4.0
GDP per capita (US\$)	968	1,031	1,157	1,242	1,294	1,337	1,370	1,403
CPI (average)	3.5	6.0	7.7	7.1	5.3	4.6	4.0	4.0
Labor								
Employment (average, million)	30.6	31.6	32.3	33.1	33.9	34.7	35.6	36.4
Employment (average)	1.9	3.2	2.2	2.4	2.6	2.4	2.3	2.3
Unemployment rate (old definition, average, percent)	11.4	11.8	11.3	11.0	11.3	11.7	12.2	12.7
(In percent of GDP, unless otherwise indicated)								
Investment and saving								
Gross investment	16.7	17.1	16.0	16.1	16.1	16.1	16.0	15.8
Private	14.2	14.8	13.7	13.8	13.9	13.9	13.9	13.7
Public	2.5	2.3	2.4	2.4	2.2	2.2	2.1	2.1
National saving 2/	18.4	19.8	19.0	18.4	18.2	18.1	17.9	17.7
Foreign saving	-1.8	-2.7	-3.0	-2.3	-2.1	-2.0	-1.9	-1.9
Public finances								
Nonfinancial public sector balance 3/	-5.6	-5.0	-3.2	-3.1	-3.1	-3.2	-3.2	-3.3
Primary balance	0.7	1.6	3.2	3.3	3.4	3.2	3.3	3.1
Revenue and grants 4/	21.0	20.7	21.8	22.5	22.5	22.4	22.5	22.4
Expenditure (primary) 5/	20.2	19.1	18.6	19.2	19.1	19.2	19.2	19.3
Interest	6.3	6.6	6.4	6.4	6.5	6.5	6.5	6.5
Nonfinancial public sector gross financing	29.0	28.3	25.3	25.1	23.3	23.6	22.3	23.3
Domestic	22.2	25.2	21.3	20.9	17.5	17.9	16.1	17.5
Foreign currency	6.8	3.1	4.0	4.2	5.7	5.7	6.2	5.8
National government balance (authorities definition)	-4.7	-3.9	-3.2	-2.6	-2.6	-2.7	-2.8	-2.9
National government balance 6/	-5.0	-4.2	-3.6	-2.9	-2.9	-3.0	-3.0	-3.1
Nonfinancial public sector debt 7/	101.3	96.1	90.0	86.8	84.9	84.0	83.8	83.6
External sector								
Export value (percent change)	2.8	9.6	2.3	5.0	4.9	4.4	4.2	4.1
Import value (percent change)	20.1	10.6	2.0	6.7	4.9	3.9	3.7	3.7
Trade balance	-6.9	-7.4	-6.6	-7.0	-6.9	-6.7	-6.4	-6.3
Current account	1.8	2.7	3.0	2.3	2.1	2.0	1.9	1.9
FDI (net, US\$ billions)	0.2	0.1	0.9	0.5	0.3	0.3	0.1	0.1
Reserves, adjusted (US\$ billions) 8/	14.7	15.2	18.0	18.3	18.7	19.4	19.9	20.5
Reserves / Short-term liabilities, adjusted 9/	122.9	121.2	130.5	127.5	128.1	123.4	120.3	119.5
Gross external financing requirements (US\$ billions) 10/	12.0	11.8	10.6	11.9	12.4	12.6	13.7	14.5
Monitored external debt 11/	79.3	71.5	65.7	61.4	59.5	59.0	59.2	59.2
Debt service ratio (in percent of exports of G&S)	20.6	19.7	18.8	20.2	20.9	20.5	21.2	20.9

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

1/ In this scenario there is no further reduction in the fiscal deficit after 2005.

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). 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/ 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, 2000–05  
(End of year unless otherwise indicated)

	2000	2001	2002	2003	2004	2005	
						Q1	Q2 prel.
<b>Capital adequacy</b>							
Total capital accounts to total assets	13.6	13.6	13.4	13.1	12.6	12.1	11.9
Net worth-to-risk assets ratio	16.2	16.1	16.7	16.7	16.5	16.6	16.5
Capital adequacy ratio (solo basis)	...	14.5	15.5	16.0	17.4	17.1	...
Capital adequacy ratio (consolidated basis)	...	15.6	16.9	17.5	18.4	18.1	...
<b>Asset quality</b>							
NPL ratio 1/	16.6	19.0	16.6 8/	16.1	14.4	13.1	10.9
NPA ratio 2/	24.0	27.7	26.5 8/	26.1	24.7	23.2	20.6
Distressed asset ratio 3/	27.7	31.7	31.0 8/	30.9	28.6	27.1	24.6
NPL coverage ratio 4/	43.7	45.3	50.2 8/	51.5	58.0	61.6	68.4
NPA coverage ratio 5/	28.6	29.6	30.1 8/	30.9	33.2	34.6	36.6
Net NPL to total capital 6/	34.5	37.7	28.9 8/	27.4	21.0	17.3	12.2
Net NPA to total capital 7/	69.6	78.9	73.3 8/	72.4	65.4	59.3	52.6
<b>Profitability</b>							
Net interest income to average earning assets	3.9	3.8	3.8	3.7	4.2	4.2	4.3
Return on assets	0.4	0.4	0.8	1.1	0.9	1.0	1.1
Return on equity	2.6	3.2	5.8	8.5	7.1	7.7	8.6
Cost-to-income ratio 9/	81.8	80.7	71.4	68.9	69.8	68.1	66.8
<b>Liquidity</b>							
Liquid assets to total assets	29.0	30.0	32.3	32.3	36.6	38.1	37.0
<b>Sensitivity to market risk</b>							
Net foreign exchange position to total capital	...	...	...	8.5	6.3	...	...

Sources: Philippine authorities; and Fund staff calculations.

1/ Nonperforming loans (NPL) over total loan portfolio excluding interbank loans (TL).

2/ NPL plus "real and other properties owned or acquired" (ROPOA) over TL plus ROPOA.

3/ NPL plus ROPOA plus current restructured loans over TL plus ROPOA.

4/ Loan loss reserves over NPLs.

5/ Allowances for probable losses on NPAs over NPAs.

6/ NPL minus loan loss reserves over capital.

7/ NPA minus allowances for probable loss on NPAs over capital.

8/ Change in series largely due to new NPL definition in 2002.

9/ Operating expenses (net of bad debts and provisions) to total operating income.

Table 8. Philippines: Indicators of External Vulnerability, 2000-05  
(In percent of GDP, unless otherwise indicated)

	2000	2001	2002	2003	2004	2005 Staff Est.
<b>External indicators (including external liquidity):</b>						
Gross international reserves, adjusted (in billions US dollars) 1/	13.4	13.2	14.3	14.7	15.2	18.0
Maturing short-term debt (in billions US dollars)	8.4	9.1	8.0	8.2	8.1	8.2
Amortization of medium and long-term debt (in billions US dollars)	3.7	4.9	5.4	5.9	5.4	6.1
Net FDI inflows (in billions of US dollars)	1.5	1.1	1.7	0.2	0.1	0.9
FX deposits residents (in billions of US dollars)	11.7	11.4	11.8	12.2	13.6	13.8 2/
Total gross external debt	75.6	81.6	77.7	79.3	71.5	65.7
<b>Public sector indicators:</b>						
Overall balance	-4.9	-4.9	-5.7	-5.6	-5.0	-3.2
Primary balance	0.7	1.3	0.1	0.7	1.6	3.2
Nonfinancial public sector debt (NFPSD)	88.1	87.4	93.7	101.3	96.1	90.0
NFPSD denominated in FX or linked to the exchange rate (in percent of NFPSD)	69.8	65.8	65.9	67.8	65.9	62.7
Short-term gen. govt debt (original maturity, in percent of NFPSD)	21.0	17.5	14.1	14.5	15.4	14.6
Average effective interest rate of government debt (in percent)	6.3	7.1	6.2	6.3	6.9	7.1
Amortization of total debt	23.9	22.3	21.6	23.4	23.3	22.1

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 September, 2005.

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

	2002	2003	2004	2005	2006	2007	2008	2009
	Projections							
<b>Fund repurchases and charges</b>								
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	38.6	25.9	15.2	14.7	2.4	0.0
In percent of adjusted gross official reserves	3.2	4.4	3.3	1.9	1.0	0.9	0.1	0.0
<b>Fund credit outstanding</b>								
In millions of U.S. dollars	1606.4	1128.8	720.6	415.6	223.9	31.4	0.0	0.0
In percent of quota	140.9	91.6	55.3	30.9	16.6	2.3	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	0.6	0.3	0.0	0.0	0.0
<i>Memorandum item:</i>								
US\$/SDR Period average	1.295	1.401	1.480	1.528	1.530	1.532	1.532	1.532

Source: Fund staff projections.

## PHILIPPINES: DEBT SUSTAINABILITY ANALYSIS

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

- **Reforms Stall.** The scenario where there are no further reforms after 2005 (Table 6) is considered as the baseline for the Debt Sustainability Analysis (Table A1). In this scenario, nonfinancial public sector (NFPS) debt would remain high at 83.6 percent of GDP in 2010. This is predicated on an assumed average real GDP growth of 4.4 percent over 2005-10 and a primary balance adjustment of about 1.6 percent of GDP in 2005, reflecting the recent increases in electricity tariffs and in alcohol and tobacco excises, as well as better-than-expected performance of social security institutions.
- **Reforms Proceed.** Under staff's recommended scenario (Table 5), reforms would continue after 2005, beginning with full implementation of the VAT reform in 2006. In such a world, public sector debt would be placed on a firmly downward path. This scenario assumes that a stronger primary balance adjustment of 2.6 percentage points of GDP over 2005-07 would improve debt dynamics both directly and indirectly, assuming that improved confidence and higher private sector investment would raise average real GDP growth to 5.5 percent.
- **Reforms Reverse.** Alternatively, reforms might reverse leading to an unwinding of progress made in reducing the fiscal deficit in 2004 and 2005. Under the assumption that the NFPS primary balance returns to its 2004 level, and that GDP growth averages 3.8 percent over 2005-2010, debt would begin to climb again.

**Future shocks could adversely affect debt dynamics.** Under the Reforms Stall scenario, the Bounds Tests indicate considerable sensitivity of the projected debt ratio to shocks, especially to the exchange rate and growth. In contrast, debt dynamics would be more resilient if strong and front-loaded reforms were adopted.

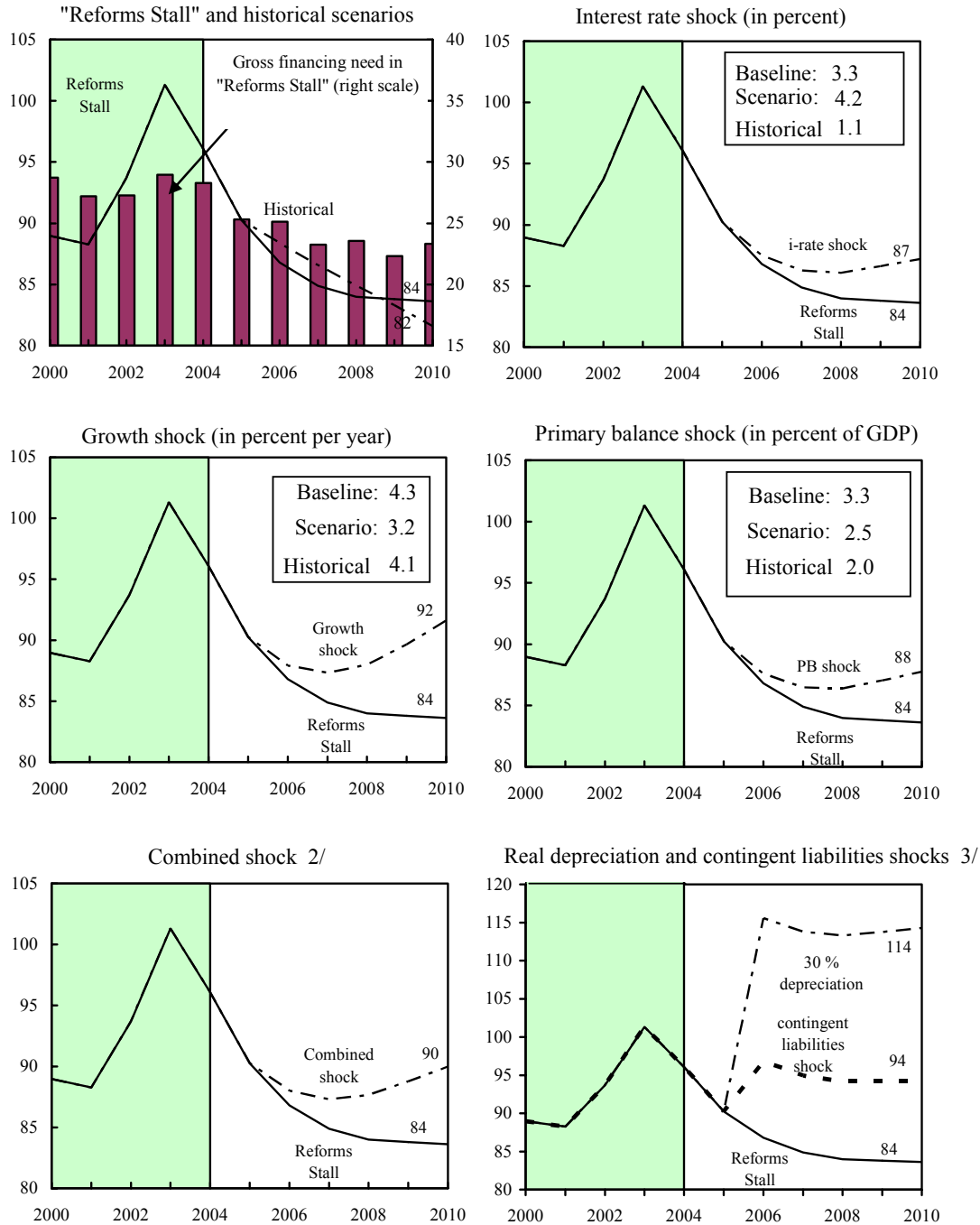
**Reducing external vulnerabilities is also strongly dependent on the success of the reform effort.** In the Reforms Stall scenario, external debt would remain high, steadying at 59.2 percent of GDP by 2010, while external financing requirements would remain large at 11 percent of GDP. In the scenario where reforms proceed, external vulnerabilities would be reduced much more markedly, with nearly twice the reduction in external debt. This is due in part to larger FDI into export oriented sectors leading to stronger balance of payments surpluses, taking the external debt level down to 47.5 percent of GDP.

Table A1. Philippines: Public Sector Debt Sustainability Framework, 2000-10  
(In percent of GDP, unless otherwise indicated)

	Actual										Est.	Projections					Debt-stabilizing primary balance 10/
	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009		2010	2011				
<b>1 Reforms stall scenario: Public sector debt 1/</b> o/w foreign-currency denominated	89.0	88.3	93.7	101.3	96.1	90.2	86.8	84.9	84.0	83.8	83.6	83.6	83.6	83.6	83.6	2.1	
2 Change in public sector debt	4.6	-0.7	5.4	7.6	-5.2	-5.8	-3.4	-1.9	-0.9	-0.2	-0.2	-0.2	-0.2	-0.2	-0.2		
3 Identified debt-creating flows (4+7+12)	7.0	-1.3	0.0	1.8	-5.8	-6.5	-6.1	-4.5	-3.6	-3.0	-2.8	-2.8	-2.8	-2.8	-2.8		
4 Primary deficit	-0.7	-1.3	-0.1	-0.7	-1.6	-3.2	-3.3	-3.4	-3.2	-3.3	-3.1	-3.1	-3.1	-3.1	-3.1	-3.3	
5 Revenue and grants 2/	23.0	23.0	20.9	21.0	20.7	21.8	22.5	22.5	22.4	22.4	22.4	22.4	22.4	22.4	22.4		
6 Primary (noninterest) expenditure	22.3	21.7	20.8	20.2	19.1	18.7	19.2	19.1	19.2	19.2	19.3	19.3	19.3	19.3	19.3		
7 Automatic debt dynamics 3/	6.5	0.6	0.2	1.9	-3.8	-3.6	-3.0	-1.3	-0.6	0.2	0.1	0.1	0.1	0.1	0.1		
8 Contribution from interest rate/growth differential 4/	-4.0	-0.6	-1.6	-0.8	-4.6	-3.6	-3.0	-1.3	-0.6	0.2	0.1	0.1	0.1	0.1	0.1		
9 Of which contribution from real interest rate	0.5	0.9	2.0	3.1	0.8	0.6	0.8	2.1	2.7	3.3	3.2	3.2	3.2	3.2	3.2		
10 Of which contribution from real GDP growth	-4.5	-1.4	-3.6	-3.9	-5.4	-4.2	-3.8	-3.5	-3.3	-3.1	-3.1	-3.1	-3.1	-3.1	-3.1		
11 Contribution from exchange rate depreciation 5/	10.5	1.2	1.8	2.8	0.8	...	...	...	...	...	...	...	...	...	...		
12 Other identified debt-creating flows	1.2	-0.6	-0.1	0.6	-0.4	0.2	0.2	0.2	0.2	0.2	0.2	0.2	0.2	0.2	0.2		
13 Privatization receipts (negative)	-0.1	0.0	0.0	0.0	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	0.0	0.0	0.0	0.0		
15 Other (specify, e.g. bank recapitalization)	1.3	-0.6	0.0	0.6	-0.4	0.2	0.2	0.2	0.2	0.2	0.2	0.2	0.2	0.2	0.2		
16 Residual, including asset changes (2-3) 6/	-2.4	0.6	5.4	5.8	0.6	0.7	2.6	2.6	2.7	2.8	2.8	2.8	2.8	2.8	2.8		
Public sector debt-to-revenue ratio 1/	387.2	383.5	448.1	483.0	465.1	413.3	385.4	377.4	374.3	372.8	372.8	372.8	372.8	372.8	372.8		
Gross financing need 7/ in billions of U.S. dollars	28.7	27.2	27.3	29.0	28.3	25.3	25.1	23.3	23.6	22.3	23.3	23.3	23.3	23.3	23.3		
Scenario with key variables at their historical averages 8/ Reforms proceed scenario	21.8	19.4	20.9	22.9	24.4	24.7	26.8	26.4	28.2	27.9	30.4	30.4	30.4	30.4	30.4		
Reform reversal scenario	90.2	88.4	86.6	84.9	83.3	81.6	81.6	81.6	81.6	81.6	81.6	81.6	81.6	81.6	81.6	-0.6	
	90.0	83.7	77.8	73.0	68.5	63.9	63.9	63.9	63.9	63.9	63.9	63.9	63.9	63.9	63.9		
	94.5	94.3	94.6	96.1	98.2	100.3	100.3	100.3	100.3	100.3	100.3	100.3	100.3	100.3	100.3		

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  $[(r - \pi(1+g) - g + \alpha\epsilon(1+r)) / (1+g+\pi+g\pi)]$  times previous period debt ratio, with  $r$  = interest rate;  $\pi$  = growth rate of GDP deflator;  $g$  = real GDP growth rate;  $\alpha$  = share of foreign-currency denominated debt; and  $\epsilon$  = 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  $\alpha\epsilon(1+r)$ .  
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 1. Philippines: Public Debt Sustainability: Bound Tests 1/  
(Public debt in percent of GDP)



Source: Fund 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 "stall reform" scenario and scenario being presented. Ten-year historical average for the variable is also shown.

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

3/ One-time real depreciation of 30 percent and 10 percent of GDP shock to contingent liabilities occur in 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, 2000-10  
(In percent of GDP, unless otherwise indicated)

	Actual		Est.					Projections			Debt-stabilizing non-interest current account 6/ 0.9
	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	
<b>Reforms stall scenario: External debt</b>	75.6	81.6	77.7	79.3	71.5	65.7	61.4	59.5	59.0	59.2	59.2
Change in external debt	-0.5	6.0	-3.9	1.6	-7.7	-5.8	-4.3	-1.9	-0.5	0.2	0.0
Identified external debt-creating flows (4+8+9)	-9.6	1.0	-14.4	-4.8	-9.5	-8.3	-5.8	-5.1	-4.8	-4.4	-4.3
Current account deficit, excluding interest payments	-12.2	-5.9	-9.0	-5.0	-5.6	-6.3	-5.4	-5.5	-5.6	-5.6	-5.5
Deficit in balance of goods and services	-1.8	3.9	0.8	9.1	8.9	8.0	7.9	7.7	7.5	7.2	6.9
Exports	54.4	48.3	48.7	48.8	49.7	45.3	43.8	43.3	43.0	43.0	42.9
Imports	52.5	52.2	49.5	57.9	58.6	53.3	51.7	51.0	50.5	50.2	49.9
Net non-debt creating capital inflows (negative)	-1.6	-2.1	-2.7	-0.7	-0.4	-2.2	-0.7	-0.5	-0.4	-0.2	-0.2
Automatic debt dynamics 1/	4.2	9.0	-2.7	0.9	-3.4	0.2	0.3	0.9	1.2	1.4	1.4
Contribution from nominal interest rate	4.0	4.0	3.3	3.2	3.0	3.3	3.2	3.5	3.6	3.7	3.6
Contribution from real GDP growth	-4.6	-1.4	-3.4	-3.4	-4.4	-3.1	-2.8	-2.5	-2.4	-2.3	-2.3
Contribution from price and exchange rate changes 2/	4.8	6.4	-2.6	1.1	-2.0	...	...	...	...	...	...
Residual, incl. change in gross foreign assets (2-3) 3/	9.2	5.0	10.5	6.4	1.7	2.4	1.5	3.1	4.3	4.6	4.3
External debt-to-exports ratio (in percent)	139.1	169.1	159.4	162.5	143.9	145.2	140.3	137.4	137.2	137.9	137.9
Gross external financing need (in billions of US dollars) 4/	5.8	10.8	9.6	12.0	11.8	10.6	11.9	12.4	12.6	13.7	14.5
in percent of GDP	7.6	15.1	12.5	15.2	13.7	10.9	11.1	11.0	10.6	11.0	11.1
<b>Scenario with key variables at their historical averages 5/</b>						65.7	63.3	60.9	59.3	57.7	55.8
<b>Reforms Proceed Scenario</b>						65.7	59.7	54.9	51.8	49.7	47.5
<b>Key Macroeconomic Assumptions Underlying Baseline</b>											
Real GDP growth (in percent)	4.4	1.8	4.4	4.5	6.0	4.9	4.7	4.4	4.2	4.0	4.0
GDP deflator in US dollars (change in percent)	-5.9	-7.8	3.3	-1.3	2.6	8.0	4.5	1.8	1.1	0.5	0.5
Nominal external interest rate (in percent)	5.2	5.0	4.3	4.3	4.1	5.2	5.3	6.0	6.3	6.5	6.4
Growth of exports (US dollar terms, in percent)	5.8	-16.7	8.8	3.2	10.8	3.0	5.9	5.1	4.6	4.4	4.4
Growth of imports (US dollar terms, in percent)	8.5	-6.8	2.3	20.4	10.2	2.8	6.2	5.0	4.3	3.9	3.8
Current account balance, excluding interest payments	12.2	5.9	9.0	5.0	5.6	6.3	5.4	5.5	5.6	5.6	5.5
Net non-debt creating capital inflows	1.6	2.1	2.7	0.7	0.4	2.2	0.7	0.5	0.4	0.2	0.2

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

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

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

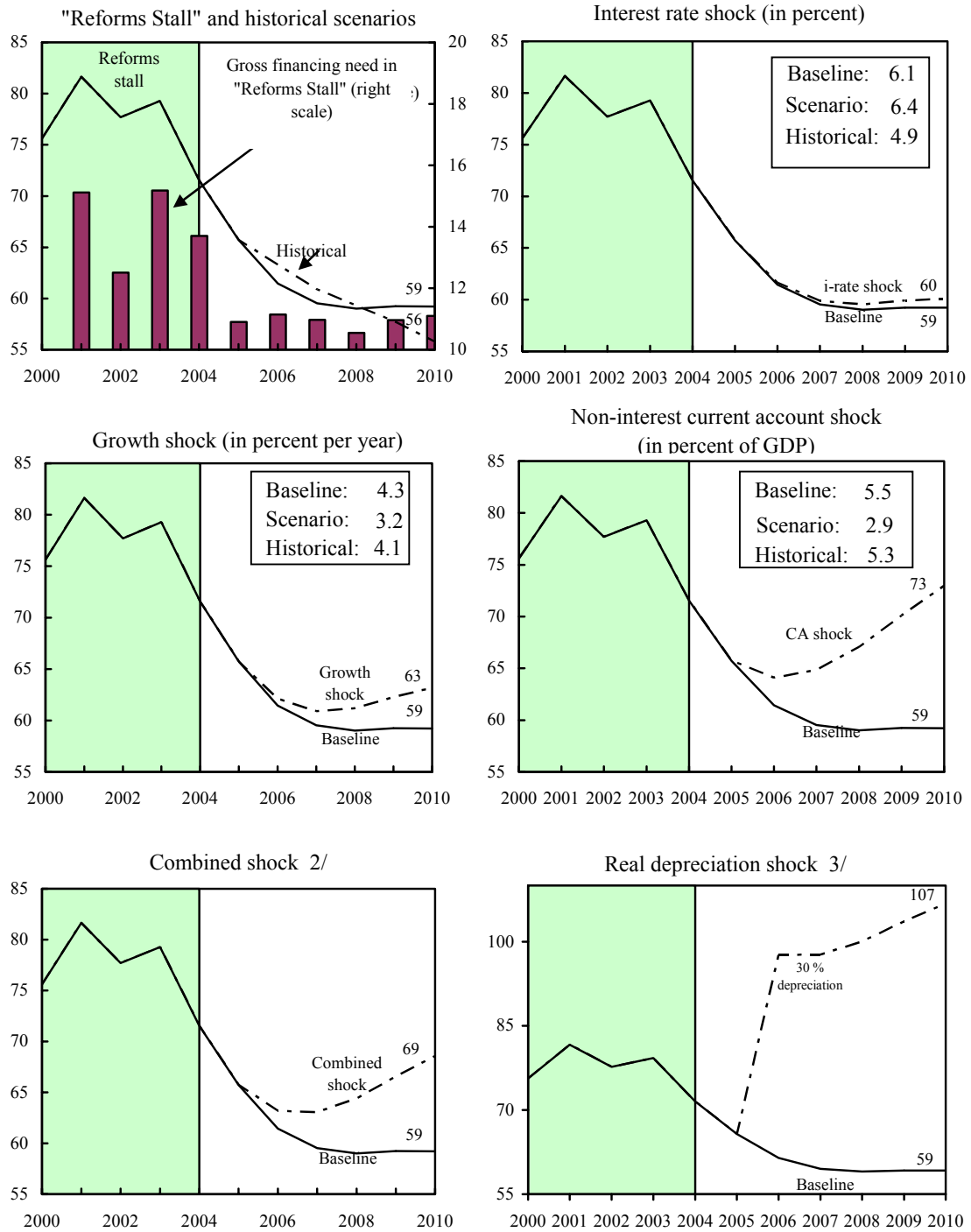
4/ Defined as current account deficit, plus amortization on medium- and long-term debt, plus short-term debt at end of previous period.

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



Source: Fund staff estimates.

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

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

3/ One-time real depreciation of 30 percent occurs in 2006.

**PHILIPPINES: FUND RELATIONS**  
(As of November 30, 2005)

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

II. <b>General Resources Account:</b>	<u>SDR Million</u>	<u>% Quota</u>
Quota	879.90	100.00
Fund holdings of currency	1,064.49	120.98
Reserve position in Fund	87.49	9.94

III. <b>SDR Department:</b>	<u>SDR Million</u>	<u>% Allocation</u>
Net cumulative allocation	116.60	100.00
Holdings	0.59	0.51

IV. <b>Outstanding Purchases and Loans:</b>	<u>SDR Million</u>	<u>% Quota</u>
Stand-by arrangements	272.06	30.92

V. **Financial Arrangements:**

<u>Type</u>	<u>Approval Date</u>	<u>Expiration Date</u>	<u>Amount Approved (SDR Million)</u>	<u>Amount Drawn (SDR Million)</u>
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

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

	<u>Forthcoming</u>			
	<u>2006</u>	<u>2007</u>	<u>2008</u>	<u>2009</u>
Principal	125.78	125.78	20.50	...
Charges/Interest	12.46	7.17	3.86	3.49
Total	<u>138.24</u>	<u>132.96</u>	<u>24.35</u>	<u>3.49</u>

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.

From November 1995 to June 1997 the peso was effectively fixed at around P 26.2–P 26.4 per U.S. dollar. On July 11, 1997, the peso depreciated to P 29.45 per U.S. dollar following an announcement by the central bank that the peso would be allowed to find its own level. Since then, it has gradually depreciated; during the last few months, it has fluctuated from P 52–55 per U.S. dollar.

### **VIII. Article IV Consultation:**

The Philippines is on the standard 12-month cycle. The 2004 Article IV Consultation was discussed by the Executive Board on March 7, 2005. At that time, Directors welcomed the efforts being made by the new administration to lay out a comprehensive package of reforms aimed at addressing the country's long-standing problems in the fiscal, power, and banking sectors, and in reducing the high debt levels. They praised the authorities' commitment to win the necessary political support for key reform measures, and were encouraged by a number of recent developments, including the passage of the bill raising alcohol and tobacco excises, and the provisional tariff increase awarded to NPC.

### **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.

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 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.

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.

## **PHILIPPINES: RELATIONS WITH THE WORLD BANK GROUP**

### **A. World Bank Lending and Non-Lending Activities**

Since the World Bank started operations in the Philippines, it has committed \$9.6 billion under IBRD loans and \$239 million under IDA credits (less cancellations) of which \$9.2 billion has been disbursed. As of June 30, 2005, the current Philippines portfolio consisted of 22 projects, amounting to \$1.14 billion (net of cancellations). Based on net commitments and by sector, the portfolio can be broken down as follows: rural development (\$352 million, 31 percent); human development (\$328 million, 29 percent); infrastructure (\$407 million, 35 percent); environment (\$35 million, 3 percent); and governance and economic management (\$22 million, 2 percent). During FY05, the Bank approved three loans for a total of \$99 million: Women's Health II (\$16 million), Land Administration and Management Project II (\$19 million), and Manila Third Sewerage Project (\$64 million).

The overarching objective of the Bank's Country Assistance Strategy (CAS) for the Philippines is to improve the lives of Filipinos through sustainable economic growth and greater social inclusion. Fiscal stability and public institutions that serve the common good are critical to these objectives. The strategy supports "Islands of Good Governance" in those government agencies, local governments, and dynamic sectors in the Philippines that demonstrate how improved accountability and service delivery will lead to better economic and social outcomes. The CAS seeks to align Bank lending more closely with the government's own investment priorities, *within* the existing national budget, implying a shift away from financing discrete projects toward programmatic engagement. The approach also encourages local government units to pursue and finance their own priorities and to foster a better partnership with the national government. The CAS sets forth a lending program of up to \$1.8 billion for the FY06-08 period. The actual lending level will be determined by progress on fiscal reforms and country demand.

An important aspect of Bank support to the Philippines is in the form of non-lending activities. These activities focus on six themes emphasized by the Bank's current assistance strategy: fiscal reform; growth and the investment climate; social development and inclusion, social protection, and poverty; governance, political economy reform, and anti-corruption; local government units, municipal finance, and fiscal decentralization; and meeting infrastructure needs. Recent examples of non-lending outputs include a Decentralization and Service Delivery Report; Development Policy Review; an Investment Climate Assessment; and a report on Meeting Infrastructure Needs.

In addition to analytical work, the Bank also provides technical assistance to the Philippines, frequently supported by trust funds such as the Institutional Development

Fund (IDF) and the Bank-managed ASEM Trust Fund.<sup>8</sup> In addition, technical assistance funded by the Policy and Human Resource Development (PHRD) Grant Facility helps the client prepare lending operations. In FY05 trust funds supported studies, project preparation, capacity building and technical assistance in such areas as: pension reform, international competitiveness, banking supervision, procurement reform, financial management capacity, corporate governance, community managed agrarian reform, public sector strengthening, poverty mapping, and rural power.

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

### **B. Consultative Group**

The Philippine Development Forum (PDF), formerly called the Consultative Group (CG), is next scheduled to convene during the first half of 2006 in the Philippines. The Bank will co-chair the meeting with the Philippine Government. An innovation to the development partner collaboration has been the formation of five subgroups focused on: social progress; growth and investment climate; economic and fiscal reforms; governance and anti-corruption; and decentralization and local government. These five groups each meet regularly throughout the year (in the Philippines) to discuss key issues and reform measures related to their relevant topics.

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<sup>8</sup> Asia-Europe Meeting – The European Union’s Asian crisis response fund, created in April 1998; intended to help eligible East Asian countries, including the Philippines, to recover from the regional financial crisis. The trust fund supports activities both in the financial/corporate and social sectors.

**Table 1. Board Approvals for Loans between July 1, 2000 and October 31, 2005**  
(In millions of U.S. dollars)

Name	IBRD amount	Effective Date
Land Administration Management Project (LIL)	4.79	1/9/01
Metro Manila Urban Integration Project	60.00	12/6/01
LGU Urban Water and Sanitation Project 2	30.00	5/16/02
Social Expenditure Management-2	100.00	12/11/02
Kalahi Community Development Project	100.00	12/16/02
Second Agrarian Reform Communities Project	50.00	6/4/03
ARMM Social Fund	33.6	5/19/03
Judicial Reform	21.9	12/04/03
Rural Power	10.00	05/06/04
Laguna de Bay Institutional Strengthening and Community Participation	5.00	04/02/04
Diversified Farm Income and Market Development	60.00	10/29/04
Second Women's Health and Nutrition Project	16.0	NYE
Second Land Administration and Management Project	19.0	10/11/05
Third Manila Sewerage Project	64.0	NYE

**Table 2. IBRD/IDA Lending Operations as of September 30, 2005**  
(In millions of U.S. dollars)

	IBRD	IDA	TOTAL
Total disbursed <sup>1/</sup>	8,938	244	9,182
Total commitments <sup>1/</sup>	9,626	239	9,865
Total undisbursed	688	0	688
Total repaid	6,000	49	6,049

IFC investments as of October 31, 2005  
(In millions of U.S. dollars)

Total commitments held by IFC and participants	514.02
Total commitments held by IFC alone	464.5
Approvals pending commitments:	
IFC	4.25
Participants	0

1/ Net of cancellations.

### PHILIPPINES: RELATIONS WITH THE ASIAN DEVELOPMENT BANK

Since joining the Asian Development Bank (ADB) in 1966, the Philippines has received 194 loans for a total of \$8.65 billion, and 312 technical assistance grants amounting to \$139 million. Forty-three percent of the loans were for projects in the energy and agriculture sectors. As of September 30, during 2005 approvals include \$25 million loan for the Small & Medium Enterprise Support project and three technical assistance grants for \$2.1 million.

ADB's private sector operations, which are made without government guarantee, amount to \$561.2 million, including 17 loans for \$520.3 million and 20 equity investments for \$36.8 million. The Philippines is one of the largest clients for such activities.

Table 1. Philippines: Cumulative ADB Lending to the Philippines <sup>1</sup>  
(As of September 30, 2005)

	No. of Loans	Amount of Loans (In millions of US \$)	Percent
Energy	24	2,207.1	25.5
Agriculture	46	1,538.5	17.8
Multisector	28	1,175.8	13.6
Transport & Communication	23	996.9	11.5
Finance	18	803.0	9.3
Water	19	686.1	7.9
Health	6	317.4	3.7
Education	8	252.1	2.9
Industry & Trade	4	149.0	1.7
Law	1	3.0	0.0
Private Sector	17	520.3	6.0
<b>Total</b>	<b>194</b>	<b>8,649.2</b>	<b>100.0</b>

<sup>1</sup> Includes loans to private sector without government guarantee, but excludes 20 private equity investments of \$36.8 million.



## PHILIPPINES: STATISTICAL ISSUES

**Although data are generally published on a timely basis, weaknesses in the statistical base continue to hamper surveillance.** The 2004 Data Module of the Report on the Observance of Standards and Codes (ROSC) noted that the most serious deficiencies relate to the national accounts and balance of payments statistics.

The Philippines has subscribed to the Special Data Dissemination Standards (SDDS) and its metadata are posted on the Dissemination Standards Bulletin Board (DSBB).

### A. National Accounts

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

**The data ROSC identified a number of causes for these problems.<sup>9</sup>**

- **Deaths and births of establishments are not adequately captured.** This gap is of growing importance given the rapid structural change in the economy in recent years, with a large number of new establishments, in particular in the electronics and information technology industries.
- **Compilation relies on an outdated benchmark year and fixed input-output (I-O) ratios.** The estimates are derived by extrapolation of the 1988 benchmark year using fixed input-output ratios. For example, GDP statistics for the electronic sector suggest that value added remained at 10 percent of exports over the past years in spite of industry evidence that the domestic component of exports has been rising sharply.<sup>10</sup>
- **Statistical techniques in estimating GDP at constant prices are inadequate.** For most activities, not all components of the production accounts are compiled, instead only value added is estimated. Value added at current prices is calculated by extrapolating the benchmark year value with an indicator for the value of output; data in constant prices are estimated using a price deflator for output. In addition, the national accounts constant price estimates for merchandise exports and imports are constructed by multiplying 1985 values by quantity data (weights) from the foreign trade statistics for current years. Because of this inappropriate method, implicit deflators for electric machinery products appear high compared with developments in world market prices.

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<sup>9</sup> Currently, the authorities are compiling new national accounts series based on the *1993 SNA* guidelines.

<sup>10</sup> Industry representatives indicate that the domestic component has increased significantly, to around 30 percent in recent years.

## B. Balance of Payments

**Steps have been taken to improve the quality of the balance of payments.** The Fund has fielded several technical assistance missions since 1995, including the assignment of a peripatetic advisor in 2003. In 2005, Bangko Sentral ng Pilipinas created a new Department of Economic Statistics, with one of its units to concentrate on compiling, analyzing, and publishing the balance of payments and the international investment position. There has been important progress since 2004, including a significant improvement in the measurement of imports to correct an underestimation of imports of electronic goods on a consignment basis, improvements in the classification and recording of remittances, the introduction of a new methodology for measuring trade credits, and progress in the direct investment survey. Major revisions to the 2003-04 accounts were made in March 2005 and work to backtrack the series to 1999 to make the series comparable is expected to be completed in the first quarter of 2006.<sup>11</sup> Data for external debt and reserves are generally of good quality, although the data ROSC mission identified scope for improvement.

**The revisions to imports have narrowed the gap between national trade data and those of partner countries on a net basis.** An interagency task force on import statistics was established in July 2002 to improve the measurement of activity in the electronics sector, which accounts for about 43 percent of trade flows. Results of surveys covering electronics sector raw material imports confirmed that imports were routinely underestimated in reports to the NSO. Import figures have therefore been revised substantially, back to 2000.<sup>12</sup> As a result, the estimated trade balance for 2001 changed from a surplus of 3.8 percent of GDP to a deficit of 1 percent of GDP. A comparison of the revised figures with trade data of partner countries suggests that the revised trade balances of 2001–02 are reasonably well measured. However, substantial differences remain with partner country data on gross flows of exports and imports, with the latter about 15 percent higher than the corresponding national data. The BSP is continuing research on the factors behind discrepancies in data related to trade in processed goods, such as electronics and textiles.

**Challenges remain for addressing certain compilation issues.** Since deregulation in the early 1990s, international transactions have increasingly flowed through nontraditional channels that are not adequately covered by the statistical reporting system. The major gap relates to Foreign Currency Deposit Units (FCDUs), which account for about 70–75 percent of foreign exchange settlements, where because of strict secrecy rules banks are not mandated to report information. Steps have been taken to measure cross-border transactions

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<sup>11</sup> Errors and omissions prior to 2003 are sizable, making the data very difficult to interpret. Errors and omissions and “trade credits” accounted for balance of payments outflows of US\$4.4 billion (5.6 percent of GDP) in 2002. Trade credit data, previously calculated as the difference between export receivables (export shipments less export receipts) and import payables (import arrivals less import payments) were unreliable, as indicated by continued accumulation of trade credit balances. They are therefore grouped with errors and omissions in the IMF presentation of the Philippines balance of payments accounts.

<sup>12</sup> Data from 1996–99 have not been revised and remain underestimated.

that skirt the domestic banking system, such as flows through inter-company accounts.<sup>13</sup> A couple of enterprise surveys, for example, have been introduced. However, these are conducted on a voluntary basis and will take time to implement fully. Unless modifications are made to secrecy rules associated with FCDU accounts to facilitate the collection of data for statistical purposes, compilation of the balance of payments will continue to face challenges in securing adequate source data.

### C. Monetary Accounts

**While compilation of the monetary statistics largely conforms to the Fund's methodology, structural changes in the financial system following liberalization affected data on the central bank, commercial banks, and nonbank financial intermediaries.**

However, the authorities have recently made progress in implementing some of the recommendations of the data ROSC. They have introduced the Depository Corporations Survey, which now includes operations of thrift and rural banks. They have also introduced uniform procedures for converting foreign currency denominated accounts to local currency in the monetary aggregates. However, weaknesses remain, including in the treatment of non-operational banks, valuation of securities, and treatment of accrued interest.

In October 2004, STA introduced standardized report forms (SRFs) for reporting monetary statistics to the IMF and requested that countries submit test data by January 2005. However, BSP has yet to submit the data to STA.

### D. Fiscal Data

**While the Philippines meets the requirements of fiscal transparency in many important respects, the recent fiscal and data ROSCs found areas that require strengthening.** An important problem is that the budget is presented on an obligations basis, while the deficit is reported on a cash basis, complicating comparisons of budgets and outcomes. In addition, for levels of the public sector beyond the budgetary central (national) government, consolidated fiscal outturns for items other than the fiscal balance are generally not available. The August 2004 GFS mission addressed shortcomings in the reconciliation of debt stocks and financing flows and advised on improving the consolidation of debt data for the public sector (and its subsectors). This has allowed publication of revised nonfinancial public sector debt data since early 2005.

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

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<sup>13</sup> According to recent household surveys, typically about 30 percent of remittances of Overseas Filipino Workers were not channeled through the banking system, suggesting that remittances may have been underestimated by about US\$3 billion (3.8 percent of GDP) in 2002.

## PHILIPPINES: COMMON INDICATORS REQUIRED FOR SURVEILLANCE

(As of December 27, 2005)

	Date of latest observation	Date received	Frequency of Data <sup>6</sup>	Frequency of Reporting <sup>6</sup>	Frequency of Publication <sup>6</sup>	Memo Items:	
						Data Quality – Methodological soundness <sup>7</sup>	Data Quality – Accuracy and reliability <sup>8</sup>
Exchange Rates	Oct. 31/05	Oct.31/05	D	D	D		
International Reserve Assets and Reserve Liabilities of the Monetary Authorities <sup>1</sup>	Oct. 05	12/12/05	D	D	M		
Reserve/Base Money	Oct. 05	12/12/05	D	W	W	O, LO, LO, LNO	LO, O, O, O, LO
Broad Money	Sept. 05	12/12/05	M	M	M		
Central Bank Balance Sheet	Oct. 05	12/12/05	M	M	M		
Consolidated Balance Sheet of the Banking System	Sept. 05	12/12/05	M	M	M		
Interest Rates <sup>2</sup>	Nov. 05	12/12/05	D	D	D		
Consumer Price Index	Nov. 05	Dec.14/05	M	M	M	O, O, O, O	O, LO, O, LO, LO
Revenue, Expenditure, Balance and Composition of Financing <sup>3</sup> – General Government <sup>4</sup>	Q2/05	Oct.7/05	Q	Q	Q	LO, LO, O, O	LO, LO, LO, LO, LO
Revenue, Expenditure, Balance and Composition of Financing <sup>3</sup> – Central Government	Sep./05	Oct.19/05	M	M	M		
Stocks of Central Government and Central Government-Guaranteed Debt <sup>5</sup>	July/05	Oct.07/05	M	M	M		
External Current Account Balance	Q2/05	Sep.26/05	Q	Q	Q	O, LO, LO, LO	LNO, LO, O, LO, LO
Exports and Imports of Goods and Services	Q2/05	Sep.26/05	Q	Q	Q		
GDP/GNP	Q2/05	Aug.31/05	Q	Q	Q	LO, LO, O, LO	LNO, LNO, O, LO, O
Gross External Debt	Q2/05	Oct.5/05	Q	Q	Q		

<sup>1</sup> Includes reserve assets pledged or otherwise encumbered as well as net derivative positions.

<sup>2</sup> Both market-based and officially-determined, including discount rates, money market rates, rates on treasury bills, notes and bonds.

<sup>3</sup> Foreign, domestic bank, and domestic nonbank financing.

<sup>4</sup> The general government consists of the central government (budgetary funds, extra budgetary funds, and social security funds) and state and local governments.

<sup>5</sup> Including currency and maturity composition.

<sup>6</sup> Daily (D), Weekly (W), Monthly (M), Quarterly (Q), Annually (A), Irregular (I); Not Available (NA).

<sup>7</sup> Reflects the assessment provided in the data ROSC (published on August 25, 2004, and based on the findings of the mission that took place during September 1-16, 2003) for the dataset corresponding to the variable in each row. The assessment indicates whether international standards concerning concepts and definitions, scope, classification/sectorization, and basis for recording are fully observed (O), largely observed (LO), largely not observed (LNO), or not observed (NO).

<sup>8</sup> Same as footnote 8, except referring to international standards concerning source data, statistical techniques, assessment and validation of source data, assessment and validation of intermediate data and statistical outputs, and revision studies.

## Philippines: Millennium Development Goals

	1990	1995	2000	2001	2002	2003	2004
<b>Goal 1: Eradicate extreme poverty and hunger.</b>							
<i>Target 1: Halve, between 1990 and 2015, the proportion of people whose income is less than one dollar a day.</i>							
1. Population below \$1 per day (percent)	20.0	18.0	15.5	14.6	...	...	...
2. Poverty gap ratio at \$1 per day (percent)	4.2	3.9	3.0	2.7	...	...	...
3. Share of income or consumption held by poorest 20 percent (percent)	...	...	5.4	5.4	...	...	...
<i>Target 2: Halve, between 1990 and 2015, the proportion of people who suffer from hunger.</i>							
4. Prevalence of child malnutrition (percent of children under 5)	33.5	29.6	...	...	...	...	...
5. Population below minimum level of dietary energy consumption (percent)	26.0	23.0	...	22.0	...	22.0	...
<b>Goal 2: Achieve universal primary education.</b>							
<i>Target 3: Ensure that, by 2015, children everywhere, boys and girls alike, will be able to complete a full course of primary schooling.</i>							
6. Net enrolment ratio (percent of relevant age group)	97.5	100.0	92.7	93.0	...	93.7	...
7. Cohort reaching grade 5 (percent)	...	...	79.3	79.3	...	...	...
8. Youth literacy rates (percent, ages 15-24)	97.3	98.1	95.1	...	95.1	...	...
<b>Goal 3: Promote gender equity.</b>							
<i>Target 4: Eliminate gender disparity in primary and secondary education, preferably by 2005, and in all levels of education no later than 2015.</i>							
9. Ratio of girls to boys in primary and secondary education (percent)	97.2	98.8	102.6	102.3	...	102.2	...
10. Ratio of young literate females to males (percent, ages 15-24)	100.4	100.4	101.3	101.3	...	...	...
11. Share of women employed in non-agricultural sector (percent)	40.4	40	41.1	42.2	...	41.1	41.1
12. Proportion of seats held by women in national parliament (percent)	9.0	11.0	12.0	12.0	18.0	18.0	18.0
<b>Goal 4: Reduce child mortality.</b>							
<i>Target 5: Reduce by two thirds, between 1990 and 2015, the under-five mortality rate.</i>							
13. Under five mortality rate (per 1,000)	63.0	50.0	40.0	40.0	37.0	36.0	36.0
14. Infant mortality rate (per 1,000 live births)	45.0	36.0	30.0	30.0	28.0	27.0	27.0
15. Immunization, measles (percent of children under 12 months)	85.0	72.0	81.0	75.0	73.0	80.0	80.0
<b>Goal 5: Improve maternal health.</b>							
<i>Target 6: Reduce by three quarters, between 1990 and 2015, the maternal mortality ratio.</i>							
16. Maternal mortality ratio (modeled estimate, per 100,000 live births)	280	240	200	200	...	...	...
17. Births attended by skilled health personnel (percent of total)	...	52.8	58.0	58.0	...	60.0	60.0
<b>Goal 6: Combat HIV/AIDS and other diseases.</b>							
<i>Target 7: Have halted by 2015 and begun to reverse the spread of HIV/AIDS.</i>							
18. Prevalence of HIV, total (percent, ages 15-49)	...	...	0.1	...	...	0.1	0.1
19. Contraceptive prevalence rate (percent of women, ages, 15-49)	36.1	48.1	47.0	47.0	...	49.0	49.0
20. Number of children orphaned by HIV/AIDS	...	...	...	4,100	...	...	...
<i>Target 8: Have halted by 2015 and begun to reverse the incidence of other major diseases.</i>							
21. Incidence of tuberculosis (per 100,000 population)	...	...	304.9	297	320	296.1	296.1
22. Tuberculosis cases detected under DOTS (percent)	...	3.0	48.1	58.0	57.6	68.2	68.2

## Philippines: Millennium Development Goals (continued)

	1990	1995	2000	2001	2002	2003	2004
<b>Goal 7: Ensure environmental sustainability.</b>							
<i>Target 9: Integrate the principles of sustainable development into country policies and programs and reverse the loss of environmental resources</i>							
23. Forested land area (percent of total land area)	22.4	...	19.4	19.4	...	...	...
24. Nationally protected area (percent of total land area)	...	4.9	...	4.9	...	5.7	5.7
25. GDP per unit of energy use (PPPS per Kg oil equivalent)	6.8	6.6	7.2	7.6	...	7.5	...
26. Carbon dioxide emissions (metric tons per capita)	0.7	0.9	1.0	1.0	...	...	...
<i>Target 10: Halve, by 2015, the proportion of people without sustainable access to safe drinking water and sanitation</i>							
27. Access to an improved water source (percent of population)	87.0	...	...	86.0	...	85.0	...
28. Access to improved sanitation (percent of population)	74.0	...	...	83.0	...	73.0	...
<i>Target 11: By 2020, to have achieved a significant improvement in the lives of at least 100 million slum dwellers</i>							
29. Access to secure tenure (percent of population)	...	...	...	...	...	...	...
<b>Goal 8: Develop a global partnership for development. 1/</b>							
<i>Target 16: In cooperation with developing countries, develop and implement strategies for decent and productive work for youth</i>							
30. Youth unemployment rate (percent of total labor force, ages, 15-24)	15.4	16.1	21.2	19.0	...	...	...
<i>Target 18: In cooperation with the private sector, make available the benefits of new technologies, especially information and communications</i>							
31. Fixed telephone lines and cellular subscribers (per 1,000 population)	10.0	27.7	124.4	197.8	232.9	310.7	310.7
32. Personal computers (per 1,000 population)	3.5	9.6	19.3	21.7	27.7	27.7	...

Sources: World Bank; and United Nations.

1/ Some targets are excluded because they are not measured on a country specific basis.

**Statement by the IMF Staff Representative  
February 13, 2006**

1. This statement provides an account of developments since the staff report was circulated to the Executive Board on January 20, 2006. Recent developments do not alter the thrust of the staff appraisal.
2. **Fiscal performance in 2005 was substantially better than target.** The National Government deficit amounted to P 146.5 billion (2.7 percent of GDP) last year, substantially below the target of 3.4 percent of GDP, and a pronounced improvement relative to the 2004 outturn (3.9 percent of GDP). Buoyant revenues and expenditure under-runs contributed about equally to the overperformance.
3. **As scheduled, the government increased the VAT rate from 10 to 12 percent on February 1, completing implementation of the VAT reform package.** A first round of measures, including broadening the base of the VAT to power and petroleum products and raising the corporate income tax rate, went into effect on November 1, 2005. Assuming that tax collection matches expectations, the VAT reform package should help bring the non-financial public sector deficit to 2.3 percent of GDP this year, down from 5.0 percent in 2004 and an estimated 2.7 percent in 2005, while also providing additional resources for capital and social spending, which have been compressed in recent years.
4. **Real GDP growth registered 5.1 percent in 2005, slightly above expectations, but down from 6.0 percent in 2004.** In the fourth quarter, growth rose to 6.1 percent (y/y), up from 4.5 percent in the previous quarter, driven in part by stronger private consumption due to surging remittances. For 2005 as a whole, the slowdown relative to 2004 mainly reflects substantially weaker investment and net exports.
5. **Financial markets have continued to reward the sustained reform momentum.** The peso has strengthened around 2.6 percent against the U.S. dollar since the beginning of the year, in line with other currencies in the region. Against the U.S. dollar, the peso is now at its highest level since September 2002, and the BSP has taken advantage of this strength to build reserves. Against this background, gross international reserves reached an all-time high of \$20.5 billion at end-January, up by \$2 billion since end-December, in part also reflecting the successful external bond placement in early January. The EMBI-PHL spread has continued to narrow since the beginning of the year and now measures 272 basis points, around 180 basis points below its level last July, when the Supreme Court suspended the VAT reform package and the former economic team resigned.
6. The attachment updates Table 1 in the Staff Report to incorporate these developments.

Table 1. Philippines: Selected Economic Indicators, 2002–06

Nominal GDP (2004): P4,826 billion (\$86.1 billion)

Population (2004): 83.5 million

GDP per capita (2004): \$1,031

IMF quota: SDR 879.9 million

	2002	2003	2004	2005 Staff Est.	2006 1/ Staff Proj.
<b>GDP and prices (percentage change)</b>					
Real GDP	4.4	4.5	6.0	5.1	5.0
CPI (annual average)	3.0	3.5	6.0	7.6	7.4
CPI (end year)	2.5	3.9	8.6	6.6	6.4
<b>Investment and saving (percent of GDP)</b>					
Gross investment	17.7	16.7	17.1	15.7	17.0
National saving 2/	23.4	18.4	19.8	18.7	19.1
<b>Public finances (percent of GDP)</b>					
National government balance (authorities definition)	-5.3	-4.7	-3.9	-2.7	-2.1
National government balance 3/	-5.6	-5.0	-4.2	-3.1	-2.5
Nonfinancial public sector balance 4/	-5.7	-5.6	-5.0	-2.7	-2.3
Revenue and grants 5/	20.9	21.0	20.7	21.8	22.8
Expenditure 6/	26.6	26.6	25.7	24.4	25.1
Nonfinancial public sector debt 7/	93.7	101.3	96.1	89.6	82.7
<b>Monetary sector (percentage change, end of period)</b>					
Broad money (M3)	9.5	3.3	9.2	14.1 8/	...
Interest rate (91-day Treasury bill, secondary market, end of period, in percent)	5.9	6.5	8.4	6.4	6.1 9/
Credit to the private sector	1.2	1.8	4.6	2.1 8/	...
<b>External Sector</b>					
Export value (percent change)	10.0	2.8	9.6	2.3	5.4
Import value (percent change)	6.2	20.1	10.6	2.0	7.4
Current account (percent of GDP)	5.7	1.8	2.7	3.0	2.1
Capital and Financial account (US\$ billions, excluding errors and omissions)	1.2	-2.2	-2.1	-0.4	-0.4
Foreign direct investment (net)	1.7	0.2	0.1	0.9	1.2
Other	-0.5	-2.4	-2.2	-1.2	-1.6
Errors and omissions and trade credit (US\$ billions)	-4.9	-0.8	0.4	-0.2	0.4
Overall balance (US\$ billions)	0.7	-1.7	0.6	2.3	2.4
Monitored external debt (percent of GDP) 10/	77.7	79.3	71.5	65.1	57.6
Debt-service ratio (percent of exports)	19.9	20.6	19.7	18.8	20.1
Reserves, adjusted (US\$ billions) 11/	14.3	14.7	15.2	18.0	20.5
Reserves / Short-term liabilities, adjusted 12/	123.9	122.9	121.2	131.1	144.6
<b>Exchange rate (period averages)</b>					
Pesos per U.S. dollar	51.6	54.2	56.0	55.1	52.6 9/
Nominal effective exchange rate (1990=100)	66.1	58.7	54.0	56.6 13/	...
Real effective exchange rate (1990=100)	102.2	89.0	85.2	95.6 13/	...

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

1/ "Reforms proceed" 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/ As of September, 2005.

9/ January 2006.

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.

11/ Gross reserves less gold and securities pledged as collateral against short-term liabilities.

12/ Reserves as a percent of short-term debt (including medium- and long-term debt due in the following year). Both reserves and debt were adjusted for pledged assets.

13/ November 2005.





INTERNATIONAL MONETARY FUND

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International Monetary Fund  
700 19<sup>th</sup> Street, NW  
Washington, D. C. 20431 USA

## **IMF Executive Board Concludes 2005 Article IV Consultation with the Philippines**

On February 13, 2006, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with the Philippines.<sup>1</sup>

### **Background**

Since mid-2004, when the current administration took office, economic reforms have moved ahead. In particular, power generation tariffs have been raised to substantially cut the losses of the National Power Corporation (NPC). The VAT reform has been fully implemented, including an extension of VAT to energy products in November 2005 and an increase in the VAT rate from 10 to 12 percent on February 1 of this year. Economic reforms were, however, temporarily blown off course in mid-2005 by political turbulence following allegations of wrongdoing against the President. During this period, key members of the economic team resigned and the VAT reform was suspended by the Supreme Court. The authorities quickly regrouped and succeeded in keeping fiscal consolidation on track. Impeachment charges were dismissed by Congress in September, and political uncertainties have since receded.

GDP grew by 5.1 percent y/y in 2005, down from 6 percent in 2004. Weak exports and a decline in investment served as a drag on activity. Private consumption has been supported by surging remittances and, to date, has shrugged off the effects of high petroleum prices. On the production side, services such as business process outsourcing, telecommunication, and tourism remain key growth drivers. Due in large part to the oil price shock, average inflation for the year was 7.6 percent, significantly above the target range of 5-6 percent.

Fiscal performance in 2005 was substantially better than target. The National Government deficit amounted to 2.7 percent of GDP, substantially below the target of 3.4 percent of GDP, and a pronounced improvement relative to the 2004 outturn (3.9 percent of GDP). Buoyant revenues and expenditure under-runs contributed about equally to the overperformance. The deficit of the 14 monitored Government Owned and Controlled Corporations fell sharply, led by National Power Corporation, which is estimated to have cut its losses to ½ percent of GDP in

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

2005, a third of the 2004 level. In addition, increased surpluses are expected for the social security institutions reflecting lower net lending and increased contributions, including from overseas workers. Taken together, the nonfinancial public sector deficit is estimated at 2.7 percent of GDP in 2005, compared to 5 percent of GDP in 2004.

Export growth was 2½ percent in the first 11 months of 2005 y/y, weighed down by anemic electronics growth which has lagged the region. Oil-related imports are estimated to be US\$1.3 billion higher in 2005. However, this has been offset by a jump in remittances. There have also been sizable equity inflows, while the government has successfully tapped sovereign bond markets, most recently with a US\$2.1 billion issue in early January. Foreign reserves (adjusted for pledged assets) reached US\$18.0 billion at end-2005, US\$2.8 billion above the end-2004 level.

A risk to the near-term outlook for the Philippine economy is that political events, such as possible constitutional change, serve to sideline economic reforms. If reforms were to stall, investment is likely to remain subdued, and GDP growth will likely remain below 5 percent in 2006. The outlook would be brighter were strong reforms to continue. The heavy reliance on external commercial borrowing also puts the Philippines at risk should there be a reversal of the currently benign environment in emerging markets. Avian flu poses another risk, although there has yet to be a case in the Philippines.

### **Executive Board Assessment**

The overall performance of the Philippine economy in 2005 was positive, with solid economic growth despite weaker investment and net exports, and moderating inflation. Moreover, notwithstanding higher oil prices and intense regional competition, the balance of payments remained strong. 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. Directors 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.

Directors considered that notwithstanding these notable achievements, the Philippines faces two key challenges going forward—namely, to strengthen its defenses against the remaining significant short-term vulnerabilities, and to move the Philippine economy to a higher and more sustained economic growth path. Directors noted that with its still high debt levels, the Philippines remains vulnerable to a sudden turn in the current benign external financing environment. In addition, further spikes in oil prices or an outbreak of avian flu pose additional near-term risks. Directors therefore urged the authorities to sustain the reform momentum by completing the remaining agenda for fiscal and other structural reforms and thereby enhance the economy's ability to absorb such shocks.

Directors underscored the importance of further enhancing the investment climate to set the stage for higher economic growth and substantial reduction in poverty. They expressed concern about the recent weakening in export performance, and stressed that a stable macroeconomic environment, increased infrastructure investment, a stronger financial system, and improved governance, including in the area of property rights, will be key to increasing the rate of investment and enhancing competitiveness over the medium term. By contrast, Directors did not consider the recent appreciation of the exchange rate as a threat to the economy's competitiveness. Directors welcomed the priority the authorities attach to raising public awareness of the benefits of reform, pointing in this context to the recent positive experience

that has highlighted how improved market confidence can reduce the costs of tough but necessary policy measures.

Directors welcomed the sharp reduction in the nonfinancial public sector deficit that is underway. They underlined the importance of the steps being taken to strengthen tax administration to ensure that the recent VAT reform package translates effectively into commensurately higher VAT revenue. Directors noted that balancing the budget over the medium term will require additional measures. They therefore encouraged the authorities to consider and pursue additional tax policy measures, such as a sufficiently ambitious rationalization of tax incentives, to broaden the tax net and improve efficiency and equity.

Directors agreed that rebalancing the composition of public expenditure, with reduced current outlays providing space for capital and social spending, should form an integral part of the fiscal consolidation. In this regard, many Directors welcomed the planned use of part of VAT reform proceeds for the financing of priority infrastructure projects and social programs.

Directors supported the authorities' plans to continue closely monitoring the performance of the major Government Owned and Controlled Corporations (GOCCs). They observed that firm-specific deficit targets can contribute to their improved governance and enhanced performance. In this context, it will be important to ensure that the turnaround in National Power Corporation's finances is sustained, and that the National Food Authority's losses are minimized by improved targeting of food subsidies.

Directors welcomed the recent interest rate actions by the Bangko Sentral ng Pilipinas (BSP) consistent with its commitment to price stability and with a view to ensuring the credibility and effectiveness of the inflation targeting regime. They also welcomed the authorities' commitment to raise rates promptly to bring inflation down within target by 2007 should inflationary pressures emerge and the inflation forecast look less favorable, for example due to second-round effects of the rise in oil prices or the VAT reform. However, Directors noted the possibility that inflation could return to target more rapidly if improving market sentiment propels higher capital inflows and peso appreciation.

Directors stressed that power sector privatization should be accelerated. They considered that, in order for needed investment in the power sector to be made, the challenge will be to shift sufficient power sector assets into private hands. This will require reducing the uncertainties that have so far deterred potential deals. Most Directors believed that successful bidding of Transco might break this deadlock. The importance of designing a comprehensive regulatory framework for the power sector, based on lessons from similar experiences in other countries, was also underscored.

Directors underlined the importance of strengthening and deepening financial and capital markets and enhancing financial sector soundness. They welcomed the recent initiatives to strengthen bank balance sheets, the progress toward bank consolidation, and the steps taken to reduce nonperforming assets including through the special purpose vehicle framework. Nevertheless, the banking sector remains fragmented and some banks weak, with the still significant level of non-performing assets (NPAs) inhibiting bank lending. Some Directors suggested that greater pressure should be exerted on weak banks to raise capital and that mergers should be encouraged. Noting the large stock of Republic of the Philippines (ROP) bonds held by domestic banks, Directors urged supervisors to monitor potential risks.

Directors expressed concern that passage of the amendments to the BSP Charter aimed at strengthening bank supervision has made little progress through Congress over the last few

years, and urged the authorities to redouble their efforts to pass this legislation to permit a durable improvement in the soundness of the banking system. Provision of appropriate legal protection for financial supervisors should remain a critical element of this effort.

Directors noted that effective enforcement of the International Financial Reporting Standards (IFRS) could provide an opportunity for bank recapitalization. They suggested that any regulatory relief that may be granted by the BSP to give time to banks to comply with the IFRS should be transparent to the markets and be made conditional on a clear recapitalization plan.

Directors considered that improving the capacity of financial institutions to price credit, based on risk, would strengthen financial intermediation. Improved transparency and more complete and accurate information disclosure by banks and other market participants will be key in this regard. Directors considered that the financial difficulties being experienced by pre-need firms, while probably not of systemic concern, illustrate the need to strengthen the supervisory and regulatory framework for the industry. On Anti-Money Laundering/Combatting the Financing of Terrorism (AML/CFT), Directors welcomed the progress being made with streamlining the reporting of suspicious transactions and accelerating the processing of cases.

Directors observed that strengthening governance will be central to the Philippines' development. This will facilitate the delivery of essential public services, and contribute to a supportive business climate. A predictable regulatory environment should enhance efficiency, boost confidence, and attract investment.

Directors noted that data provision for surveillance purposes is adequate overall, and welcomed the authorities' efforts to effect required strengthening, particularly in the balance of payments data. In this context, Directors encouraged the authorities to take on board the recommendations of Fund technical assistance missions.

Directors agreed to continue post-program monitoring (PPM) for an additional year. Although the significant progress in reform and the low level of the Philippines' outstanding borrowing from the Fund have reduced the need for PPM, Directors saw merit in extending PPM for another year in light of its facilitating role in reducing the country's remaining fiscal and external vulnerability.

**Public Information Notices (PINs)** form part of the IMF's efforts to promote transparency of the IMF's views and analysis of economic developments and policies. With the consent of the country (or countries) concerned, PINs are issued after Executive Board discussions of Article IV consultations with member countries, of its surveillance of developments at the regional level, of post-program monitoring, and of ex post assessments of member countries with longer-term program engagements. PINs are also issued after Executive Board discussions of general policy matters, unless otherwise decided by the Executive Board in a particular case. The Staff Report for the 2005 Article IV Consultation with the Philippines is also available.

Philippines: Selected Economic Indicators, 2002-06

	2002	2003	2004	2005	2006
				Staff Est.	Staff Proj. 1/
<b>Growth and prices (in percent change)</b>					
GDP growth	4.4	4.5	6.0	5.1	5.0
CPI inflation (average)	3.0	3.5	6.0	7.6	7.4
<b>Public finances (in percent of GDP)</b>					
National government balance (authorities' definition)	-5.3	-4.7	-3.9	-2.7	-2.1
National government balance 2/	-5.6	-5.0	-4.2	-3.1	-2.5
Nonfinancial public sector balance 3/	-5.7	-5.6	-5.0	-2.7	-2.3
Revenue and grants 4/	20.9	21.0	20.7	21.8	22.8
Expenditure 5/	26.6	26.6	25.7	24.4	25.1
<b>Money and credit (in percent change)</b>					
Broad money (M3)	9.5	3.3	9.2	14.1 6/	...
Interest rate (91-day Treasury bill, secondary market, end period, in percent)	5.9	6.5	8.4	6.4	6.1 7/
Credit to the private sector (net)	1.2	1.8	4.6	2.1 6/	...
<b>Balance of payments (in percent of GDP)</b>					
Trade balance	0.5	-6.9	-7.4	-6.5	-6.9
Current account balance	5.7	1.8	2.7	3.0	2.1
<b>Gross international reserves</b>					
In billions of U.S. dollars	16.2	16.9	16.2	18.5	20.5 7/
Adjusted, in billions of U.S. dollars 8/	14.3	14.7	15.2	18.0	...
Adjusted, in percent of short-term liabilities 9/	123.9	122.9	121.2	131.1	...

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

1/ Projection assumes that reforms proceed.

2/ IMF definition. Excludes privatization receipts of the national government, and includes operations of Central Bank-Board of Liquidators.

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 the difference between nonfinancial public sector revenue and balance.

6/ As of September 2005.

7/ At end-January 2006.

8/ 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.

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

**Statement by Jong Nam Oh, Executive Director for the Philippines  
and Cyd Amador, Senior Advisor to the Executive Director  
February 13, 2006**

**Key Points**

- The economy has continued to advance, with growth supported by steadfast implementation of prudent policies and reforms. The authorities remain committed to sustaining strong policies.
- Progress toward fiscal consolidation has lifted confidence. The better shape of fiscal finances will create room for maneuver to meet priorities, reduce vulnerabilities, and help ensure debt sustainability.
- Raising the growth trajectory requires meaningful structural reforms on a broad front, particularly in the power and financial sectors. Improving the business environment is also a key plank of the reform program.

Our authorities welcome the productive exchange of views with the staff during the mission, which provided the opportunity to assess economic performance and policies as well as policy challenges over the medium term. They thank the staff for the well-structured and thoughtful analysis and helpful insights on issues that have a bearing on long-term growth. Staff presentations on important issues during the mission added value to, and improved the quality of, dialogue. Our authorities are particularly appreciative of staff advice grounded on cross-country analyses, which disseminate lessons learned from wide-ranging reviews of policy experiences. They also value highly the Fund's support in knowledge transfer and capacity-building activities.

**The economy has continued to grow at a solid pace on the back of the authorities' commitment to prudent policies and reform.**

The economy delivered a good performance last year, as output grew at a respectable rate of 5.1 percent, price pressures abated, progress toward fiscal consolidation gathered steam, and the external position remained comfortable. Viewed against the headwinds of high oil prices, rising global interest rates and political developments, these gains attest to the implementation of sound economic policies and the headway made in advancing reforms.

Yet, the authorities are keenly aware of underlying vulnerabilities. Oil prices, if they continue to spike, would fuel inflation and could weigh down on demand and confidence. The international economic environment could become less supportive, and benign global financial conditions could reverse, exposing the Philippines to adverse shifts in market sentiment due to its debt load and financing requirements. The central challenge confronting the authorities is to buttress the foundations of the economy against downturns and unanticipated shocks through disciplined policies and sustained reform efforts that will strengthen the economy's flexibility and competitiveness and lay the contours for robust

growth and enduring development. The challenge is daunting but achievable, and steady, careful steps are being taken to meet it.

Meaningful social and economic progress require that tangible advances are made toward meeting the people's development aspirations. Realizing the full gains from sound economic policy, however, takes time. Continued, strong macroeconomic conditions will help propel the reform engine. Apart from this, the authorities are mindful of the need to raise social ownership for reform and prudent policies. They have continued to raise public awareness of the benefits of reform as well as the costs of adjustment. They have shown that they are not averse to delivering difficult messages if such are needed to shift reform efforts to higher gear. Since many reforms require political action, they continue to work closely with legislators to advance the economic agenda.

**Responsive monetary policy continues to focus on containing the risk of inflation while allowing room for the economy to grow. The external position has benefited from stronger confidence stemming from disciplined macroeconomic policies.**

Recent policy moves clearly demonstrate the BSP's commitment to price stability. Monetary policy was tightened to pre-emptively address inflation risks, particularly price jolts that may come from rising inflation expectations (due in part to the possible narrowing of interest differentials) and rapid liquidity growth. Prudent policy tightening and the peso appreciation helped trim the inflation rate toward the end of 2005. The inflation outlook supports the need for continued caution in the policy stance. Monetary authorities will continue to evaluate the impact of recent policy actions, stay alert to signs of emerging inflation pressures, and stand ready to calibrate policy settings, as warranted, while taking care not to hit the brakes too hard to avoid restraining growth.

Monetary authorities continue to improve their communications on policy intentions and actions. Policy clarity is particularly important with the implementation of the VAT reforms in order to minimize any build-up in inflation expectations from this event.

The external position remains comfortable, buttressed by higher remittances and investments. The peso firmed, as revenue-raising reforms have had a salutary effect on investor sentiment. Sovereign bond spreads tightened on the back of improved fiscal accounts and in line with emerging market trends. The authorities have continued to build cushions against shocks by accumulating reserves and undertaking early financing of external requirements. Export growth, however, was quite modest. This highlights the need for reforms that will strengthen competitiveness and help power exports. Well aware of this, the authorities continue to press ahead with their efforts to strengthen the business climate, including through complementary reforms in the power and financial sectors.

**Fiscal discipline has started to pay off. The authorities continue to put a premium on fiscal prudence to ensure fiscal sustainability over the medium term and create fiscal space for growth-supporting infrastructure and social programs.**

Responsible fiscal stewardship has led to an overperformance in deficit reduction, and this has had strong, positive confidence effects. The 2005 National Government budget deficit—which settled at 2.7 percent of GDP—was better than expected due to higher revenues,

prudent spending and savings in interest payments. This, together with the improved position of other public sector entities, contributed to the significantly lower consolidated public sector deficit. Our authorities are committed to sustaining the headway that has been achieved toward fiscal consolidation.

Enhanced revenue generation has played a key role in bridging the fiscal gap. There are welcome signs that revenue-raising efforts (both administrative and legislative) are yielding desired results, with the tax effort expected to turn around in 2005 after the trend decline for the past seven years. A further increase in the tax effort could be realized this year as a result of the recent VAT reforms and the increase in corporate income tax. At the same time, care has been taken to temper the impact of fiscal adjustments on the poor and the vulnerable through well-targeted and affordable mitigating measures. The effective implementation of tax policy reform is a crucial test of the authorities' commitment to fiscal soundness.

Better tax compliance and more effective enforcement of tax laws are important in boosting revenue and in ensuring fairness in tax burden-sharing. To plug tax leaks, our authorities continue to strengthen tax administration through improved taxpayer registration, expanded automation, intensified benchmarking and audits, and the system of rewards and sanctions for revenue personnel that starts to take force this year. There are also programs to train tax officials in the assessment and collection of the higher VAT liability to lock in the potential revenue gains from the landmark VAT reforms. Furthermore, the high-profile campaigns against tax evaders and erring revenue personnel will continue and will be strengthened by better equipping revenue agencies with technical knowledge on criminal investigation and financial accounting that will tighten case build-up. These efforts require sustained, strong commitment and the authorities are single-mindedly pursuing these initiatives.

Asset sales have continued, and the government plans to step up the privatization of non-energy assets with a view to bolstering the fiscal position and reducing the government's direct involvement in economic activity.

Expenditure reform is an integral part of fiscal consolidation. Civil service reform is gaining momentum. The rationalization of the bureaucracy is aimed at both pruning costs and restructuring the government through closure of offices that have outlived their purposes and the integration of agencies with shared objectives and overlapping functions. The government continues to guard against fiscal laxity in the operations of the public sector as a whole. The authorities are intensifying the monitoring of GOCCs, improving governance in these institutions, reinstating GOCC performance contracts, and pursuing reforms in the social security agencies, government financial institutions and local government units, with a view to improving their financial conditions. In particular, they have started developing medium-term deficit targets for the National Food Authority (NFA) and continue to consider ways to stem its losses through streamlining of operations and better targeting of rice subsidies.

Well aware that additional measures will be needed to promote fiscal soundness in the period ahead and achieve a balanced budget, the authorities are considering further fiscal reforms. They are championing before the legislature the rationalization of fiscal incentives as well as the passage of the simplified net income tax system for self-employed individuals and professionals and the enactment of a fiscal responsibility bill.



While the VAT reforms could have some cyclical dampening impact on consumption, its effects on growth will be determined by accompanying policies. The authorities believe that perseverance with fiscal reform will create much-needed space for deficit reduction and win back room to meet priorities, such as infrastructure, sorely needed to address gaps that have hindered regional competitiveness and stronger growth, and social programs (particularly nutrition, health, education and housing) that are critical for poverty reduction as well as economic and social stability. Any expansionary fiscal impulse will be responsibly pursued to preserve hard-won gains toward fiscal prudence and avoid compromising the objectives of fiscal consolidation and sustainability. In this connection, and consistent with its commitment to greater transparency, the government intends to give updates on the utilization of the revenues from the VAT reforms. In 2006, the government plans to use 70 percent of the VAT reform proceeds for deficit reduction and the remaining 30 percent for budgetary support to fund priority infrastructure projects and social programs. The authorities are hopeful that this reporting mechanism will help discipline the budget and marshal popular support for reforms.

Prudent public debt management will improve debt dynamics and help ensure debt sustainability, reducing the economy's exposure to destabilizing shifts in market sentiment and associated volatilities in capital flows. Priority is being given to improving the liability portfolio by optimizing ODA financing, lengthening the debt maturity profile, diversifying the currency mix, and reducing the reliance on external borrowing.

### **Deepening fundamental reforms will help raise the economy's growth potential.**

Structural reforms have advanced, but further steps are needed to solidify recent gains and achieve durable growth. The authorities are well aware of the need to sustain the pace of reforms across a broad front to unlock the economy's productive potential and strengthen its capacity to withstand shocks. The recent reforms, particularly in the fiscal area, have sparked a strong response in investment. There are indications that foreign direct investment has picked up in manufacturing and ICT-related businesses. The recent opening up of the mining industry should also stimulate investment. Foreign portfolio investment has also responded favorably to the better fiscal news. There is, however, further scope for addressing remaining weaknesses in the business environment.

Meeting infrastructure shortfalls is a key challenge, and the policy space created by fiscal discipline will help the authorities respond more decisively to this concern. Good governance is central to the country's development and is an important policy concern for our authorities. Improving public governance will facilitate the delivery of essential public services, decrease the cost of doing business, and help create a predictable regulatory environment for investment, generating large efficiency gains and confidence effects. The government is wide awake at the wheel in this regard, with—among other things—a proactive campaign against corruption through better standards in public tendering and procurement, enhanced transparency and intensified lifestyle checks to promote probity among civil servants. There have been some palpable results, with the dismissal, suspension and reprimand of errant personnel. The authorities will persevere in this difficult but necessary task.

Boosting competitiveness will also require that reform efforts in the power and financial sectors shift to higher gear. In the power sector, important progress has been made in raising generation tariffs. This has reduced the sector's losses and its call on public finances. Beyond contributing to the achievement of fiscal policy objectives, a financially viable power sector will help ensure adequate, reliable and affordable power that, in turn, will help lay down an enabling environment for more dynamic private sector activity. Delays have been encountered in the privatization schedule, partly as the authorities continue to work on design, contractual and regulatory issues. Privatization of power assets remains a top priority for the authorities, and they are hopeful that further progress can be made this year on the sale of these assets, including the transmission infrastructure.

A strong and well-functioning financial sector is an engine of growth. Financial sector reforms will continue to be pursued to ensure that banks and the capital market meet the needs of the growing economy. Progress has been made in strengthening bank balance sheets, as evident in improved asset quality indicators. Banking reform priorities will continue to focus on improving risk-based supervision technology and capacity, promoting corporate governance, and aligning the regulatory framework with international standards and best practices. The authorities continue to encourage banks to intensify efforts to clean their books, and they are hopeful that the extension of the Special Purpose Vehicle (SPV) Act will be approved early this year to sustain the momentum in the sale of non-performing assets and spur lending activity. The adoption of international accounting and financial reporting standards and the forthcoming compliance to the Basel II framework will further realign local banking practices with global standards. While the BSP is rapidly aligning the Philippine banking system with international norms, it is also carefully studying the banks' sensitivity to these changes. The possibility of granting temporary regulatory relief to banks that will be significantly affected by the new international financial reporting standards is currently being examined. The authorities will consider this only after a careful assessment of the results of the quantitative impact study. They are also mindful of the importance of keeping any relief temporary and of clearly disclosing the conditions under which relief will be granted, such as the need for those banks to have well-considered plans for bridging capital gaps.

The BSP will continue to strongly advocate for amendments to its charter, which include those that will strengthen bank supervision by extending legal protection to its officials performing their duties as regulators and bank examiners. At the same time, the BSP is working on a liability cover plan for its bank examiners.

Work is underway to strengthen the capital market with a view to developing alternative and efficient vehicles for mobilizing long-term funds for investment. The authorities continue to work with Congress on the legislation for the credit information system, the personal equity and retirement account and the pre-need code. The latter will include a regulatory framework that will help ensure investor protection and market integrity. Other legislation that our authorities continue to pursue are the Corporate Recovery Act, the Revised Investment Companies Act, and the amendments to the Insurance Code and the Corporation Code.

### **Concluding remarks**

Our authorities are fully committed to macroeconomic prudence and purposeful structural reform. They are also committed to continued close and constructive engagement with the Fund through policy dialogue, which has been pivotal in anchoring good policies and guiding the reform process.