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Philippines: Selected Issues

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PHILIPPINES

Selected Issues

Prepared by Staff Team led by Markus Rodlauer and Prakash Loungani

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List of Acronyms

AFP	Armed Forces of the Philippines
ASEAN	Association of South East Asian Nations
BIR	Bureau of Internal Revenue
BOC	Bureau of Customs
BOI	Board of Investment
BSP	Bangko Sentral ng Pilipinas
CARP	Comprehensive Agragrian Reform Program
CB-BOL	Central Bank—Board of Liquidators
CBP	Central Bank of the Philippines
CPSD	Consolidated Public Sector Deficit
CTRP	Comprehensive Tax Reform Package
EFF	IMF Extended Arrangement Facility
FDI	Foreign Direct Investment
GFIs	Government Financial Institutions
GOCCs	Government Owned and Controlled Corporations
GSIS	Government Service Insurance System
IPPs	Independent Power Producers
LGUs	Local Government Units
NG	National Government
NFA	National Food Authority
NPC	National Power Corporation
OPSF	Oil Price Stabilization Fund
PEZA	Philippine Economic Zone Authority
PHIC	Philippine Health Insurance Corporation
PPP	Purchasing Power Parity
SSIs	Social Security Institutions
SSS	Social Security System
TFP	Total Factor Productivity

I. OVERVIEW[1]

1. **The Philippines has received considerable attention in recent years as it "emerged" in the early 1990s from a long period of slow growth and economic imbalances, and then managed to escape the "Asian crisis" relatively unscathed**. This suggests that the reforms under way since the late 1980s, and intensified in the 1990s, have paid off, and are continuing to bear fruit with the help of skillful crisis management through the recent turbulence. By the same token, the pressure of recent shocks has put the spotlight on the remaining structural weaknesses that need to be addressed for sustained rapid growth and development. The Philippines' recent experience may contain valuable lessons for emerging economies' efforts at crisis prevention and crisis management, as well as for the country's own policy choices at the threshold of the next decade. This paper describes this experience, focussing on the factors behind the relatively strong performance in recent years as well as the remaining reform agenda.

Background

2. **The economic situation in the Philippines deteriorated sharply in the 1980s.** Roiled by economic policy mistakes, external shocks, natural disasters, and political instability, the economy suffered two setbacks that left real per capita income at the end of the decade about 7 percent lower than at the start. This performance contrasted sharply with that of other countries in the region, which resulted in the latter being called "Asian tiger" economies while the Philippines was often labeled the "sick man of Asia."

3. **The first half of the 1980s witnessed the collapse of the Marcos regime and the growth strategy pursued since the mid-1970s**. Although growth averaged over 6 percent during 1975–80, it was accompanied by a large buildup of external debt, much of it to fund an expansion of the public sector. Easy credit encouraged excessive borrowing by private firms, and protectionist industrial and trade policies caused investment to increase mainly in import-substitution and nontradeable activities, undermining competitiveness. Serious governance problems, often characterized as "crony capitalism," exacerbated the vulnerabilities. A series of external shocks in the early 1980s[2] exposed these weaknesses and, compounded by domestic events,[3] led to a major crisis with default on external obligations, widespread failure of domestic banks and corporations, and a deep recession.

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[1]Prepared by Markus Rodlauer.

[2]Including the second oil price shock, a hike in world interest rates, recession in industrialized countries, and the Latin American debt crisis.

[3]A financial scandal in 1981 and the assassination of Ninoy Aquino in 1983.

4. **While the economy remained on a rocky path during the second half of the 1980s, this period witnessed important changes that paved the way for fundamental improvement in the 1990s**. After growth bounced back during 1986–89 under a new government, the recovery faltered in 1990–91 under a string of natural disasters,[4] external shocks, and renewed political instability. The setback was compounded by policy slippages, including a sharp widening of the fiscal deficit, lax monetary policy, and real currency appreciation, leading to a sharp increase in the current account deficit, a jump in inflation, and a near-balance of payments crisis in 1991. The repeat "boom-and-bust" cycle also reflected structural constraints including high import-dependence and a shallow domestic capital market. At the same time, however, the change in government in 1986 ushered in a new, democratic, and open political regime that, although initially plagued by instability, set the stage for the political stability achieved in the 1990s. The Aquino government also initiated outward-looking and market-oriented reforms that, although implemented only partially and not without setbacks, signaled a shift in policy direction on which the comprehensive reforms of the 1990s would build.

1990–96: Reforms bear fruit

5. **The 1990s have witnessed impressive economic progress in the Philippines,** reflecting sound economic policies in a more favorable external environment and greater political stability. By 1996, growth had accelerated to around 6 percent; inflation was down to 5 percent; and the external position had strengthened with rapid export growth and rising reserves. The new government led by President Ramos (1992–98) embraced a comprehensive reform strategy aimed at further opening up the economy, reducing macroeconomic imbalances, and addressing other structural rigidities. Under this program, supported since 1994 by an extended arrangement (EFF) from the IMF, the fiscal deficit was brought down sharply, privatization was accelerated, and the central bank was recapitalized under a new statute. A number of important sectors were opened to new competition (including banking, telecommunications, domestic shipping, and the oil sector), and limits on foreign participation were liberalized in various sectors. Quantitative import restrictions were removed (except for rice), and the average import tariff is now around 10 percent, one-third the level of the mid-1980s.

6. **Notwithstanding the progress made, some barriers to sustained rapid growth proved difficult to uproot, and the Philippines' arrival as a successful emerging market economy entailed new vulnerabilities**. The lingering structural problems included low domestic savings; limited progress in addressing long-standing public sector issues such as weak tax collection, and civil service and local government reforms; weaknesses in the banking sector; and the continued high incidence of poverty. Many of these problems reflected the legacy of the past as unequal income distribution, past heavy regulation of the economy, and the degradation of governance under the Marcos regime created powerful interest groups

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[4]Including a major earthquake, drought, and a volcanic disaster.

resisting the reform efforts designed to level the playing field. The acceleration of growth, investment, and capital inflows experienced in the mid-1990s masked these shortcomings, but also heightened the economy's vulnerability to the eventual shift in market sentiment. The de facto pegging of the peso to the U.S. dollar in late 1995 added to the risks by encouraging rapid growth of short-term capital inflows.

7. **Thus, on the eve of the Asian crisis, the Philippine economy was vulnerable, albeit less so than the most heavily affected neighboring countries**. By mid-1997, the peso had appreciated by over 25 percent in real effective terms since 1993 (nearly 40 percent since 1990), and the external current account deficit had widened to over 5 percent of GNP (with a trade deficit of about 13 percent). Large external borrowing in 1996, especially by banks, had raised foreign currency debt exposures, including on short-term debt which, at around $10 billion, was about equal the level of usable gross official reserves. Private sector credit had expanded very rapidly during 1995–96, including a significant rise in credit to real estate and consumption. While these developments had increased the economy's vulnerability, the Philippines was less susceptible to a sudden downturn than most other East Asian economies. In particular, the period of rapid credit expansion and debt accumulation in the Philippines was much shorter than elsewhere, resulting in lower levels of corporate leverage; major banks were well capitalized; and the structural and political reforms under way since the mid-1980s had created a more open, market-oriented, and competitive system that was able to resist the type of systemic collapse witnessed elsewhere. Both government and the private sector had significant experience with crisis management, and a flexible policy response to the unfolding crisis was facilitated by the close policy dialogue under the existing arrangement with the IMF.

1997–99: Crisis management

8. **From early 1997, economic conditions deteriorated as the regional downturn interacted with the country's own vulnerabilities**. A decline in capital inflows and a slowdown in manufacturing output combined with sharp falls in the stock market and mounting pressures on the peso. The authorities initially responded by tightening monetary policy and by intervention to maintain the de facto peg of the peso. When this stance became unsustainable in the aftermath of the float of the Thai baht, the peso was floated on July 11, accompanied by a strengthening of fiscal, monetary, and structural policies. The new program was supported by augmentation and extension of the EFF (scheduled to expire in mid-1997), followed by a new two-year stand-by arrangement in early 1998.

9. **The authorities' strategy focused initially on stabilizing the situation through relatively tight monetary and fiscal policies; as stabilization took hold, the stance shifted gradually toward supporting recovery. The program also comprised a set of key structural reforms to underpin stabilization and medium-term growth prospects**. Monetary policy during this period would "lean against" pressures in the exchange market by raising interest rates, without, however, attempting aggressively to resist market forces. Likewise, the Bangko Sentral would intervene in the exchange market to provide liquidity and

restore calm during periods of extreme volatility, but refrain from large-scale intervention to defend any particular level of the rate. As the peso began to stabilize during the second half of 1998, interest rates were brought down, very cautiously at first in view of the still unsettled external environment and the relatively high rate of inflation. The monetary stance became more fully supportive of recovery in early 1999 as the turnaround in the balance of payments was firmly established and inflationary pressures abated. Fiscal policy was also adapted gradually to the slowdown in output and the associated revenue shortfall: from a pre-crisis target for 1998 of a fiscal surplus of 1 percent of GNP, the program was revised several times to an eventual deficit target of 3 percent of GNP. Structural reforms under the program, in addition to completing the agenda of the Ramos administration (oil deregulation, tax reform, and continued trade liberalization), focused on strengthening the banking sector and improving tax administration, both key to the stabilization and medium-term growth objectives.

10. **Financial markets remained volatile for the next year or so, reflecting both external and domestic developments**. Several waves of external shocks put further pressure on the peso and equity prices. The collapse of the Korean and Indonesian economies brought the peso to a low of ₱ 46 per U.S. dollar in January 1998 (a 44 percent depreciation from mid-1997). After a brief recovery in early 1998, the deterioration in Japan coupled with uncertainties over the policies of the newly elected Estrada government caused a new downturn over the summer that culminated in the emerging market crisis in September[5] (with the stock market index falling below 1,200, compared with the high of over 3,400 in January 1997). Since then, however, financial markets have strengthened continually, with equity prices up more than two-fold; peso appreciation and a large increase in official reserves; and interest rates declining to below precrisis levels.

11. **Economic activity began to stall in the second half of 1997, followed by a slight recession in 1998**. After growing by 5.2 percent in 1997,[6] real GDP dropped by 0.5 percent in 1998, weighed down by a severe drought that reduced agricultural output by over 6 percent. Industry also declined (by 1.7 percent), while services remained relatively buoyant (growing by 3–5 percent). On the demand side, growth was supported by continued strong export growth (20 percent in volume terms) which was one of the key factors distinguishing the Philippines' adjustment experience from that of its neighbors. Private investment, however, fell sharply, and unemployment rose to over 10 percent. Reflecting the impact of peso depreciation and a drought-related increase in food prices, inflation reached 10.4 percent by year-end. In the external accounts, 1998 witnessed a dramatic turnaround in the current

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[5]Following the introduction of capital controls in Malaysia and Russia's default on part of its government debt.

[6]On a seasonally adjusted quarter-to-quarter basis, real GDP growth decelerated sharply in the second half of 1997 (to an annual rate of 1½ percent).

account, to a surplus of nearly 2 percent of GNP, on the strength of continued export growth while imports fell sharply.

12. **Following the upturn in financial markets, the real economy also bottomed out in early 1999**. Led by a recovery in agriculture, first-quarter real GDP grew by 1.2 percent, and by the second quarter there was evidence of bottoming out in other sectors as well. Thus, on balance, the Philippine economy has been able to weather the regional crisis better than most of its neighbors, reflecting more favorable starting conditions as well the pragmatic implementation of sound economic policies. That this has been achieved during a period of political transition[7] testifies to the resilience of the Philippine economy and the consensus for sound economic policies.

Remaining challenges

13. **While policies pursued over the past decade have had major positive results, events over the past two years have highlighted that much remains to be done**. The task is not only to restore the momentum of growth and investor confidence of the mid-1990s, but also to sustain it through policies that prevent a return to the boom-bust cycles of the past while ensuring the Philippines' full and competitive participation in the global marketplace. Against this background, and considering the policy agenda into the next decade, two aspects stand out. First, to deal with the still quite pervasive legacy of the past, such as low savings, widespread poverty, accommodation of rent-seeking activities, and a weak public sector. And second, to successfully manage the new challenges of globalization, allowing the country to fully partake of the benefits of integration while minimizing the associated risks of excessive leverage, currency overvaluation, and sudden capital flow reversals. In particular, this agenda includes:

- maintaining prudent macroeconomic policies, with emphasis on avoiding fundamental inconsistencies that risk disruptive shifts in capital flows;
- raising domestic savings and investment from the current unsustainably low levels;
- further leveling the playing field through domestic and external liberalization, as well as effective programs to assist the poor and to enhance the opportunities of the disadvantaged;
- streamlining and strengthening the public sector, a traditional "Achilles heel" of the economy;

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[7]Presidential and legislative elections were held in May 1998, and President Estrada, his government, and a new Congress took office in July.

- further strengthening prudential, supervisory, and debt resolution frameworks in the financial and corporate sectors (including prudential-based management of foreign currency risk); and

- improving further the investment climate, including by strengthening governance and "economic security."

14. In a wider sense, successful implementation of this agenda will need to be embedded in a continuous strengthening of Philippine democracy and its institutions, to overcome elements of stagnation such as a weak judicial system; corruption in public administration; concentration of control over economic resources, the media, and the political process; and rapid population growth.

* * * * *

15. The chapters that follow cover a range of topics, reviewing the issues that have arisen as the Philippines has progressed from a major crisis case in the 1980s to a successful emerging market in the 1990s. Chapter II examines the evolution of output growth and the factors that have contributed to its acceleration in the 1990s, as well as the remaining structural barriers to sustained rapid growth. Chapter III reviews fiscal developments and the various reforms that have been implemented to put the public finances on a sounder footing, and discusses the remaining weaknesses in public sector management which have been brought to the fore by the recent economic slowdown. Chapter IV considers the conduct of monetary policy, describing inter alia the evolution of the central bank from an institution with limited independence, a weak balance sheet, and underdeveloped instruments of monetary control to a modern, independent, and financially sound "Bangko Sentral." Chapter V describes external sector developments and prospects, reviewing the structural transformation that has occurred, and is still under way, in the external accounts; the section also evaluates external competitiveness from a variety of angles, and looks at the medium-term outlook and the related policy issues. Chapter VI reviews the development of the banking sector in the Philippines, describing how it has "emerged" as an increasingly sophisticated market in the 1990s while outlining the reform challenges that remain. A final chapter discusses social issues, reviewing in particular the impact on poverty of accelerating growth in the 1990s.

II. ECONOMIC GROWTH

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II. ECONOMIC GROWTH[1]

A. Introduction

1. **The Philippine economy has long been set apart from many of its Asian neighbors by its weaker growth performance; however, its performance in recent years offers grounds for optimism.**

- In 1950, Philippine per capita income placed it in the center of a group of its Asian neighbors; by 1996, it had slid to the bottom of the group (Figure II.1). Relative to the United States, Philippine per capita income fell from one-seventh in 1950 to one-tenth by 1996, while all its neighbors improved, some spectacularly. Over the last three decades, per capita real GDP growth in the Philippines averaged less than one percent a year, compared with close to 3 percent per year in the ASEAN-3 (Indonesia, Malaysia, and Thailand).

- However, the country's more recent economic performance offers grounds for some optimism; in particular, the period 1993–98 was marked by a performance better than the historical average, at a time when performance in the ASEAN-3 countries had slipped below historical norms (Table II.1).

- At the height of the Asian crisis, Philippine real GDP declined only 0.5 percent in 1998 (despite a very bad year for agriculture), compared with declines of 6–14 percent in the ASEAN-3.

Table II.1. Growth in the Philippines and ASEAN-3:
Historical Average and Recent Performance

	Philippines	Indonesia	Malaysia	Thailand
Per capita real GDP growth, average 1969 to 1998	0.8	2.6	2.9	2.6
Real GDP growth, average 1969 to 1998	2.3	3.4	3.8	3.4
Per capita real GDP growth, average 1993 to 1998	1.3	0.2	1.9	1.1
Real GDP growth, average 1993 to 1998	3.0	1.5	3.6	1.9

Source: Penn World Tables, updated using growth rates from World Bank and IFS databases.

[1]Prepared by Piyabha Kongsamut and Athanasios Vamvakidis.

2. **This chapter reviews the growth experience of the Philippines, with a view to assessing the outlook and policy requirements for rapid growth over the medium term.** Section B presents stylized facts about Philippine economic growth, recent changes in economic performance, and the role of policies and institutions in shaping growth. Section C describes growth performance during the Asian crisis. Section D contains a statistical analysis of the sources of growth, with particular focus on the contribution of trade liberalization. The chapter concludes with an assessment of the medium-term growth outlook.

The main findings of each section are as follows:

- **Role of policies: The increasingly outward-oriented and market-based policies adopted since 1986 appear to have borne fruit.** Historically, the salient features of Philippine growth have been: (i) its unevenness or "boom-bust" nature; (ii) absence of productivity gains; and (iii) a distorted industrial structure (biased towards very capital-intensive, import-competing production). However, the turnaround in the orientation of economic policies since 1986 appears to have yielded results in the form of (i) strong economic performance—particularly since 1993—and the resilience exhibited during the Asian crisis; (ii) signs of pick-up in productivity growth; and (iii) some movements towards a less distorted industrial structure.

- **Sources of growth: Statistical analysis indicates that the pick-up in performance in recent years is due to increasing openness, stable investment rates, and an increase in foreign direct investment (FDI).** Empirical estimates of the determinants of growth for the period 1970 to 1995—building on Fischer (1993) and Barro and Sala-i-Martin (1995)—show that the weaker performance of the Philippines, on average, relative to East Asian countries is due to its lower degree of openness and lower (and uneven) investment rates, including FDI. By the same token, the recent pick-up in Philippine performance can be attributed to some catching-up with East Asian countries with respect to these determinants.

- **Medium-term growth outlook: Prospects depend on maintaining the broad thrust of policies adopted since 1986, while deepening considerably the reforms in several areas.** In particular, robust growth is contingent on:

  - continued trade liberalization, accompanied by a shift towards broad-based incentives and complementary investments in infrastructure;
  - maintenance of high and stable investment rates (including FDI, but supported as well by higher domestic savings);
  - a low inflation environment, which in turn requires fiscal consolidation and a continuation of prudent monetary policies;

Under this scenario, the estimates of potential output growth in the Philippines range between 3½ percent and 5 percent for the period 2000–05.

B. The Role of Policies and Institutions in Shaping Growth

Stylized facts about Philippine growth

3. **Growth since the 1970's has been uneven** (Table II.2). The rapid growth of the 1970's proved unsustainable and culminated in a sharp reversal during the first half of the 1980's. The period since has been marked by slower but somewhat steadier growth. Performance since 1994 has been particularly encouraging, with the economy achieving increasing growth rates up until the outbreak of the Asian crisis in 1997 (see Section C for a discussion of the crisis period).

Table II. 2 GDP Growth by Sub-Periods, 1969–98

	Philippines	Malaysia	Indonesia	Thailand
1969–1974	4.0	7.6	5.6	4.6
1975–1980	3.9	6.6	5.9	5.5
1981–1986	-1.3	1.5	3.4	3.4
1987–1992	2.6	7.1	4.4	6.5
1993–1998	3.0	3.6	1.5	1.9

Source: IMF, World Economic Outlook database.

4. **Despite recent progress, per capita income remains low** (Figure II.2). Per capita GDP is below its level in 1980 and only 3 percent higher than that in 1990. The debt crisis in the early 1980s, the near-crisis in 1991, and the mixed performance in the intervening years took their toll from which the economy has yet to recover fully.

5. **For East Asian countries in general, empirical studies point to capital accumulation, rather than productivity gains, as the more significant contributor to growth**. In traditional models, per capita income growth can be driven by improvements in aggregate productivity ascribed to technological progress, or increased factor inputs (physical and human capital). Attempts to measure the relative contributions of factor inputs and technological progress have been the focus of extensive research. A commonly used approach is to deduct from growth in output per worker a weighted average of the accumulation of

physical and human capital per worker, and to interpret the residual as total factor productivity (TFP) growth—the increase in productivity brought about by technological advances and greater organizational efficiency. In the case of East Asian economies, the most common finding is that capital accumulation has made the largest contribution, while productivity growth has made smaller but still significant contributions. Some studies suggest that almost all of the region's growth was due to capital accumulation, with productivity growth contributing almost nothing.[2]

6. **In the case of the Philippines, productivity growth has historically made little—or even a negative—contribution to output growth; but there is some evidence of a pick-up in recent years**. Most studies indicate that TFP growth in the Philippines has been negative (Table II.3). When TFP growth is estimated over more recent periods, there is evidence of improved performance in the 1990s, with TFP growth averaging between ¾ percent and 1 percent a year.

Table II.3: Philippines: Estimates of Total Factor Productivity Growth

Source	Period	TFP growth
Collins and Bosworth (1996)	1960–94	-0.4
	1984–94	-0.9
Benhabib and Spiegel (1994)	1984–94	-0.9
Dowling and Summers (1998)	1961-95	0.0
	1986–95	-0.1
IMF (1995)	1961–94	-0.8
	1994–95	1.0
Sarel (1997)	1978–96	-0.8
	1991–96	0.7

7. **At the sectoral level, aggregate growth has been driven mainly by the industry and service sectors; agriculture has rarely contributed more than 1 percent of growth each year over the past 20 years** (Figure II.3). Agriculture still accounts for a large proportion of output, and employment in the sector remains high, at 43 percent of total

[2]See Young (1992 and 1995), Krugman (1994).

employment. While other countries in the region have benefited from continuing shifts in the output and employment structure away from agriculture, the Philippines has lagged behind (Table II.4).

Table II.4: Structure of Output and Employment, 1970–96

	Shares of Production				Shares of Employment			
	1970	1980	1990	1996	1970	1980	1990	1996
Philippines								
Agriculture	30	25	22	21	54	51	45	43
Industry	32	39	35	32	17	16	15	16
Manufacturing	25	26	25	23	12	11	10	10
Services	39	36	44	47	30	33	40	41
Indonesia								
Agriculture	45	24	19	16	66	56	50	46
Industry	19	42	39	43	10	13	17	14
Manufacturing	10	13	21	25	8	9	12	13
Services	36	34	42	41	24	31	33	39
Malaysia								
Agriculture	29	22	19	13	52	48	31	17
Industry	25	38	40	46	15	18	24	36
Manufacturing	12	21	26	34	8	11	17	27
Services	46	40	41	41	33	35	45	47
Thailand								
Agriculture	26	23	13	11	79	73	67	45
Industry	25	29	37	40	6	8	11	24
Manufacturing	16	22	27	29	4	6	9	15
Services	49	48	50	50	15	20	22	31

Sources: World Bank and IMF; Leipziger (1997), Dolan (1993), Hill (1995), Jomo (1990), Krongkaew (1995).

Role of policies and institutions

8. **As in many developing countries, government policies have played an important role in shaping the nature and extent of growth in the Philippines**. In particular, government policies in the period following independence were characterized by (i) import-

substitution; (ii) a strongly interventionist stance, as reflected in a range of fiscal incentives and directed credit; and (iii) the promotion of capital-intensive industries in a labor-abundant country. Despite piecemeal attempts at reform, the above policies prevailed through the 1970s and much of the 1980s.

There were fundamental problems with these policies.[3]

- **The financing for these policies was difficult to secure on a sustained basis. As a consequence, growth was uneven.** The economy suffered through episodes of severe macroeconomic imbalances as manifested in balance of payments crises, large fiscal deficits, and high inflation. In particular, the rapid build-up of external debt prior to 1982 helped feed an unsustainable boom which ended in the debt crisis.[4]

- **Government intervention in the economy hindered productivity growth and the efficient allocation of resources.**[5] The trade regime was protectionist and discretionary. While there were export incentives, the policy tilt was still in favor of capital-intensive industries that could not compete in international markets. The central bank provided subsidized credit to enterprises, and later rescued them from financial difficulties. The pricing policies of marketing boards in the agricultural sector did not encourage efficient production,[6] nor did they encourage increased processing of products before export. Land reform was held back by the vested interests of traditional landowners. During this period, the role of the public sector expanded as public corporations were established, encroaching into more and more areas of economic activity.

9. **The period since 1986 has been marked by a turnaround in the orientation of policies, although policy implementation was hampered by political instability.** When the

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[3]Krueger (1998) provides a lucid discussion of the shortcomings of an import-substitution strategy.

[4]For a detailed economic history of the Philippines, see Dolan (1991) and Leipziger (1997).

[5]As suggested in IMF (1995), the poor record of productivity growth in the Philippines likely reflects "the misallocation of investment. A large share of public investment during the 1970's and early 1980's went toward high-risk, capital-intensive projects, some of which subsequently failed. Meanwhile, the allocation of private investment was distorted by protectionist measures and specific fiscal incentives favoring capital- and import-intensive industries."

[6]For example, two of the major export products (sugar and coconuts) were put under the control of marketing boards which nominally were set up to help farmers but actually enriched a few businessmen. Also, price controls existed for many products.

Aquino government took power in 1986, it adopted an ambitious reform agenda which included liberalization of the trade and exchange regimes. The quantitative restrictions on imports were gradually phased out or tariffied, and the tariff structure was simplified and rationalized. A new, more liberal Foreign Investment Act was passed. Many public corporations were privatized. A new program of land reform was also promised as part of the Comprehensive Agricultural Reform Program (CARP). Some of the reforms were implemented early on, but others (mainly land reform) were subsequently reversed or watered down. Political instability—there were six coup attempts in the first three years of the Aquino administration—was an impediment to full implementation of the reform program, and a series of shocks to the system (natural disasters, power shortages) contributed to continued macroeconomic imbalances.

10. **The Ramos government, which assumed office in 1992, adopted a host of reforms designed to put the economy on a rapid sustainable growth path**. During this period most restrictions on current and capital transactions were lifted and tariff reforms continued (Chapter V). A new Central Bank Act was passed in 1993, establishing price stability as the key objective of monetary policy and strengthening the legal framework for improved bank supervision. At the same time, the Central Bank was recapitalized, with the portfolio of nonperforming assets hived off to a separate entity (Chapters IV and VI). Marketing monopolies were abolished, and producer price controls were eliminated. Electricity generation and telecommunications were opened to the private sector, foreign participation was allowed in the banking sector, and the domestic shipping and oil sectors were liberalized. A Comprehensive Tax Reform Package was passed in 1998 (see Chapter III). During this period, the external debt burden was brought down to more manageable levels, helped by debt restructuring (which had begun in the 1980s and was completed in 1994) and prudent fiscal management.

11. **The reforms since 1986 appear to have had a favorable impact on economic performance**. Per capita growth has picked up, particularly since 1993. Productivity growth has picked up as well, and the industrial structure is showing signs of dynamism. As noted in IMF (1995), "this improvement in TFP is consistent with enhanced efficiency arising from the reform program."[7] In particular, the role of the public sector in the economy has been reduced through fiscal consolidation, the divestment of many public enterprises, and structural reforms such as trade liberalization, financial sector liberalization, and private sector participation in

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[7]Some other explanations for the pick-up in TFP growth in East Asian countries are advanced in Dowling and Summers (1998). They point out that the rise in TFP coincided with "a huge wave of foreign direct investment into developing Asia. During this period the multinationals brought with them not only capital but also management and organizational skills which could be reflected by higher estimates of TFP. Another hypothesis which is consistent with these facts is that TFP growth in Asia coincided with liberalization of trade within Asia and an increase in the pace of world trade growth after 1985 and on into the 1990's" (p.181).

activities which were previously in the public domain (e.g., power generation and infrastructure projects). Market incentives have replaced the more direct hand of the government.

C. Growth Performance During the Asian Crisis

Growth performance

12. **The Philippines has managed to escape the Asian crisis relatively unscathed**. In particular, output experienced a slight contraction in 1998 while in the other ASEAN-5 countries and Korea the decline in output has been severe (Table II.5).

Table II.5: Economic Growth in the Crisis Countries
(Percent change)

	1996	1997	1998
Philippines	5.7	5.2	-0.5
Indonesia	8.0	4.6	-13.6
Thailand	5.5	-0.4	-8.0
Malaysia	8.6	7.7	-6.7
Korea	6.8	5.0	-5.8

Source: IMF, *World Economic Outlook*.

13. **The decline in output in the Philippines was largely a result of adverse weather conditions brought about by El Niño**. In 1998, agricultural output fell by over 6 percent, while non-agricultural output grew by 1 percent. Had the weather conditions been normal, the Philippines economy could have avoided a recession.

14. **External demand continued to grow during the crisis period, while domestic demand contracted**. Domestic investment experienced a large decline, but the drop in domestic demand was muted by continued consumption growth (particularly by the private sector). On the external side, rapid export growth continued, albeit at a slowing pace, while imports contracted reflecting the investment decline.

15. How is it that the Philippine economy was able to avoid the large declines in output experienced by other crisis countries?

Possible explanations

16. **The stage of the economic cycle may have played a role in the muted impact of the external shock on the Philippines**. At the onset of the Asian crisis, the country was still in the initial stages of an economic boom (as opposed to the most heavily affected crisis countries which had experienced very rapid growth for much longer periods). While there existed elements of a bubble economy (two years of rapid economic growth, with a boom in real estate and construction supported by large capital inflows and rapid bank lending), the expansion was still in its early stages, and the adjustment to the reversal of capital flows was not as painful as for the other countries.

17. **The reforms carried out since 1986 seem to have helped to improve the resilience of the economy**. The increased market orientation of the economy and institutional strengthening made domestic systems more robust. In particular, reforms of the financial sector and trade liberalization seem to have played an important role.

- **The reforms have strengthened the structure of the economy and the financial system, building greater resilience against shocks**. The experience of the external debt crisis in the 1980s triggered the associated domestic financial crisis and measures to open up the banking system to more competition (including from abroad), creation of a new and independent central bank (Bangko Sentral), and improved banking supervision and prudential regulations. As a result, the banking system was better able to handle subsequent shocks.

- **The winding down of government interference in business decisions triggered further reform and changed the behavior of the private sector**. In particular, the backlash against "crony capitalism" and the BSP's virtually complete retreat from directed lending activities avoided much of the inefficiencies in financial intermediation experienced in other crisis economies. The business environment became increasingly market-oriented as the reforms took hold. As a result, the stronger elements of the private sector have been able to better withstand difficult economic conditions.

- **Trade liberalization exposed domestic manufacturers to more competition forcing them to learn to operate successfully in international markets**. A favorable impact of trade liberalization on Philippine growth is suggested by the discussion in the next section.

D. Sources of Growth in the 1990s

Trade liberalization and growth

18. **The positive impact of trade liberalization on growth has been well documented in the empirical literature** (see, for instance, Vamvakidis (1999)). Both cross-country and time series studies generally show that open economies grow faster and have higher investment shares on average. These results are robust to the choice of a large variety of openness measures, such as trade shares, tariff and nontariff barriers and indices of trade distortion. Further evidence comes from the fact, noted above, that many of the economies that followed import substitution policies performed badly during the 1980s and 1990s. Theoretical growth studies have provided the foundations for these empirical findings, arguing that openness influences growth through more investment and technological progress.

19. **From the late 1980s, the market-oriented reforms are reflected in changes in Philippine trade shares**. Figure II.4 shows that the ratio of exports to the GDP increased fairly consistently during the 1980's, with the trend accelerating in the 1990s. The ratio of imports to the GDP shows a similar pattern with the trend starting to accelerate in the late 1980s.

20. **Statistical tests confirm that the period 1989 to 1992 was marked by a significant change in the behavior of export shares**. To determine formally if the structure of trade has changed during the recent decade, we follow a method—developed in Ben-David and Papell (1997, 1998) and described in Annex II.1—that determines when structural change in a variable has occurred by estimating the year of a break in the trend of the variable. (Note that the year of the break is not pre-determined, but estimated through time series regressions.) Application of this method to export and import data for the period 1960–97 yields the following results:

- The estimates show that there has been a change in the trend of these variables: the hypothesis of "no break" can be rejected at the 5 percent significance level for both variables.

- As shown in Table II.6, the break year for the export share is estimated to be 1992; the export share averaged 20 percent before 1992, and nearly doubled in the period thereafter. The break year of the import share is estimated to be 1989, also with a near-doubling of the import share from its average of 21 percent before 1989.[8]

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[8]Sachs and Warner (1995) suggest that the Philippines has been an open economy since 1988. Ben-David and Papell (1997) estimated the trend break years as 1982 using the export share and 1979 using the import share. However, the end-point of their sample did not permit 1989 or 1992 to be considered as trend breaks (as explained in Annex II.1).

21. **The estimates above show a structural change in trade patterns at a time when economic performance also improved significantly.** While this provides suggestive evidence, a more formal investigation of the impact of trade liberalization on growth has to control for other variables that also influence growth. This is attempted below.

Table II.6: Structural Breaks in Trade Shares, 1960–97

Measure of Trade Share	Year of Structural Break	Trade Shares: Pre- and Post-Liberalization	
		Average Value Before Structural Break	Average Value After Structural Break
Exports/GDP	1992	20	38
Imports/GDP	1989	21	40

Source: Fund staff estimates.

Evidence from panel regressions

22. **This section provides estimates of the impact of various determinants—policies and structural factors—on Philippine economic growth.** The estimates are based on panel (i.e., cross-country, time-series) regressions and thus provide an estimate of the *average* impact of a particular determinant on growth.[9] These estimated average impacts can be used to shed light on: (i) why the Philippines, historically, has done worse than other country groups, particularly in East Asia, and (ii) which factors account for the recent improvement in performance.[10]

23. **Slower growth in real per capita GDP in the Philippines relative to other country groups mirrors the behavior of the likely growth determinants.** Table II.6 presents average values over the period 1970–95 of the growth determinants for the Philippines, and for the groups of developing countries (countries with GDP per capita less than 5,000 in 1995, measured in 1987 U.S. dollar), developed countries, and East Asia (excluding Japan). Comparing the Philippines with the other country groups leads to the following conclusions:

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[9]The methodology follows Fischer (1993) and Barro and Sala-i-Martin (1995).

[10]Since the effect of different factors may vary for different countries, the estimates provide an order of magnitude, rather than a precise measure of the impact of a particular policy on growth in the Philippines.

Table II. 6: Country Comparisons of the Determinants of Growth

Country or Group	Philippines		Developing Countries		Developed Countries		East Asia	
Year(s)	1970–95	1995	1970–95	1995	1970–95	1995	1970–95	1995
Real $GDP per capita	600	614	1,118	1,172	1,1745	14,376	2,640	4,821
Real GDP per capita growth	0.9	2.4	1.2	1.7	2.2	2.2	5.7	7.0
Openness								
Trade/GDP (PPP adjusted)	12.1	19.9	21.4	23.3	72.8	77.3	70	95.8
Trade/GDP	52.8	80.5	72.0	79.0	93.3	90.7	113.5	148.0
Import duty ratio	14.9	14.8	15.1	12.5	5.1	1.7	6.7	4.4
Export duty ratio	1.7	0.0	4.3	1.1	0.4	0.0	2.9	0.3
Investment shares								
Investment/GDP	24.3	22.2	23.6	24	22.9	21.2	29.6	35.8
Net FDI/GDP	0.7	2.0	1.3	3.0	1.2	2.0	2.5	4.3
Other determinants								
Capital market openness	2.0	2.0	1.8	2.7	5.6	7.9	4.2	5.4
CPI inflation	14.0	8.1	68.8	21.7	9.9	3.1	8.4	7.3
Government consumption/GDP	9.5	11.4	16.0	14.6	17.3	18.0	10.4	9.5
Age dependency ratio	80.9	72.1	81.2	76.0	58.0	52.7	66.3	53.0
School enrollment ratio, primary	96.6	100	76.8	83.8	93.0	93.2	95.2	94.3
School enrollment ratio, secondary	65.6	79.3	40.5	49.4	81.7	101.5	50.5	61.0

Sources: Data are from *World Development Indicators*, with the exception of the capital market openness measure.

- **The Philippine economy remains less open than the other country groups**, despite recent liberalization. A variety of trade variables are used to test for the robustness of

this conclusion, since trade measures are not always highly correlated with each other.[11] All indicators show that the Philippines, despite the trade reforms in the 1990's and the large increase of the trade share, is less open than all other country-groups, and especially compared to the rest of East Asia.

- **The investment share of the Philippines is similar to that of other country groups but lower than in the rest of East Asia.** This is true both of domestic investment and FDI. However, while the average share of net FDI to GDP was relatively small on average, it has increased considerably in recent years (reaching the ratio in developed economies in 1995). In addition, **the ratio of savings to GDP has been relatively low in the Philippines** (21 percent on average in 1970–95, compared to 26 percent in developed countries and 30 percent in East Asia). Higher savings, especially domestic savings, would be necessary to finance a higher rate of investment.

- **Capital markets in the Philippines are less open than in developed countries and in the rest of East Asia**, as measured by an index of free capital mobility (as well as the average share of net FDI to GDP, as noted earlier). The index—constructed by Gwartney, Lawson and Block (1996) using data from the IMF's Annual Report on Exchange Arrangements and Exchange Restrictions—measures both the freedom of foreigners to invest within the country and the freedom of citizens to invest abroad. The higher the value of the index, the freer are capital transactions with foreigners. Measured on a scale of 1 to 10, the Philippines averaged 2, compared with 4 for East Asia and 5.6 for developed economies.

- **Inflation** has been lower, on average, in the Philippines than in other developing countries.

- The **share of government consumption** in GDP is lower in the Philippines than in other country groups. Empirical studies have found that government consumption can reduce growth if it crowds out private sector investment; if it increases rent-seeking behavior; and if it distorts market incentives (in contrast, government investment can promote economic growth if it improves infrastructure).

- The **age dependency ratio** of the Philippines is comparable to the average in developing countries, but considerably higher than the average in developed countries and in the rest of East Asia.

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[11]Four variables are chosen, based on the availability of data and their inclusion in earlier studies: the trade share (PPP adjusted), the import duty ratio, the export duty ratio and an openness index constructed by Sachs and Warner (1995). The latter is equal to the number of years a country has been "open" in the period 1970–95.

- With respect to **school enrollment ratios**, the Philippines is ahead of all other country groups for primary schooling, and behind only the developed countries group for secondary schooling.

24. **Panel regression analysis indicates that greater openness and higher investment shares (including FDI) have a significant influence on growth—which may explain the recent pick-up in Philippine performance.** The results also indicate that a low inflation environment is conducive to growth. Methodology and estimates are described in Annex II.2; the main findings are as follows:

- **Impact of trade liberalization:** The estimates indicate that, on average, opening to international trade leads to faster growth; the trade variables are statistically significant at least at the 10 percent level in most specifications, except the export duty ratio. Based on these estimates, trade liberalization since the 1980's is estimated to have contributed between 0.2 and 0.7 percentage points to Philippine growth. These estimates should be considered as a lower limit of the impact of trade on growth, since they measure only the direct impact. Trade may also influence growth indirectly through other growth determinants. For example, Levine and Renelt (1992) and Vamvakidis (1999) have shown that open economies invest more than closed economies, and through this effect grow faster.[12]

- **Impact of investment shares**:

    - Higher domestic investment also contributes to faster growth. The Philippine investment share has been quite volatile and in 1995 was below the historical average. The estimates suggest that an increase of the Philippine investment share from 22 percent to 25 percent would contribute to faster growth of 0.6 percent.

    - Foreign direct investment has a positive and statistically significant impact on growth.[13] The Philippine FDI to GDP ratio increased from -0.4 percent in 1970 to 2.0 percent in 1995. The estimates imply that this increase should be correlated with faster growth by about 0.8 percent. If it had reached the average level in the rest of East Asia (4.3 in 1995) growth would have been higher by 1.5 percentage points.

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[12]Since growth regressions control for differences in investment shares, the estimate of the trade variables will not measure this effect.

[13]Borensztein, De Gregorio, and J-W. Lee (1998) find that FDI contributes to economic growth only when the host country has a minimum threshold stock of human capital.

- **Impact of other variables:**

  - The coefficient for inflation is always statistically significant, but small, suggesting that episodes of very high inflation have a negative impact on growth.

  - The regressions indicate the existence of conditional convergence, since the coefficient of the initial GDP per capita is always negative (though not always statistically significant).

  - The estimates of the free-capital-mobility variable are not significant in any of the specifications, and therefore, the impact of financial openness on growth could not be established empirically.

  - The age dependency ratio, the ratio of government consumption and the schooling variables do not have a statistically significant impact, after controlling for differences in the other independent variables. However, these variables are significant in cross-country regressions.

E. Medium-Term Growth Outlook

25. **The findings of the previous sections suggest that sustained growth is contingent on continuing with the outward-oriented and market-driven policies adopted since 1986**. In particular, the following developments would improve the medium-term growth outlook: (i) continued trade liberalization; (ii) raising saving and investment rates, including FDI; (iii) a low inflation environment; and (iv) improved allocation of resources across sectors. Each of these developments would, in turn, require a deepening of reforms, as described below (and in other chapters of the paper). Under this scenario, potential output growth in the Philippines could rise close to 5 percent for the period 2000–05 (see Box II.1).

- **Continued trade liberalization**: The regression results suggest that openness is critical for growth. As noted earlier, despite recent progress, the Philippines is still less open than other country groups; consequently, further trade liberalization is essential. In addition, the experience of other countries suggests that continued growth benefits from trade liberalization require a shift to the provision of broad-based incentives (rather than a "picking-winners" approach), and complementary investments in infrastructure.[14]

[14]See Krueger (1998).

- **Higher investment (including FDI)**:

    - The regression results indicate strong association between investment shares and GDP growth. The Philippines' investment share lags behind that of East Asia (though the crisis has emphasized the need to pay attention to *quality* of investment, not just quantity).

    - Attracting FDI will require continued liberalization and improvements in "governance." An attractive investment climate includes "economic security" (enforcement of contracts; stable legal and tax regime; reliability of basic economic services).

    - Raising domestic savings is critical to finance the higher investment rates while limiting the dependence on foreign savings and the resulting vulnerability to capital flow reversals (Figure II.5).

- **Low inflation**: The regressions results indicate that episodes of very high inflation are detrimental to growth. In recent years, the Philippines has been able to avoid high inflation. Continuing this will require prudent monetary policies and a return to fiscal consolidation following the temporary widening of the fiscal deficit during the crisis.

- **Improved allocation of resources across sectors**: As noted in Section II.B, a shift in the pattern of production and employment from agriculture to manufacturing and services would raise growth rates as resources are shifted towards more productive areas of activity. Improving agricultural performance would facilitate this shift (as discussed in Chapter VII).

Box II.1. Estimates of Potential Output for the Philippines, 2000–05

Estimates of potential output are a useful input into policymaking. For example, potential output growth provides a guideline for medium-term growth projections. Potential output growth is also used in estimating a cyclically-neutral budget balance, which provides a measure the actual fiscal stance (expansionary or contractionary, relative to a base year) and fiscal impulse (change in fiscal stance between two periods). Finally, estimates of the output gap—generated from potential and actual output—can be used to gauge inflationary pressures in the economy.

The methods used to derive estimates of potential output for the Philippines are:

Production function approach: This method assumes that economics' production functions can be approximated by the Cobb-Douglas technology with two-factors, capital and labor. Assumptions about growth in these two factors are used to derive the series for potential output.

Hodrick-Prescott (HP) filter: This is a statistical method which removes short-run fluctuations and leaves behind a series whose smoothness is determined by a parameter choice.

Growth accounting approach: This method is based on the panel regressions described in the main text. The estimate of potential output is derived on the basis of the coefficient estimates and assumptions about how a deepening of assumed reform efforts will translate into values for the independent variables.

Estimates of Potential Output Growth for the Philippines: Average, 2000–2005

Production function approach	3.5
Hodrick-Prescott (HP) filter	3.8
Growth accounting approach	4.8

TRADE LIBERALIZATION IN THE PHILIPPINES: RESULTS FROM "TREND BREAK" TESTS

The first step is to determine whether the variable of interest follows a unit root process. If the variable does *not* contain a unit root, the test consists of estimating the equation:

$$x = \alpha + \beta DU_t + \gamma t + \vartheta DT_t + \sum_{i=1}^{n} c_i x_{t-i} + \varepsilon_t$$

where, x is (for example) the ratio of exports to GDP, t is time, DU_t is equal to 1 if $t > T_{br}$, where T_{br} is the break year, and 0 otherwise, DT_t is equal to $t - T_{br}$ if $t > T_{br}$ and 0 otherwise, and x_{t-i} is the value of x lagged i times.

If x follows a unit root process, a test in first differences improves power (Vogelsang (1997)). In this case x has no trend, and structural break is a break in the mean of the change of x. The estimated model is the following:

$$\Delta x_t = \alpha + \beta DU_t + \sum_{i=1}^{n} c_i \Delta x_{t-i} + \varepsilon_t$$

The number of lags in the regression is determined—following the methodology in Campbell and Perron (1991) and Ng and Perron (1995)—by initially estimating with a maximum number of lags and sequentially dropping one lag until the first significant lag is found. If no lag is significant, the estimated model does not include any lags. Following Ben-David and Papell (1997 and 1998), the maximum number of lags is 8, and the test is conducted for the 10 percent significance level.

The data set is for the period 1960–97, but the estimation trimming is 5 years. Hence, the regression is estimated sequentially for each year in the period 1965–92 ($1965 < T_{br} < 1992$). The value of T_{br} which maximizes the F-value for testing the hypothesis $\beta = 0$ is the year of the structural break. If no DU_t is found to be statistically significant, then x does not have a structural break. If x follows a unit root and the first model is estimated, the appropriate critical values are taken from Vogelsang (1997). If x does not follow a unit root, the standard F-statistic for the hypothesis $\beta = 0$ can be used.

It is important to note that this methodology can detect only one structural break. If the variable in question has more than one structural break, this methodology will detect the larger break (if the breaks do not offset each other), but not any other structural breaks. This is a drawback, but it should be more of a problem with longer time series than the ones used here.

Impact of Trade Liberalization on Growth

The regressions are estimated using a random effects estimator for a panel of all countries with available data (54 to 93 countries, depending on the independent variables in the regression), with each data point being a five-year average over the period 1970–95. Since the sample is a panel (i.e., it includes both cross-country and time-series variation), the estimated impacts will be smaller than in the more commonly-used cross-country regressions,[15] because most of the growth determinants vary considerably across countries, but to a much smaller extent through time. However, these panel regression estimates will be more reliable for projecting the impact of *changes* in policies on growth.

As discussed in the main text, the trade liberalization since the 1980's is estimated to have contributed between 0.2 and 0.7 percentage points to Philippine growth.

- The numerical estimates of the trade share imply that an increase of this share by 10 percent is correlated with faster growth by 0.1 to 0.6 percent annually (0.3 on average), depending on the specification. The trade share of the Philippines (PPP-adjusted) was equal to 14.2 in 1980 (there are no available data for the PPP adjusted trade share before 1980) and has increased to 19.9 in 1995.[16] The estimate of the trade share implies that this increase by 5.7 percentage points is expected to be correlated with an increase of GDP growth by 0.2 percentage points during the same period. If the trade share of the Philippines had reached the level of the average trade share in developed economies in 1995 (which was 77.3), growth would have been higher by 1.7 percentage points, and 2.3 percentage points higher if the trade share had reached the average level in the rest of East Asia (equal to 95.8).

- The openness index estimates imply that a year of openness leads to faster growth by 0.1 percent. Since the Philippines has been open since 1988, it is expected that the growth contribution of openness should have been 0.7 percentage points.

- The import duty coefficient is significant at the 10-percent level in only one of the two specifications (and only when the trade share is included in the regression). A possible reason is that the import duty is just a proxy, often not very precise, of the weighted average tariff rate. The average estimate of the import duty is -0.06. This estimate implies that a reduction of the import duty ratio by 10 percent, is correlated with faster growth by 0.6 percentage points. The Philippine import duty ratio has remained almost the same during the period 1970–95. As Table 2 shows, it was equal to 14.8 in 1995. If it had reached the average level in the rest of East Asia, equal to 4.4 in 1995, growth would have been higher by 0.6 percentage points on average, and if it reached the average level in developed countries, equal to 1.7 in 1995, growth would have been higher by 0.8 percentage points.

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[15]Growth regressions are usually estimated using a cross section of countries, for 5 or 10 or even 20 year averages. The sample would be too small and variation too little to estimate a growth regression using annual data for only one country.

[16]Philippine trade over GDP has increased considerably more than the PPP adjusted share, as Table 3 shows.

Annex Table II.1. Results of Panel Growth Regressions

	(1)	(2)	(3)	(4)	(5)	(6)	(7)
Real $GDP per capita	-0.90	-0.29	-0.80	-0.54	-0.38	-0.26	-1.13
	(-2.59)	(-1.11)	(-2.39)	(-1.46)	(-1.01)	(-0.85)	(-2.94)
Net FDI/GDP	0.34	0.28	0.25	0.29	0.56	0.46	0.30
	(2.78)	(3.01)	(2.28)	(1.56)	(4.13)	(3.40)	(1.56)
GDP	0.20		0.25	0.01	-0.04		0.31
	(0.19)		(1.44)	(0.06)	(-0.22)		(1.74)
Investment/GDP	0.16	0.21	0.18	0.20	0.21	0.20	0.17
	(4.93)	(7.68)	(5.93)	(4.59)	(6.51)	(6.32)	(3.68)
Age dependency ratio	-0.03	0.02	-0.01	-0.03	-0.01	0.02	-0.06
	(-1.35)	(1.23)	(-0.30)	(-1.65)	(-0.27)	(0.90)	(-2.80)
Government consumption/GDP	-0.06	-0.09	-0.04	-0.06	-0.03	-0.05	-0.06
	(-1.30)	(-2.09)	(-0.88)	(-1.15)	(-0.66)	(-1.11)	(-1.12)
CPI inflation	-0.1E-2	-0.1E-2	-0.1E-2	-0.1E-2	-0.1E-2	-0.1E-2	-0.1E-2
	(-3.30)	(-3.75)	(-3.80)	(-3.94)	(-3.58)	(-3.86)	(-4.02)
School enrollment ratio, primary	0.00	-0.01	-0.01	-0.02	-0.01	0.00	-0.01
	(-0.04)	(-0.74)	(-0.36)	(-1.60)	(-0.83)	(-0.31)	(-0.61)
School enrollment ratio, secondary	0.02	0.01	0.00	0.01	0.02	0.00	-0.02
	(1.00)	(0.69)	(0.23)	(0.64)	(1.14)	(0.17)	(-0.94)
Trade/GDP	0.01	...	0.01	0.02	...	...	0.06
	(2.04)		(1.80)	(3.97)			(3.89)
Openness	...	0.10	0.10	...	...	0.10	...
		(2.98)	(2.77)			(2.84)	
Import duty ratio	...	...	...	-0.07	...	...	-0.05
				(-1.76)			(-1.43)
Export duty ratio	...	...	...	0.06	...	...	0.05
				(1.03)			(1.08)
Free capital mobility	....	...	...		-0.01	-0.04	0.06
					(-0.18)	(-0.47)	(0.71)
R-squared	0.49	0.62	0.60	0.74	0.53	0.60	0.76
Countries	93	86	83	60	82	77	54
Observations	235	245	207	130	241	224	120

Sources: Data are from World Development Indicators, with the exception of capital market and trade openness.

Note: The above estimates are from random-effects panel data regressions. The data are five year averages for the period 1970–95. All regressions have GDP per capita growth as the dependent variable. The regressions that include the trade share include, in addition, the log of GDP to control for country-size differences.

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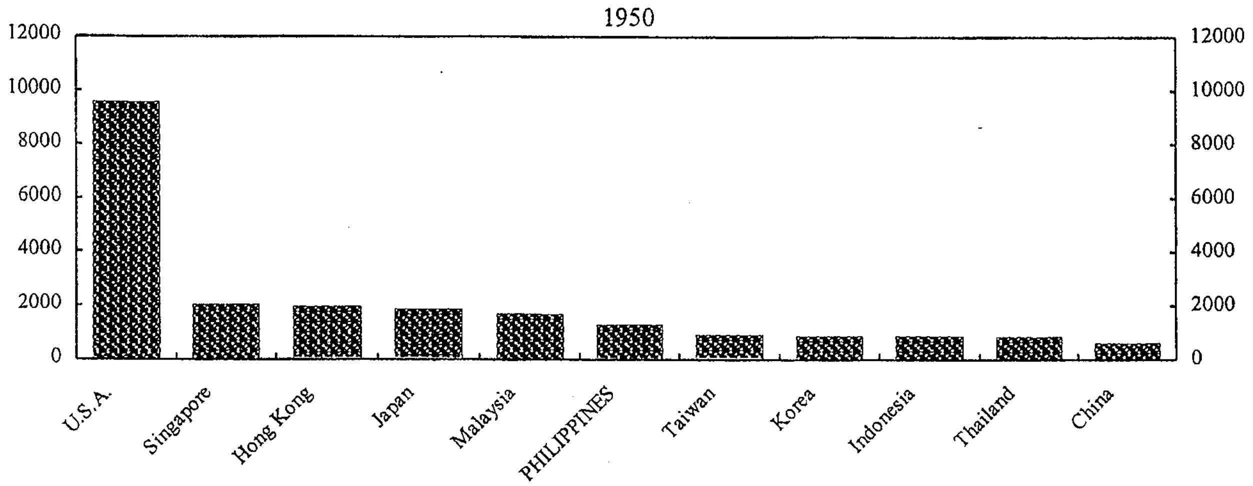
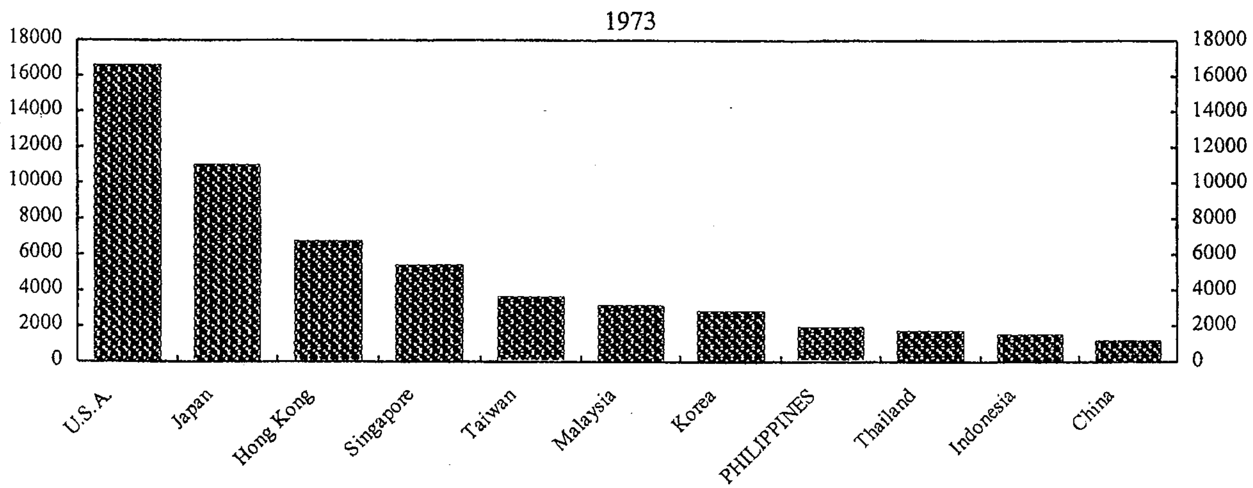
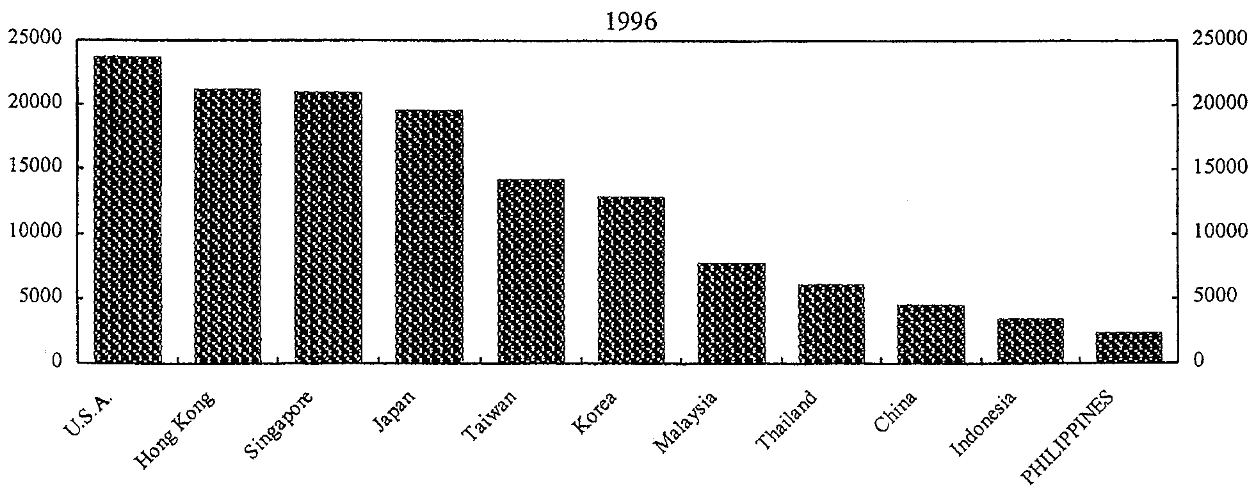
Figure II.1
Philippines: Real GDP per Person in 1950, 1973, 1996
(Constant prices based on PPP exchange rates -- 1990 international dollars)







Source: IMF, World Economic Outlook database.

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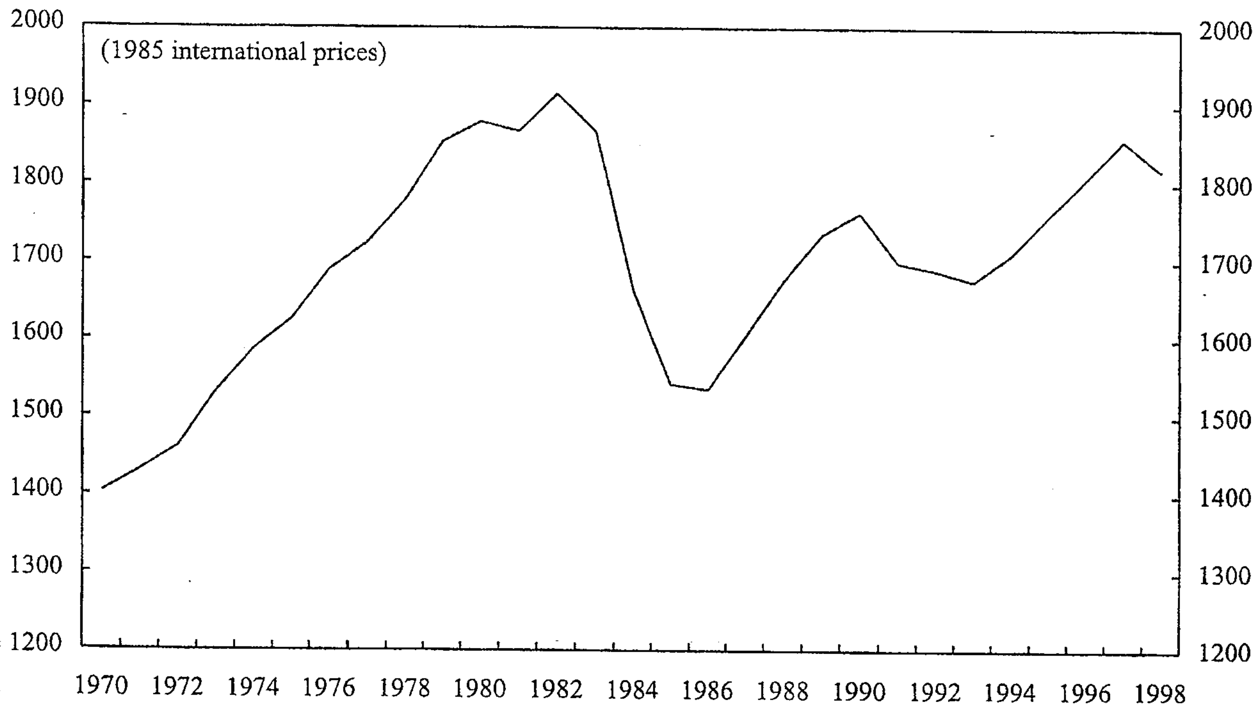
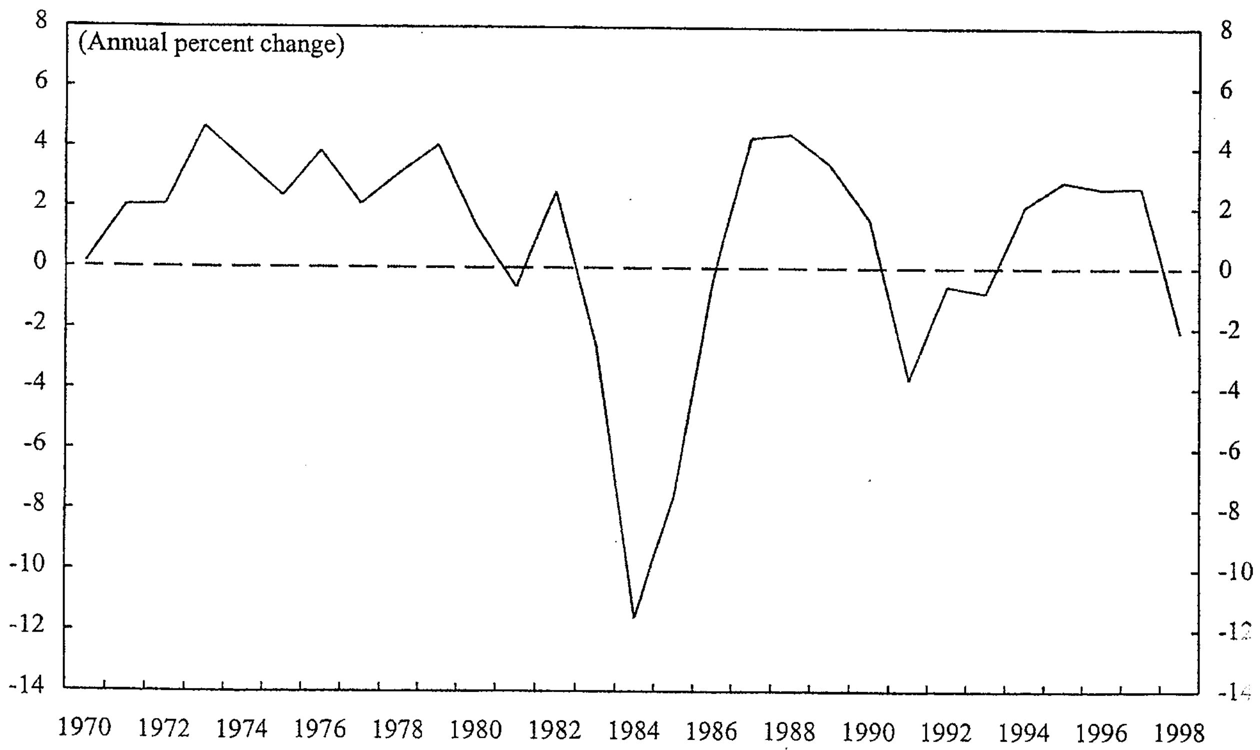
Figure II.2
Philippines: GDP per Capita, 1970-98



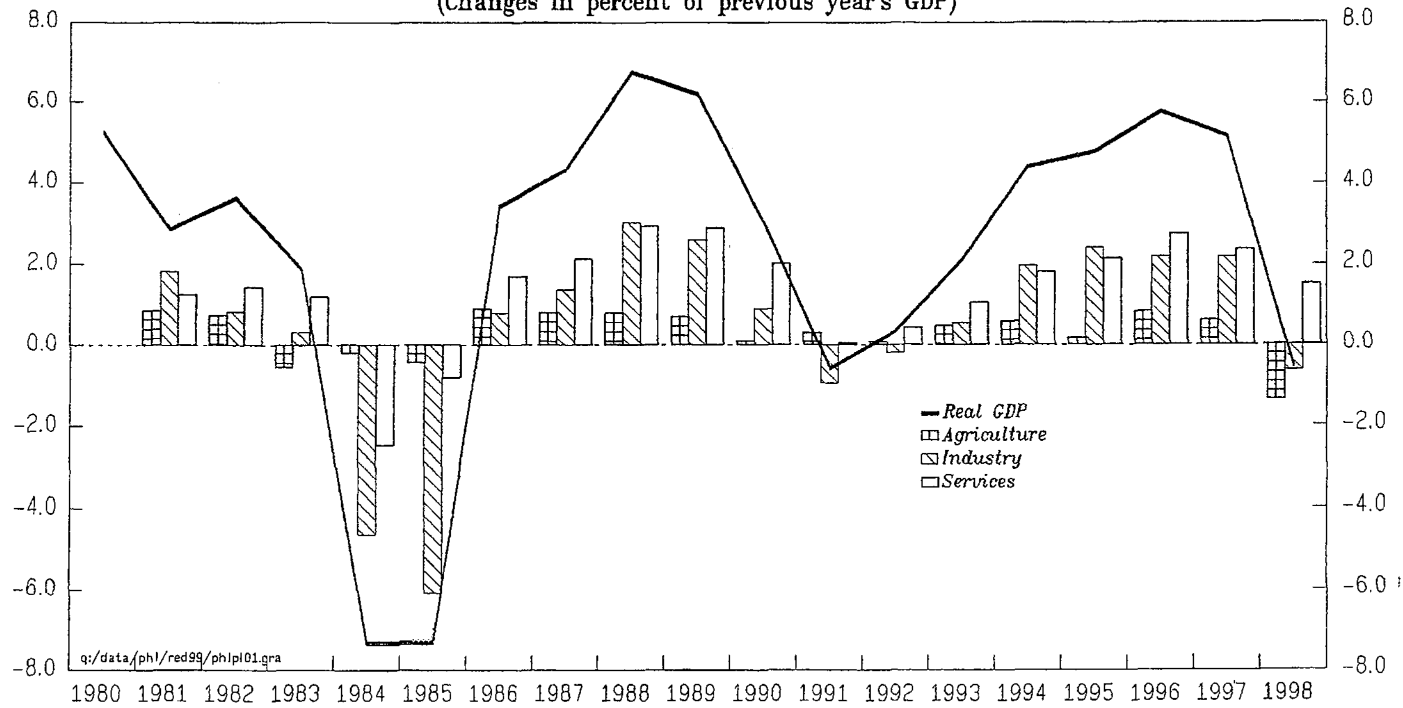


Sources: Penn World Tables; World Bank; and IMF, World Economic Outlook.

Figure II.3
Philippines

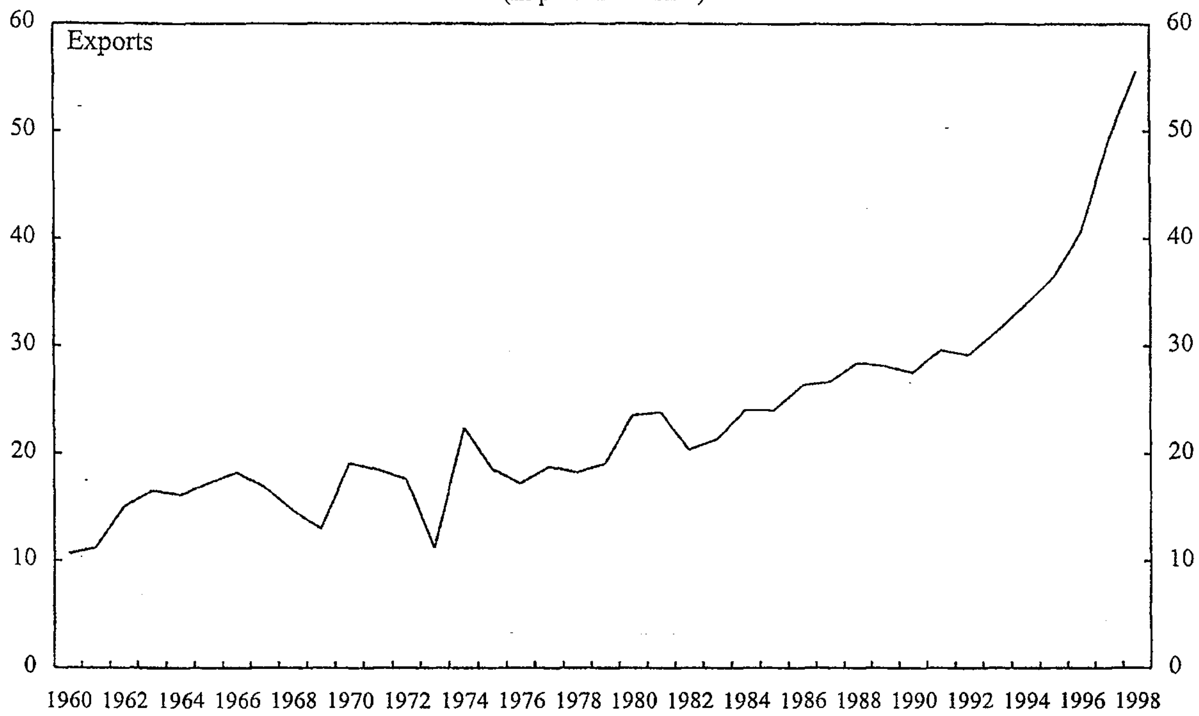
GDP GROWTH BY SECTOR, 1980-98

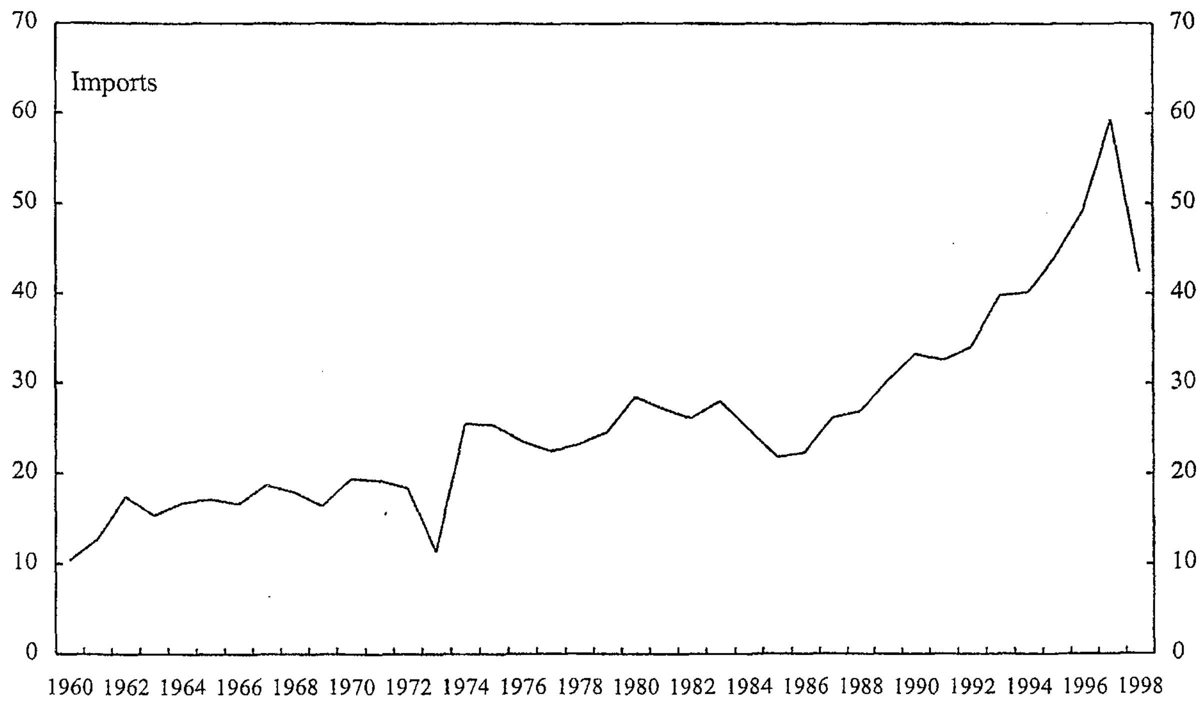
(Changes in percent of previous year's GDP)



Source: Data provided by the Philippine authorities.

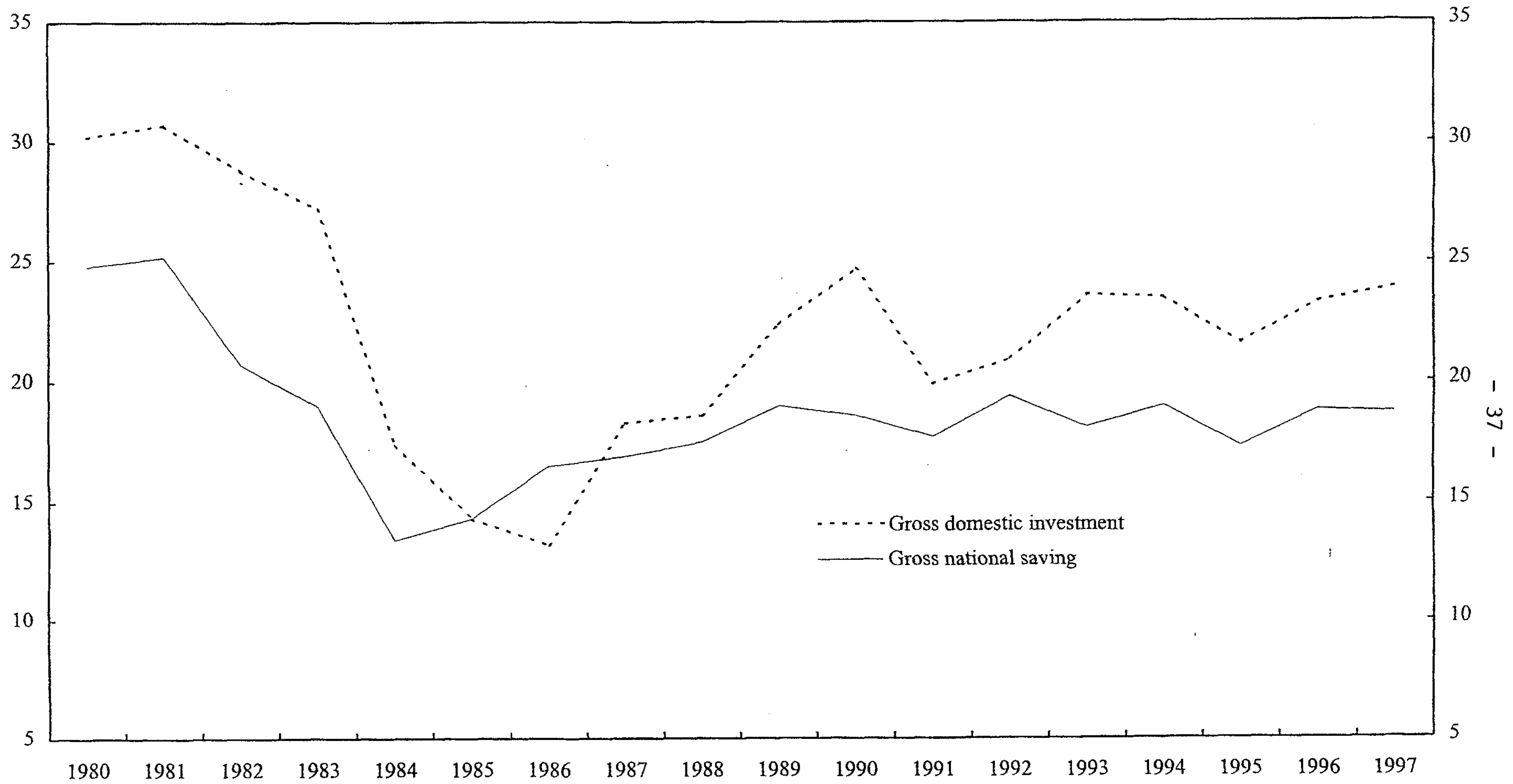
Figure II.4
Philippines: Exports and Imports, 1960-98
(In percent of GDP)





Sources: IMF, International Financial Statistics; and data provided by Philippine authorities.

Figure II.5
Investment and Saving, 1980-97
(In percent of GNP)



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Source: Data provided by the Philippine authorities.

III. Public Finance: Sustainable Fiscal Adjustment

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III. PUBLIC FINANCE: SUSTAINABLE FISCAL ADJUSTMENT[1]

A. Introduction

1. **Since the early 1990s, there has been a significant improvement in the Philippines' fiscal accounts.** The consolidated public sector balance moved from deficits in the range of 2–5 percent of GNP at the beginning of the 1990s to a balanced position in 1996. This reflected not only a substantial reduction in the deficit of the monitored Government Owned and Controlled Corporations (GOCCs) and a strong consolidation in the National Government (NG) balance, but also an improvement in the position of other public sector entities. Since 1997, fiscal balances have moved back into deficits as fiscal policy turned expansionary in support of domestic demand mainly by accommodating the revenue losses associated with the crisis-related slowdown of growth.

2. **This chapter describes Philippine fiscal developments in recent years and outlines the reform agenda to ensure medium-term fiscal sustainability.** Section B describes the evolution of the tax system and changes in the level and composition of government expenditures. It also describes developments in public sector entities outside of the national government. Section C analyzes the response of fiscal policy to the challenges posed by the Asian crisis. Section D evaluates the sustainability of Philippine fiscal policy, and Section E presents the remaining reform agenda.

3. **The performance of fiscal policy can be assessed along many inter-related dimensions.** IMF (1998) provides general considerations that should guide such an evaluation:

- **Quality of the Tax System:** Does fiscal policy rest on a fair, efficient and transparent system of taxation (ideally, a system of easily administered taxes, moderate tax rates, and a minimum number of exemptions)?

- **Level and Composition of Public Expenditures:** Is the aggregate level of expenditures and the composition of expenditures appropriate to the government's objectives with respect to growth and equity?[2] How well has policy been geared toward curtailment of unproductive public expenditures?

- **Fiscal Stance:** How well has fiscal policy responded to changing economic circumstances, in particular to the sharp changes as a result of the Asian crisis?

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[1]Prepared by Kristina Kostial and Victoria Summers.

[2]The impact of fiscal policy on equity is discussed in Chapter VII.

- **Fiscal Sustainability:** Could current fiscal policies be maintained into the (indefinite) future without leading the government into insolvency?

4. **Applying these considerations to the conduct of Philippine fiscal policy, the main conclusions of the chapter are:**

- **Tax Policy:** Major tax reforms since 1986 have been beneficial in increasing the progressivity of taxes, lessening distortions and simplifying the tax system. However, tax incentives continue to erode the tax base and administration remains weak, resulting in an inadequate revenue yield and weak buoyancy (positive cyclical response) of the tax system.

- **Expenditure Policy:** Continued weaknesses in the tax effort and substantial debt service payments have constrained policy choices, particularly by limiting much-needed outlays for infrastructure and social sectors (health and education). Some unproductive expenditures have been scaled down (for example, military expenditures), but others have not, including the cost of an over-staffed civil service and an inefficient intergovernmental transfer system.

- **Fiscal Stance:** Policymakers responded appropriately to the regional financial crisis by allowing fiscal deficits to widen in line with the slowing economy. However, faster progress with tax administration reform may have prevented the need for expenditure cuts in 1998, and allowed the provision of a larger expenditure stimulus.

- **Fiscal Sustainability:** Indicators of sustainability have improved considerably in recent years. Nevertheless, a review of prospective fiscal developments suggest that the fiscal situation remains vulnerable. Strong economic growth and continued progress in key fiscal reform areas are needed to keep government on a debt sustainable path over the medium-term.

B. Fiscal Developments During the 1990s

Overview

5. **The consolidated public sector deficit (CPSD) declined sharply during 1990-96** (Figure III.1). Although some of this improvement was due to nonrecurrent factors such as receipts from the privatization of government assets, the underlying CPSD (which excludes privatization receipts) also improved substantially. Three fifths of the improvement in the underlying CPSD occurred in 1991. Since then, improvement has been less rapid, and has resulted largely from favorable interest rate developments and from lower expenditure rather

than strengthened revenue effort. Fiscal deficits widened in 1997–98 mainly as a result of the slowdown in economic activity associated with the Asian crisis.

6. **The improvement in the CPSD has to a large extent been driven by improvements in the balance of the NG, which went from a large deficit to an almost balanced position in 1996 and 1997**. Supported by strong gains in revenues at the beginning of the 1990s, the NG deficit narrowed from around 2½ percent of GNP in 1991 to ½ percent of GNP in 1996 and 1997 while the expenditure ratio remained roughly the same. Since then, the NG deficit has widened due to the adverse impact of the Asian crisis mainly on the revenue side. An increase in tax revenues between 1991 and 1998 was largely offset by declines in nontax revenues (excluding privatization). At the same time, noninterest current expenditure increased by about 1½ percent of GNP, due to a sharp increase in the wage bill and transfers to LGUs. In contrast, operation and maintenance outlays and capital expenditures were compressed in an effort to limit the overall deficit.

7. **Other public sector entities also improved their financial position in the 1990s, with aggregate deficits declining to below 1½ percent of GNP**. An important factor in this regard was the decision of the government in 1996 to discontinue its intervention in the petroleum market via the Oil Price Stabilization Fund (OPSF). However, in recent years, growing surpluses of the social security institutions (SSIs), LGUs and Government Financial Institutions (GFIs) have masked a deteriorating position of GOCCs, in particular the National Power Corporation (NPC).

8. **Reflecting these developments, the public debt-to-GNP ratio declined until 1997, but has picked up since then**. Total gross liabilities of the public sector[3], as a ratio to GNP, fell from about 110 percent in 1990 to around 90 percent in 1997, but increased to more than 100 percent in 1998. For the NG, the debt-to-GNP ratio fell from 70 percent in 1990 to 53 percent in 1996, before rising to around 60 percent in 1998. As a result of the still high level of outstanding debt, interest constitutes a relatively large share (more than 30 percent) of NG expenditure.

9. **Despite the reforms of the 1990s, particularly tax reforms, a number of public sector issues remain to be addressed.** In the NG budget, a stronger revenue effort is needed by improving tax administration and curbing fiscal incentives. On the expenditure side, the rapidly rising wage bill and allotments to LGUs will need to be contained through civil service reform and a review of intergovernmental fiscal relations. Outside the NG, the most pressing issue is the restructuring and privatization of the NPC.

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[3]Defined as domestic and foreign gross liabilities of the NG, CB-BOL, GFIs, SSIs, LGUs, OPSF, all GOCCs (including lease obligations of the NPC) and the BSP; this is a broader definition than employed in the Staff Report Tables.

Trends in national government revenues and expenditures during the 1990s

10. **As noted there has been substantial consolidation in the NG fiscal accounts in the early 1990s, although part of it was reversed over the past two years**. The main issues in the NG budget are weak tax administration, the wide range of tax incentives, intergovernmental fiscal relations and civil service reform.

Revenues

11. **Historically, tax collection in the Philippines has failed to harness its full potential**. Although the revenue effort has been similar to that in Indonesia and Thailand, it has been lower than in Korea and Malaysia (Table III.1). As discussed below, revenue generation has suffered from weak tax administration and the provision of fiscal incentives. Because of low collections from direct taxes (mostly caused by under performance of the enterprise profit tax due to the extensive use of tax holidays), the Philippines has had to rely more on indirect taxes, particularly import duties.

Table III.1. Revenue Generation and Structure in the Asian-5
(in percent of GDP, 1990–96 average)

	Philippines	Indonesia	Korea	Malaysia	Thailand
Tax Revenues	15.6	15.8	16.6	20.4	16.7
Taxes on Income, Profits and Capital Gains	5.3	9.3	5.9	9.2	5.2
Of which: Corporate income tax	2.1	4.9	2.4	6.8	3.0
Social Security Contributions	0.0	0.0	1.3	0.3	0.2
Taxes on Payroll and Work Force	0.0	0.0	0.0	0.0	0.0
Taxes on Property	0.0	0.3	0.4	0.1	0.4
Domestic Taxes on Goods and Services	4.8	5.0	6.3	6.0	7.5
Taxes on International Trade & Transactions	4.8	0.9	1.4	3.9	3.3
Other Taxes	0.6	0.1	1.2	0.9	0.0
Nontax Revenues	2.7	1.9	2.6	6.8	2.0
Total Revenues	18.3	17.7	19.2	27.2	18.6

Source: *Government Finance Statistics Yearbook*.

12. **Philippine revenue policy has aimed at reducing the reliance on international trade taxes while bolstering domestic tax revenue**. Mainly because of reductions in the effective import tariff, revenue of the Bureau of Customs (BOC) has fallen from more than 5 percent of GNP in the early 1990s to 4 percent in 1997 and 3 percent of GNP in 1998. At the same time, major tax reforms have yielded an increase in the domestic tax collections by more than 3 percent of GNP over the period 1991–97.

13. **Since 1986, tax reform has been an ongoing concern**. The two major phases of tax reforms have been the 1986 tax reform package, and a comprehensive set of reforms started in 1994 (including the Comprehensive Tax Reform (CTRP) package of 1996–97). The 1986 reforms included changes in the individual and corporate income tax, the adoption of a VAT, and abolition of most export duties. Starting in 1994, the government embarked on a comprehensive set of reforms which included expansion of the VAT, rationalization of excise and oil product taxes, and major amendments to income tax legislation (Box III.1).

14. **While these reforms have produced a more structurally sound tax system, the improvement in collections intended under the CTRP has not materialized to the extent expected**. In particular, the VAT expansion has failed to yield the envisaged revenue gains, with the ratio of domestically collected VAT to GNP falling from 2.1 percent of GNP in 1994 to 1.7 percent in 1998. While part of this can be attributed to the recent slowdown in economic activity, it is likely that weak administration and failure to rein in tax incentives have also contributed.[4]

15. **Rationalization of tax incentives is an important unfinished item of the reform agenda** (Box III.2). Despite the government's original plans, the final CTRP legislation did not address the tax incentives problem. Key areas for reform include abolishing tax holidays and the Investment Priorities Plan, limiting the use of tax credits (which are vulnerable to fraud), and reducing the number of specific laws that render tax administration difficult. Rationalization of incentives and phasing out of tax holidays could result in a substantial, but unquantifiable gain in revenues.[5]

16. **Improving tax administration is also critical**. In recent years, both the BOC and the Bureau of Internal Revenue (BIR) have made progress in modernizing their operational procedures, building new computer and information systems and restructuring their

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[4]In addition, it should be noted that the full positive impact of the income tax changes were not realized in 1998, the first year of enactment, due to delays in implementation of some provisions.

[5]The government is in the process of reviewing the fiscal incentive system with a view to rationalizing it.

Box III. 1. Philippines: Tax Reforms Since 1994

In 1994, the government launched a reform program designed to correct the long-standing problem of low tax collection by expanding the tax base. Much of this ambitious program has been realized with the important exception of tax incentive rationalization. However, despite intentions to raise the tax revenue ratio, particularly for consumption taxes, the reform has turned out broadly revenue neutral.

- The first phase of the program was a **reform of the VAT** system bringing a significant number of services, previously not taxed, into the system. This law was passed in 1994, though its implementation was delayed until 1996 as a result of a legal challenge to its constitutionality. The effect on revenue has been disappointing as the collection of VAT on domestic consumption fell from 2.0 percent of GNP in 1994 to 1.7 percent of GNP in 1998.

- The second phase of the reform, referred to as the **Comprehensive Tax Reform Package** (CTRP), covered income and excise taxes, rationalization of tax incentives, and statutory changes to tax administration.

- **Excise tax reform** was enacted effective at the end of 1996. This legislation rationalized excise taxation on alcohol and tobacco products, in part by levying specific rather than ad-valorem taxes to reduce tax evasion. As a result, excise tax revenue jumped by ½ percent of GNP to 2.5 percent of GNP in 1997; however, with the adverse effect of the Asian crisis on the sale of gasoline, excise tax revenue fell to 2.2 percent of GNP in 1998.

- Also during 1996, **oil product taxation** was rationalized, with a substantial reduction in import tariffs which was partly offset by the introduction of petroleum excises.

- **Income tax reform** was passed in December 1997. Ultimately the net revenue gain from the overall income tax package in the form enacted was small.

  - Major amendments to the **individual income tax** included changes in the rate structure, bringing the top marginal rate into line with the corporate tax rate (currently at 33 percent, but scheduled to be reduced to 32 percent in 2000), and increases in the level of personal exemptions. (The provisions of the individual tax reform, while structurally sound, were anticipated to result in a revenue reduction of approximately P 8 billion annually; however, a wage increase offset this revenue loss such that revenues from the individual income tax increased by 0.2 percent of GNP to 2.3 percent of GNP in 1998.) The package included the reimposition of an individual tax on corporate dividends through final withholding at a 6 percent rate, increasing to 10 percent by 2000.

  - Important structural improvements were made to the **corporate income tax,** including most notably: a gradual rate reduction to 32 percent; the enactment of a fringe benefits tax; adoption of net operating loss carry forward; disallowance of tax benefits of interest arbitrage; taxation of interest paid to residents from foreign currency deposit accounts; and the adoption of a corporate alternative minimum tax (although not in the preferred form of a tax on net assets, as originally proposed by the government, but rather as a tax on gross receipts less cost of goods sold).

- The CTRP also included various provisions designed to increase administrative efficiency and reduce the scope for fraud and abuse.

organizations. While customs administration improved notably during 1994–97, the BIR remains plagued by major deficiencies, including corruption, lack of large taxpayer control, inadequate audit programs, and weak enforcement. BIR is currently in the process of reassessing its reform strategy.

Expenditures

17. **In addition to the weak revenue effort, sizable interest and wage bills have constrained the Philippines' room for maneuver on the expenditure side** (Table III.2). As a result, capital outlays in the Philippines have been substantially lower than in the other Asian countries. The broad composition of NG expenditures has remained unchanged in the 1990s, with current expenditures of around 16 percent of GNP and capital expenditures around 3 percent. While expenditures show hardly any cyclical response, the composition of current spending has changed markedly in recent years as lower outlays on interest, operations and maintenance, and subsidies were offset by higher allotments to Local Government Units (LGUs) and a ballooning wage bill. The temporary hike in the interest bill in 1998 due to the regional crisis was countered by restraints in capital outlays.

Table III.2. Philippines: Expenditure Structure in the Asian-5
(In percent of GDP, 1990–96 average)

	Philippines	Indonesia	Korea	Malaysia	Thailand
Current expenditure	16.5	8.7	14.4	20.9	11.0
Wage bill	5.6	2.6	2.2	7.9	5.0
Purchase of goods and services	2.8	1.7	3.1	4.3	3.9
Interest bill	5.8	1.8	0.6	4.3	0.9
Subsidies and transfers	2.3	2.7	8.4	5.1	1.2
Capital expenditure	2.7	7.7	2.8	5.1	4.4
Net lending	0.4	0.4	2.2	0.3	0.2
Total Expenditure	19.5	16.9	19.4	26.3	15.6

Source: *Government Finance Statistics Yearbook*.

Box III. 2. Philippines: Tax Incentives

Philippine law includes a vast array of investment tax incentives of all types, granted by the Board of Investment (BOI), special economic zones, the Philippine Economic Zone Authority (PEZA), and specific laws. Tentative estimates of the revenue loss due to these incentives point to an order of magnitude of around 1 percent of GNP.

Board of Investment (BOI): As originally enacted in 1987, the Omnibus Investments Code provides a number of tax incentives for BOI registered enterprises, including income tax holidays, customs duties exemptions, and export tax credits. BOI registration may be given to firms in export oriented industries, "catalytic industries" (i.e., certain sectors of manufacture and agriculture/forestry), industries undergoing adjustment (e.g., textiles), support activities (i.e. infrastructure, telecommunications, transportation) and "mandatory inclusions" (e.g., minerals, iron and steel). The scope is very broad--it is estimated that approximately one-third of all imports of capital equipment is by BOI registered enterprises.

Investment Priorities Plan. Under the Omnibus Investment Code of 1987 an annual plan must be drawn up by the BOI and approved by the President. This plan covers priority areas which receive tax and other incentives and is viewed as a prime vehicle of industrial policy.

Income tax holidays. BOI registered firms are eligible for income tax holidays lasting up to eight years. If tax holidays were to be abolished, this would most likely apply only to newly registered firms as contracts with already registered firms would need to be grandfathered.

Tax Credits. These are benefits designed to offset the adverse incentives of BOI duty exemptions for using imported capital equipment rather than domestically manufactured equipment. BOI enterprises are entitled to credits in the amount of the differential between the 3 percent minimum tariff (or the rate of zero, whichever applies) and the standard tariff rate which would have applied to domestic capital which they purchase, had it been imported.

Special economic zones and PEZA: Enterprises located in the former Clark and Subic bases (the **"special economic zones"**), are entitled to similar tax holidays and duty exemptions as those for the BOI firms, but on a permanent basis. In addition, there are extremely broad provisions for retail duty free shopping in these zones, extending not only to international travelers upon their return or departure from the Philippines, but to residents of the zones and even residents near the zones. **PEZA** (one of the monitored GOCCs) administers numerous export processing zones which grant tax benefits to eligible firms; these zones have been multiplying rapidly.

Other laws

Export Development Act of 1994. The Export Development Act allows for various incentives to encourage the growth of export industries.

Agriculture and Fisheries Modernization Act of 1997. This bill exempts from customs duty all imports (not just for capital) used for agriculture; implementing rules and regulations still need to be adopted, but—if interpreted liberally—the implementation of this bill could result in a revenue loss of up to 0.8 percent of GNP.

In addition to the above laws, there exist a plethora of special laws for certain industries (e.g., the Iron and Steel Industry Act and Mining Act), many of which fall under the supervision of the Department of Trade and Industry.

18. **Transfers to LGUs have been a rapidly growing burden on the NG budget**. The 1991 Local Government Code, which restructured intergovernmental finances (see below), requires the NG to transfer a specific proportion of domestic tax revenue to LGUs.[6] Due to its design, transfers to LGUs tripled to almost 3 percent of GNP in 1998 and are expected to increase further in the coming years (Figure III.2).

19. **While civil service reform has been on the agenda for over a decade, actual progress has been slow**. A program to "streamline the bureaucracy" was launched in 1994 to rationalize the compensation structure for the civil service while reducing personnel, so as to maintain the overall wage bill at the 1995 level of 5.6 percent of GNP. While substantial wage increases have been granted to all employees, the size of the civil service has not been sufficiently reduced nor have the wages of senior officials been increased adequately. As a result, the NG wage bill has increased by almost 2 percent of GNP since 1994 (Figure III.3).[7]

20. **Capital spending in the 1990s has been insufficient to greatly reduce the backlog of decades of under-investment in infrastructure**. Despite a relatively high road intensity compared to other East Asian countries, road standards and maintenance are inadequate and less than 20 percent of the total road network is paved. Also ports and the rail system suffer from lack of maintenance and supply of clean and safe water for urban as well rural residents is insufficient. While the government has tried to encourage private sector participation through Build-Operate Transfer arrangements, private sector involvement in infrastructure has been limited.

21. **Accommodated by a reduction in the interest bill, NG expenditure has been reallocated toward social and general public services** (Figure III.4).[8] However, this development reflects mainly an increase in the wage bill (as discussed above) and has not led to an improvement in the provision of basic education and health care services, as discussed in Chapter VII.

22. **Military spending in the Philippines has been low during the 1990s, but could rise substantially in the future** (Box III.3).

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[6]The NG transfers to LGUs 40 percent of domestic revenue of the third preceding year (including 9 percent which is earmarked for capital outlays of LGUs).

[7]Following adoption of the 1991 Local Government Code, there was a small drop in NG employment that was reversed in later years.

[8]This breakdown includes NG transfers to LGUs, but does not cover total LGU spending.

Box III. 3. Philippines: Military Expenditures: Developments in the 1990s and Outlook

Military spending in the 1990s has been below the Asian average. Direct military spending has been cut by half in the period 1990–98 to around 1 percent of GNP in 1998 while military spending including outlays for health, education, social security and housing has hovered around 1½ percent of GNP.[1] Currently, around 70 percent of the Department of National Defense's budget is allocated to cover salaries, contributions to a pension fund, as well as direct pension benefits. With roughly 20 percent of the budget used for operation and maintenance, capital outlays amount only to around 10 percent.

Military Spending, 1993–98
(In percent of GDP)

	1993	1995	1996	1997	1998
Philippines	1.4	1.6	1.3	1.6	1.3
Developing Asian countries	2.0	1.8	1.7	1.7	1.7

Sources: WEO; and authorities.

Military spending may increase substantially in the future. The implementation of the Armed Forces of the Philippines (AFP) Modernization Act (enacted in 1995) will boost military spending as it appropriated an amount of P 165 billion for the modernization of the AFP over a period of 15 years. The AFP modernization will be financed through an extra budgetary fund which has been endowed with P 30 billion from privatization receipts, but has not yet become operational.

[1]Data from other sources (US Arms Control and Disarmament Agency, Stockholm International Peace Research Institute and Institute for International Strategic Studies) indicate that military spending was in the range of 1.4–2.8 percent of GDP for 1992-1996. The variance can be explained by different definitions employed to measure military spending. However, most sources report a declining trend in military spending.

Other public sector entities

23. **After large deficits in the 1980s, the fiscal position of other public sector entities improved substantially in the 1990s**. Besides the NG, the consolidated public sector encompasses the following entities:

- Local Government Units (LGUs);[9]
- Fourteen Government Owned and Controlled Corporations (GOCCs);

[9]Comprising 78 provinces, 81 cities, 1,526 municipalities, and more than 40,000 villages.

- Oil Price Stabilization Fund (OPSF)—abolished in 1998;
- Central Bank-Board of Liquidation (CB-BOL);
- The old Central Bank of the Philippines (CBP) replaced in 1993 by the Bangko Sentral ng Pilipinas (BSP);
- Social Security Institutions (SSIs); and
- Government Financial Institutions (GFIs).

Their consolidated balance (excluding the NG) has been in the range of small surpluses (in 1991 and 1996) and deficits below 1½ percent of GNP. Future reform efforts need to focus on intergovernmental fiscal relationships and the financial position of GOCCs, in particular the National Power Corporation (NPC).

Local Government Units (LGUs)

24. **The 1991 Local Government Code reformed the governance structure in the Philippines by transferring more powers to LGUs**. Along with this reform, many former NG expenditure responsibilities (in the areas of agriculture, environment and natural resources, health, infrastructure and maintenance, and social welfare) were devolved to LGUs, which have become the main provider of the social safety net. To finance the increased LGU spending, the code has guaranteed transfers from the NG and granted fiscal autonomy to LGUs, including local taxing powers and the right to borrow.

25. **Decentralization has more than doubled the size of LGU budgets**. Substantial transfers from the NG, but also improved internal revenue generation, have enabled LGUs to increase their expenditures from 1½ percent of GNP in 1990 to almost 4 percent of GNP in 1998, while running small surpluses in the range of 0.1–0.4 percent of GNP (Figure III.5).

26. **However, implementation of the LG Code has revealed some structural weaknesses**.

- While the code has empowered LGUs with many new responsibilities, it has left the existing **administrative structures** largely intact. As a result, many LGUs are not equipped with the necessary organization and implementation capacity to discharge the mandate they received. At the same time, **transparency and monitoring** of LGUs is weak as there are no unified accounting and reporting rules.

- The **transfer arrangements** are not providing incentives to LGUs to increase their tax effort and have created an over-dependence of some LGUs on the allotments from the NG (some provinces and municipalities now get more than 95 percent of their income from the NG allotment). Also, LGU revenue collection appears to be inefficient, with the costs of tax collections estimated to range from 30 percent of revenue collected to more than 100 percent.

- Coordination between different levels of government is deficient and some **expenditure responsibilities** have not yet been completely devolved, resulting in duplication or inadequate delivery of services. This shortcoming has been exacerbated by the distribution formula which does not ensure a minimum quality of goods and services provided by LGUs.[10]

- While only few LGUs have tapped capital markets so far, there is a **risk of moral hazard** from implicit guarantees from the NG.[11]

Government Owned and Controlled Corporations (GOCCs)[12]

27. **After a short period of consolidation through the middle of the 1990s, GOCC balances have deteriorated in recent years**. Privatization in 1994 and 1995 reduced the size of the GOCC sector by roughly 30 percent. Since then, a rise in current spending of the remaining GOCCs has led to a gradual increase in the consolidated GOCCs' deficit (Figure III.6). Principally responsible for this deterioration have been the NPC and the National Food Authority (NFA).

28. **After major progress in the mid 1990s, privatization has leveled off in recent years** (Figure III.7). In 1986, the Committee on Privatization (to oversee the privatization program) and the Asset Privatization Trust (to deal with the marketing aspect of privatization) were created. After a slow start, the privatization process gained strong momentum in the mid-1990s with the sale of Petron and the National Steel Company. In light of the slow pace of the privatization program in recent years, the mandate of the privatization agencies has been extended until December 1999.

29. **Since the power crisis of the early 1990s, NPC has been incurring sizable deficits**. NPC entered the 1990s in a fragile position as it had financed its 1980 expansions by extensive

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[10]The distribution formula is based on population, land area, class of local government, but not on the cost of devolved functions, the capacity to raise own revenues, or an equalization of needs across jurisdiction.

[11]LGU borrowing is not managed within the overall public debt management.

[12]The GOCCs consist of 14 holding companies, namely the National Power Corporation, Philippine National Oil Corporation, Metropolitan Water and Sewerage System, National Irrigation Administration, National Development Company, Light Rail Transit Authority, National Electrification Authority, National Housing Authority, National Food Authority, Philippine Economic Zone Authority, Philippine National Rail, Local Water Utilities Administration, and Philippine Port Authority.

external borrowings (Box III.4). Its position was further weakened by the power crisis at the beginning of the 1990s. Part of the government's response involved the signing of contracts with Independent Power Producers that locked NPC into power purchases on relatively expensive terms for the next decades. Bolstered by fast growing sales; NPC's position improved temporarily in the mid-1990s, but it has deteriorated sharply in recent years, reflecting depressed power sales as a result of the economic slowdown and delays in the implementation of tariff increases. Plans for reform of the power sector and privatization of NPC have been held up by delays in passing enabling legislation (the Omnibus Electricity Bill).

Box III.4. Philippines: Electricity sector and National Power Corporation (NPC)

NPC is the largest GOCC in the Philippines. It is the only seller of electricity in the wholesale market and has a monopoly in transmission. Distribution is handled by the private sector.

Background

- During the 1980s, electricity tariffs were not adjusted in a timely matter. Therefore, NPC's substantial expansion was covered almost exclusively by external borrowings guaranteed by the NG.

- At the beginning of the 1990s, the Philippines faced severe shortages of electricity, inter alia brought about by a lack of preventive maintenance. To cope with the power crisis, NPC signed contracts with Independent Power Producers (IPPs). The IPP contracts currently cover about 40 percent of power generation and are long-term (many still have terms of 15 years remaining).

Main problems in the 1990s

- NPC's debt to equity ratio ballooned from 1.6 in 1993 to 4.2 percent in 1997 and deteriorated further in 1998, reflecting high operating expenses, increased financing charges, and currency depreciation.

- The IPP arrangements include a type of guarantee under which NPC is obligated to purchase power under a take-or-pay provision that the government guarantees. These contracts are very lucrative to the IPPs—and very expensive for NPC.

- NPC's room for increasing its tariffs is limited as Philippine end-user tariffs are the highest in Asia outside Japan, reflecting only partly NPC's costs, but also inefficiencies in the distribution sector (mainly handled by rural electric cooperatives).[1]

- Due to the Asian crisis, power sales have been depressed. As NPC has minimum off-take agreements with IPPs, NPC has had to buy power for which demand did not exist.

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[1]While East Asian countries' distribution losses were around 13 percent in 1992–95, Philippines distribution losses were higher by 3 percent. Moreover, the average collection efficiency of the distribution sector is only around 90 percent.

30. **NFA's financial position has been somewhat volatile due to its principal mandate to stabilize the domestic market of rice.**[13] NFA was created 27 years ago, with its mandate supposed to be temporary until the agricultural sector develops sufficiently. To date, NFA continues to handles procurement, marketing, and distribution of grains and its interventions have been costly at times. In addition to its regulatory and supervisory function, NFA is involved in providing a limited social safety net to the poorest 10 percent of the population in some regions (by distributing vouchers to poor families, with the help of nongovernmental organizations, for buying fortified rice at a subsidized price). With support from the Asian Development Bank, the government intends to liberalize the grain market in the near future.

Oil Price Stabilization Fund (OPSF)

31. **The government ceased to intervene in the oil market, by deregulating the sector in 1996 and subsequently abolishing the OPSF.** The OPSF was set up in 1984 to shield consumers from fluctuations in world oil prices and the exchange rate, but delays in price increases led to the accumulation of large deficits in the OPSF. Since deregulation (completed in early 1998), prices for petroleum products are allowed to move freely and the OPSF has discontinued its operations.

The Central Bank

32. **With the liquidation of the old central bank CBS, a new central bank (BSP) and a fund to liquidate the CBS' debt (CB-BOL) were created in 1993.** The CBS had been running deficits in the range of 1–2 percent of GNP. The CB-BOL assumed the (entirely external) debt of the CBS and—to service the principal and interest on its liabilities—was endowed with government securities for P 220 billion and mandated to receive a certain share of BSP's profits. In the period 1994–98, CB-BOL has had annual deficits of around 1 percent of GNP and the BSP has achieved moderate profits in most years.

Social Security Institutions (SSIs)

33. **Reflecting sizable increases in their membership while the number of beneficiaries has been lagging, the SSIs have been running substantial surpluses.**[14] With the exception of 1994 when the SSIs invested in shares of Meralco (the Manila Electric

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[13]For example, this mandate explains the substantial deficit of 0.4 percent of GNP in 1998 to finance rice emergency stocks in preparation for potential crop damage by La Niña.

[14]There are three payroll tax-funded SSIs with now around 20 million members. Public employees are covered under the Government Service Insurance System (GSIS). Private sector employees have to enroll at the Philippine Health Insurance Corporation (PHIC) and the Social Security System (SSS).

Company), the aggregated balance of the SSIs has been in surplus. After a decline in the surplus in the mid-1990s due to an increase in benefits, the surplus increased in 1998, reflecting, inter alia, an increase in membership and contribution rates.

34. **However, the financial viability of the SSIs system is a matter of concern at present levels of benefits and returns**. The SSIs' capacity to pay may be undermined by sizable lending at below-market interest rates to their members and the government and in-house management that is not independent from political interference. This could result in a cut in future pension benefits or the need to raise membership contributions.

Government Financial Institutions (GFIs)

35. **After taking action to improve their lending practices and financial controls in the 1980s, the GFIs have been producing profits**. The GFIs comprise the Development Bank of the Philippines, Phil Guarantee (recently renamed TIDCORP), and the Land Bank. The aggregated balance of the GFIs has been in surplus hovering around 0.3 percent of GNP in the 1990s. The Development Bank of the Philippines is slated for privatization.

C. Fiscal Response to the Asian Crisis, 1997–99

36. **The overall fiscal response to the Asian crisis was broadly appropriate, although better tax administration might have prevented the need for expenditure cuts**. With monetary policy geared toward stabilizing the peso, fiscal policy took up the task of supporting domestic demand (Box III.5). The extent of fiscal relaxation reflected the more modest economic slowdown compared with other crisis countries, as well as constraints imposed by the high level of public debt, and concerns over adverse market reaction to a higher deficit. In implementing fiscal policy, better tax collection would have helped shield critical expenditures from cuts, particularly on social priorities and infrastructure.

37. **To examine further the policy response to the crisis, fiscal developments in 1997–98 are decomposed into those caused by economic factors and policy factors, respectively**. The analysis decomposes changes in the fiscal balances into:

- endogenous changes due to **economic factors**, which are further broken down into three main components: growth and imports, exchange rate, and interest rate;

Box III.5. Philippines: Fiscal Stance, 1997–99

Following several years of fiscal consolidation, 1997-98 witnessed a shift to a more expansionary fiscal policy.

- Although the fiscal program for 1997 had envisaged a further deficit reduction, a sizable revenue shortfall resulted in a widening of the deficit, implying a fiscal stimulus of 0.6 percent of GNP. The revenue shortfall reflected mainly administrative slippages in revenue collection, as economic growth was not seriously affected by the regional crisis until 1998; delays in implementing the CTRP also played a role.

- While the initial program for 1998 aimed at returning gradually to the earlier consolidation path by reversing the policy slippages in 1997, it was modified to accommodate a significant increase in the fiscal deficit to take into account the effects of lower growth and somewhat higher social spending. As a result, fiscal policy imparted a stimulus of 1 percent of GNP, reflecting a sharp fall in revenues that was only partly offset by expenditure restraint.

The original program for 1999 had foreseen a return to fiscal consolidation assuming the recovery was well established by then. However, as prospects for recovery remained uncertain, the government decided not to withdraw fiscal stimulus, while medium-term considerations prevented provision of additional stimulus. Thus, the fiscal program was revised to keep a broadly unchanged fiscal stance, with a further fall in revenue offset by expenditure savings.

Table. Philippines: Fiscal Balances, 1996–99

(In percent of GNP)

	1996	1997	1998	1999
	Actual	Actual	Actual	Proj.
Underlying consolidated public sector balance 1/	0.0	-1.5	-3.1	-3.2
National government balance 2/	-0.6	-0.7	-2.6	-2.7
Primary balance 3/	4.1	3.6	2.1	1.6
Neutral national government balance 4/	-2.3	-2.0	-2.7	-2.9
Fiscal stance 5/	-1.7	-1.2	-0.1	-0.1
Fiscal impulse 6/	-0.6	0.6	1.2	0.0
Of which: Revenue	-0.7	-0.1	2.2	0.3
Expenditure	0.1	0.7	-1.0	-0.3
Memorandum items				
Real GDP growth (in percent)	5.7	5.2	-0.5	2.2
Potential GDP growth (in percent)	4.3	4.3	3.0	3.0

Sources: Authorities; and Fund staff estimates.

1/ Consolidated public sector minus privatization receipts of the national government and GOCCs.

2/ Includes the net deficit of the Central Bank Board of Liquidators and excludes privatization receipts.

3/ The primary balance is defined as the national government balance excluding interest payments.

4/ Describes a fiscal policy that is neither pro-cyclical nor counter-cyclical (neutral revenue is defined as the revenue ratio in the base year 1991, when actual output is assumed to have been equal to potential, multiplied by actual GNP; neutral expenditure is the expenditure ratio in the base year, multiplied by potential GNP in the current year).

5/ Defined as the difference between the actual and the neutral fiscal balance. A positive fiscal stance represents an expansionary fiscal policy relative to the base year, while a negative fiscal stance represents a contractionary fiscal policy relative to the base year.

6/ Defined as the change in the fiscal stance between succeeding years. A positive fiscal impulse stems either from a revenue impulse, a situation in which actual revenues grow more slowly than neutral revenues, or one in which actual expenditures grow more rapidly than neutral expenditures, or both.

A caveat needs to be added to this kind of analysis. The analysis is based on the assumption of recurrent cycles around potential output, contrasting the actual fiscal balance with a measure of the cyclically-adjusted balance or neutral balance. However, when there are large adjustments including possibly persistent changes in economic conditions (e.g., in the exchange rate) and structural changes in the economy, the assumption of a recovery back toward the original equilibrium may be less valid.

- changes induced by **policy measures**, defined to include both active and passive discretionary policy measures;[15] and

- **residual changes** that cannot be accounted for by either of these factors.

38. **The decomposition highlights the following developments (Table III.3).**

- **In 1997, the fiscal deficit widened slightly relative to the previous year, although economic factors worked in the direction of shrinking the deficit.**

    - Among the *economic factors*, a lower domestic interest bill was the dominant influence on the fiscal outcome.

    - The major *policy measures* in 1997 were a substantial increase in the wage bill (by 0.9 percent of GNP) and somewhat higher capital expenditure, partly offset by the elimination of the transfer to the Oil Price Stabilization Fund.

- **In 1998, the fiscal deficit widened further by 1¾ percentage points of GNP (relative to 1997), with the widening of the deficit due to changes in economic factors partially contained by policy measures.**

    - Three *economic factors* (income growth, interest rates, and change in the mix of dutiable imports) contributed to a widening of the fiscal balance. The predominant factor was the slowdown in growth and the change in imports from the previous year, which affected revenues by 1½ percent of GNP.

    - The *policy measures* were almost entirely on the expenditure side, as outlays were compressed to contain the effect of economic factors on the fiscal balance.

D. Fiscal Sustainability and Medium-Term Outlook

39. **As a minimum policy requirement, fiscal policy should not lead to a situation in which the public debt-to-GDP ratio is increasing continuously**. Historical data can be

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[15] Active policy refers to discrete and well-defined policy measures taken by the authorities, usually in the form of nominal changes in spending or revenue measures. Passive policy refers to not adjusting nominal expenditures as income changes. It should be noted that some judgement is involved in assigning changes in the fiscal balance to one of the categories. Any form of policy inaction can be viewed as a deliberate policy action in favor of the status quo—a problem that is particularly acute in the area of expenditure policy.

Table III.3 Philippines: Changes in National Government Fiscal Balances, 1996–98
(Relative to previous year)

(In percent of GNP)

	1996	1997	1998
Expenditures	19.2	19.9	19.5
Change in expenditure		0.7	-0.5
Cyclical change		0.1	1.2
Change in exchange rate		0.4	1.1
Change in domestic interest costs (including CB-BOL)		-0.3	0.2
Other		0.7	-1.7
Identifiable policy changes 1/		0.8	-1.6
Of which: Personnel costs (wage adjustment)		0.9	0.3
Allotments to local governments		0.2	-0.2
Transfers to OPSF		-0.4	0.0
Other		-0.1	-0.1
Revenues	18.6	19.2	16.9
Change in revenue		0.6	-2.3
Cyclical change		0.4	-1.2
Income decline/increase		0.4	-1.2
Change in exchange rate		0.3	0.6
Change in mix of dutiable imports		-0.3	-0.6
Other		0.1	-1.1
Identifiable policy changes		-0.1	-0.2
Other 2/		0.2	-0.9
Balance	-0.6	-0.7	-2.6
Change in balance		-0.2	-1.9
Due to cyclical factors		0.4	-2.4
Other		-0.5	0.5
Identifiable policy changes		-0.9	1.4
Residual		0.4	-0.8
Memorandum Items:			
Nominal GNP (billions of pesos)	2,261	2,523	2,794

Source: Authorities; and Fund staff estimates.

1/ Including changes to maintain a constant expenditure/GDP ratio.

2/ Includes change in the effectiveness of tax administration and CB-BOL operations.

analyzed to determine whether Philippine fiscal policies so far have been sustainable. A medium-term projection can be used to take into account prospective developments which could have a significant bearing on the future sustainability of fiscal policies.

40. **Although there are risks to fiscal sustainability, historical indicators and the medium-term outlook both suggest "sustainable" public debt dynamics**. Historical indicators point to a substantial improvement in the NG position.[16] While some developments pose a threat to fiscal sustainability (e.g., the system of intergovernmental fiscal finances and the recent increase in the wage bill), the medium-term fiscal outlook appears sustainable provided the government follows through with reforms.

41. **Key indicators of sustainability—fiscal balances and debt-to-GNP ratios—have improved in recent years**. However, with a shift to more expansionary fiscal policies in response to the Asian crisis, there has been some deterioration in 1998.

- *Overall balances*. The reduction in the consolidated public sector deficit as well as in the NG budget deficit in the 1990s have resulted in an improvement in fiscal sustainability during the 1990s (Section III.B). However, in response to the Asian crisis, both the NG as well as the consolidated balance deteriorated significantly.

- *Sustainable primary deficit*. The NG budget has registered primary surpluses throughout the 1990s. Moreover, after a period of unsustainable fiscal policies at the time of the debt crisis in the 1980s, the NG primary balance has been more contractionary than a "sustainable primary balance," with the exception of the crisis year 1998 (Figure III.8). In Figure III.8, fiscal sustainability fs is measured by comparing the actual primary deficit pd^a with the sustainable primary deficit pd^s[17]:

$$fs = pd^{a} - pd^{s} = pd^{a} - (g-r)d - (g-r^{*}-c)d^{*} \quad \textbf{(1)}$$

where g is real domestic growth, r real domestic and foreign interest rates, c the rate of real exchange rate depreciation, and d the domestic and foreign debt ratios to GNP.[18] A positive

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[16]However, econometric analyses (unit root tests) cannot fully rule out non-sustainability of total gross liabilities of the public sector.

[17]Defined as the deficit level that could be financed without adding to the debt burden and without resorting to monetary financing.

[18]The character "*" indicates foreign debt and foreign interest payments. Note that this formula does not include a seignorage component, since it is assumed that most of BSP's profits are transferred to the government.

sign indicates that the primary deficit exceeds the sustainable level, resulting in an increase in the debt to GNP ratio while a negative sign implies a decline in the ratio.[19]

- *Level of public indebtedness.* After a steep rise in the 1980s, NG debt has been on a declining trend from a peak near 90 percent of GNP in 1986 to around 60 percent at the end-1990s. A similar picture emerges for gross liabilities of the public sector ("public debt" in the following) (Figure III.9). The peak in the debt stocks in the mid-1980s, with public debt reaching almost 150 percent of GNP, coincides with the debt crisis, when the government had to assume guaranteed private sector obligations in the context of debt rescheduling.

42. **A number of prospective fiscal developments could pose a risk for sustainability**. Pressure for more expansionary fiscal policies might arise on both the revenue and expenditure sides, including intergovernmental finances. Moreover, the NG's finances may be adversely affected as it has to take over contingent liabilities of some sectors (such as the NPC).

- **NG revenues**
  - A significant part of the fiscal adjustment in the 1990s was based on **nonrecurrent receipts from privatization**—a development that is not likely to be repeated in the medium term.
  - Planned changes to the **tax system** are likely to have a substantial impact on revenues. To bolster revenues, the losses from continued trade liberalization need to be offset by gains from curbing tax incentives (in contrast with continued pressures to expand such incentives).
  - Weak **tax administration** remains a major risk.
- **NG expenditures**
  - The rapidly increasing **wage bill** threatens future consolidation.
  - Weaknesses in **intergovernmental finances** also endanger fiscal consolidation. In particular, continually rising NG transfers to LGUs (partly caused by the present transfer formula) would raise the fiscal deficit unless NG expenditures are devolved at the same time. In addition, as LGUs have the right to borrow,

[19] Alternative fiscal sustainability measures (such as the constant net worth deficit (Buiter (1985)), the primary gap (Blanchard (1990)) and the medium-term tax gap (Blanchard (1990)) are not taken into account as they are based on a smaller information set of macroeconomic variables.

there is a risk of weakening fiscal discipline unless appropriate debt management and control procedures are in place.

- **Other public sector entities**

    - It is possible that the government may have to assume some **liabilities of other sectors** as part of their restructuring. These sectors include the banking sector, the energy sector and other sectors with public enterprise involvement. Even if the government intends ultimately to privatize many of the GOCCs, it may need first to "clean up" their balance sheets.

    - While a comprehensive assessment of the financial position of the **social security institutions** is not available, some current features of the system might endanger actuarial solvency.

    - The continued intervention in the **grain market** is financially risky and may result in a drain on the budget. Due to the unpredictable nature of NFA's operations, its intervention adds volatility to the consolidated balance.

43. **Under an illustrative medium-term scenario—which assumes that many of the areas of vulnerability discussed above are addressed satisfactorily—the public sector debt stock declines from 76 percent of GNP in 1998 to 60 percent of GNP in 2010, despite the assumption of debt from other sectors**. The illustrative scenario (detailed assumptions and results are presented in Annex III.1) assumes that the NG takes over part of the liabilities and implements reforms in the banking and energy sectors and other sectors with public enterprise involvement. Despite the consequent increase in the interest bill, the improvement in the revenue ratio and the reduction in the wage bill assumed under the scenario is sufficient to permit a decline in the ratio of debt to GNP. Even if medium-term real GNP growth turned out to be somewhat weaker than the assumed 5 percent, fiscal policies would remain sustainable—albeit, of course, with a slower reduction of the debt stock.

E. Remaining Reform Agenda

44. **Further public sector reforms are essential to support sustainable rapid growth**. The following summarizes the key items on the reform agenda discussed in previous sections:

- **A strengthened revenue effort under a less distortionary and more efficient tax system:**

    - **Tax administration** needs to be strengthened to ensure sufficient revenues, transparency, and uniform treatment of taxpayers. Strategic priorities are better control of large taxpayers and adequate enforcement procedures.

- **Fiscal incentives** should be streamlined and substantially reduced. This will help raise the revenue ratio, make the tax system less distortionary, and reduce discretion in tax administration.

- **More growth-oriented expenditure:**

    - Further **reform of intergovernmental finances** will be key to sustained fiscal consolidation. To avoid duplication of responsibilities and rationalize expenditures, the scope of devolved services should be reviewed with a view to improving efficiency and quality of services. The revenue sharing formula should be revised to encourage the mobilization of local revenues and ensure regional equity, and the credit policy framework should include appropriate incentives for prudent LGU borrowing decisions.

    - The **structure and size of the civil service** need to be rationalized.

- Reforms in **other public sector entities** should focus, in particular, on:

    - The **National Power Corporation** (NPC) whose financial position is not sustainable. Deregulation of the electricity market, and reform and privatization of NPC should proceed swiftly after passage of the Omnibus Electricity Bill.

    - The **National Food Authority**'s (NFA) intervention in the grain market should be phased out gradually. Increasing private sector participation in the rice market should be allowed and rice should be sold at cost recovery prices.

    - The actuarial solvency of **Social Security Institutions** (SSIs) needs to be preserved, including by improving the management of their investment resources and delinking them from political interference. Moreover, the coverage of the SSIs should be extended.

Illustrative Medium-Term Scenario

The illustrative scenario is predicated on the following principal assumptions and reforms:

- Real GNP growth will pick up to 5 percent in the medium term, while inflation will stabilize at 5 percent.

- Government savings rise by 2 percent of GNP over the next ten years, with capital spending increasing from 3 to 4 percent of GNP.

- Impending reforms of the taxation of the financial sector, the tariff structure, and tax incentives will be revenue neutral. At the same time, the revenue ratio (excluding CB-BOL) will be raised by around 2 percent of GNP over the next five years, to return to the level of 1997.

- The wage bill will be reduced gradually over the next five years from 6.5 percent of GNP in 1999 to 5.6 percent of GNP in 2006.

- The reform of intergovernmental relationships will stabilize NG transfers to LGUs at around 4 percent of GNP from 2003 onwards.

- As a working assumption, the NG budget will assume long-term debt from other sectors of around 15 percent of GNP.

- The deficit of the GOCCs will be eliminated gradually over the medium term.

- For presentational simplicity, it is assumed that the NG will take over the debt service for the entire stock of public debt and the financing of the GOCC and CB-BOL deficits from 2000 onwards. The scenario does not take into account any surpluses of the remaining public sector entities (SSIs, GFIs and LGUs).

Table. Philippines: Fiscal Sustainability, 2000-2010

(In percent of GNP)

	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010
Public debt	72.9	90.8	80.2	80.5	79.5	78.0	76.2	74.2	72.0	69.5	66.9	64.1	61.3
Foreign	38.5	47.9	41.7	39.0	36.1	33.5	31.1	28.8	26.7	24.8	23.0	21.3	19.8
Domestic	34.5	42.9	38.6	41.6	43.4	44.5	45.1	45.4	45.3	44.7	43.9	42.8	41.5
NG deficit	-1.9	-2.3	-4.3	-3.9	-3.7	-3.5	-3.4	-3.2	-2.9	-2.7	-2.4	-2.3	-2.1
Revenues	16.5	15.8	16.6	16.9	17.2	17.5	17.7	17.9	18.1	18.2	18.3	18.3	18.3
Expenditure	18.3	18.1	20.9	20.8	20.9	21.0	21.1	21.1	21.0	20.9	20.7	20.6	20.4
Of which: Interest bill 1/	3.6	3.4	5.5	5.3	5.4	5.4	5.4	5.4	5.3	5.2	5.0	4.9	4.7
Of which: Capital expenditure	3.1	3.0	3.4	3.5	3.6	3.7	3.8	3.9	4.0	4.0	4.0	4.0	4.0
Of which: Wage bill	7.1	6.4	6.4	6.3	6.1	5.9	5.8	5.7	5.6	5.6	5.6	5.6	5.6
Of which: Maintenance	2.3	2.1	2.4	2.5	2.6	2.7	2.7	2.7	2.7	2.7	2.7	2.7	2.7
GOCC deficit	-1.5	-1.1	-0.9	-0.8	-0.7	-0.6	-0.5	-0.4	-0.3	-0.3	-0.2	-0.2	-0.1
CB-BOL deficit	-0.9	-0.4	-0.7	-0.6	-0.5	-0.4	-0.4	-0.3	-0.3	-0.2	-0.2	-0.1	-0.1

Source: Fund staff estimates.

1/ Assumes that the NG will service all public sector debt (including CB-BOL and GOCCs) and assume liabilities of 15 percent of GNP of other sectors.

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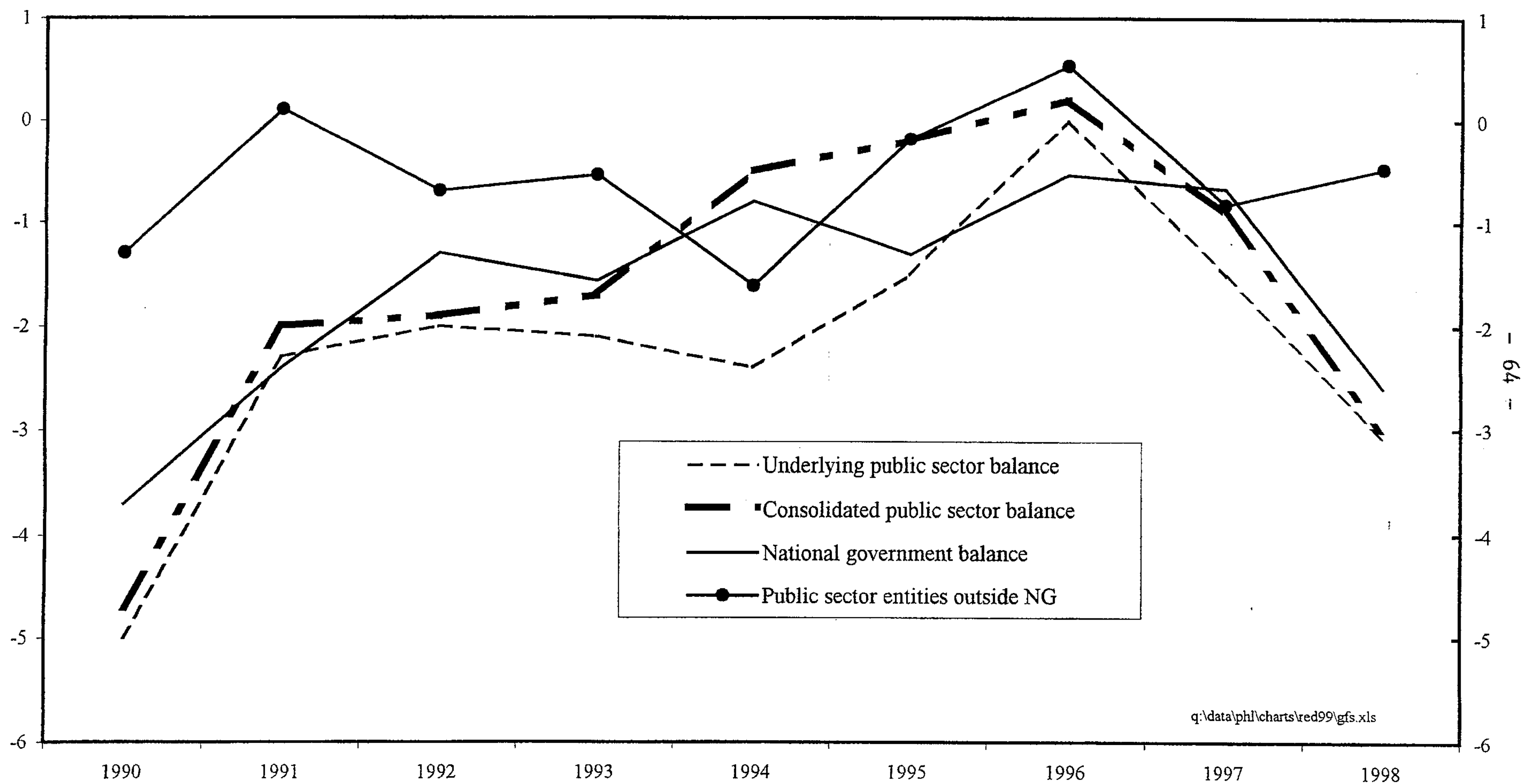
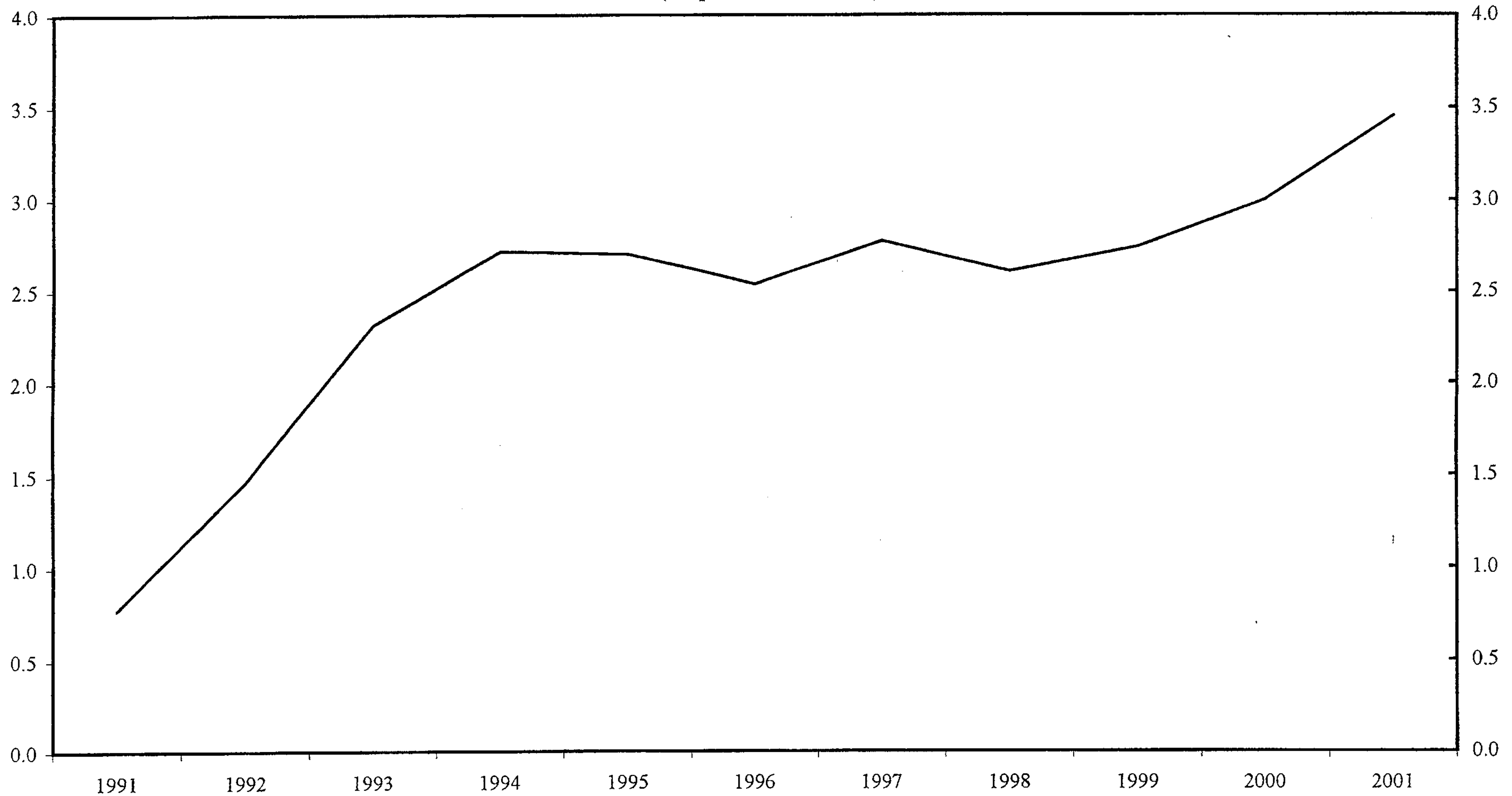
Figure III.1
Philippines: Public Sector Balance and National Government Balance, 1990-1998
(In percent of GNP)



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

Figure III.2
Philippines: National Government Transfers to Local Government Units, 1991-2001
(In percent of GNP)



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

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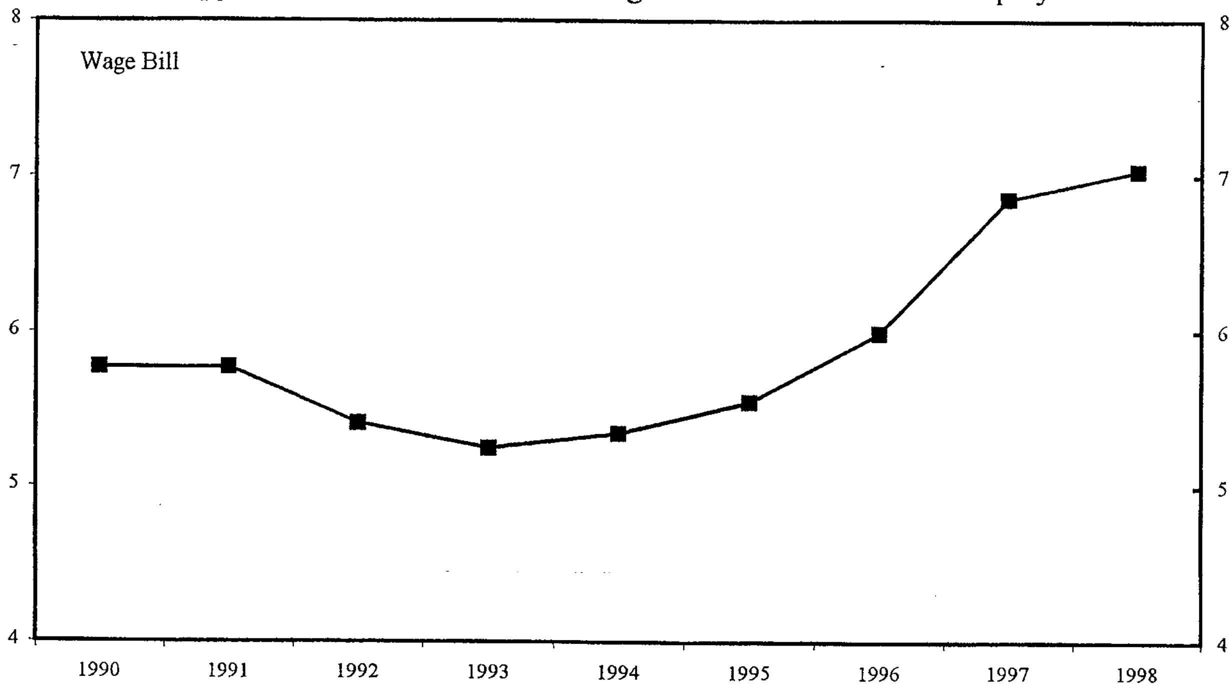
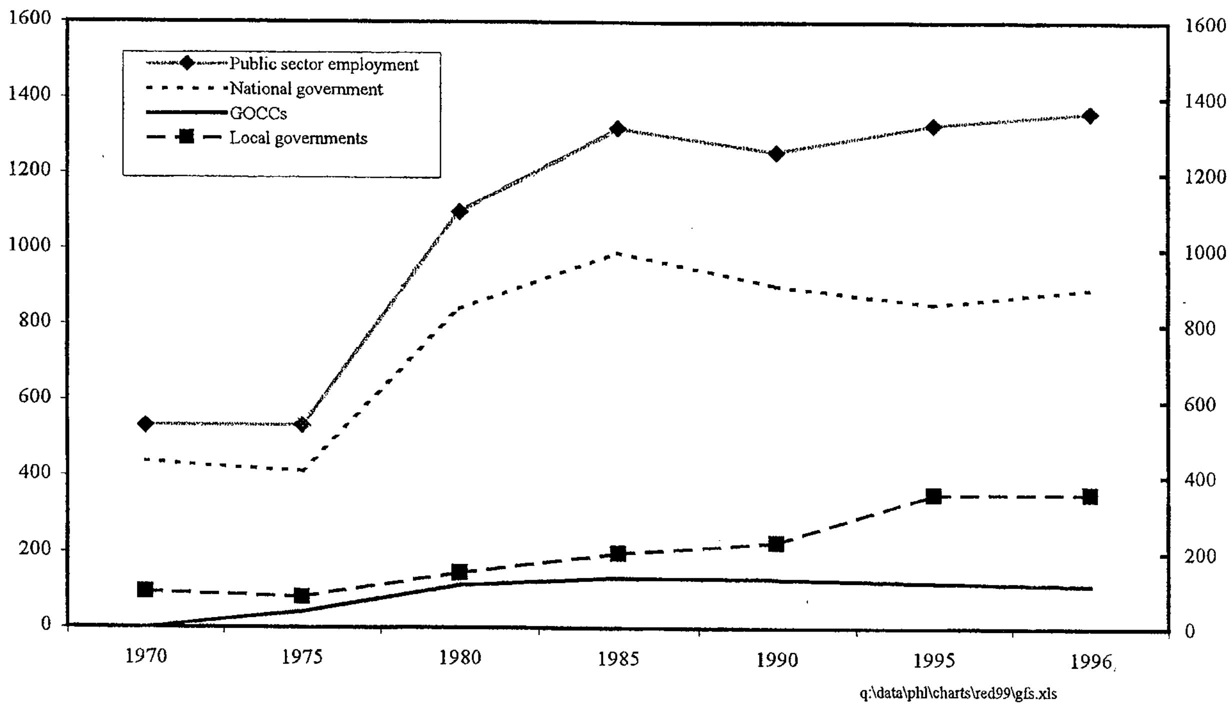
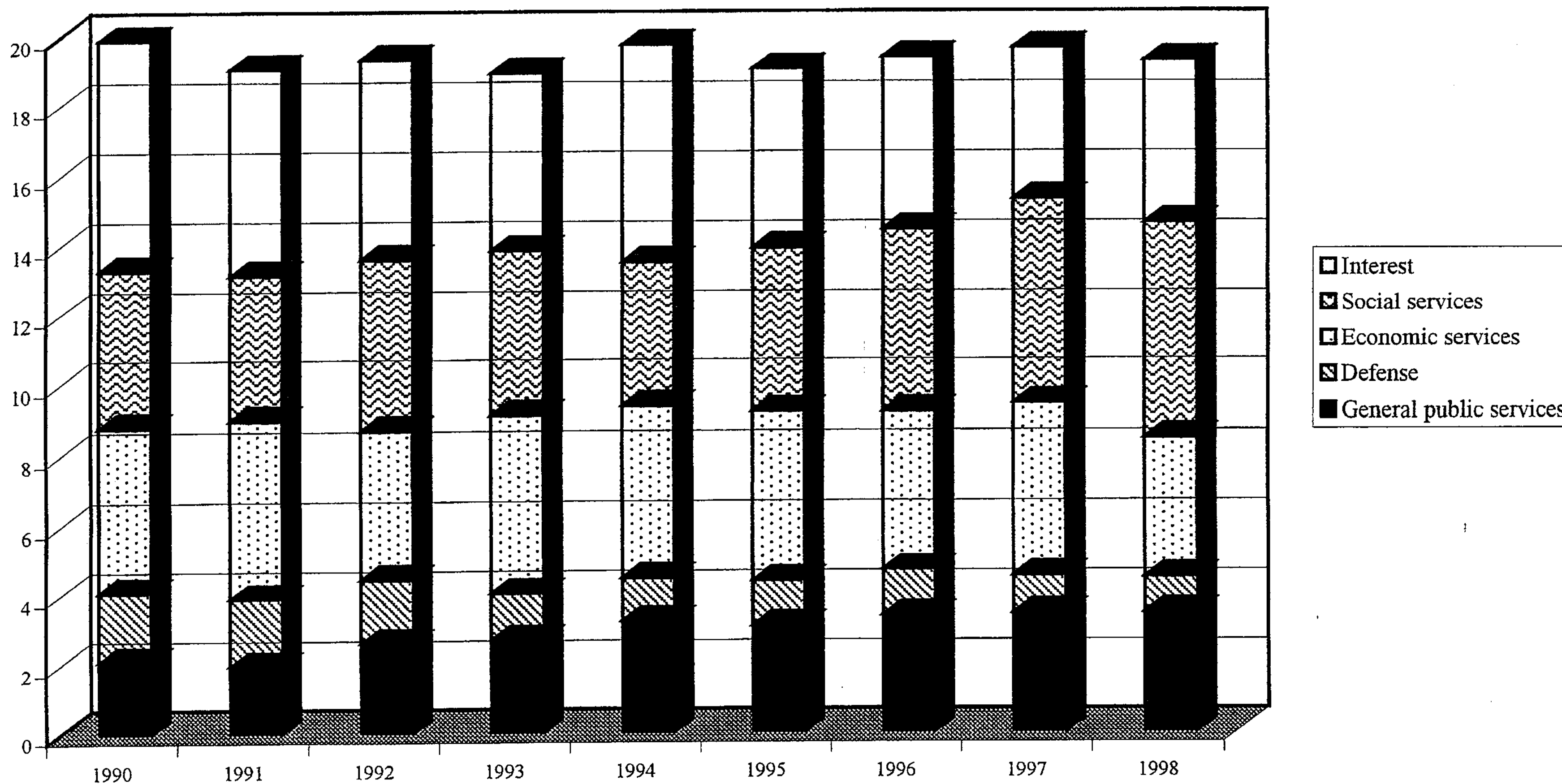
Figure III.3
Philippines: National Government Wage Bill and Public Sector Employment





Sources: Data provided by the Civil Service Commission; and staff estimates.

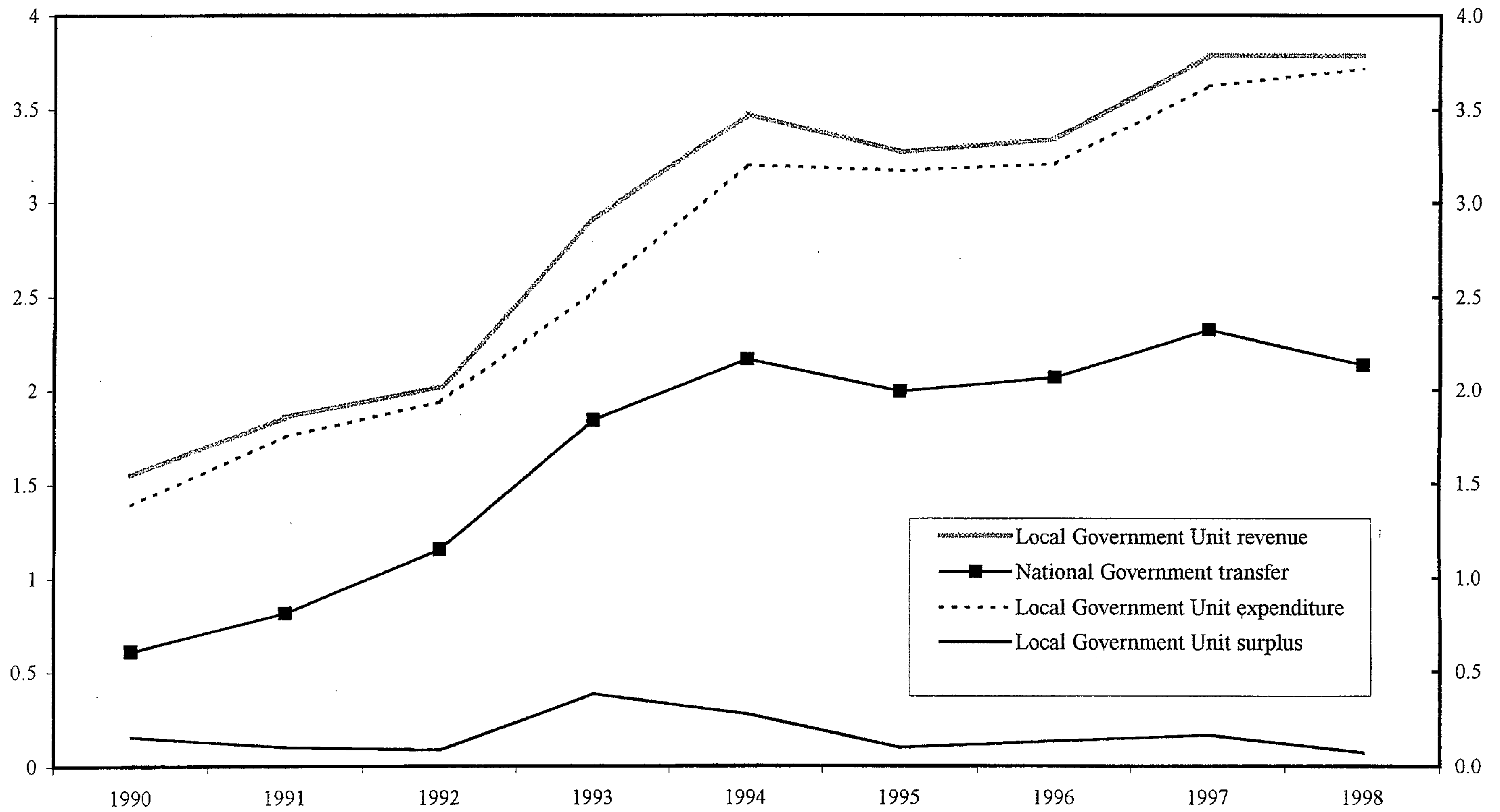
Figure III.4
Philippines: National Government Expenditure in a Functional Breakdown, 1990-1998
(In percent of GNP)



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

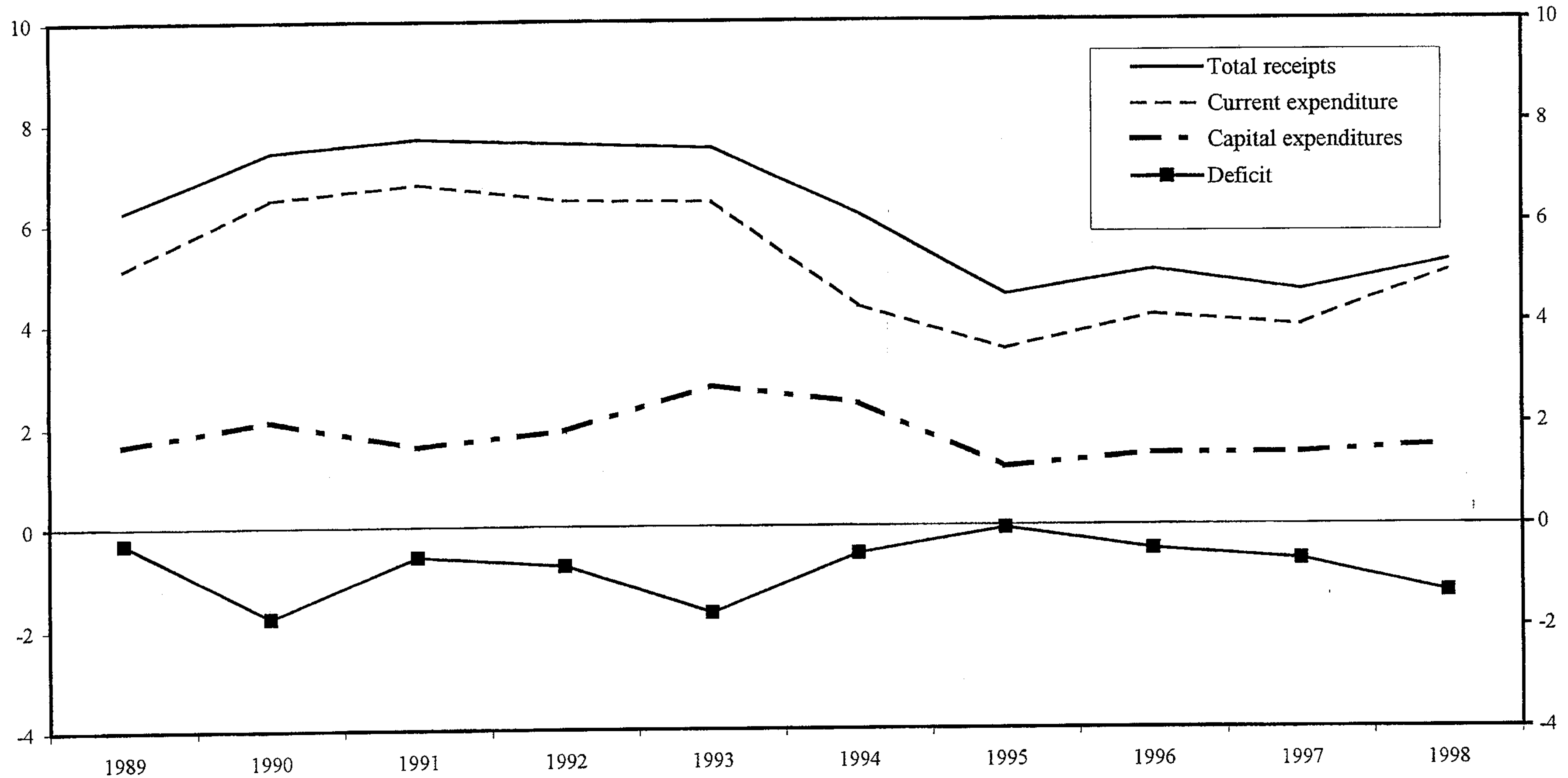
q:\data\phl\charts\red99\expenditure.xls

Figure III.5
Philippines: Local Government Units, 1990-98
(In percent of GNP)



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

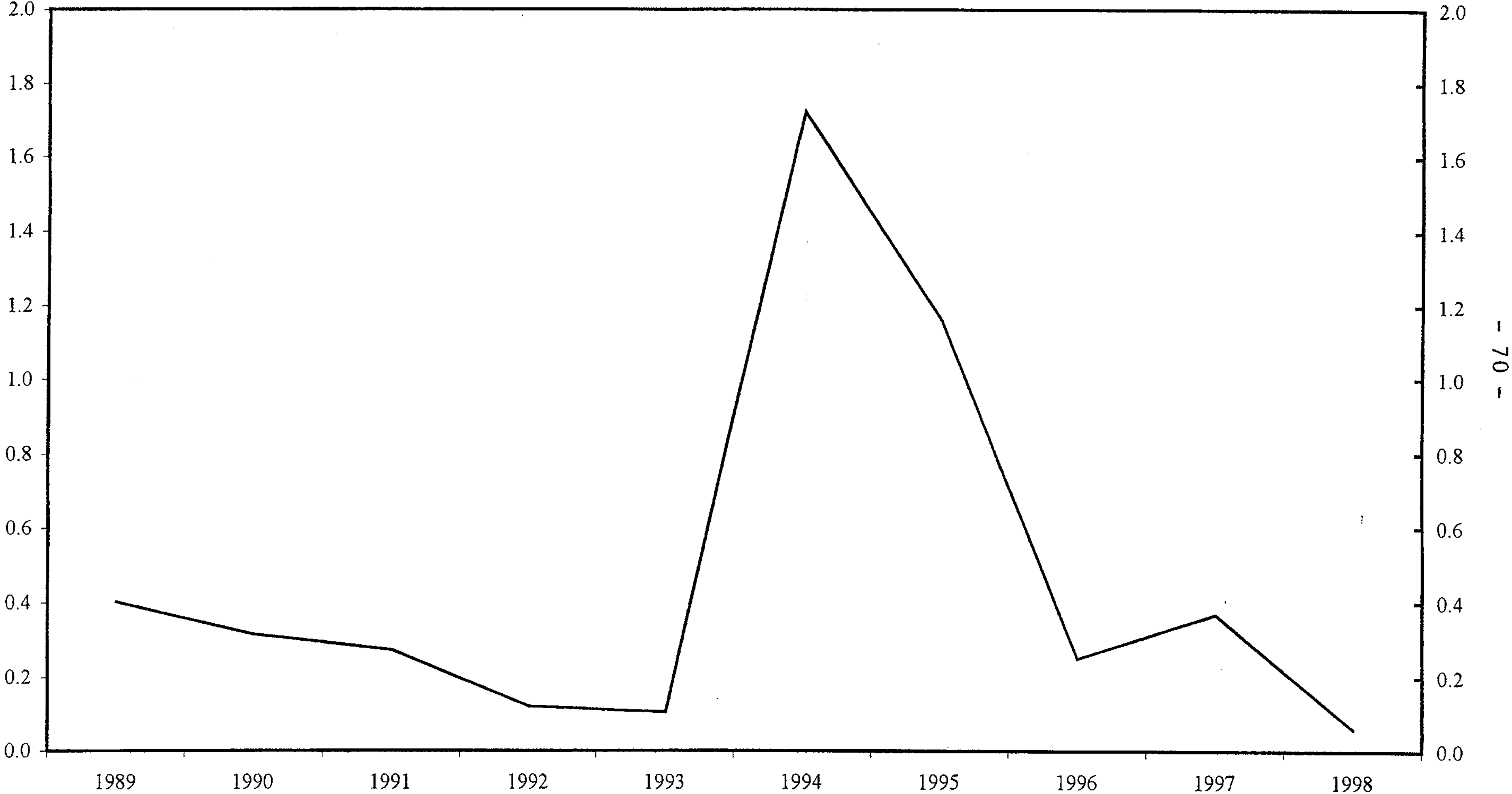
Figure III.6
Philippines: Government Owned and Controlled Corporations, 1989-1998
(In percent of GNP)



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

q:\data\phl\charts\red99\gocc.xls

Figure III.7
Philippines: National Government Privatization Receipts, 1989-1998
(In percent of GNP)



Source: Data provided by the Philippine authorities.

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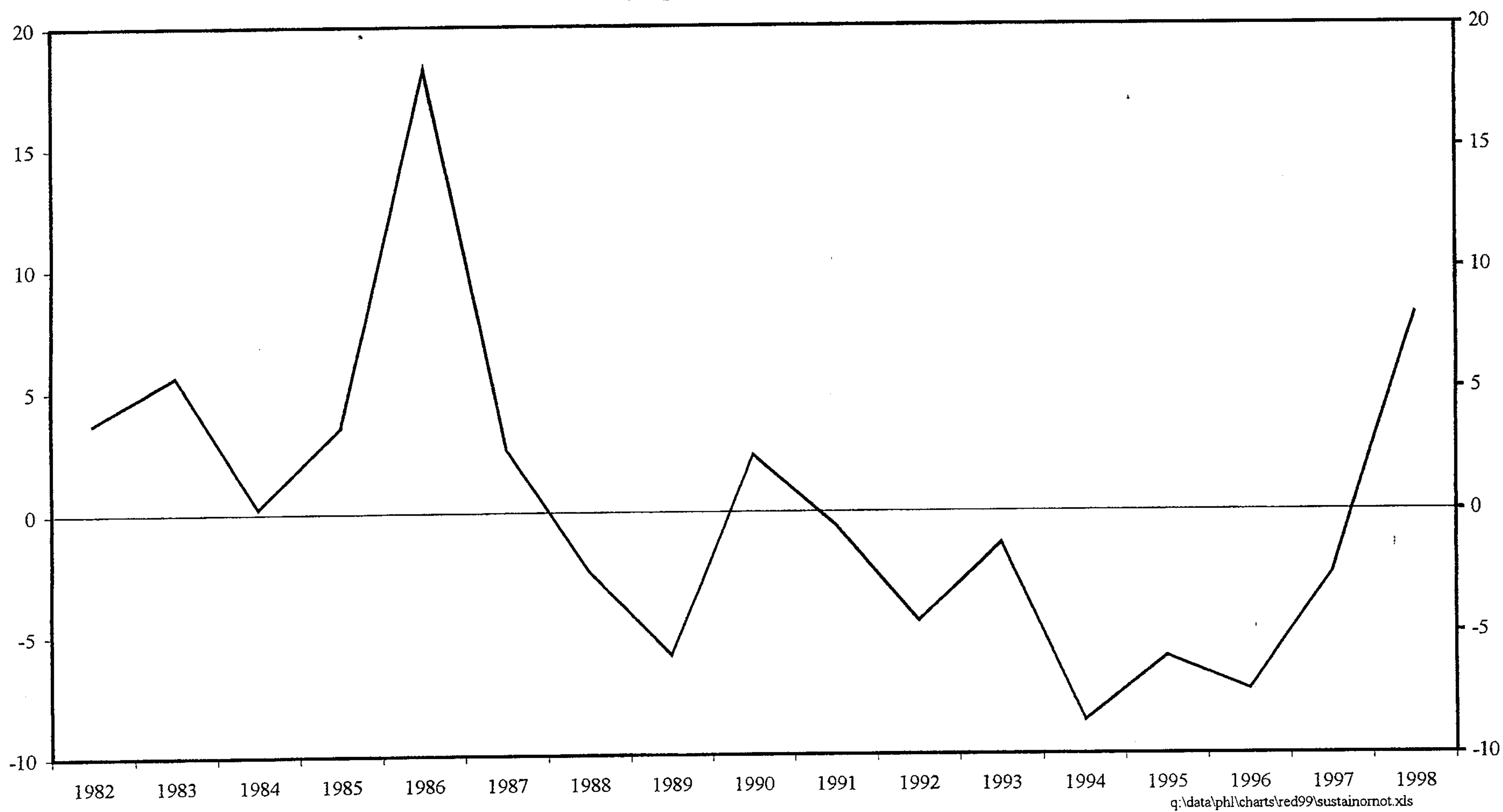
Figure III.8
Philippines: Sustainability of National Government Primary Balances, 1982-1998
(In percent of GDP)



Sources: Data provided by the Philippine authorities; and staff estimates.
1/ Negative indicates sustainable policies whereas positive indicates unsustainable policies.
2/ Sharp peaks in 1985 and 1998 reflect substantial increases in the debt stock.

Figure III.9
Philippines: Public and National Government Debt, 1972-1997
(In percent of GNP)

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

IV. Monetary and Exchange Rate Developments and Policy

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IV. Monetary and Exchange Rate Developments and Policy[1]

A. Overview

1. **Over the past two decades, the Philippines has been transformed from an economy that performed substantially below its potential to a dynamic emerging-market economy.** Most recently, the economy has been able to weather the Asian crisis better than many other countries in the region, and has emerged from the crisis with strengthened institutions and a track record of successful crisis management.

2. **A key feature underlying the transformation and the favorable recent experience has been the evolution of monetary policy institutions and decision-making, from a controlled and only partially effective system in the early 1980s to an independent, well-functioning system at the end of the 1990s.** In the early 1980s, monetary policy was far from independent and lacked a coherent focus, contributing to a loss of monetary control, spiraling inflation, and a full-blown external payments crisis. At the end of the 1990s, the situation is dramatically different, with an independent, modern central bank that has a clear mandate to control inflation and an established reputation for sound macroeconomic management.

3. **A crucial factor underlying the improvement in monetary policy implementation has been the establishment of a new central bank, the Bangko Sentral ng Pilipinas (BSP).** The old Central Bank of the Philippines became insolvent, largely as a result of its bailing-out of domestic banks that had run into financial difficulties during the 1980s, and was closed down in 1993. In the same year, the new BSP was established with a fresh balance sheet, recapitalized by the national government, and with a clear mandate under the revised Central Bank Act to pursue price stability conducive to sustained growth. Since its establishment, the BSP has faced new challenges, including a surge in capital inflows (in 1994–96) and their sharp reversal in the wake of the Asian crisis (1997–98). The BSP has met these challenges successfully, although at times a certain lack of clarity in the monetary framework has hampered policy implementation (for example, in resolving the tensions between external and domestic targets). Overall, however, monetary policy under the BSP has consistently been marked by a clear focus on macroeconomic stability.

4. **A signal achievement of the BSP has been successful monetary management during the Asian crisis.** The crisis management strategy centered around the floating of the peso accompanied by a relatively tight interest rate policy. Exchange market intervention was limited to what was needed for building up reserves to programmed levels and for "smoothing" operations (providing liquidity during periods of severe market pressure). Interest rates were used to "lean against the wind" of exchange market pressure—without, however, using interest rates aggressively to defend a particular level of the peso. Other,

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[1]This chapter was prepared by Vivek B. Arora.

nonmarket measures to support the exchange rate (e.g., a volatility band on daily fluctuations) were used when exchange market pressures were especially severe, but their use was only temporary. Since late 1998, with the peso stabilizing and inflation well under control, monetary policy has shifted toward supporting the recovery. Credit growth has remained weak, however, notwithstanding the decline of interest rates below pre-crisis levels. Reviving credit growth without undermining the hard-won stabilization gains has thus become an important policy concern.

5. **In the period ahead, the main challenges for the BSP are to control inflation and sustain confidence in the peso on a lasting basis.** Consistent with its legal mandate, the BSP will need to consolidate its independence in pursuing the goal of price stability. As key requirements to this end, the BSP needs to maintain a strong financial position and implement monetary policy in a consistent and transparent framework that is well understood by the public.

B. Early Experience: 1980-93

Crisis, Reforms, and Renewed Pressures

6. **Monetary developments during the 1980s and early 1990s were marked by two "watersheds"—the debt crisis in 1983 and the demise of the old central bank in 1993.** Throughout the period, monetary policy was conducted in a difficult environment, characterized by conflicting demands on the central bank as well as political and economic instability. Monetary policy lacked a coherent focus because the central bank had limited autonomy and no clear mandate on the basis of which to resolve these conflicting demands. The central bank was expected to play its traditional monetary role, but in addition was burdened with financing the fiscal deficit, bailing out troubled commercial banks and channeling resources to priority sectors. The effectiveness of bank supervision was hampered by government interference in the banking system, which also featured large-scale lending by government financial institutions to nonviable borrowers, often at controlled interest rates.[2]

7. **In the early 1980s, a combination of factors contributed to a buildup of financial pressures.** The external position weakened as expansionary fiscal policies were financed by accumulation of external debt and monetary policy accommodated rapid credit expansion by domestic banks. The imbalances become unsustainable in the face of a series of external and domestic shocks. In 1983, massive capital flight triggered off a full-blown financial crisis, including default on external debt service and widespread insolvency of domestic banks and

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[2]On the macroeconomic setting in the 1980s, see Templo (1998) for a brief but lucid summary and Dohner and Intal (1988) and World Bank (1987) for more detailed discussions.

enterprises. A deep and protracted recession followed, with four years of economic contraction and a legacy of the crisis that continued to affect the economy for a decade.[3]

8. **The response to the crisis entailed an important change in the monetary regime, featuring a floating exchange rate system and a shifting of monetary policy implementation away from controls and toward more indirect instruments**. After large devaluations in 1983–84, and a sharp rise in inflation, the central bank in 1984 switched to a floating exchange rate system and adopted base money as the chief intermediate monetary target. Interest rate controls and credit ceilings were phased out and replaced by open-market instruments and reserve requirements as main tools of monetary control. The new focus on base money facilitated the restoration of monetary control, and inflation was brought down relatively quickly—albeit in an environment of very high real interest rates and contracting economic activity.

9. **The second half of the 1980s saw further progress in improving monetary operations, although the legacy of the crisis continued to weigh heavily on the economy**. The period saw important reforms in bank supervision, development of monetary policy instruments, and major reforms in public enterprises and banks. These reforms were supported by the accession of the Aquino government in 1986 that oversaw an improvement in public governance and a new, market-oriented and outward-looking approach to economic policies. However, commercial banks continued to suffer from weak balance sheets and high intermediation costs (the latter in part resulting from the weak financial position of the central bank) while the unresolved external debt situation cut off the country from foreign credit and, more generally, undermined confidence. As a result, domestic interest rates remained high throughout the period. Toward the end of the decade, fiscal and monetary policies slipped again, partly under the pressure of political instability. While formally floating, the exchange rate of the peso was "managed" to a significant extent during this period (including through moral suasion by the central bank). The rising imbalances were exacerbated by external and domestic shocks, leading to a near-crisis in 1990–91 that again necessitated a sharp adjustment of macroeconomic policies. In the ensuing sharp slowdown of growth, banks' balance sheet problems arose again, triggering renewed emergency assistance by the central bank.

C. Years of Change: 1993-97

A Reformed Central Bank and New Challenges for Monetary Policy

10. **Starting in 1993, economic policies were given a renewed focus on macroeconomic stability and market-oriented reforms under the new Ramos administration elected the previous year.** Political stability was regained and reforms

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[3]See World Bank (1987) for a fuller discussion of the episode.

initiated in key sectors, including banking. Macroeconomic policies were focused more clearly on stability, a key measure in this regard being the establishment of a new central bank.

A reformed central bank

11. **The new Bangko Sentral (BSP) was established in 1993 as an independent monetary authority with full administrative autonomy** (Box IV.1).[4] With a strengthened balance sheet and the legal autonomy provided to it by the new Central Bank Act, the BSP was well placed to implement monetary policy effectively and to facilitate financial intermediation. Fiscal adjustment and reforms, privatization of government-owned and controlled corporations (GOCCs), and banking sector reforms also lightened the burden that had been felt by the old central bank. Finally, the BSP started with a clean balance sheet, with capitalization from the national government (NG).[5]

Box IV.1 The Bangko Sentral ng Pilipinas

Establishment. The Bangko Sentral ng Pilipinas (BSP) was established in 1993 to replace the former Central Bank of the Philippines (CBP).

The CBP suffered extensive losses as a result of its rescues of domestic banks in the 1980s and eventually became insolvent. The bad assets of the CBP were taken over by a new body, the Central Bank Board of Liquidators (CB-BOL), and the BSP was established as the new central bank.

Establishment of the BSP entailed an extensive restructuring of its administrative set-up and operating procedures as well as a recapitalization program. The balance sheet of the BSP was fortified by new capital from the budget, treasury bills for open-market operations, and a large amount (₱ 220 billion) of deposits from the National Government. In addition, the BSP was exempted from all taxes for a five-year period. The new Central Bank Charter clarified that the primary objective of monetary policy was to "maintain price stability conducive to the balanced and sustained growth of the economy. 1/

(continued...)

1/ The BSP was also charged with supervising the financial system, which is discussed in Chapter VI on the banking sector. This box focuses on the BSP's role in monetary policy.

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[4]The old central bank was declared insolvent and its assets and liabilities transferred to the Central Bank Board of Liquidators (CB-BOL).

[5]The NG issued to the BSP ₱ 170 billion in treasury bills and ₱ 50 billion in treasury bonds, together equivalent to about 15 percent of GNP, or 125 percent of base money. The former (₱ 170 billion) transfer has been dedicated to servicing the liabilities of the old central bank (handled by the CB-BOL) and the latter to bolstering the BSP's capital. In addition, the NG committed to make additional transfers of ₱ 50 billion (of which ₱ 10 billion has been transferred to date).

Box IV.1 The Bangko Sentral ng Pilipinas (continued)

Institutional setting. The policy-making body of the BSP is the Monetary Board, which is appointed by the President for six-year terms.

The Board is a seven-member body, comprising the Governor of the BSP (as its chairman), a Cabinet member, and five members from the private sector. The Board decides on an inflation objective, in agreement with other key agencies (the Committee on the Financial Program, the Development Budget Coordinating Committee, and the National Economic Development Authority), and approves a monetary program consistent with the inflation objective.

Intermediate targets. Monetary policy implementation is formally based on quantitative targets for the stock of base money.

Base money targets replaced credit targets in 1984. The switch was intended to place greater emphasis on reducing inflation, which had risen to over 50 percent. The idea was that by controlling base money the BSP would have greater control over broad money, which was closely related to inflation. On account of the uncertainties surrounding money demand, base money targets have typically been raised to allow for unexpected increases in money demand reflected in higher-than-targeted international reserves. Starting in 1994, when capital inflows surged and there was a need to guard against the inflationary risks of capital inflows, such increases in base money targets have been made only if inflation has been on track.

In late 1995, the BSP switched to a *de facto* fixed exchange rate regime, seeking to maintain the peso at a value of ₱ 26 per U.S. dollar. The BSP continued to set base money targets, notwithstanding the currency peg that eliminated scope for an independent monetary policy. The floating of the peso on July 11, 1997, restored the consistency of the monetary and exchange rate framework.

Instruments. The main instruments of monetary policy are open-market operations (OMOs), reserve requirements, and a "special deposit facility" for banks. On a day-to-day basis, the BSP adjusts the level of base money through OMOs, mainly comprising short-term repurchase (RP) and reverse repurchase (RRP) agreements. The interest rates on RPs an RRPs are the key "policy" interest rates determined by the BSP. The policy rates form the reference rates around which other short-term interbank rates fluctuate. The BSP also engages in outright purchases and sales of government securities.

The BSP from time to time adjusts reserve requirements, which consist of a statutory reserve requirement (SRR) and a liquidity reserve requirement (LRR). Reserve requirements apply only to peso deposits (not foreign-currency deposits). The SRR is partially remunerated—40 percent of it earns interest (albeit at a below-market rate, currently 4½ percent)—while the LRR, being held in the form of government securities is renumerated at 100 basis points below the 91-day T-bill rate (a market rate). The SRR, although it has been lowered since the early 1990s (when it was 22–25 percent), remains high relative to other countries. Traditionally, the high SRR reflected the need for central bank financing of the budget and the central bank's weak net income position. The income position has once again become an issue with expiry of the BSP's five-year tax exempt status in mid-1998 (discussed below). The SRR was reduced from 13 percent in 1997 to 10 percent in 1998. The LRR, initially only 2 percent, was raised in mid-1997 to 8 percent as part of the effort to tighten policies; in early 1999, the LRR was gradually lowered to 4 percent.

Since December 1998, the BSP has provided a "special deposit facility" for banks. The facility, which carries a small mark-up over the 91-day T-bill rate, serves as an alternative to RRPs for withdrawing liquidity from the system and does not incur the DST. While little used at first, since March 1999 the stock of special deposits has been roughly equal in size to outstanding RRPs. (As of mid-June 1999, outstanding RRPs and special deposits were ₱ 56 billion and ₱ 51 billion, respectively.)

New challenges for monetary policy

The monetary framework and the demand for money[6]

12. **Monetary policy has responded flexibly, and with a clear focus on macroeconomic stability, to the challenges that have arisen in recent years, although it has at times lacked a clear framework of targets and instruments**. As noted, monetary policy since 1984 has been formally based on a floating exchange rate and base money targets in pursuit of an inflation objective. However, the BSP has tended to follow multiple objectives, and the policy dilemmas resulting from conflicting goals and intermediate targets have at times not been resolved in a consistent and transparent framework.[7] For example, during 1995–97 the peso was de facto pegged to the U.S. dollar while base money targets were retained, undermining the effectiveness of monetary policy.

Box IV.2. Key Monetary Aggregates and Interest Rates

Measure of money	***Definition***
Reserve money	Currency plus DMBs' reserve deposits.
Base money	Reserve money plus DMBs' reserves held as government securities, reserve-eligible securities, and the reserve deficiency.
Broad money (M3)	Narrow money plus quasi-money; where narrow money comprises currency plus domestic-currency demand deposits, and quasi-money comprises domestic-currency time- and saving deposits.
M4	M3 plus foreign-currency deposits of residents.
Interest rates	***Features***
RP and RRP rates	Policy rates. Preannounced by the BSP.
T-bill rates	Market rates. Determined at weekly auction every Monday. The 3-month T-bill rate is the bellwether market rate.
Interbank rates	Market rates.
Interbank call loan rate	Short-term interbank rate.
Prime lending rate	Rate charged by banks to prime borrowers. Falls within a margin (currently 1–6 percentage points) above the 3-month T-bill rate, the margin being based on an informal agreement of banks with the Bankers' Association of the Philippines (BAP).
Deposit rates	Determined by banks.

13. **Monetary policy has also been complicated by instability of money demand, which has limited the usefulness of monetary targets**. Demand for base money has been

[6]Box IV.2 summarizes the key monetary aggregates and interest rates.

[7]See Debelle and Lim (1998) for a discussion.

difficult to predict against the background of unstable broad money demand and significant unforeseen shifts in the money multiplier. The instability of money demand is not surprising given the major dislocations (as well as innovations) experienced by the financial system.

14. **As one would expect for a developing country with a growing economy and increasing financial intermediation, the demand for money in the Philippines has increased significantly over the past two decades.** The recurrent macroeconomic cycles and financial crises have, however, created instability and unpredictability in the demand for money in the short term. The income velocity of money has correspondingly shown a trend decline, but has been characterized by marked short-run volatility (Figure IV.1).

15. **The increase in the demand for money has been reflected in a substantial increase in the ratio of money to GNP.** The share of the broadest monetary aggregate, M4, in GNP nearly doubled from 31 percent in 1980 to 58 percent in 1998 (Figure IV.2). In part, the increase reflected a growing demand for foreign currency deposits of residents, which increased from close to zero in 1980 to 17 percent of GNP in 1998. But it also reflected growing demand for peso deposits, as M3 increased from below 30 percent of GNP in 1980 to 41 percent in 1998. Reserve money, on the other hand, increased only very modestly, from 7 percent of GNP in 1980 to 9 percent in 1998.[8]

16. **The trend decline in the income velocity of money is consistent with the standard pattern for developing countries with ongoing financial deepening.**[9] The standard pattern is a U-shaped curve: velocity declines in the early stages of financial development, as growing monetization contributes to an increase in the demand for money; subsequently velocity increases with increasing financial sophistication, as the growth of money substitutes (e.g., credit cards) contributes to a reduction in the demand for money.[10] The process appears still

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[8]The modest increase in reserve money relative to the broader aggregates reflects that the increase in the broader aggregates owed to a growth in savings deposits (associated with development of the banking system) rather than in currency. In part it also reflects the lowering of reserve requirements on peso deposits over time, as the BSP has been on a much sounder financial footing than the old central bank, as well as the rise of (nonreservable) foreign currency deposits.

[9] See, for example, Bordo and Jonung, 1987.

[10]See Chapter VI for a review of the spread of financial intermediation in the Philippines.

to have some way to go in the Philippines as the ratio of M3 to GNP, at 41 percent, is low by Asian standards (Table IV.1). The short-run volatility in velocity can be traced to the macroeconomic cycles and financial crises that the Philippine economy has faced. The periods of sharp increases in velocity (mainly the mid-1980s and 1998) were also periods of overheating and/or financial crises (Figure IV.1).

Table IV.1. Selected Countries: Broad Money/GDP, 1998 (In percent)

China	131	1/
India	54	1/
Indonesia	58	1/
Korea	175	2/
Malaysia	155	2/
Philippines	41	2/
Thailand	106	3/

Sources: Country authorities; and Fund staff estimates. Ratio for Philippines is relative to GNP.
1/ M2
2/ M3
3/ M2A

17. **An empirical analysis of the demand for broad money indicates a long-run, equilibrium (cointegrating) relationship between money demand and nominal income** (Annex IV.1). The relationship appears, however, to have become less stable in recent years. The demand for M3 is positively influenced by real income and negatively influenced by expected inflation. **However, it was not possible to find a satisfactory short-run dynamic(error-correction) equation**. The failure to find a satisfactory error-correction model implies that the short-run predictability of money demand is low, limiting the usefulness of monetary targeting.

18. **In the 1990s, a pickup in the pace of financial development has been accompanied by an increase in the volatility of money demand**. The analysis in Annex IV.1 indicated structural breaks in the relationship between money demand and its determinants in the mid-1980s and in 1990. This suggests that the (long-run) relationship between broad money and inflation may be becoming less close than previously.

Capital inflows and monetary expansion

19. **During 1994–96, monetary management was complicated by a surge in capital inflows.** During the period, the monetary policy approach shifted several times, in search of a way to deal with the inflows, resulting in rapid monetary expansion in 1994–95, but then moved to tighten in 1996–97. The exchange rate was allowed to appreciate in 1993–94, but subsequently increasing concern over the exchange rate first led to some stop-go cycles for the monetary stance and then, from late 1995, to a de facto peg to the U.S. dollar. The experience with sterilization was mixed: on the one hand, sterilization was accompanied by higher interest rates, which in turn attracted further inflows and resulted in rising fiscal costs; on the other hand, monetary expansion in 1996 *was* contained by a large contraction in net domestic assets of the BSP (offsetting the expansion from rising net foreign assets, Figure IV.3).[11]

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[11]It is difficult with the available data to formally estimate an "offset coefficient", which measures the extent to which the central bank's domestic money operations are undone by (continued...)

20. **In late 1994, a first wave of capital inflows (including remittances) put pressure on base money**. With inflation already around 10 percent, the authorities attempted to keep base money within the program ceilings. Their initial policy response to the inflows was to allow the exchange rate to appreciate, while using sterilized intervention to smooth the trend.

21. **As inflation gradually receded, the policy stance was changed, but the change did not prove sustainable.** The authorities became concerned that the strong exchange rate might endanger the then-nascent export-led recovery and signal that monetary policy was too tight. Net domestic assets of the BSP were increased, raising base money well above the program ceiling until the exchange rate stabilized at end-1994 (some 13 percent stronger than its 1993 level). However, this policy proved not to be sustainable. Reserves began to fall almost immediately. In addition, interest rates declined initially but began to rise sharply as inflationary expectations increased.

22. **Following the experience in 1994, the authorities shifted to a strategy involving elements of inflation targeting**. Although they continued to formulate base money targets, policy implementation was to depend on whether inflation was on track (consistent with a projected monthly path).[12] As long as this was the case, the operating target was the net domestic assets (NDA) of the BSP. Targeting NDA was intended to allow the BSP to accommodate unexpected capital inflows, which would likely reflect higher-than-expected demand for money. (Base money targets could be increased for any excess of foreign reserves over the targeted level.) If the BSP felt, however, that the inflows might be inflationary they could choose not to intervene and instead allow the exchange rate to appreciate. If inflation turned out higher than targeted, the operating target was base money (as before). In these circumstances, the authorities would respond to unexpected capital inflows either by allowing the exchange rate to appreciate or by sterilized intervention.

23. **The approach was felt to have several important advantages.** It established the reduction of inflation as the clear objective of monetary policy. It put less weight on intermediate targets, which may have been sending misleading signals, and more on the final objective (inflation). And it allowed the authorities flexibility in how to respond to capital inflows, depending not on the nature of the underlying shock (difficult to identify) but on its impact on prices.

24. **Performance under this approach, however, was mixed.** This was mainly because, in addition to inflation control, monetary policy continued to follow other objectives (such as

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[11](...continued)
capital flows in the reverse direction.

[12]The judgment of whether inflation was on track was on a backward- rather than a forward-looking basis since it was based on whether inflation in any particular month was higher or lower than projected for that month at the time the monetary targets were formulated.

the level of the exchange rate). Policy cycles emerged under which interest rates were pushed down until foreign reserves began to decline, forcing the monetary stance to be tightened again. A notable example occurred in early 1995. Soon after the new monetary strategy was adopted, it became clear that money demand was weaker than expected. The authorities responded by keeping the operating targets (base money/NDA) well below projected ceilings. By midyear, the policy had started to generate large capital inflows, and the authorities started to relax the monetary stance. Interest rates started to decline, but market confidence fell steadily and culminated in September-November in a speculative attack on the peso.

25. **The overall experience with sterilized intervention also was mixed.** On the one hand, sterilization preserved a large interest differential in favor of the peso, while the signals sent by exchange market intervention suggested to market participants that if the exchange rate were to move, it would move only in an upward direction. The result was effectively a one-way bet for speculators, resulting in a flood of additional inflows. At the same time, it is clear that the BSP, even if unable to stem the inflows through exchange market intervention, did manage to tighten domestic monetary operations sufficiently to prevent a surge in reserve money (Figure IV.3).

Fixed Exchange Rates and an Externally Financed Credit Boom

26. **The period from 1996 to mid-1997 was characterized by a fixed exchange rate and an externally financed credit boom, which placed new pressures on monetary policy**. As noted, in late 1995 the BSP switched to a de facto fixed exchange rate regime, pegging the peso to the U.S. dollar. The action was followed by a period of very rapid credit growth, fueled by large-scale external borrowing (much of it short term), a boom in asset prices, and a widening of the external current account deficit. A strong bias in incentives toward borrowing and lending in U.S. dollars rather than in pesos (reserve requirements and taxation were higher for peso transactions, Table IV.2), contributed to a buildup in foreign exchange exposure and the attendant vulnerabilities.

Table IV.2 The Bias Against Peso Intermediation

		Peso	Foreign currency
1.	Statutory reserve requirement	10 percent.	None.
2.	Liquidity reserve requirement	4 percent.	None.
3.	Liquid asset requirement on deposits	None.	30 percent.
4.	Depositors	20 percent tax on interest income.	7.5 percent tax on interest income.
5.	Banks	33 percent tax on interest income from loans; 20 percent tax on interest income from T-bills and other qualified assets.	10 percent tax on interest income earned on loans to residents; no tax on interest earned on loans to nonresidents.

Source: Based on information provided by the Philippine authorities.

27. **The very rapid expansion in credit was entirely in private sector credit,** which grew by 44 percent in 1995 and over 50 percent in 1996. Credit to the real estate and construction sectors accounted for a large part of the increase, even though their shares still remained relatively modest (at mid-1997, real estate accounted for only about 11 percent of outstanding bank loans and construction for less than 4 percent).[13] A significant part of the increase was financed by foreign inflows, with banks' net foreign liabilities and foreign currency deposits rising sharply in 1996. Although banks were subject to overall limits on foreign exchange exposure, they met the limits in part by lending domestically in foreign exchange and by holding forward positions (mostly with exporters). Faced with these developments, the BSP, starting in 1996, progressively tightened prudential limits (including by placing a limit on the share of real estate loans in a bank's portfolio, and by imposing a liquid-asset cover requirement on foreign currency deposits—see Chapter VI).

D. The Crisis and its Aftermath: 1997-99

28. **In common with other Asian countries, the Philippines came under severe financial pressure in mid-1997.** On July 11, a few days after the floating of the Thai baht, the peso was floated, and the focus of monetary policy in the subsequent period was on restoring confidence in the peso and containing inflation. More recently, as the peso has strengthened and inflation remained well under control, attention has shifted toward supporting a recovery in the real economy.

The Crisis Management Strategy

29. **The BSP has been broadly successful in managing the currency turmoil.** It reacted promptly to the onset of the crisis in July 1997, floating the peso and tightening monetary policy through higher interest rates. For about a year, the external position remained vulnerable, and the BSP used interest rates to "lean against" pressures on the peso—but without raising rates aggressively in an attempt to defend any particular level of the peso.[14] In recent months interest rates have gradually come down and are now below their pre-crisis levels. Credit growth has remained weak, however, reflecting weakness in credit demand (consistent with the output gap and uncertainty regarding the strength of the recovery) as well as banks' desire to strengthen their balance sheets.

30. **While the monetary framework has continued to be formally based on base money targets, interest rates have become the driving variable**. In implementing monetary

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[13]See, for example, BSP (1999), Table 31.

[14]Initially, overnight policy interest rates were raised to around 30 percent (for a relatively short period). Over the following year, rates trended down to the 15 percent range (with inflation in the upper single digits). Whenever there was serious pressure in the exchange market, the BSP would raise policy interest rates.

policy, the BSP typically forms a judgment about the appropriate level of policy interest rates based mainly on market signals about underlying monetary conditions (such as the exchange rate and market interest rates). In the period since the crisis, the use of a de facto interest rate target, oriented initially mainly to conditions in the exchange market, was appropriate given the uncertainties about money demand (exacerbated as a result of the crisis). As a result, monetary targets have typically been missed (undershot) by large margins.

31. **While open market operations (OMOs) are the principal monetary policy instrument, the BSP has also made significant use of reserve requirements**. During the height of exchange market pressures in 1997, total reserve requirements (on peso deposits) were raised to 21 percent, comprising an 8 percent "liquidity reserve" (renumerated at close to market rates) and a 13 percent statutory reserve (largely unremunerated—Box IV.1). The use of reserve requirements was partly to effect a rapid tightening of liquidity conditions when necessary (without an up-front rise in BSP "headline" policy rates); considerations over the BSP's net income position have also played a role in the choice of policy instruments (as explained below).

32. **The peso has continued to float, with exchange market intervention limited to what was needed for meeting the reserve targets under the current Fund program and for smoothing operations.** Nonmarket intervention measures have sometimes been used to restore orderly market conditions during periods of severe pressure; such measures have typically been used on a temporary basis. One such measure has been a "volatility band" that entailed a suspension of foreign exchange trading whenever the exchange rate moved outside a specified range.[15] Another has been the use of nondeliverable forward contracts (NDFs), under which the BSP provided forward cover to eligible borrowers (e.g., companies with unhedged foreign liabilities, selected banks).[16] Despite the recent pressures experienced from volatile capital flows—first the surge in inflows in 1994–97, then the outflows in 1997–98—the authorities have remained steadfast in their opposition to capital controls.

33. **The BSP lost its tax-exempt status in July 1998, with the expiration of a five-year transition period granted at its creation in 1993.** It has since paid taxes, mainly a documentary stamp tax (DST) on open-market operations and tax on income earned from sale of government securities. In addition, the BSP has been required since 1993 to transfer part of its earnings to the national government (Box IV.3). A draft bill is pending in Congress that

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[15]The band was initially invoked by the Bankers' Association of the Philippines on July 11, 1997—and entailed a suspension of trading for two hours whenever the rate moved more than 1.5 percent on either side of the opening rate. The band was re-introduced in October 1997, and involved the suspension of trading for half an hour, one hour, and the rest of the day, respectively, whenever the exchange rate moved 2 percent, 3 percent, and 4 percent away from a central rate. The band was lifted in March 1998.

[16]See Chapter V for a discussion of the use of NDFs in the Philippines.

would restore the BSP's tax exemption; at the same time, BSP transfers to the government would be increased. Under a proposed financial sector tax reform package, DST on secondary issues would in any case be eliminated. In the meantime, the BSP has shifted monetary operations partly to instruments that do not incur tax, such as reserve requirements, a special deposit facility for banks, and paperless open-market operations.

The Challenges Ahead

34. **Looking ahead, continued success of monetary policy will require a consistent and transparent policy framework, appropriate operational arrangements, and independence for the BSP to use its instruments to achieve its statutory goal of controlling inflation**. As the crisis subsides, the BSP needs to clarify the monetary framework, including the choice of an intermediate target, if any (the alternative being adoption of an inflation-targeting framework). A particular challenge for monetary policy will be managing potentially volatile capital flows—suggesting continuation of the floating exchange rate regime. While a clear and consistent monetary framework is clearly necessary, success on this front will likely require active support from fiscal policies. The BSP should remain both operationally and financially independent. Independence in this context refers to the BSP retaining full discretion over the use of its instruments of monetary control, with a view to achieving the inflation objective (set in collaboration with other government agencies).The BSP's monetary operations should remain free of taxes and the government should fulfill its outstanding obligation to complete capitalization of the BSP, so that income considerations do not influence the choice of monetary instruments. To complement its independence, the BSP needs to ensure that its actions are transparent and well understood by the public.

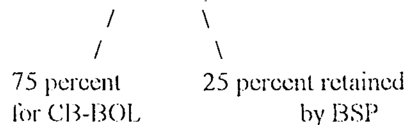
Box IV.3. Financial Obligations of the BSP

BSP transfers to the government

Under the new Central Bank Act (1993) the BSP is committed to transferring 75 percent of its net profits (net income after tax) to the CB-BOL sinking fund until such time as the CB-BOL's liabilities are extinguished. Subsequently, it is envisaged under the Act that the BSP would reduce its transfers to the NG to 50 percent. The government committed itself to transferring an additional ₱ 50 billion to the BSP for recapitalization; of this, ₱ 10 billion has been transferred.

In practice, actual transfers are based on a Memorandum of Agreement (MOA) between NG and BSP that was signed in 1993. Under the MOA, BSP submits as interest rebate to the NG the difference between net income after taxes and 1 percent of its total assets (domestic and foreign). The 1 percent of total assets is split between CB-BOL and BSP: 75 percent of it (called "dividend") is transferred for paying off CB-BOL's liabilities, and 25 percent is retained by BSP for building up capital/reserves. In sum:

(Net income after taxes) minus (1 percent of total assets) = Interest rebate to NG



For example, in 1998, net income after taxes was ₱ 12 billion (accruals basis). Total assets were ₱ 730 billion, so 1 percent of total assets were ₱ 7.3 billion. Interest rebate to NG was thus ₱ 4.7 billion (derived as 12.0 billion minus 7.3 billion). Transfers to CB-BOL were ₱ 0.5 billion (equal to 75 percent of ₱ 7.3 billion) and the BSP retained ₱1.8 billion (equal to ₱ 7.3 billion minus ₱ 5.5 billion).

Taxation of the BSP

Following its establishment, the BSP was exempt from taxation for a five-year period which ended in July 1998. Subsequently, the BSP has had to pay taxes, including documentary stamp tax (DST) on its open-market operations. In 1998, BSP paid taxes of ₱ 5.5 billion to BIR.

An amendment to the Central Bank Act, seeking to restore tax exemption for the BSP, submitted to Congress in January 1999 remains pending (as of June 1999). A phased elimination of DST (on secondary issues) is envisaged as part of the ongoing financial sector tax reforms, but this too will take time.

Meanwhile, the BSP has moved toward less costly forms of monetary operations. Special deposit accounts, which unlike standard RRPs are not subject to DST, had increased to ₱ 24 billion in March (roughly the same size as RRPs). In January, the BSP entered the Multi-transactions Interbank Payments System (MIPS); OMOs conducted through MIPS are paperless and thus also not subject to DST.

Annex IV.1. Analysis of the Demand for Broad Money in the Philippines

1. **The specification of the demand function for money follows the traditional practice of describing real money balances as a function of a scale variable and an opportunity-cost variable.** The scale variable is represented by real GNP, to represent real income, and the opportunity cost variable by expected inflation, to represent the value of the goods that are forgone when money is held instead. The money-demand equation is specified as:

$$\frac{M}{P} = \alpha_0 + \alpha_1\left(\frac{Y}{P}\right) + \alpha_2\pi^e + \epsilon \qquad (1)$$

In the equation, (M/P) and (Y/P) represent the logarithms of real money balances and real GNP, respectively; π^e represents expected inflation (measured as the first difference of the logarithm of the price level (CPI)); and ϵ represents the error term.[17] The coefficients on real income and inflation would be expected to be positive and negative, respectively.

2. **It is common when estimating money-demand functions to use the methodology of cointegration.** An important reason that the methodology is attractive is that a cointegrating relationship among variables can be interpreted as the long-run equilibrium relationship among them. A cointegrating relationship among real money balances, real income, and expected inflation, for example, would indicate that even if these variables experience a shock that drives them out of equilibrium, they will eventually return to the equilibrium relationship.

3. **As a preliminary exercise, in order for it to be legitimate to include the above series together in a regression, it was necessary to test that the time series were of a similar order of integration.** Unit-root tests indicated that the variables were integrated of order 1: the levels were nonstationary but their first differences were stationary (Table IV.3). For inflation, this was true only around a trend.

4. **A Johansen cointegration test on equation (1) indicated that a cointegrating relationship could not be rejected** (Table IV.4). The number of cointegrating equations was one. The coefficients on real GNP and inflation had the expected signs (positive and negative,

[17]The above equation imposes homogeneity of degree one in prices.

respectively) and were significant.[18] The short-run error correction model, however, was not satisfactory: the error correction coefficient, while it had the right sign, was very small (0.02). (In addition, the income variable was not significant.) The failure to find a satisfactory error correction model implies that the short-run predictability of monetary developments is poor. This result is consistent with the expected effect of financial liberalization on developments in the monetary aggregates, as well as with the monetary and real shocks that the economy has experienced.

Table IV.3. Augmented Dickey-Fuller Tests
for a Unit Root, 1991–98 (Test Statistics) 1/

Series 2/	With trend and intercept		With only intercept	
	Level	First difference	Level	First difference
Broad money, M3 (real)	-1.6*	-5.7**	0.2*	-5.1**
GNP (real)	-2.4*	-17.4**	-0.3*	-16.3**
CPI inflation	-3.8* 3/	-4.8**	-3.6**	-4.9**

Sources: Staff calculations, based on data provided by the Philippine authorities.

1/*: unit root not rejected. **unit root rejected.
2/ All series are in logarithms. Inflation is measured as the first difference of the log of the CPI.
3/ 1-percent level of significance.

Table IV.4. Philippines. The Demand for Money, 1991–98
Dependent variable: real M3; Independent variables: Real GNP, expected inflation

Likelihood ratio (Johansen test)	44.34
Co-integration status	Not rejected
Number of co-integrating equations	One
Estimated coefficients (t-statistics in parentheses)	
Long-run coefficients	
Real GNP	3.62 (5.4)
Expected inflation	-0.84 (-2.5)
Error-correction estimates	
Lagged dependent variable	0.18 (1.1)
Real GNP (first difference)	0.12 (0.9)
Expected inflation (first difference)	-0.01 (-2.9)
Error-correction term	-0.02 (-4.3)

Source: Staff calculations.

[18]The coefficient on GNP (3.6) was larger than found in earlier analyses (e.g., Aghevli and others (1979) and Tseng and Corker (1991)) which tended to find a coefficient of around 1.5.

5. **A Chow test was used to test for structural breaks in the relationship and found that a structural break in 1983 and another in 1990 could not be rejected.** (The F-statistics were 4.3 and 3.7 respectively, with 2.7 being the critical level.) This coincides with the financial crisis of 1983 in the first instance, and the acceleration of financial development in the 1990s in the second.

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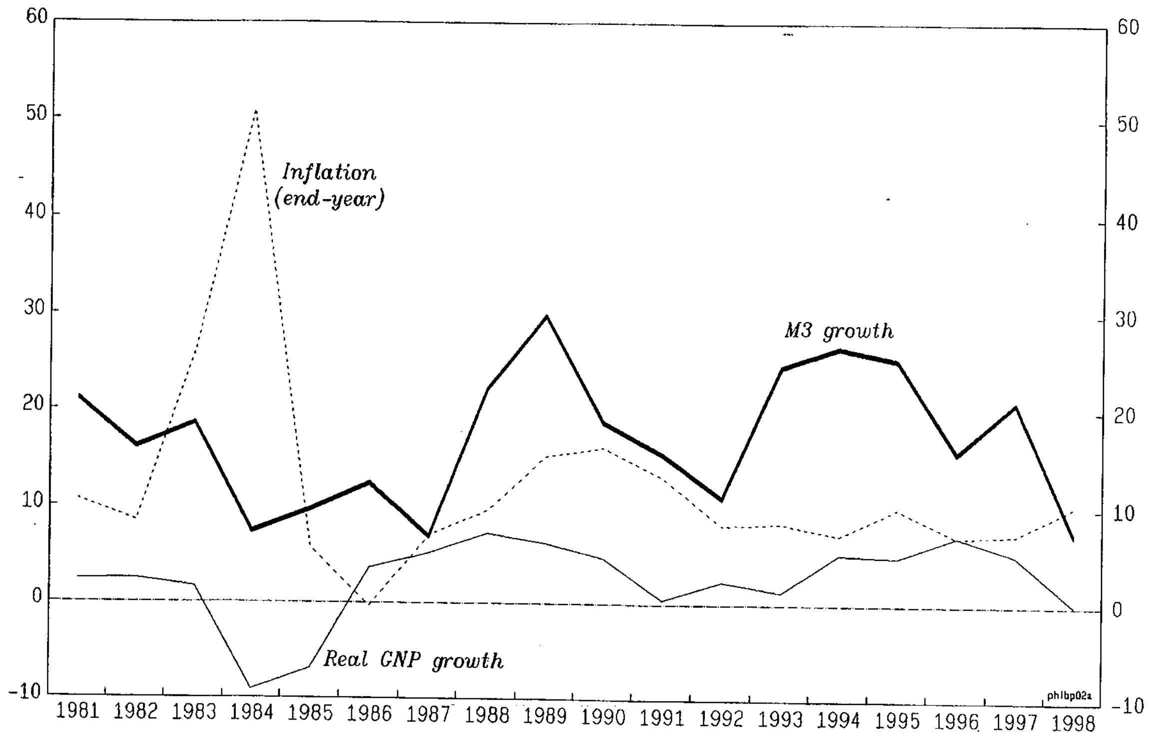
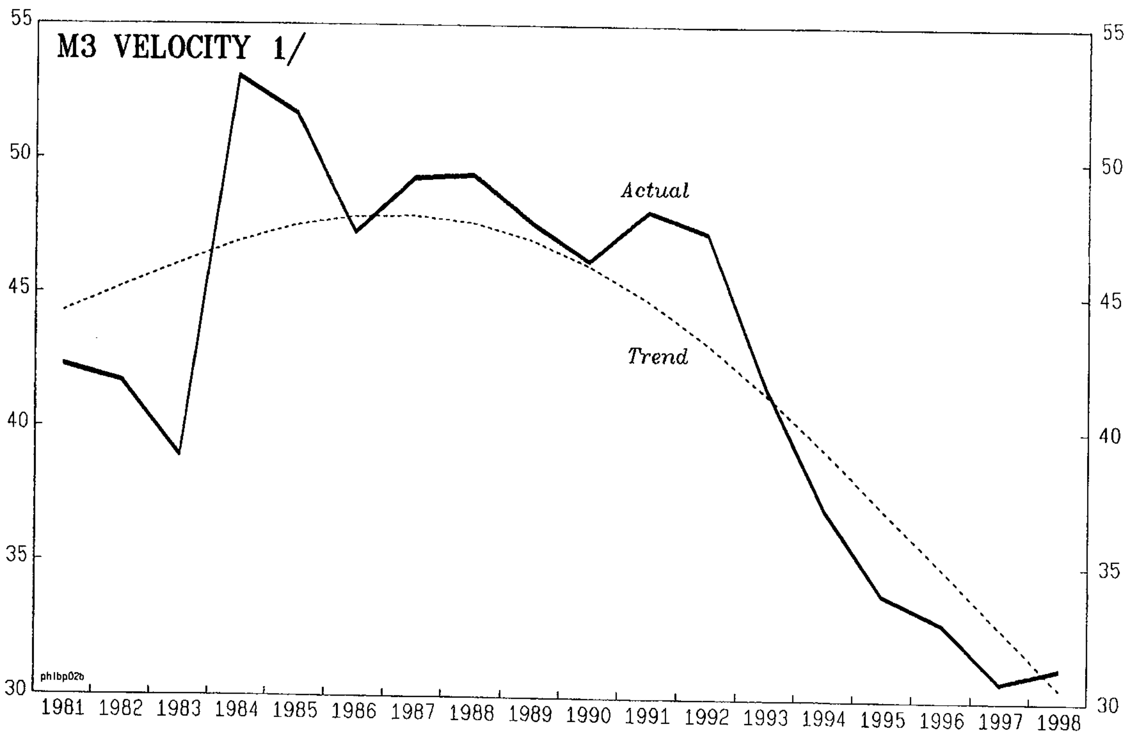
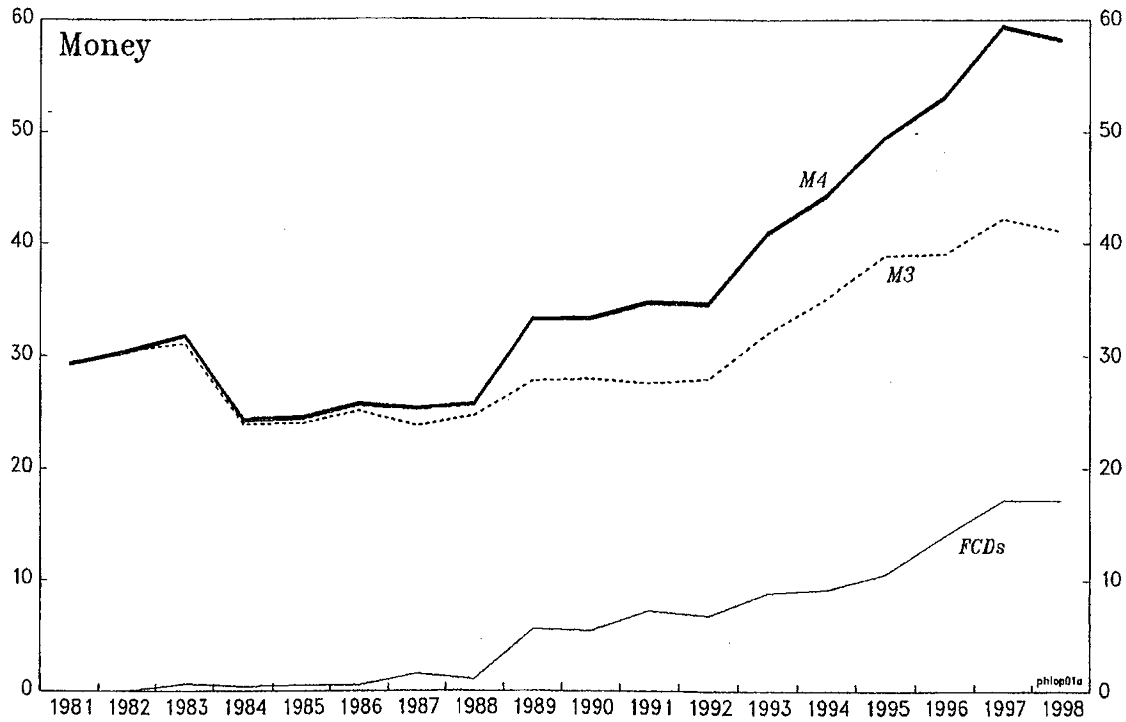
FIGURE IV.1
PHILIPPINES
MONEY DEMAND, 1981-98
(In percent)

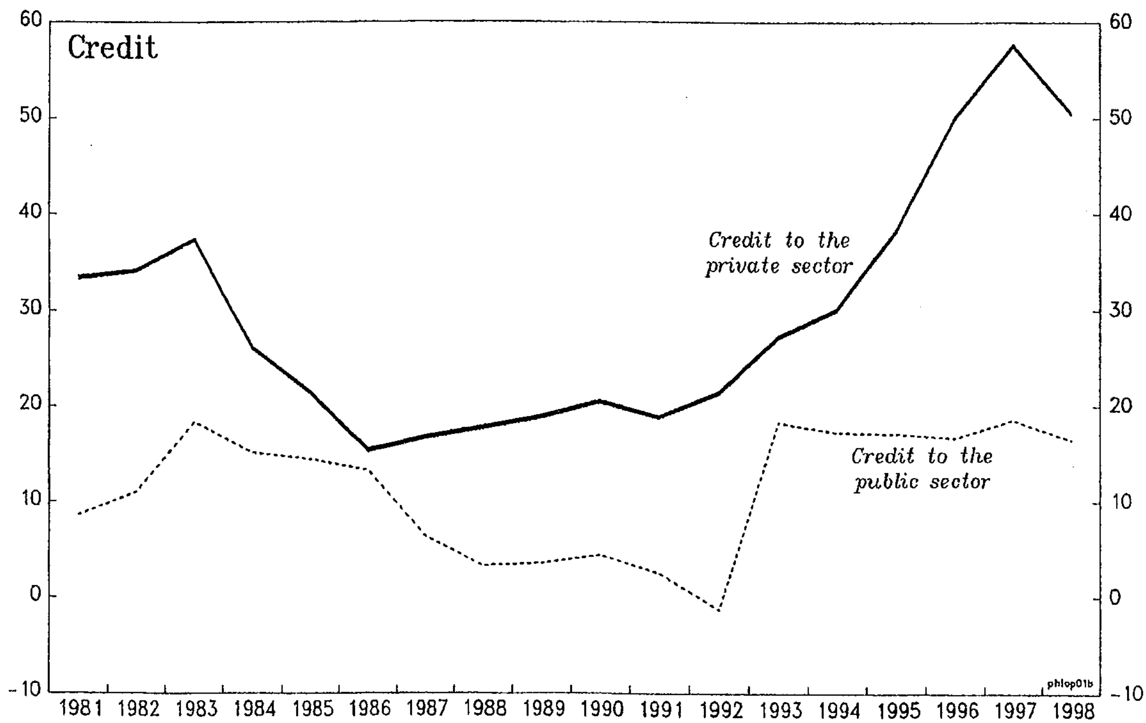




Source: Data provided by the Philippine authorities; and staff estimates.
1/ Based on real GNP and the consumer price index.

FIGURE IV.2
PHILIPPINES
MONEY AND CREDIT, 1981-98
(In percent of GNP)

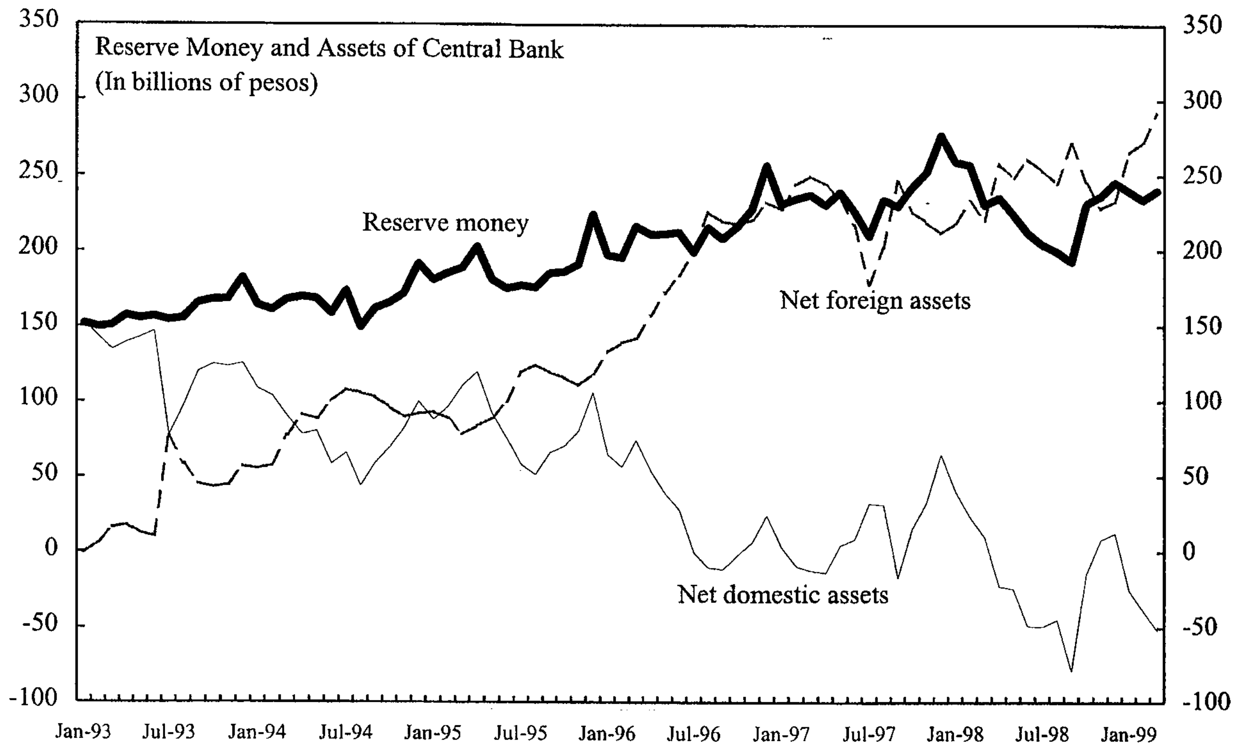


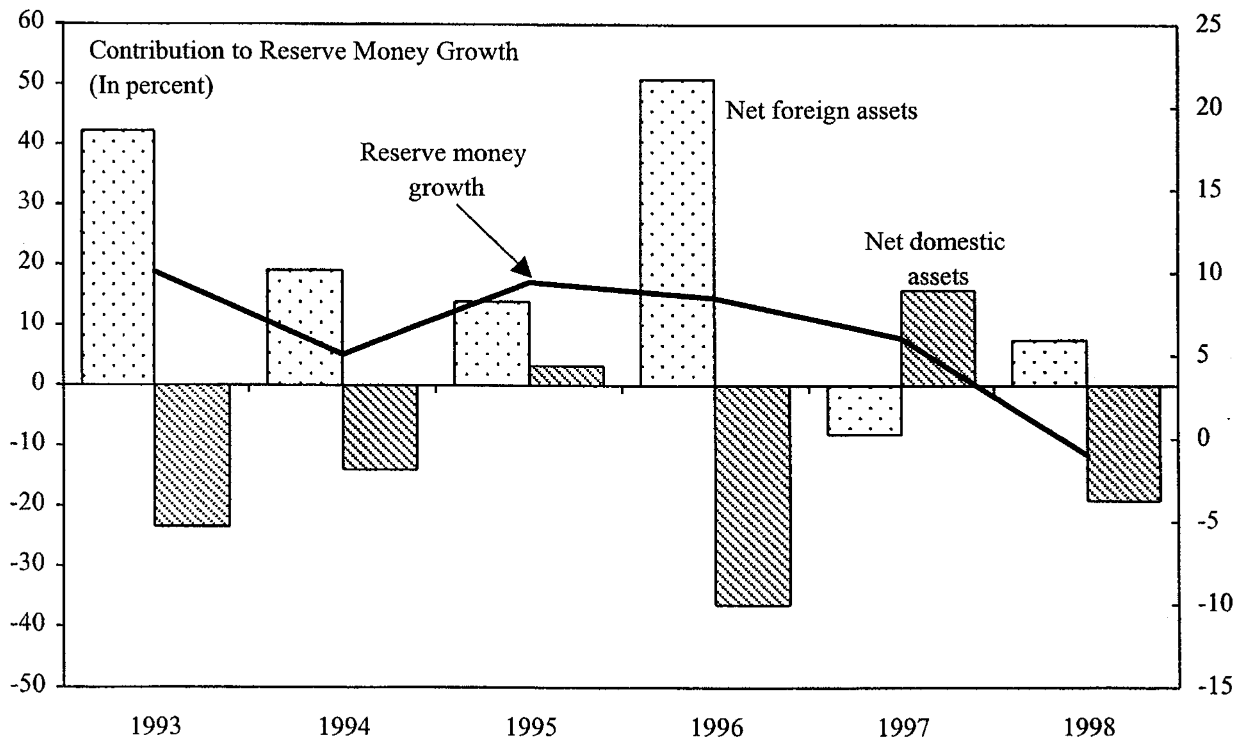


Sources: Philippine Statistical Yearbook, 1998; and data provided by the Philippine authorities.

Figure IV.3

Philippines: The Monetary Impact of Foreign Inflows, 1993-98





Sources: IMF, International Financial Statistics; and Fund staff calculations.

V. External Sector

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V. EXTERNAL SECTOR[1]

A. Overview

1. **Although the external sector came under heavy pressure during the Asian crisis, it proved less vulnerable than in the most heavily affected countries**. The policy response to crises in the mid-1980s and early 1990s, particularly in external debt management and banking policies, helped contain the buildup of imbalances and manage the crisis as it unfolded. Nevertheless, large capital inflows in the mid-1990s nearly overwhelmed the policy framework and led to sizable overvaluation of the peso, a growing current account deficit, and rapidly rising short-term debt. The de-facto pegging of the peso to the U.S. dollar in late 1995 exacerbated the vulnerability to short-term capital flow reversals. When the tide turned in 1997, the authorities tried to defend the peso for a few months, but then adapted quickly by floating the peso, tightening financial policies, and accelerating structural reforms. These policies succeeded in stabilizing the external position without the severe disruption experienced in the other crisis countries.

2. **Analysis of external competitiveness suggests that the peso was overvalued prior to the Asian crisis, then "overshot" in the other direction, and is now close to equilibrium**. Analysis based on the methodology developed by the IMF's Coordinating Group on Exchange Rates (CGER) suggests that prior to the crisis the peso was overvalued by 10–15 percent in real effective terms. Following the float, the peso depreciated by over 30 percent, resulting in undervaluation to the tune of 10–15 percent. Since late 1998, the peso has appreciated, bringing it close to its equilibrium level.[2]

3. **Examination of recent trade developments indicates that a favorable structural change took place in the early 1990s, with exports strongly benefiting from prior investments and regulatory changes**. Philippine export market shares increased faster than three of the "Asian-5", with the exception of Korea's. The change reflects rapidly increasing exports of electronics and electronic components. Although such growth has come partly at the expense of more traditional exports, it has shown the Philippine's capacity to partake fully in one of the most dynamic and competitive export markets in the world.

4. **Over the medium term, it is expected that the current account (now in surplus of 2 percent of GNP) will return to a deficit of about 2–3 percent of GNP**. Such a position would be consistent with a medium-term savings–investment norm estimated using the CGER methodology.

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[1]Prepared by Charalambos Christofides.

[2]It should be noted that the analysis is based on *medium-term* estimates of the equilibrium exchange rate, and should not be taken as indicators of imminent short-term movements.

B. Developments in the Balance of Payments and External Debt

Background

5. **The Philippine economy experienced major external imbalances over the past two decades**. Starting in the early 1980s, the economy slid into a full-blown balance of payments crisis, resulting in default on external debt followed by a severe recession.[3] The crisis was the result of earlier policies favoring an expansion of the public sector, import substitution, and easy credit to the private sector financed through external debt. Although efforts to support exports had started as early as 1970 with the Export Incentives Act,[4] effective protection remained substantial, especially in import substituting sectors. Large public and private investments initiated during this period were heavily dependent on imports and foreign financing, and eventually proved unable to generate the foreign exchange earnings to service the debt. The resulting vulnerability became unsustainable in the face of large external shocks[5] and growing political uncertainty.[6]

6. **From the mid-1980s, reforms produced a gradual improvement in economic performance, but the economy remained vulnerable to a "boom-bust" cycle**. The period 1986–89 saw a recovery of growth and investment and a return of foreign capital, supported by policy reforms including a breakup of agricultural monopolies, import liberalization, and tighter debt management. However, import dependence remained high and domestic saving weak, and a strong recovery of growth combined with expansionary fiscal policy resulted in a return of unsustainable current account deficits (peaking at more than 6 percent of GDP in 1990). Thus, a few years of rapid growth were capped by near-exhaustion of reserves, a peso depreciation, and yet another debt rescheduling.

7. **In the early 1990s, reforms accelerated and the economy became more resilient in the face of external shocks**. Trade liberalization accelerated, with average nominal tariffs expected to fall below 10 percent by 2000 (from over 40 percent in 1980, and 27 percent in

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[3]In 1988, debt restructuring agreements were concluded in line with a 1987 Paris Club agreement. In all, almost US$13 billion of debt was restructured, about 136 percent of 1988 exports of goods and services.

[4]R.A. No. 5186 offered fiscal exemptions to exporters of both goods and services to stimulate exports of non traditional manufactures.

[5]Including a jump in world interest rates, recession in the United States, and the Latin America in a Debt Crisis.

[6]Culminating in the assassination of Ninoy Aquino in 1993.

1990).[7] In 1991, a new Foreign Investment Act was introduced, which simplified the approval process and allowed foreign ownership of up to 100 percent in many sectors. 1992 witnessed a sweeping exchange liberalization that removed current and most capital account restrictions. These reforms strengthened resource allocation on the economy, boosted exports, and were followed by full restoration of the Philippines' access to global capital markets—setting the stage for the Philippine's relatively robust performance during the Asian crisis.

8. **Despite severe early pressures from "contagion," the external position has proved remarkably resilient in the face of the Asian crisis**. As for other countries in the region, the crisis first manifested itself in falling equity prices and pressure on the exchange rate, with an acceleration of capital outflows, particularly in the aftermath of the Thai baht devaluation on in July 1997. Contagion was evident in the lack of differentiation in the key foreign exchange bond spread indicators, which initially rose to prohibitive levels for all countries affected by the crisis, with little differentiation between borrowers.[8] However, compared with the most heavily affected crisis countries, capital outflows from the Philippines were less severe, and the hemorrhage of reserves was arrested earlier. Unlike in previous crises, external debt service was not interrupted, and the domestic banking and corporate sectors—while showing signs of stress—were able to withstand severe external shocks better than in the past.

9. **Nevertheless, while the crisis was less severe in the Philippines than in some other countries in the region, it revealed underlying weaknesses that remain to be addressed**. The trade deficit had widened to well over 10 percent of GNP by 1997, and the peso was significantly overvalued. While capital flows through the early 1990s consisted mainly of longer term (including concessional) lending from both multilateral agencies and other bilateral sources,[9] 1995–96 witnessed a jump in short-term borrowing. Clearly, macroeconomic policies and prudential systems were not fully attuned to the challenges of the Philippines' emerging integration in the globalized capital markets. Assessment of balance of payments developments was seriously hampered by statistical problems related to transactions through foreign-currency deposit accounts. The following sections explore these developments in greater detail.

Recent developments

10. **The Philippine current account has been marked by large cyclical swings in recent years**. The current account deficit widened to over 5 percent of GNP in 1997,

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[7]Moreover, all but one quantitative restriction have been tariffied.

[8]See Baig and Goldfajn, "Financial Market Contagion in the Asian Crisis," IMF Working Paper, WP/98/155 (November 1998).

[9]See Philippines—Background Paper, SM/95/253, Chapter I (September 25, 1995).

followed by a surplus of 2 percent in 1998. The trade balance shifted even more sharply, from a deficit of over 13 percent of GNP in 1997 to balance in 1998. This dramatic adjustment reflected the combined effects of weaker growth, peso depreciation, and continued expansion of the most important export market (the United States). Imports contracted sharply (by 19 percent in dollar terms) reflecting lower volumes (13 percent) as well as prices. Part of the improvement in the trade account was offset by weaker services, especially income transfers (which in the Philippines are particularly important given the large number of Philippine workers employed abroad).[10]

11. **Unlike most other crisis countries, the Philippines has benefitted from continued strong export growth**. Exports volumes rose by 23 percent in 1997 and by 20 percent in 1998. This reflected the fact that Philippine exports go disproportionately to the United States (which continued to grow fast while Asian growth slumped) and have shown evidence of structural improvement, with strong gains in market shares arising mainly from investments in the electronic sector.[11]

12. **Mirroring the current account, the capital account moved from large-scale inflows in 1995–96 to a sizable outflow in 1997**. Like other Asian countries, the Philippines experienced a surge of inflows during 1993–96 (averaging about 6 percent of GNP). Net inflows fell to 1 percent in 1997 and were close to zero in 1998, the first full year following the Asian crisis. The capital inflows included foreign direct investment (which averaged about $1.2 billion during 1993–97 compared with $0.6 billion during the three preceding years), borrowing by commercial banks (with net liabilities up by almost $1 billion per year on average), and medium and long-term loans (which rose from annual net outflows of $1.1 billion during 1990–92 to inflows of $2.3 billion during 1993–97). Trade-related capital and suppliers credits stayed about the same during this period.

13. **The growing capital inflows during 1994–96 raised concerns at the time, and policies (especially monetary and exchange rate policies) were searching for ways to contain their effects (see Chapter IV)**. However, the focus perhaps was too narrowly directed at limiting nominal peso appreciation and/or controlling the monetary impact of the inflows. In hindsight, a more strategic and consistent approach was warranted especially to forestall the large rise in short-term foreign borrowing in 1995–96. By the same token, it is important to note that a significant part of the capital inflows received by the Philippines during that period were medium- to long-term investments responding to the increase in capital productivity resulting from reforms. In particular, there were large foreign investments

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[10]Income transfers were probably affected by rate of return considerations and by income considerations. In peso terms, fewer dollars needed to be exchanged to support a given income transfer following the depreciation of the peso.

[11]Described in Box V.1.

in the fast-expanding electronics export sector (see below), which rapidly became the dominant export sector in the Philippines.

14. **During 1997, capital withdrawals started in the equity markets, followed by turnarounds in commercial bank net foreign assets and capital flight**. Trade financing and suppliers credits also declined, although largely in tandem with declining import volumes—there is no evidence of significant cuts in trade lines.[12] Likewise, commercial banks' large foreign currency deposit base proved stable throughout the crisis.[13] There was also continued strength in medium and long-term net inflows, and relatively strong foreign direct investment (which in fact rose from 1997 to 1998).

15. **Faced with the sudden decline in net private capital inflows, the authorities increased public foreign borrowing, including from multilateral[14] and bilateral[15] resources**. This policy was part of a strategy to allow an orderly adjustment to the shock in private capital flows while containing the underlying vulnerabilities. The strategy to control vulnerabilities centered on a relatively tight monetary policy, a floating exchange rate (with occasional—and limited—intervention to prevent disorderly market conditions),[16] measures to strengthen the banking sector, and better monitoring of short term debt.[17] The lessons learned from the earlier crises, especially the safeguards put in place to prevent renewed excessive debt accumulation, clearly contributed to the success of this strategy.

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[12]This was in contrast to the experience in the early 1990s when most trade lines were not rolled over.

[13]The stability of short-term foreign bank lines may be attributable to the fact that Philippine banks in the 1990s have become net depositors in the Euro-markets, with part of FCDU deposits redeposited abroad.

[14]Mainly the IMF (extension and augmentation of the 1994 EFF, and a new SBA in March 1998) World Bank (a Banking Sector Reform Loan in 1998, and additional program loans planned for 1999), and the Asian Development Bank (with loans for energy sector, capital market and Metro Manila Air Quality development).

[15]Most notably from Japan (OECF and JEXIM), and significantly expanded under the "Miyazawa" initiative.

[16]Intervention during this period was mainly in the form of nondeliverable forward contracts between the BSP and market participants. The use of NDFs in the Philippines is briefly summarized in Box 2.

[17]For a description of efforts to improve external data, see Box V.3.

16. **While the external position remained vulnerable through the summer of 1998, it has since improved.** These developments were in line with global market developments, but domestic factors were also at play. In particular, while there was some market uncertainty following the May 1998 elections about the policies of the future government, confidence improved once the government had set out its policies. Since September 1998, the peso has appreciated significantly and gross usable reserves have risen to over 120 percent of short-term debt, up from less than 80 percent in early 1998.

17. **Following the steady decline in the debt/GNP ratio through 1996, the ratio has increased again in recent years, to 76 percent, partly influenced also by the peso depreciation.** Debt reduction operations, prudent fiscal policies, and rapid growth had reduced debt relative to GNP from 65 percent in 1990 to 47 percent in 1996. In addition, a policy of lengthening debt maturities had reduced the debt-service burden (with the debt-service ratio falling from 35 percent in 1990 to about 13 percent in 1996). Mainly because of peso depreciation, the debt-service ratio, however, has remained low at 13 percent in 1998.

C. External Competitiveness

18. **During the period 1993–97, the current account deficit grew to over 5 percent of GDP, and the peso is estimated to have become overvalued by 10–20 percent.** The peso appreciated faster in real effective terms than other Asian currencies, and the current account deficit widened significantly beyond the level consistent with medium-term equilibrium even after accounting for the impact of the economic cycle.

19. **In 1998, the current account turned into a surplus as output growth fell far below potential and the peso "overshot" to become temporarily undervalued.** However, the exchange rate has appreciated significantly since late 1998, virtually eliminating by mid-1999 all of the estimated undervaluation.

External competitiveness indicators

20. **Because of recent volatility and data limitations, the usual real exchange rate indicators provide little evidence regarding the adequacy of competitiveness at a certain exchange rate.** Because there are no direct measures of an "internal" real exchange rate (prices of nontradeables relative to those of tradeables), the proxy of nonfood prices in the CPI relative to the price of food was used (Figure V.1, top panel). This measure shows sizable real appreciation during the 1990s (some 25 percent from end-1989 to end-1997; 13 percent since end-1995), but is obviously distorted by the larger volatility of food prices.[18]

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[18]For example, in 1997–98, reflecting the impact of drought on food prices, the ratio continued rising notwithstanding the large depreciation after the float of the peso in mid-1997.

21. **Other measures of competitiveness, such as the real effective exchange rate (REER) index compiled by the IMF, show a much larger appreciation prior to the crisis, followed by sizable depreciation after the float of the peso in mid-1997.** Figure V.1 (bottom panel) shows real appreciation of more than 50 percent from the trough in 1990 to mid-1997 followed by a depreciation of about 30 percent. The problem then is to determine an appropriate base period during which the exchange rate was judged to have been in equilibrium. While 1993 has often been cited as a year with broad equilibrium both domestically and in the external accounts, such an assessment inevitably involves a large amount of judgment.

22. **Comparison with the "Asian-4" countries (Figure V.2) shows that the Philippine peso has been stronger in real effective terms throughout much of the 1990s.** That this relative real appreciation was not reversed during the recent crisis is significant and may indicate that fundamental structural change has been at work. For a more formal assessment, we now turn to an analysis of the medium-term underlying current account position.

A predicted current account

23. **A regression equation with good explanatory power can be estimated for the current account, based on the REER and the output gap.** This equation is able to explain the sharp recent turnaround in the current account relatively well.

To use the CGER methodology, two elasticities are estimated:

- the change in the current account as a result of the change in cyclical conditions (measured by the output gap); the elasticity allows the construction of a cyclically adjusted current account;
- the change in the current account as a result of the change in the exchange rate.

24. After a specification search, a simple reduced-form regression was estimated for the period 1982–98 (t–statistics in parentheses):

$$CA_Y_t = \underset{(4.83)}{-2.52} - \underset{(2.88)}{0.15}{*}R_t - \underset{(2.33)}{0.13}{*}R_{t-1} - \underset{(2.97)}{0.57}{*}YGAP_t, \quad \sigma_\varepsilon=1.97,\ D.W.=2.04,\ R^2\text{-BAR}=0.62.$$

In this equation, the current account balance (CA_Y) is measured as a percent of GDP; R denotes the logarithmic change in the REER; and YGAP denotes the output gap.[19] Figure V.3 suggests that the current account in the Philippines responds significantly to movements in the REER, a finding confirmed by the regression estimates. As Figure V.4, top panel shows, the equation has good explanatory power and captures rather well the dramatic turnaround in the current account from 1997 to 1998.

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[19] As estimated using a Hodrick–Prescott filter.

A "warranted" current account and the equilibrium exchange rate

25. **A "warranted" current account can be constructed using the CGER methodology for estimating a savings-investment norm**. The CGER procedure was operationalized taking into account the influence of demographic, fiscal, and output variables for the Philippines relative to the equivalent variables in a set of industrial economies. The norm is found to fluctuate, but to be significantly less volatile than the cyclically adjusted current account (estimated using the regression estimated above—Figure V.4, middle panel). For 1998, the norm indicates a deficit slightly above 2 percent of GDP, while the actual current account position was a surplus of 1.8 percent. Using the implied long–run elasticity for the REER estimated above, the analysis indicates that the exchange rate became undervalued by 10–15 percent.[20]

26. **The norm is consistent with the indications from the REER measures that the peso was overvalued during the period prior to the Asian crisis**. It is noteworthy that the norm indicates that the actual current account was closest to the "warranted" level in 1991, and not in 1993 as is sometimes assumed. In 1998, the current account overshot its warranted level, as it moved into sizable surplus.

27. **The implied exchange rate disequilibrium over the period 1982–98 is shown in Figure V.4 (bottom panel)**. This computation uses the long–run implied price elasticity estimated above (which, at 0.28, is somewhat higher than the 0.2 that is often assumed in similar studies). Corresponding to the shifts in the relationship between the cyclically adjusted and the "warranted" current accounts, the REER in 1998 overshot the equilibrium level, becoming undervalued by some 10–15 percent.

Exports as indicators of competitiveness

28. **Since the early 1990s, the Philippines appears to have experienced a favorable structural improvement in its external trade.** Analysis of trade flows can provide useful insights on competitiveness. In particular, structural changes in trade flows and sustained changes in market share can be indicators of shifts in the equilibrium exchange rate. As documented in Chapter II, econometric analysis confirms a structural break in trade performance around the early 1990's; the ratios of export to import volumes (Figures V.5 and V.6) support a similar conclusion.

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[20]The CGER procedure produces an estimate for a "normal" current account (the so called "savings-investment norm") by using a panel set of countries that are used as comparators (see Isard and Faruqee (1998)). The procedure allows for a "recalibration" of the result, to introduce a "fixed effect" correction intended to help match the predicted savings-investment norm with some historical average for the country. For the Philippines, the correction was made to match the average current account up to 1993 (later years were excluded so as not to contaminate what should be a medium-term estimate without the effect of recent events).

29. **There has been a significant gain in export market share since 1994, following a decade of relatively stagnancy.** Figure V.7 shows that the growth of Philippine export market share has outpaced that of all the other Asian-5 countries, except Korea. This is indicative of a favorable structural shift, in particular since it coincided with real appreciation.

Developments in export components

30. **The main driving force behind the recent favorable export performance has been the electronics sector, which has experienced rapid growth since 1994 and has become by far the dominant export sector** (Figure V.8 and Box V.1). To a large degree, the Philippine's continued export-led growth is now tied to the success of electronics exports. Food exports (except coconuts) have also kept growing. Other traditional exports, and especially garments, have performed less well. The worst performance has been turned in by minerals exports.

31. **Some observers have pointed to the risks inherent in over-specialization, and have noted evidence of competitiveness problems in the comparatively weak performance of traditional exports**. The local value added in electronics exports is also still relatively low (10-30 percent), as they depend considerably on imported raw and processed materials (especially wafers). The World Bank points out that this situation can only be remedied through the upgrading of local technology and growth of domestic firms that can provide a wider array of ancillary services.[21] Support of small and medium enterprises, including better access to finance, should also help in the context. For garments, the key was judged to be better quality of production, distribution, and marketing. Notwithstanding these caveats, it is clear that the dynamism of electronics exports could not have come at a better time for the Philippines, sustaining growth and export earnings at a time of crisis.

D. Medium-Term Outlook and Issues

32. **Over the medium term, the current account is projected to return to a deficit that is consistent with the medium-term investment norm (2–3 percent of GDP)**. The speed with which the norm is reached depends on the projected paths for output and the real effective exchange rate (REER). The extent to which exports continue to gain market share is an additional uncertainty. Given the outlook for continued FDI and rising portfolio inflows, financing the current account deficit and projected debt amortization should not pose a problem. Reserves are expected to continue to increase, to the equivalent of four months of imports by the end of the projection period (2004). Although external debt would continue to increase in absolute terms, it would decline relative to GNP (to 67 percent, from 76 percent in 1998).

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[21]World Bank, "*Philippines: Country Economic Review*," November 1998.

33. **In support of such a scenario, a challenging policy agenda remains:**

- Macroeconomic policies will need to combine prudent demand management with exchange rate flexibility, to preserve competitiveness and prevent the buildup of excessive leverage and debt (especially short-term). Continued upgrading of prudential and supervisory standards in the banking system will also be necessary for the successful management of the "capital inflows problem."

- Continued trade and investment liberalization will be crucial for the Philippines to fully partake in the benefits of globalization. Average import tariffs are set to come down to 5 percent by 2004, an objective that should be maintained. In addition, protection in agriculture should be reduced to enhance productivity growth in that sector, and to permit dynamic export growth in this area of apparent comparative advantage.

- Support for exports by building up infrastructure, enhancing access to finance for small and medium-size enterprises, and improvements in services (including in the area of public administration) will also be necessary in order to sustain gains in market share.

- Debt management should continue to be modernized, to keep pace with rapidly evolving financing techniques and, in particular, to keep on top of all forms of short-term exposures.

- Balance of payments statistics need to improve further to prevent reliable estimates of current account developments. This should include the use of source data on transactions through FCDU accounts (even if provided by banks in appropriate form, to accommodate the laws on bank secrecy), or the development of reliable alternatives (survey methods).

Box V.1 . Electronics Exports—Rapid Growth

Although growth of electronics exports took off only in 1994, the sector has long historic roots in the Philippines. This was evident in the continuous upgrading of the capabilities of the sector, which started in the 1970s with basic assembly and packaging of components, added assembly and testing technologies in the 1980s, and expanded to the production of complete computer peripherals, module assembly and component manufacturing in the 1990s. Wafer fabrication and original design is considered as being within the sector's capabilities within the next five years.

Electronics Exports

Year	Exports ($ billion)	Growth Rate (percent)	Share in Total Exports (percent)
1994	4.9	28	36
1995	7.6	55	43
1996	10.6	40	52
1997	15.0	41	59
1998	19.7	32	67

Source: Semiconductor Industries Association.

Despite the Asian crisis, 38 new electronics companies were registered during 1998 (according to BOI/PEZA data), at a total project cost of ₱ 15 billion, bringing the total number of companies to 462. Of these, 138 were Philippine (although such companies were relatively small), 133 Japanese, 46 Korean, 39 United States (accounting for about 70 percent of exports), and 20 Taiwanese.

The geographic distribution of electronics exports is well diversified, with 32 percent going to the United States, 22 percent to Europe, 15 percent to other ASEAN countries, 13 percent to Japan, 8 percent to Taiwan, and 10 percent to other destinations. In terms of employment, the sector contributes some 250 thousand jobs in 1998, up from 38 thousand in 1985. Employment in the semiconductor subsector has been growing more slowly than in other electronics subsectors, reflecting its relative capital intensity.

Factors contributing to the sector's growth include:

- A high emphasis by local producers on the quality of production, using the latest manufacturing techniques.
- Wages are higher in the Philippines relative to China and Indonesia, but local labor is considered highly skilled, technically proficient, cost competitive, and well-trained. Philippines has significant numbers of technically trained (engineering and information technology) personnel: with a labor force of 31.2 million, of which 28.3 million are employed, Philippines had 438,988 enrolled students in 1997–98, and graduated 74,750 students per year (in technical fields). In all, there are 1,345 colleges and universities.
- The strategic location of the Philippines (together with human resources) is often cited as the dominant reason for FDI.

Domestic value added in electronics exports has almost tripled since the 1980s, increasing to almost 30 percent (25 percent for computers) in 1998, from about 10 percent in the early 1990s. This finding, however, does not apply to all manufacturing processes (e.g., packaging is still heavily dependent on imports, especially of wafers).

Box V.2. Non Deliverable Forwards (NDFs): Their Use in the Philippines

An NDF is a forward contract without an exchange of principal; instead, only the difference between the contract exchange rate and the spot rate at maturity is settled, in local currency. The NDF typically covers the foreign exchange risk (in case of a depreciation; the Central Bank makes a profit when the currency appreciates) of an underlying foreign loan, the maturity of which tends to match that of the NDF. The contract exchange rate is usually determined by the current exchange rate adjusted for the differential between the domestic t-bill rate and LIBOR.

There is little conceptual difference between foreign exchange market intervention through NDFs and intervention through forwards. The main exception concerns the accounting treatment of NDFs, which makes them less transparent (as they are not reflected in reserves when they are contracted):

- In forward (currency swap) intervention, commercial banks would make a simultaneous spot sale of dollars to the central bank and a forward purchase of dollars from the central bank. The central bank would then sell the dollars in the foreign exchange market. The net effect of these transactions on reserves would be zero (unless reserves were explicitly defined to exclude forward liabilities), but forward liabilities would go up by the full amount of the swap.

- In intervention through NDFs, commercial banks are encouraged to borrow abroad, selling the dollar proceeds in the foreign exchange market. In exchange, they get an NDF from the central bank, which assures them of having enough pesos to buy the dollars they will need at the end of the contract. When the loan is unwound, the commercial banks repays the foreign dollar loan.

The BSP has used two main types of NDFs: (1) **Special NDFs**, contracted primarily with local branches of foreign banks. Typically, these borrow foreign exchange from their parent banks, at maturities of up to a year. The banks would sell the loan proceeds in the interbank foreign exchange market (thereby supporting the peso). The NDF in effect covers the downside foreign exchange risk for the bank, with an upside potential for the BSP. (2) The **currency risk protection program (CRPP)**, applied to corporations with unhedged foreign exchange liabilities contracted prior to some cutoff date. The corporation in effect gets a foreign exchange guarantee from a local bank that "off loads" the risk through an NDF with the BSP.

The stock of NDFs rose to about $1 billion in 1998 (mainly special NDFs), following pressures in the foreign exchange market. Since then, the stock of NDFs has generally trended downward.

Box V.3. External Data Issues

External sector data, especially on the trade and external debt side, are generally of high quality and are available in sufficient detail and frequency, but their compilation has become increasingly difficult in recent years. In particular, increased use of Foreign Currency Deposit Units (FCDUs) and of Offshore Banking Units (OBUs) has made it very difficult to correctly allocate the transactions between current/financial account categories, given banking secrecy laws. As a result, the estimates of services are effected by large uncertainties, and possibly include a sizable amount of capital account transactions.

Significant improvements have been made in recent years. In particular, the BSP has included in external debt reports of several items previously excluded (most notably of credit lines to banks extended from headquarter banks located abroad). A simplified and more informative foreign exchange reporting form has been introduced, and the BSP is working on a number of improvements to the reporting system on derivatives. Much of this is work in progress. However, it is also apparent that the strict bank secrecy provisions prevent substantial progress on improving the estimates of transactions through FCDU accounts.

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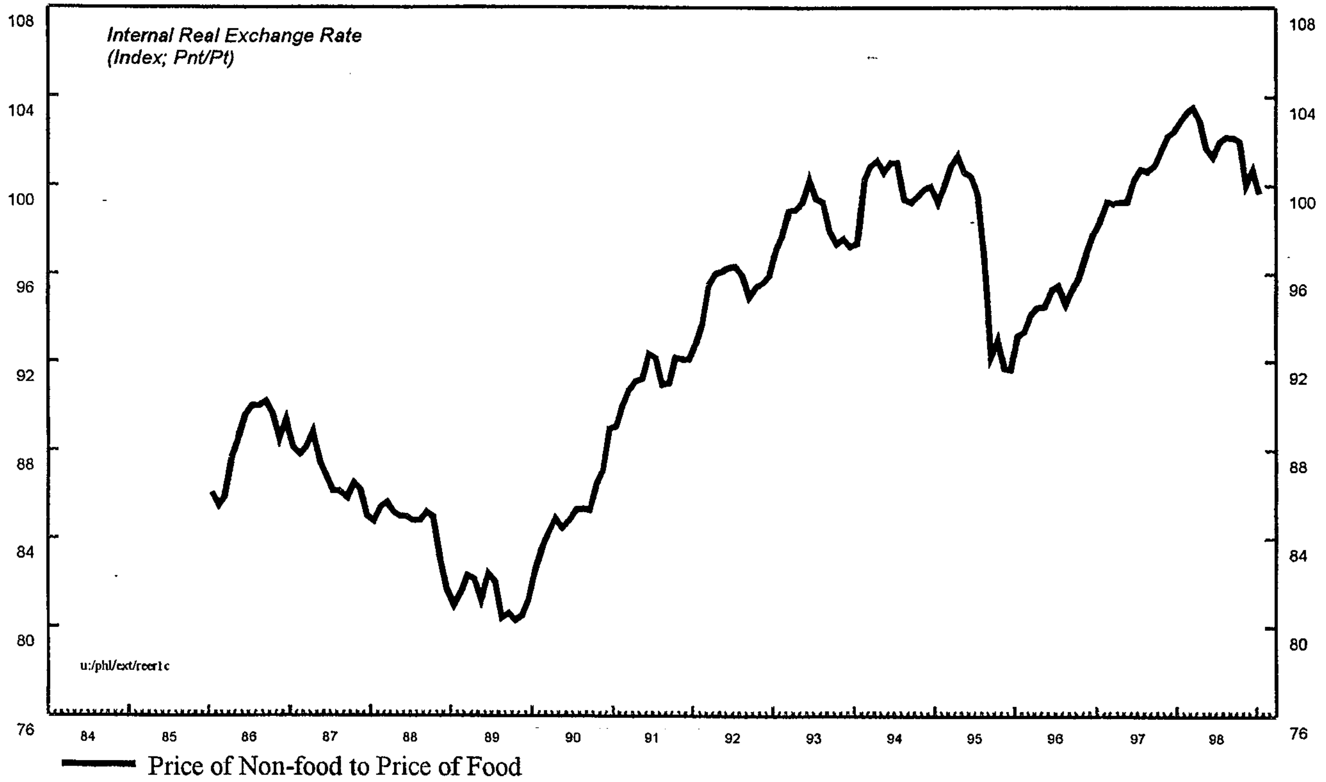
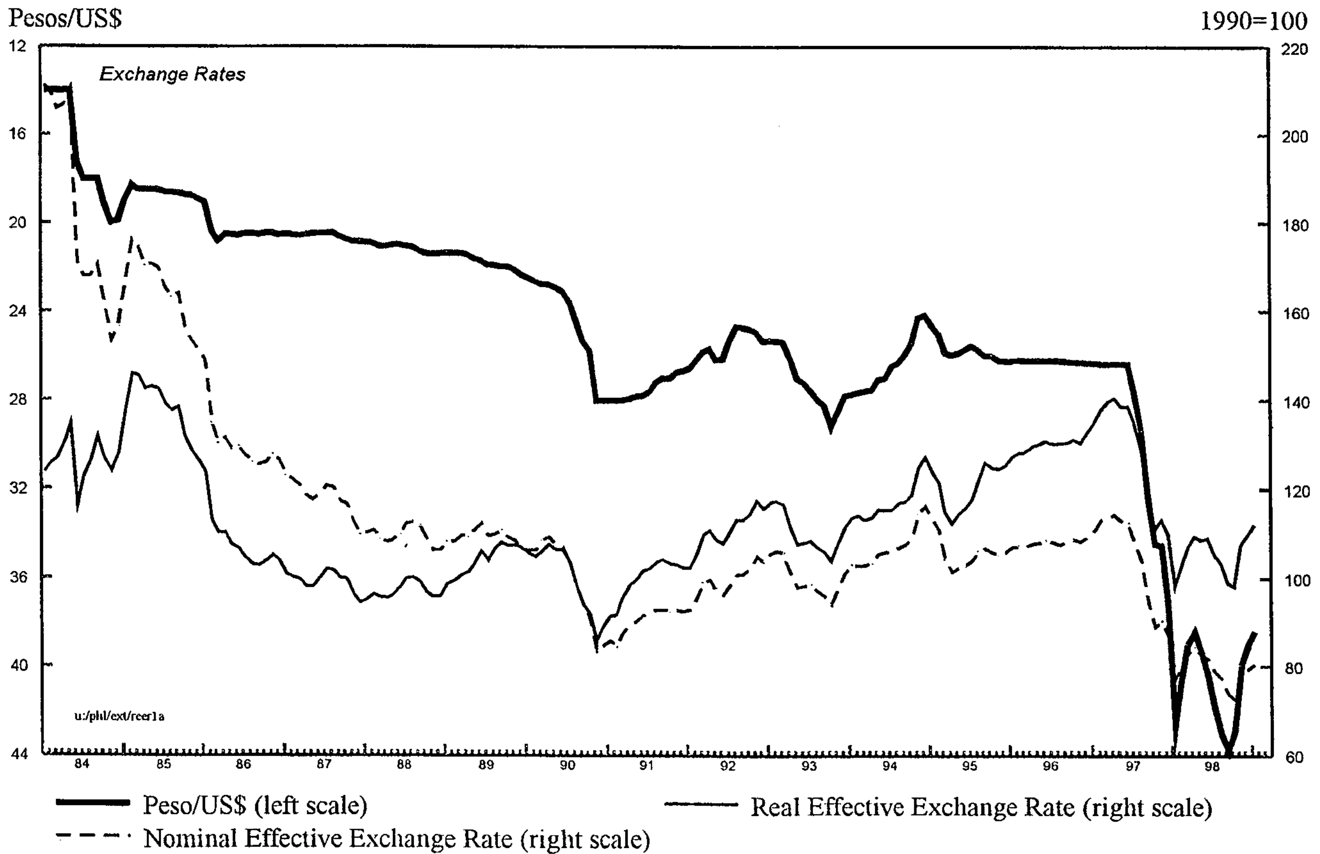
Figure V.1. Real Exchange Rate Measures, 1984-99. 1/

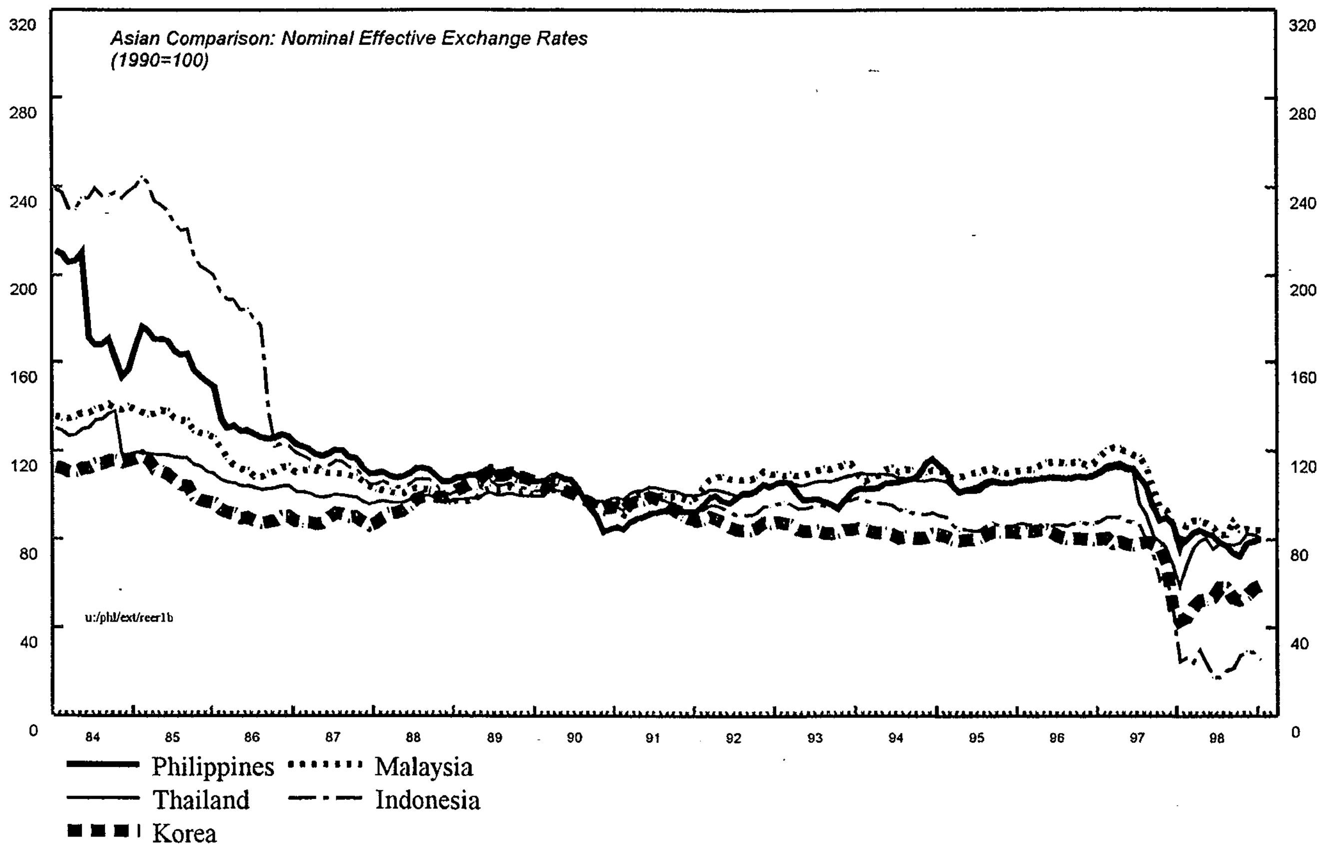


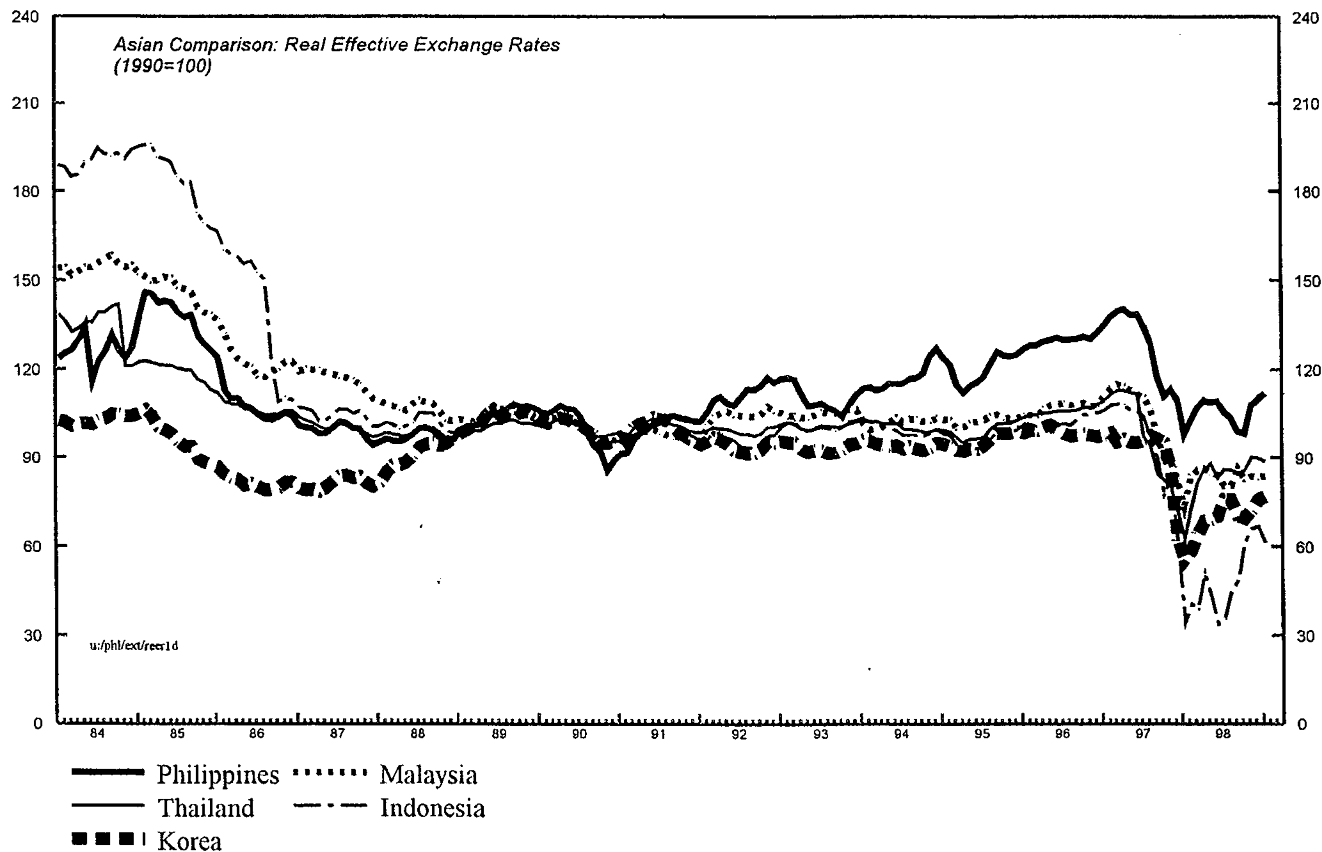


Sources: Philippine authorities; IMF INS; and Fund staff calculations.

1/ An upward movement indicates an appreciation of the peso.

Figure V.2. Asian Exchange Rates, 1984-99. 1/



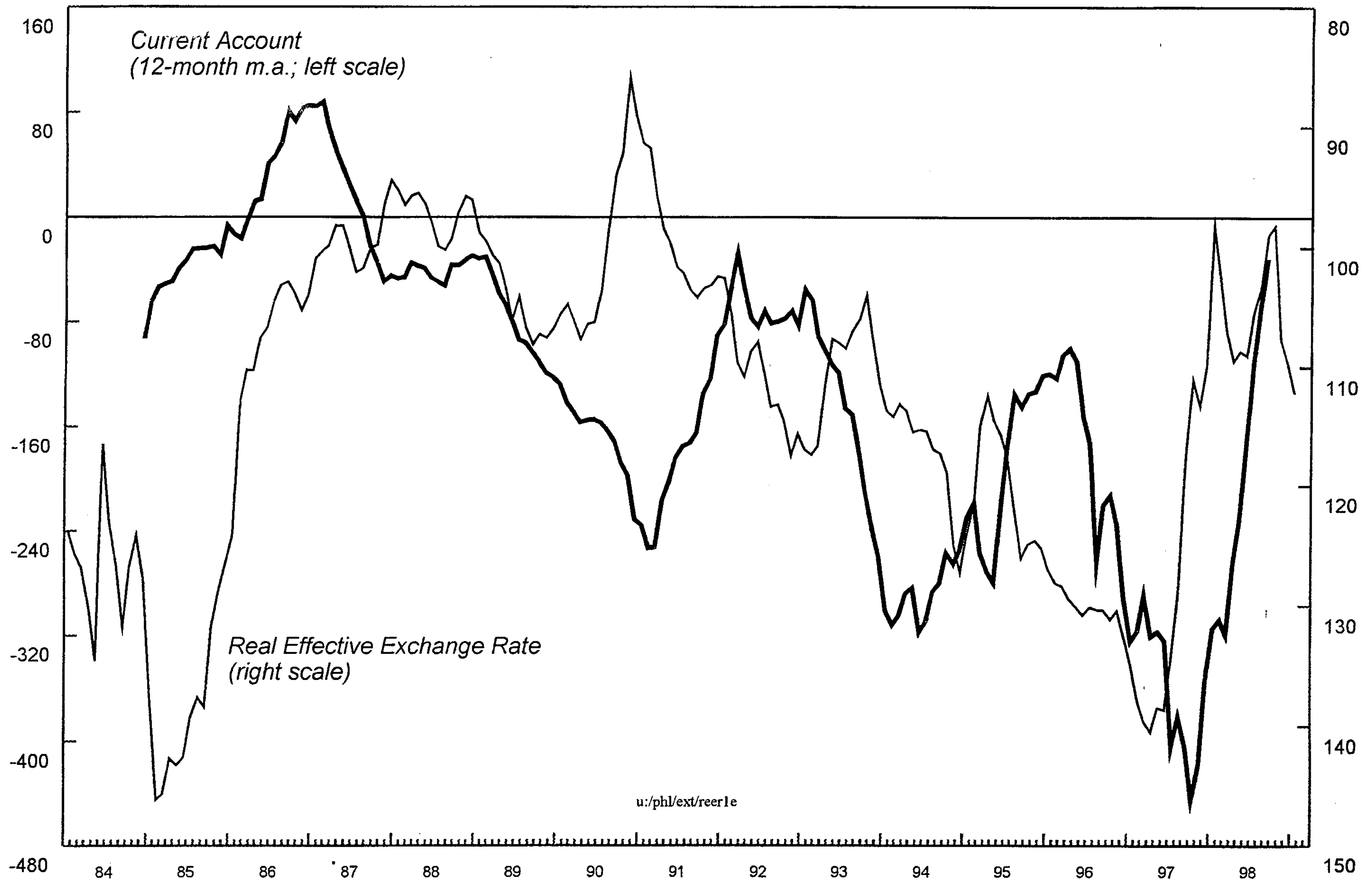


Sources: IMF INS; and Fund staff calculations.

1/ An upward movement indicates an appreciation.

Figure V.3. Current Account and Real Exchange Rate, 1984-99. 1/

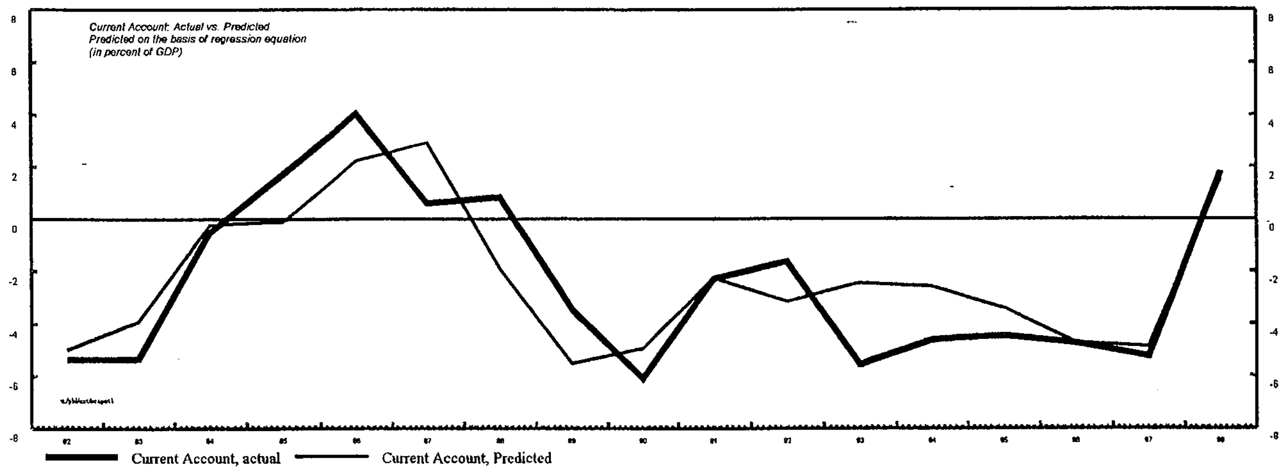
millions of US$ | 1990=100, inverse scale

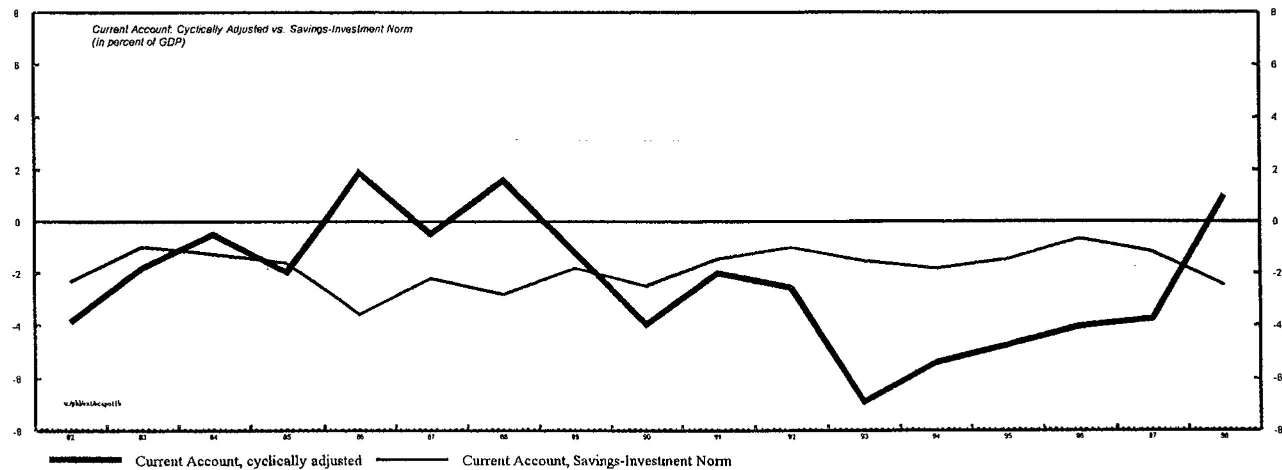


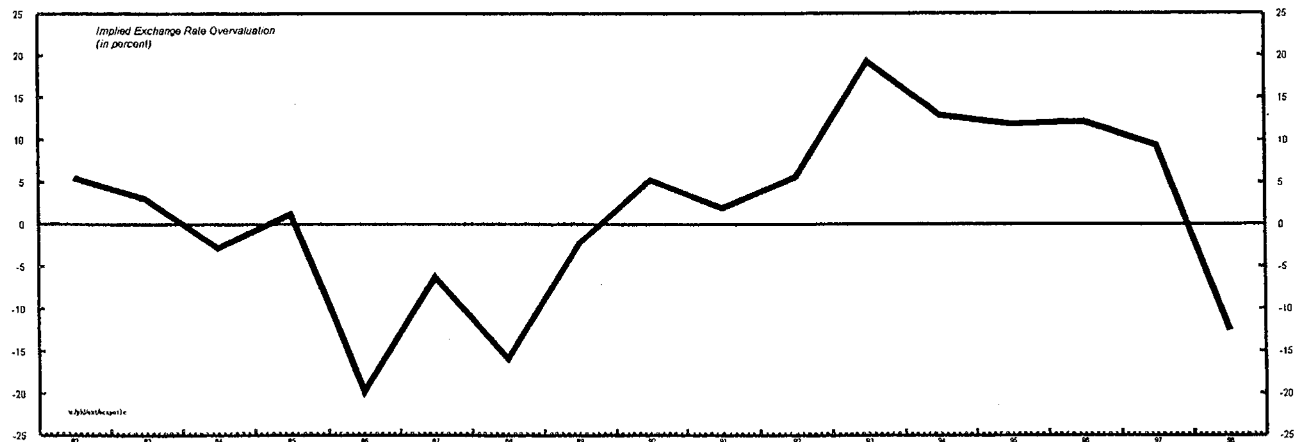
Sources: IMF INS; WEFA; and Fund staff calculations.

1/ An upward movement in the exchange rate denotes depreciation.

Figure V.4. Actual, Warranted, and Cyclically-Adjusted Current Account, and Implied Equilibrium Exchange Rate, 1982-98.





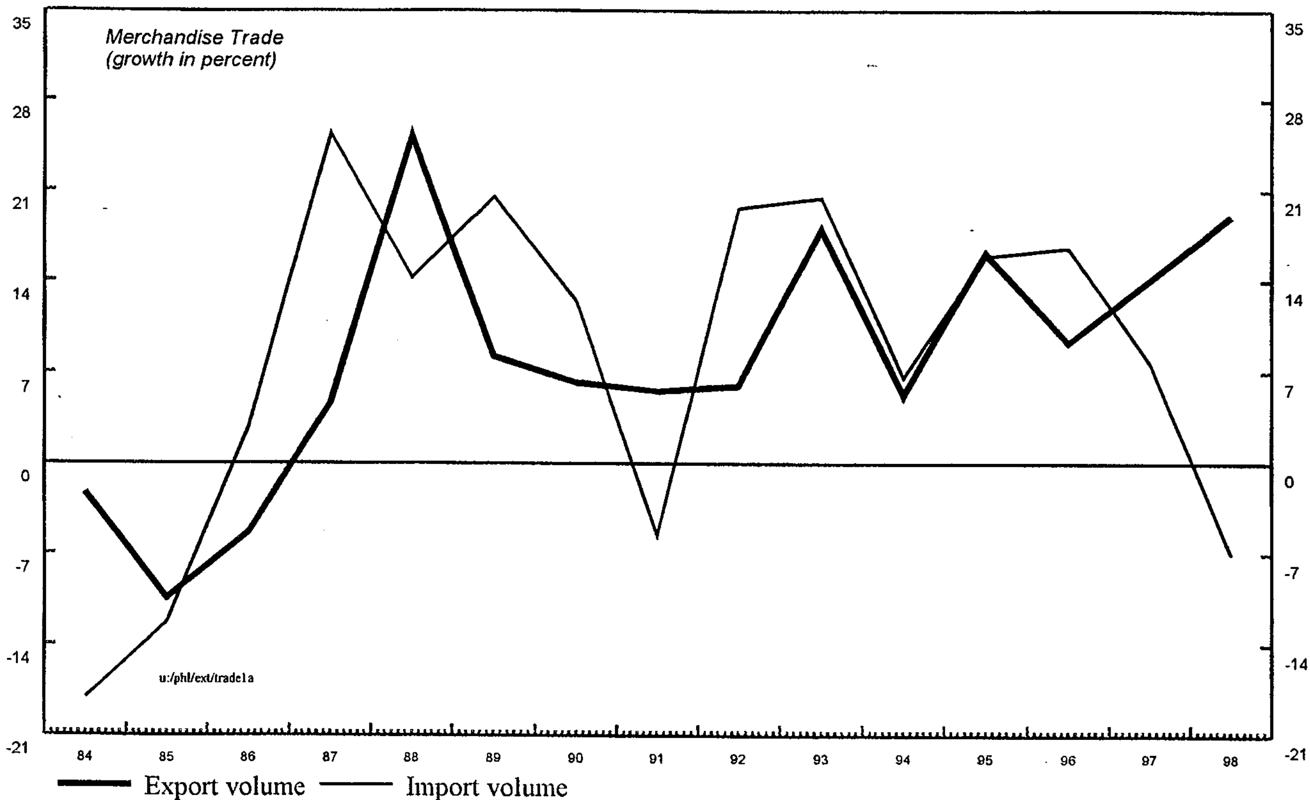


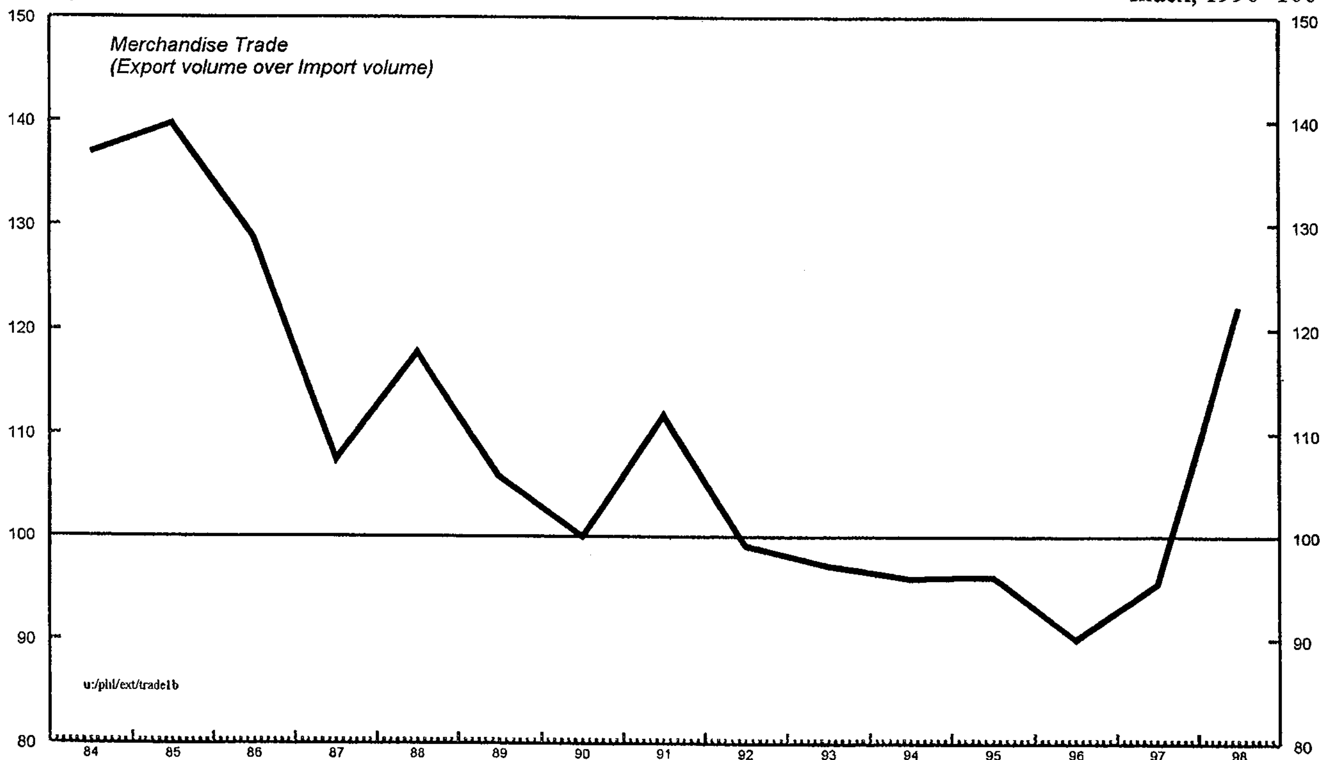
Source: IMF RES department, Philippine authorities, EIS, and Fund staff calculations.

1/ Predicted current account on the basis of regression estimates.

2/ Savings-Investment norm calculated using the CGER methodology.

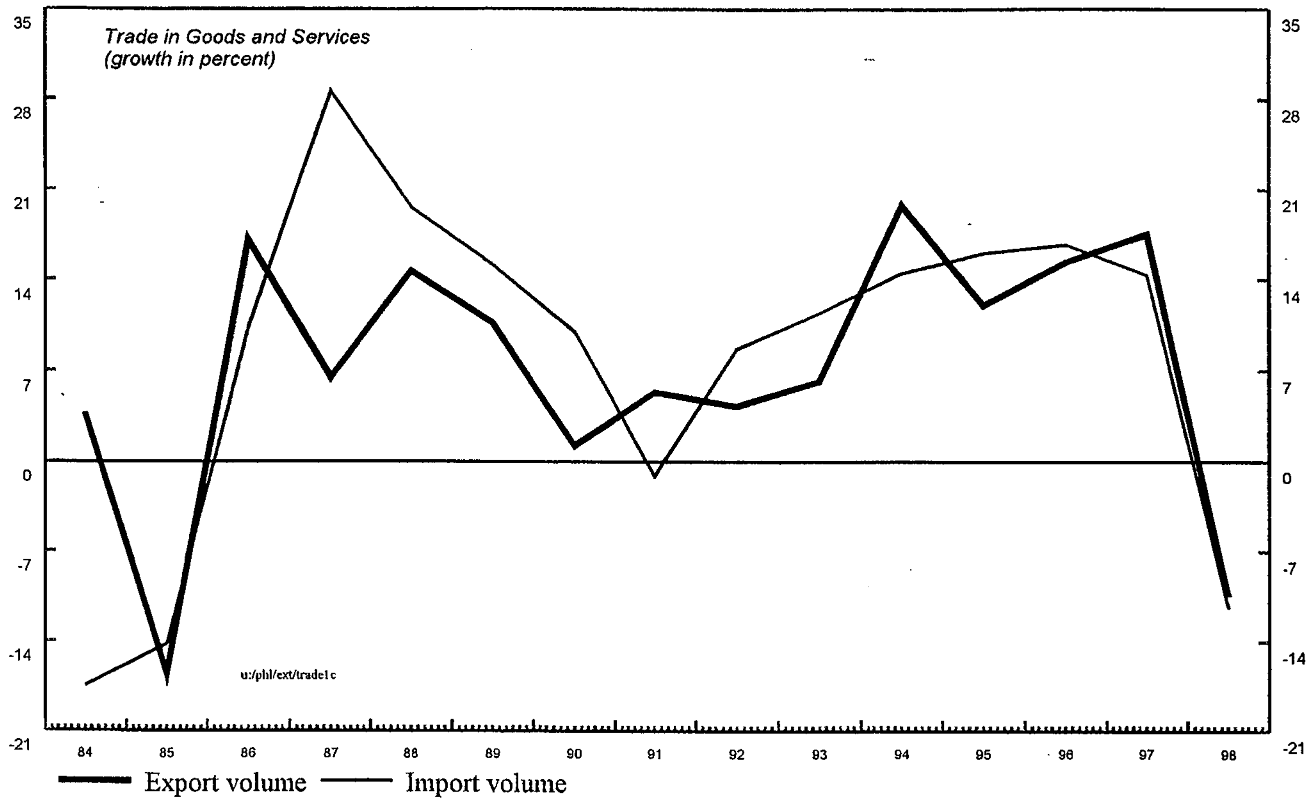
Figure V.5. Merchandise Trade Volume, 1984-98.

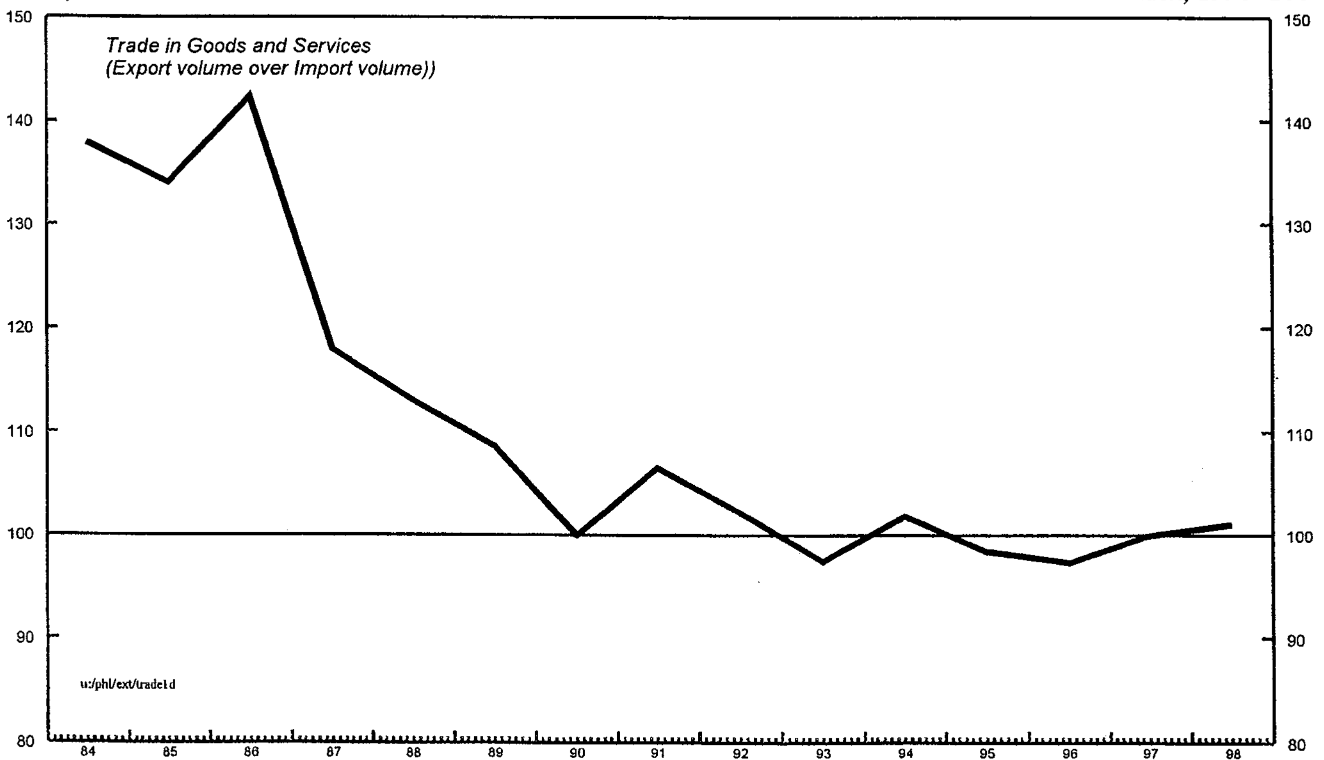




Sources: Philippine authorities, WEO, and Fund staff calculations.

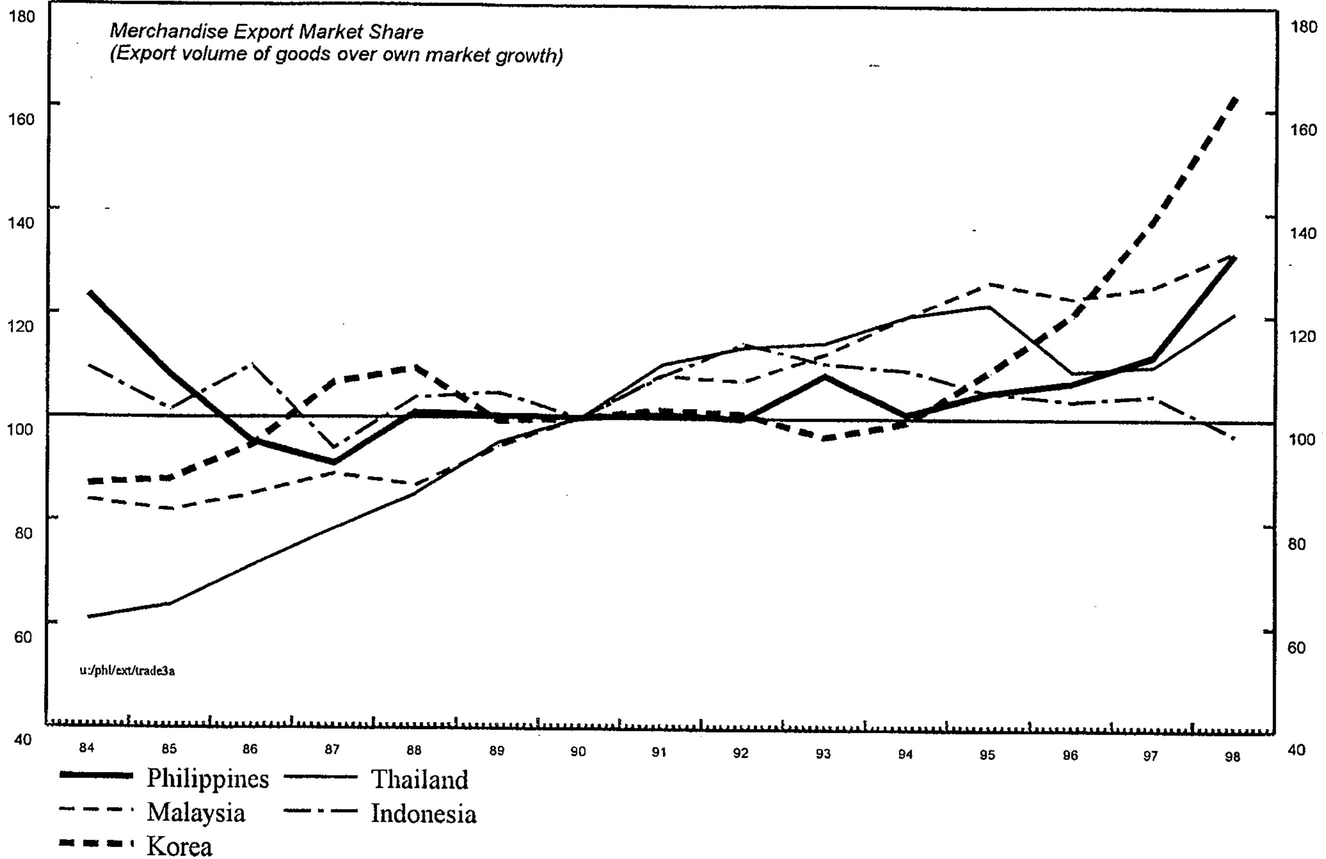
Figure V.6. Goods and Services Trade Volume, 1984-98.

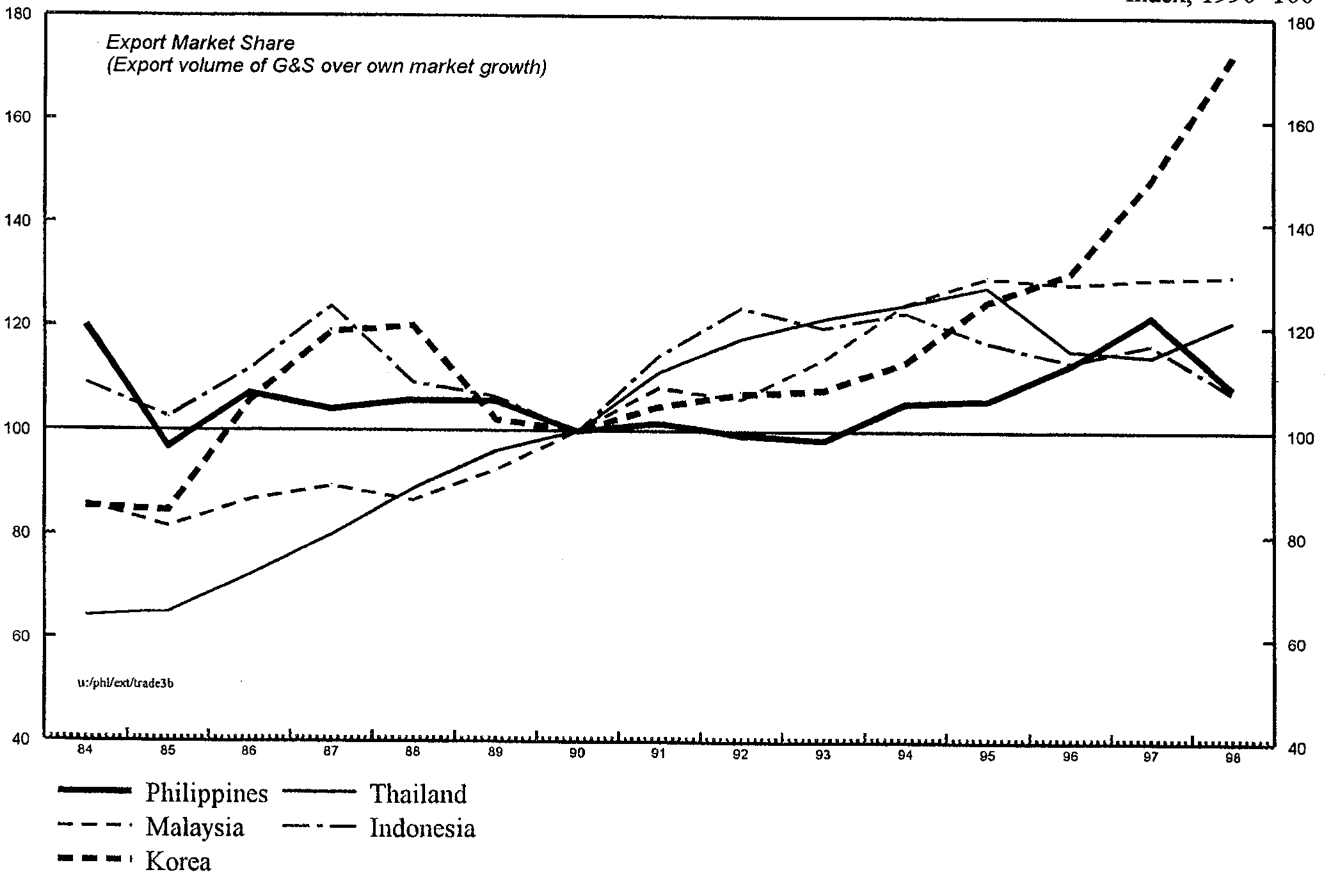




Sources: Philippine authorities, WEO, and Fund staff calculations.

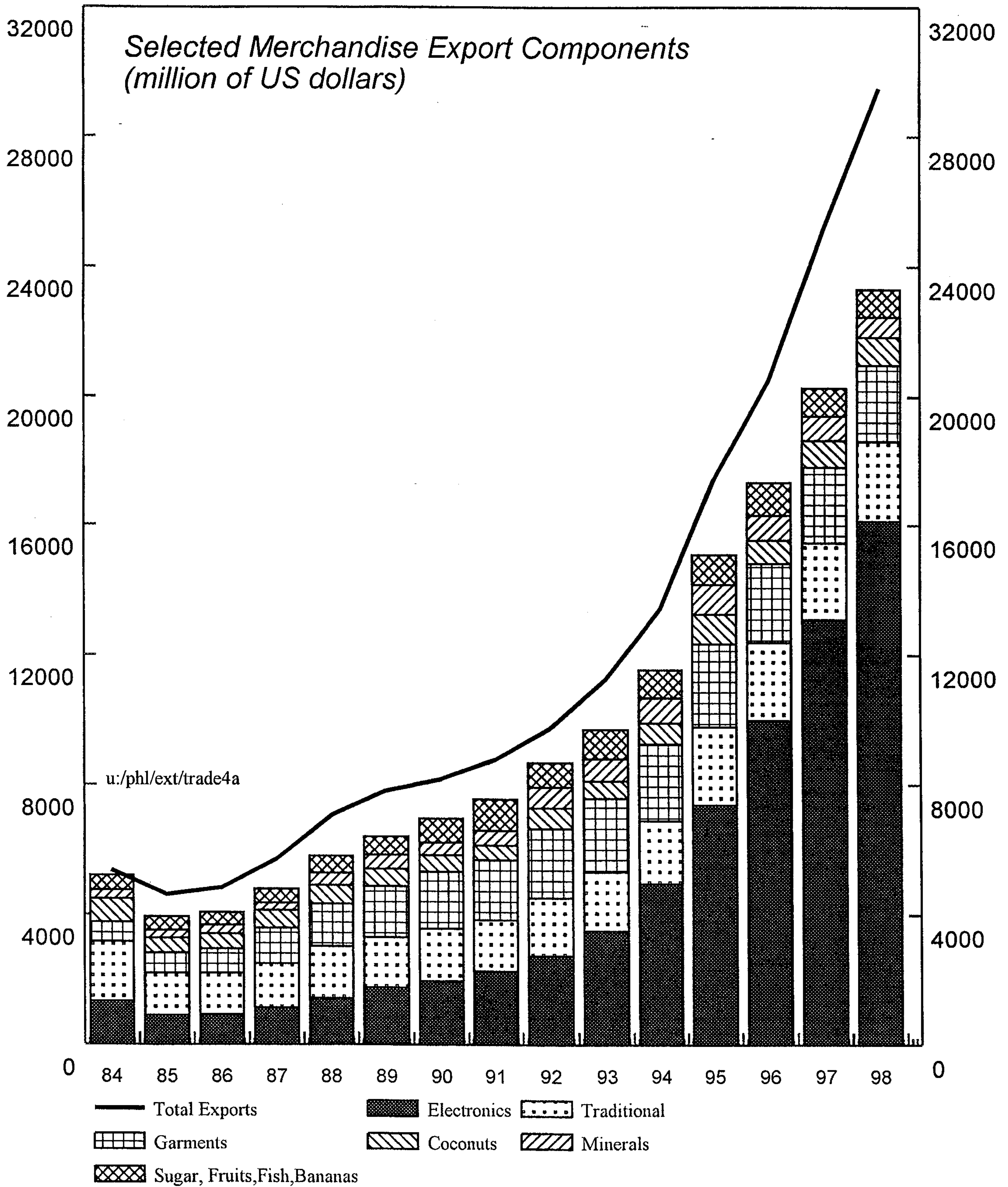
Figure V.7. Asian Export Competitiveness, 1984-98.





Sources: WEO, and Fund staff calculations.

Figure V.8. Selected Export Components, 1984-98.



Sources: Philippine authorities, WEFA, and Fund staff calculations.

VI. BANKING SYSTEM REFORM

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VI. BANKING SYSTEM REFORM[1]

A. Introduction

1. **Major improvements in financial and structural policies have played a key role in promoting the emergence of a modern banking system**. Historically, the banking sector in the Philippines has suffered from the strong cyclical movements of the economy, and numerous structural problems have acted as obstacles to efficient financial intermediation. However, this situation has improved noticeably in recent years. As the Philippine economy emerged in the 1990s, from a long period of stagnation and macro imbalances, the banking sector also became more efficient and more resilient against shocks. In particular, financial sector reforms since the mid-1980s have improved the system's ability to perform its basic functions of financial intermediation and facilitation of payment flows. Those reforms were directed mainly at encouraging greater competition, strengthening supervisory and regulatory systems, and streamlining the tools of monetary policy.

2. **Reforms of recent years have also helped shield the Philippine banking system from the worst effects of the Asian crisis in 1997–98.** Even so, the banks came under significant stress. The authorities responded with a program of further reforms to strengthen the capacity of banks to face adverse shocks and to reinforce the institutional framework to deal with troubled banks.

3. **The chapter is organized as follows**. Following a description of the Philippine banking sector in Section B, this chapter provides an overall assessment of its soundness (Section C), followed by an overview of previous efforts at financial sector reform (Section D). Section E discusses the authorities' current reform program put in place in response to the regional crisis. Finally, the last section summarizes the agenda for further reform.

B. Philippine Banking System

Size of the banking system

4. The banking system in the Philippines comprises 54 commercial banks,[2] 118 thrift banks, and 839 rural banks (see Box VI.1 for a description of the structure of the banking system). Total assets of the banking system amounted to over ₱ 2.8 trillion by end-1998, roughly equivalent to annual GNP. Commercial banks as a whole (expanded, non-expanded and foreign commercial banks) currently represent 90 percent of the banking system, up from 85 percent in 1991; thrift banks and rural banks account for 8 percent and 2 percent, respectively (Figure VI.1). There are also several kinds of nonbank financial intermediaries

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[1]Prepared by Enrique G. de la Piedra.

[2]One small commercial bank, Orient Bank, is now under receivership and is not operating.

(Box VI.2), although their importance is smaller than that of the banking sector. The Bangko Sentral (BSP) central bank is the main supervisory agency of the banking system (Box VI.3).

Box VI.1. Structure of the Philippine Banking Sector

There are five types of banks in the Philippines: universal banks (also called "expanded commercial banks"), commercial banks, thrift banks, rural banks, and government-owned banks. the difference between universal banks and commercial banks is that the former—which are the most important component of the banking sector—may underwrite securities and own equity in non-financial enterprises while commercial banks may not. Among universal and commercial banks, only one bank—the Philippine National Bank (PNB)—is partly owned by the government. Thrift banks—which include savings and mortgage banks, private development banks, and stock and savings associations—service mainly to the consumer retail market and small- and medium-sized enterprises. The rural banking system services the needs of the agricultural sector, farmers and rural cooperatives; rural banks are not allowed to issue mortgage certificates.

In general, foreign banks may operate in the Philippines at any time by acquiring up to 60 percent of the voting stock of an existing domestic bank or by investing in up to 60 percent of the voting stock of a new institution incorporated locally. In addition, foreign banks may set up branches in the Philippines, although the number of such branches has been capped at 14 since 1995, when ten foreign banks were authorized to set up new branches. The authorities have proposed a legislative amendment that, if approved, would allow foreign banks to invest in up to 100 percent of the voting stock of local banks in distress, although they would be required to reduce their ownership to 85 percent of the bank's stock after five years and to 70 percent after ten years. (This amendment may be further modified in the legislative process.) On average, foreign equity was just under one-fifth of total equity for universal banks, about 13 percent for commercial banks, and negligible in the case of thrift banks.

There are two fully government-owned banks, the Land Bank of the Philippines (LBP) and the Development Bank of the Philippines. These are specialized development banks, although they also undertake some commercial banking functions (mainly for their traditional clients). The mandate of the LBP is to promote the growth of the agricultural sector. The main activities of the DBP are the on-lending, on a wholesale basis, of official development assistance funds (which amounts to 60 percent of its lending) and retail lending in certain areas not attended by commercial banks—mainly environmentally oriented investment projects. Both banks provide financial services to the government and other official financial institutions, such as the Philippine Deposit Insurance Corporation (PDIC).

Box VI.2. Nonbank Financial Intermediaries

The nonbank financial system in the Philippines comprises a number of different institutions, including investment houses, financing companies, investment companies, securities dealers and brokers, fund managers, pawnshops, lending investors, non-stock savings and loan associations, building and loans associations, venture capital corporations, cooperatives, credit unions and insurance companies (see Lirio 1998). As of mid-1998, the nonbank financial intermediaries accounted for 18 percent of the financial system's assets and 8 percent of its liabilities (excluding the BSP). Of all these institutions, only financing companies and investment houses may be authorized by the Monetary Board to engage in quasi-banking business and are then referred to as quasi-banks; in this case, they are authorized to borrow funds for purposes of relending or purchasing of receivables, but are not permitted to issue deposit liabilities.

According to the provisions of the BSP Act, only the following will ultimately remain under BSP supervision: non-bank financial intermediaries with quasi-banking functions, trust or investment management authority, building and loan associations, non-stock savings and loan associations, trust companies, nonbank financial intermediaries which are subsidiaries or affiliates of banks or quasi-banks, and nonbank financial intermediaries, such as pawnshops, placed under BSP supervision in accordance with special laws. The supervision of insurance companies engaged in securities dealership or brokerage is the responsibility of the Office of the Insurance Commission and the Securities and Exchange Commission, although the BSP has supervisory authority over those insurance companies and dealers or brokers which are subsidiaries or affiliates of other supervised institutions.

Box VI.3. The Prudential Framework for the Banking System

According to the BSP Act, the ultimate authority in the area of bank licensing and supervision in the Philippines is the seven-member Monetary Board of the BSP, which is chaired by the Governor of the BSP. Within the BSP, the Supervision and Examination Sector (SES), headed by a Deputy Governor who reports directly to the Governor, is charged with the supervision of all banks operating in the country as well as all nonbank financial intermediaries authorized to perform quasi-banking functions. BSP guidelines require that all head offices of banks operating in the country, at least 50 percent of the branches of a bank, and at least 85 percent of a bank's total resources be examined on a yearly basis.

In addition to the BSP, the Philippine Deposit Insurance Corporation (PDIC) has some supervisory responsibilities. In particular, PDIC—which is charged with insuring deposits and rehabilitating or liquidating banks closed and placed under receivership by the Monetary Board—is also empowered by its charter to examine banks and to require them to submit relevant information. In the normal course of events, however, the PDIC makes extensive use of the supervisory information and findings of the BSP.

Trends in banking system activity

5. **With the liberalization of the banking environment and improvement in the business environment during the 1990s, banking activity increased at a brisk pace until the onset of the 1997 regional financial crisis.** Total deposits and loans of the banking system increased around 25 percent and 35 percent a year, respectively, during 1993 to mid-1996 (Figure VI.2). Thus, financial intermediation has deepened significantly in the Philippines, with the ratio of broad money to GDP nearly doubling from 34 percent in 1991 to 61 percent in 1997, and claims on the private sector rising from 18 percent of GDP to 56 percent during the same period. Nevertheless, the degree of financial deepening in the Philippines remains relatively low compared with other Asian countries affected by the regional crisis (Figure VI.3).

6. **From mid-1997, the growth of banking activity decelerated sharply and came to a virtual halt in 1998** (with total banking system loans contracting by 2 percent and deposits expanding by only 5 percent). The financial crisis and measures to strengthen the banking system prompted a more conservative lending posture of banks as they complied with new minimum capital and loan loss provisioning requirements in particular. Also, demand for credit slowed sharply with the slowdown of economic activity and higher interest rates.

7. **Mirroring the overall trends in banking activity, financial intermediation in foreign currency grew significantly—owing in part to the prevailing institutional advantages for bank operations in foreign currency[3]—followed by deceleration thereafter.** Total foreign currency deposits in the banking system expanded at a annual rate of 38 percent during 1994–96, reaching over US$16 billion in June 1997 (Figure VI.4). As a result, foreign currency deposits represented more than half of total bank liabilities, up from only 3 percent in 1990. Following the onset of the regional crisis, foreign currency deposits started to contract, falling by 17 percent between June 1997 and June 1998. Most of the banks' foreign currency liabilities are to domestic residents, which could make the system less vulnerable to capital flight than the banking systems of other Asian countries. Although nonresidents' deposits grew by 70 percent a year during 1994–97 and continued growing in the first half of 1998, they still accounted for less than 25 percent of total foreign currency deposits by June 1998.

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[3]See Nellor (1998). After a long period in which interest from foreign currency operations was fully tax exempt, it is now subject only to a 7.5 percent withholding tax (compared with 20 percent in the case of peso deposits). At the same time, profits from the banks' foreign currency deposit units (FCDU) operations are taxed at a 10 percent preferential rate on gross income, compared to the standard tax rate of 35 percent on net profit from other operations. Also, domestic banking activity is subject to the gross receipts and documentary stamp taxes, while transactions in foreign currency with non residents and with other FCDUs are exempt. Finally, while peso deposits are subject to significant reserve requirements, largely unremunerated, foreign currency deposits are not subject to reserve requirements.

8. **Banks' derivatives activity also grew fast in recent years**, although it remains concentrated in relatively simple contracts; around two-thirds of such activity is conducted by foreign banks. Derivatives transactions of the banks in their regular books and their FCDUs reached about US$8 billion and US$1.6 billion, respectively, as of mid-1998; almost the entire volume of banks' derivative transactions were foreign exchange derivatives, mainly nondeliverable forward contracts (NDFs).

Concentration and competition in the banking system

9. **The Philippine commercial banking system is highly concentrated**. The ten largest banks (which include nine domestic banks and one foreign bank) account for more than 55 percent of the banking systems' resources and demand liabilities. Domestically owned private banks in the Philippines have been traditionally owned by family-run industrial groups;[4] these families also have major interests in the nonfinancial sectors. The larger thrift banks are in some cases controlled by commercial banks; smaller thrifts are usually family-owned. Rural banks are either family owned or run as cooperatives.

10. **In order to increase competition in the banking sector, the authorities licensed ten new foreign bank branches in 1995**. As a result, competition increased in certain areas, such as project and trade finance, top-tier corporate customers, and wholesale portfolios. However, owing in part to limitations on the activities of foreign banks,[5] domestic banks remain dominant in the retail banking sector, although they face some degree of competition from the smaller thrift and rural banks which enjoy tax and reserve requirement advantages.

C. Soundness of the Banking System

11. **The Philippine banking system is, on average, well capitalized**. Nonetheless, banks have suffered significant stress following the onset of the regional crisis in mid-1997. After a brief description of the main effects of the Asian crisis on the banking sector, this section discusses the soundness of banks based on three indicators: capital adequacy, the quality of the asset portfolio, and earnings and profitability.

The banking sector in the wake of the Asian crisis

12. **The banking sector come under stress during 1997–98**. Owing to the effects of the regional crisis and major drought, starting in 1997, economic growth in the Philippines slowed, the peso depreciated, interest rates increased, and corporate profits declined. As a result, since mid-1997 the quality of bank assets deteriorated, capital adequacy weakened, and bank lending slowed sharply. Banks' recourse to central bank emergency lending

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[4]See Fry (1988) and Tan (1993).

[5]The number of branches that foreign banks are authorized to open cannot exceed six, while their borrowing from head offices cannot exceed US$4 for every US$1 of domestically held capital.

increased from ₱ 4.5 billion at end-1997 to a peak of P14.3 billion in May 1998. The external shock of the crisis interacted with domestic vulnerabilities that had built up in the years preceding the crisis. In particular, there was rapid credit growth with growing exposure of the banking sector to real estate activities and unhedged foreign currency borrowing. These problems were particularly acute in the case of smaller commercial banks, thrift banks and rural banks, owing to the characteristics of their asset portfolio,[6] weak credit management systems, and generally slower response to the rapidly changing environment.

13. **However, owing in part to past reforms (described below) the financial condition of the Philippine banking system has remained better than in several of the neighboring countries, and major bank failures have been avoided.**[7] The recent tightening of prudential standards has helped improve this even further. Compared with countries in the region, banks in the Philippines are better capitalized—especially at the top end of the market—the corporate sector is less leveraged, and the real estate boom was not as long or as pronounced.[8] At the same time, following the onset of the crisis, banks have stepped up credit collection efforts, reduced higher-risk exposures, and reappraised lending strategies, which should support an early recovery of bank lending.

Capital adequacy

14. **The banking system's overall capital adequacy increased during 1998**, reaching 17.6 percent by end-December. This increase reflected the slowdown in asset growth, concentration of new lending in zero-risk assets (government paper) and new minimum capital requirements (see below). This improvement followed a gradual decline of capital adequacy ratios since 1992 that had reflected the very rapid growth of bank assets during the period. The current level of capital adequacy is well above the minimum regulatory

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[6]Real estate loans, lending to small businesses, and consumer loans figure more prominently in the portfolio of these banks, compared with bigger banks which tend to have a more diversified portfolio.

[7]Since the start of the current difficulties in the financial sector, one small commercial bank, seven thrift banks, and 18 rural banks have failed; however, the combined size of these banks' assets is very small—less than 1 percent of the assets of the banking system—and thus their problems have not had any systemic implications.

[8]Property demand in the Philippines was flat during 1989–94, which in turn prevented a boom and subsequent oversupply of real estate projects (the office vacancy rate in Manila by early 1997 was around 2 percent, compared to about 12 percent in Jakarta and Bangkok). At the same time, the prevalence of pre-sold projects helped limit large-scale reliance on bank finance for real estate purposes. In addition, the BSP in 1997 took measures to limit bank lending for real estate projects.

requirement of 10 percent,[9] which is somewhat higher than in most Asian countries (Figure VI.5). On average, all classes of banks enjoyed healthy capital adequacy ratios; among large banks, all except one have capital adequacy ratios in excess of 10 percent.

Asset quality

15. **The ratio of nonperforming loans (NPLs) to total loans reached 11 percent in December 1998,**[10] compared to a level of only 4 percent in June 1997. The ratio is much higher among thrift banks and rural banks than in the case of commercial banks. The worsening of prudential indicators over the past two years reflects both the deterioration in asset quality as a result of weakening economic conditions, and the tightening of prudential standards which has made the degree of loan portfolio impairment more transparent (Figure VI.6).

Earnings and profitability

16. **Bank earnings have declined significantly since 1997**, reflecting both the general slowdown in the business environment as well as the need to meet the new general and specific loan loss provisioning requirements. For the banking system as a whole, the average return on equity (ROE) declined to 0.37 percent in June 1998, from 1.66 percent in 1997 and an average of over 2.3 percent during 1990–96. At the same time, the ratio of operating expenses to operating income reached 90 percent.

D. Financial Sector Reforms Prior to 1997

17. **After a major financial and balance of payments crisis of the early 1980s, the authorities started a process of financial sector reform that intensified in the early 1990s and set the stage for the dynamic expansion of the financial sector since then**. These measures were aimed at strengthening the operations of the banking system by improving the regulatory environment, enhancing competition, and liberalizing the financial environment. In the initial stage, interest rates were liberalized, controls on foreign currency operations were eased, and the central bank streamlined its monetary policy instruments. At the same time, universal banking was introduced and minimum capital requirements were raised.

18. **Throughout the 1980s, the financial sector suffered from the lingering effects of the 1982–83 crisis**. The crisis had severely affected the health of the financial system,[11] and

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[9]For capital adequacy, the BSP has adopted a net worth-to-risk asset ratio which measures capital in relation to the degree of risk of different categories of assets. The risk weighting methodology includes two weights: zero for highly liquid assets and 100 percent for the remainder of the balance sheet items, i.e., fixed assets, loans, and investments.

[10]The ratio increased further to 13.1 percent in March 1998.

[11] See Nascimento (1991).

led to a contraction of almost 60 percent in real terms of banks credit to the private sector between 1982 and 1986. In turn, the central bank provided significant levels of financial assistance to troubled banks. Also, weak financial and nonfinancial institutions were taken over by the government-owned banks, while the Philippine National Bank and the Development Bank of the Philippines were rehabilitated and restructured, in part by transferring their non performing assets to an agency created especially for this purpose.

19. **Starting in the early 1990s, the authorities intensified the reform effort**. A centerpiece of this effort was the restructuring and recapitalization in 1993 of the central bank, which had become technically insolvent following the crisis of the 1980s. The new central bank (the BSP) also was granted substantial independence from other branches of government. In addition, the authorities eased restrictions on the entry and operation of banks to increase competition and strengthen the banking system. Ten new foreign banks were licensed to operate in the country (in addition to the four already operating) and foreign banks were authorized to purchase up to 60 percent of the equity of local bank; and the bank branching policies were liberalized. The authorities also tightened prudential regulations, including through higher minimum capital requirements and a liquid asset requirement on FCDU loans. Finally, several measures were adopted to reinforce the legal framework, including in the areas of banks' derivatives trading, thrift banks, and rural banks.

E. 1998–99 Reform Program

20. **Banking sector reforms were strengthened to face the problems arising from the regional crisis that broke out in 1997**. The authorities in early 1998 adopted a comprehensive banking sector reform program aimed at strengthening banks' capacity to withstand shocks and enhancing the authorities' ability to deal with banks in financial difficulties. The strategy, developed in collaboration with Fund and the World Bank,[12] envisaged a decentralized private-sector led improvement of bank balance sheets and risk management practices, encouraged by a tightening of prudential and supervisory standards and development of a more transparent bank exit and resolution strategy. A separate (government-led) plan was designed to deal with the Philippine National Bank (the largest bank in distress, with 46 percent government ownership).

Bank supervision and regulation

21. **Despite significant improvements in the supervisory framework prior to the onset of the Asian crisis, serious weaknesses undermined the effectiveness of bank supervision**. The main issues related to the prudential standards in place, supervisory skills and practices, and enforcement of the bank regulatory and supervisory framework. In particular:

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[12]Banking sector reform is a major component of the program supported by the current stand-by arrangement with the Fund, and the World Bank in December 1998 approved a Banking Sector Reform Loan (BSRL).

- Even if average bank capital levels remained adequate, capital adequacy ratios had been declining since 1992. At the same time, average capital adequacy levels disguised the presence of individual institutions—especially smaller ones—that suffered from low capital levels.

- Loan classification and provisionary standards deviated from best supervisory practice, in several respects. In particular, collateralized substandard loans were not being provisioned for, and banks were not required to make general loan loss provisions.

- The supervisory methodologies used by the BSP were outdated and not geared to the assessment of risk.

- Additional shortcomings were present in other areas of supervisory responsibility, including disclosure of information, bank licensing, and bank accounting practices.

To address the weaknesses in the regulatory and supervisory framework, the authorities took a set of measures to strengthen the position of the banks as well as the ability of the BSP to supervise them, along the lines of best international practice. The full implementation of these measures will be of key importance in ensuring the continued soundness of the banking system.

Minimum capital and loan loss provisioning requirements

22. **To strengthen the ability of banks to deal with adverse shocks, the authorities announced an ambitious plan to increase bank capital and enhance provisioning by banks against substandard loans.**

- An increase in minimum capital requirements for banks through end-2000, with intermediate levels for end-1998 and end-1999, was announced in March 1998.[13] At the same time, the lower capital adequacy ratio of 8 percent (instead of the usual 10 percent) in place for certain universal banks was phased out in January 1999.[14]

- New loan loss provisioning requirements, following the tightening of loan classification guidelines, were announced on October 1997.[15] The new provisioning requirements are generally in line with best international practice and those in place in other Asian countries. Banks are now required to make a general loan loss provision (gradually rising

[13]Circular 156 of March 19, 1998, BSP, Office of the Governor.

[14]Circular 168 of July 3, 1998, BSP, Office of the Governor.

[15]Monthly installment loans are now to be considered non performing after three months in arrears rather than six, whereas quarterly-installment loans are to be treated as non performing after one quarter in arrears rather than two.

to 2 percent by October 1999)[16] as well as specific loan loss provisions for "especially mentioned" and collateralized substandard loans.

Supervision methodologies

23. **Fundamental changes have been initiated in the focus and methodology of bank supervision, to enhance the capacity to assess the health of individual banks and to detect cases of bank distress early on.**

- The BSP is changing the focus of supervision from a purely compliance-based and check list-driven process to a forward-looking and risk-based framework. This change has been well-received by the banks. The examination process is being reoriented to assess the various elements of risk, and the systems used by banks to manage those risks, (including liquidity, interest rate, and foreign exchange risks, as well as risks arising from off-balance sheet activities).

- Improvements have also been made in bank rating methodologies. The CAMEL rating system[17] has been revised to ensure that the composite rating will never be better than a bank's individual factor rating for capital adequacy.[18] In addition, as of July 1998, "sensitivity to market risk" has been added to the traditional CAMEL rating system.[19] Also, the composite rating system will be based on the weighted sum of the component ratings, with weights depending on the size, complexity of activities and risk profile of the institution being rated. Examiners are also starting to use qualitative analysis to determine the component ratings.[20] Finally, a revised examination format has been introduced,[21] to replace the very detailed examination report in use until recently.

- The authorities have initiated action to undertake consolidated supervision of financial conglomerates. An amendment of the General Banking Act has been submitted to Congress that would impose consolidated capital requirements and extend consolidated supervision of financial institutions to include their interests in non-financial ventures. As a preliminary step, the BSP is conducting consolidated supervision of banks and quasi-

[16]In April 1999, as a measure to encourage new lending by banks, the stock of loans above the end-March 1999 level was exempted from the general loan loss provision.

[17]"CAMEL" stands for Capital, Assets, Management, Earnings, and Liquidity.

[18]Supervision and Examination Sector Order 3, of March 6, 1998.

[19]The rating system is now called CAMELS.

[20]Supervision Guidelines No. 98–7, of May 22, 1998.

[21]Supervision and Examination Sector Order No. 10 of November 28, 1997.

banks based on the inclusion of their financial subsidiaries and affiliates.[22] The authorities have also started to compile a list of the laws and regulations that would need to be modified to fully implement consolidated supervision.

- External auditors have been required to report to the BSP all matters that could adversely affect the financial condition of a bank. In this regard, the authorities will begin a system of accreditation of external auditing firms that banks are authorized to hire for the examination of their balance sheets. If an auditing firm fails to properly inform the BSP on the problems of a bank, it would be "blacklisted" by the Monetary Board (for a period during which banks would not be permitted to engage its services).

Other supervisory issues

24. **Several other initiatives have been taken to strengthen the soundness of the banking system and the BSP's ability to monitor it**.

- To enhance transparency and market discipline, banks listed by the Philippine Stock Exchange are now required to disclose publicly, on a quarterly basis, the level of NPLs, the ratio of NPLs to the total loan portfolio, the amount of classified assets and other risk assets, and the extent of specific and general loan loss reserves.[23]
- Stricter licensing guidelines for new banks have been in place since July 1998.[24] Also, the BSP has announced that it will impose higher profitability guidelines on thrift banks and rural banks wishing to set up additional branches.
- To improve banks' accounting practices, the BSP has required them to mark to market their trading securities portfolio.[25]

Bank exit and resolution

25. **Traditionally, there have been several impediments to a smooth process of bank exit in the Philippines**. Bank supervisors have been hampered by the lack of immunity for actions related to the discharge of their responsibilities and by bank secrecy regulations. The Monetary Board typically has not been subjected to specific time limitations governing the different steps that it must take before placing a bank under receivership. Also, the BSP

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[22]Monetary Board decision 553 of April 15, 1998, BSP.

[23]Circular 157 of March 19, 1998.

[24]Monetary Board Resolution 832 of June 10, 1998, BSP.

[25]Circular 161 of March 30, 1998.

could suffer financial losses if a decision is taken to close a bank.[26] Finally, the Philippine Deposit Insurance Corp. (PDIC) has been constrained in its role as *receiver* (because it cannot dispose of the assets of a bank under receivership as soon as it is closed), in its role as *insurer* (because the secrecy law prevents it from accessing vital deposit information before a bank is closed), and in its role as a *liquidator* (because it cannot proceed rapidly and on a timely basis mainly because of the inefficiency of the judicial system).

Recent measures to enhance bank resolution

26. **A number of measures have been adopted to enhance the BSP's ability to deal with troubled banks**. As a result, the BSP is now better prepared to identify early on cases of bank distress, and have better instruments to deal with banks that develop problems. Also, steps have been taken to enhance the role of the PDIC as receiver, and to reduce the financial risk for the BSP associated with bank closures.

- To permit early detection of problems, the BSP has compiled a list of banks in potential distress.[27] On the basis of this list, which is updated regularly, the BSP has adopted a program of intensified monitoring and special examinations of selected banks. The Monetary Board has allowed the supervision services of the BSP to conduct such special examinations without the need for specific previous authorization.[28]

- The BSP has issued a matrix of sanctions and a matrix of corrective actions to be taken according to the degree of capital shortfall of individual banks.[29] Also, the BSP has issued harsher nonmonetary penalties to deal with banks that are in violation of supervisory rules, and has submitted draft legislation to allow for a ten-fold increase in the current value of monetary penalties. The BSP has formulated contingency plans to deal with any systemic bank problems, in cooperation between the PDIC and the Department of Finance.

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[26]Such losses may arise from three sources: uncollateralized overdraft lending to a troubled bank; inability by the BSP to execute the collateral backing emergency loans to banks—in part owing to valuation problems; and the fact that, in the event of insufficient resources, the PDIC has unlimited access to BSP credit.

[27]The list is compiled on the basis of forward- as well as backward-looking indicators.

[28]In principle, no bank can be inspected more than once a year without authorization of the Monetary Board. However, the Monetary Board has granted a blanket authorization to conduct bank inspections on a rolling six-month basis. An amendment to the BSP Act has been proposed to make this authorization permanent.

[29]Circular 176 of September 7, 1998 and Circular 181 of November 15, 1998.

- To improve the ability of the PDIC to act as the receiver of banks, it has been determined that once the PDIC recommends that a bank be liquidated, the Monetary Board will approve the liquidation within 10 days. Also, the authorities are proposing legislation that would allow it to sell distressed bank assets to pay for the administration costs related to receivership.

- The Monetary Board has approved additional guidelines for emergency loans to banks. These guidelines—which restrict the activities of the bank concerned, halt the distribution of dividends, and impose certain obligations on the banks' owners and officers—reaffirm the fully collateralized nature of emergency loans, and represent an important step forward in insulating the BSP from the risk of financial loss. The BSP is also are aware of the risk of financial loss arising from uncollateralized overdrafts to banks, and has submitted a proposal to amend the BSP Act to eliminate this practice. In the meantime, the BSP has issued regulations to require thrift banks to provide collateral against all BSP overdrafts,[30] and intends to issue similar regulations for commercial banks.

PNB

27. **Strengthening the PNB on a sustainable basis is an important part of the authorities' banking reform program**. The Philippine National Bank (PNB), the second largest bank in the country and partially owned by the government, suffered to a greater degree than other banks from the fallout of the regional crisis (see Box VI.4). The authorities have announced publicly their intention to privatize the bank by mid-2000, the latest. In the meantime, PNB has moved to write down its capital from ₱ 22 billion to ₱ 5 billion to reflect the impairment of its assets, while at the same time constituting additional loan loss provisions and phasing out obsolete information systems. PNB management intends to recapitalize the bank through the sale of undervalued assets, and possibly a rights issue to existing owners during 1999.

F. Initial Results and Agenda for Further Reform

28. **Implementation of the banking reform program adopted in early 1998 has been largely on track, and initial results are positive**. Banks are seeking market-bases solutions to capital deficiencies (including fresh capital infusions and merges), and loan loss provisions have been strengthened significantly. Corrective supervisory action, supported by appropriate sanctions, has encouraged the pace of resolution. These measures included memoranda of understandings with noncompliant banks (regarding minimum capital requirements), supervision of certain banking activities, down-grading of licenses, and closure of banks. As a result, while the financial condition of banks had deteriorated over the past year, the situation is under control.

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[30]Circular 163 of April 8, 1998 and Implementing Guidelines of September 3, 1998.

Box VI. 4. PNB

PNB, established in 1916, has over 320 branches and accounts for about 10 percent of the banking sector's assets. It is the country's largest bank in terms of liabilities and the second largest in terms of assets. However, it lags behind industry leaders in a number of areas, including credit and risk management policies and the degree of automation of its operations. In June 1996, the government reduced its ownership in PNB from 100 percent to 45.6 percent. The stock in private hands is widely dispersed.

PNB's financial performance has deteriorated significantly in the last few years, following a series of large corporate loan defaults (including Philippine Airlines (PAL)). Return on assets remains the lowest among the large banks in the country. The difficulties of PNB were exacerbated by the onset of the 1997 regional financial crisis and the accompanying devaluation of the peso and economic downturn. PNB was particularly vulnerable because it had lent aggressively in foreign currency; at about 35 percent of total loans, it had the highest proportion of credit in foreign currency among the large banks. Also, the bank is highly exposed to the property sector (14 percent of its loan portfolio). After a drop in net income of 75 percent in 1997, compared to an average increase of 10 percent in the net income of the four other largest banks in the Philippines, financial results in 1998 continued to worsen. [Net loss of ₱ -- billion].

In early 1999, provisions of ₱ 8.9 billion (about 7 percent of the loan book) were constituted retroactively for 1998; obsolete information systems were written off; the cost of unfunded pensions and retrenchment packages were explicitly allowed for; and capital was written down from ₱ 22 billion to about ₱15 billion, reducing the CAR to about half the required 10 percent. Management of the bank has indicated its intention to remedy the capital shortfall through the sale of undervalued assets (including its headquarters building) and a rights issue.

29. Looking ahead, to further strengthen the soundness of the system and reinforce supervisory capabilities, continued reforms should focus on: (i) reducing distortions in financial intermediation; (ii) further strengthening the prudential framework; (iii) streamlining the process of bank exit and resolution; and (iv) the PNB.

Reducing distortions in financial intermediation

30. **Although important steps to improve the efficiency of financial intermediation have been taken, further progress is needed**. In particular, the authorities should:

- **Eliminate the bias in the tax system and in the regulatory framework** against financial intermediation in pesos.[31] This would help reduce vulnerability to exchange rate volatility and lower costs of peso intermediation.

[31] See footnote 3 above.

- **Reduce and avoid frequent changes in reserve requirements**. Since reserve requirements are mostly nonremunerated, they impose a tax on financial intermediation. In addition, their frequent modification imposes a cost n the banks as they adapt their balance sheets and could result in banks' permanently holding excess reserves.[32]

- **Eliminate mandatory credit allocation programs, to avoid misallocation of resources**.[33] Currently, banks are required to lend 25 percent of their credit to agriculture and agro-processing industries and 10 percent to small- and medium-sized enterprises.

- **Allow further foreign participation in the banking sector**. Additional top-rated international banks should be allowed to open branches in the Philippines, and existing limits to the expansion of such branches should be liberalized (including limits on foreign ownership of local banks, the number of branches that foreign banks can open, and restrictions on financing from abroad for foreign banks).

Strengthening the prudential framework

31. **The BSP should continue to implement the strengthened prudential framework rigorously**. In particular, it should:

- Enforce full and prompt compliance with minimum capital and loan provisioning requirements. Noncompliant banks should be subject to the procedures for prompt corrective action approved by the Monetary Board.

- Prudential forbearance and pressures to dilute the new standards for loan provisioning, classification standards, and disclosure requirements should be resisted. The two-percent general provision requirement, and the recent exemption of incremental loans, should be reviewed at an early date.

- Specific loans loss provisions should be made tax deductible, and in accordance with best international practice.[34]

Banks' vulnerability to exchange rate volatility

32. **Continued strengthening of prudential standards will be critical to the management of cross-border flows and associated risk**. Banks are subject to caps on their

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[32]See Hardy (1997) for a discussion of the drawbacks of reserve requirements as an instrument of monetary control.

[33]See Alexander, Baliño and Enoch (1995) for an analysis of the adverse effects of directed credit and other direct instruments of monetary policy.

[34]See Escolano (1997) for an analysis of the tax treatment of loan losses and loan reserves of banks.

overbought and oversold foreign exchange positions and to cover requirements for their foreign currency liabilities. In addition, banks should maintain adequate assets to cover for all foreign currency liabilities, as well as appropriate control and reporting systems regarding their foreign exchange exposure. Banks should be asked regularly to submit detailed information on their foreign exchange transactions, including positions by currency and maturity of the spot and forward books. At the same time, additional prudential requirements should be market-based and compatible with maintaining an open capital account.

Supervisory resources and training

33. **BSP supervisory resources should be focused on supervision of large banks.** Although expanded commercial banks make up more than two thirds of the banking system's assets, only about one-quarter of BSP supervisory staff is involved in their supervision (while more than one-third is dedicated to supervising rural banks–which account for 2 percent of total assets). Of course, the necessary focus of resources on larger potential problem banks needs to be balanced against the need to enforce prompt corrective action vis-à-vis all noncompliant banks.

34. To ensure the successful implementation of modern supervisory methodologies, BSP and PDIC supervisory staff should continue to receive intensive training in the area of risk-based supervision, including assessment of risk, appraisal of banks' risk management, and forward-looking assessment of banks.

Legal protection for bank supervisors

35. **It would be desirable to clarify the protection for bank supervisors by way of clear and explicit legal statute.** Although in principle no public officer in the Philippines is civilly liable for official acts, unless there is a clear showing of bad faith, malice, or gross negligence,[35] the courts have allowed civil laws suits to be brought against individual bank supervisors in connection with such acts.

Bank secrecy

36. **Current legislation on bank secrecy should be modified, to bring bank supervisors within the perimeter of the law.** The present situation is at variance with best international practice; it prohibits banks from releasing any information on their deposit accounts, except when the depositor authorizes it or under a court order. As a result, the supervisory authorities do not have detailed information on the banks' primary funding source. The law also impedes speedy resolution of bank failures as the PDIC has no information on individual depositors prior to closure of the bank.

[35]Executive Order No. 292, July 1987.

Banks' trust activities

37. **The BSP should clarify the relationship between trust accounts and the bank,** including regulations on conflict of interest. There is a widespread perception among bank clients that a banks' trust activities are fully guaranteed by the parent bank.

Streamlining the process of bank exit and resolution

38. The framework for bank resolution must be strengthened further.

- As soon as bank is placed under receivership, the PDIC should be able to resolve it as soon as possible to avoid a further deterioration in the value of the bank's portfolio. In particular, the PDIC should be authorized to swiftly carve out bad assets from a bank under receivership, to improve the chances for a quick sale to a new owner.

- To enhance transparency, just as PDIC receivership is subject to time limits (up to 90 days),[36] it would be useful also to set time limits for the Monetary Board's actions in the area of bank resolution.

- Banks should not be allowed unilaterally to declare "bank holidays," (suspension of operations) without full intervention by the supervisory authorities. In line with best international practice, any bank that declares a bank holiday should be immediately placed under receivership or conservatorship.[37]

- To limit the risk for the BSP arising from financial assistance to troubled banks, all forward emergency assistance should be fully collateralized, and the limit on emergency loans related it to the size of a bank's capital rather than deposits.[38]

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[36]Extendable five times by an additional 30 days each, through Monetary Board Resolution.

[37]The BSP can use two institutional arrangements to oversee operations of banks in trouble that have not yet been closed. A comptroller is named automatically when a bank is granted an emergency loan. However, the powers of the comptroller are very limited, involving only reports to the Monetary Board but without authority to override the decisions of the bank's board. Conservatorship is a more powerful arrangement, as the conservator has the authority to override the decisions of the bank's board and management.

[38]Currently, emergency loans are capped at 50 percent of deposits., there is a strong element of moral hazard because a bank in distress has an incentive to increase its deposits by any means possible—and thus further complicate its difficulties—before approaching the BSP for an emergency loan.

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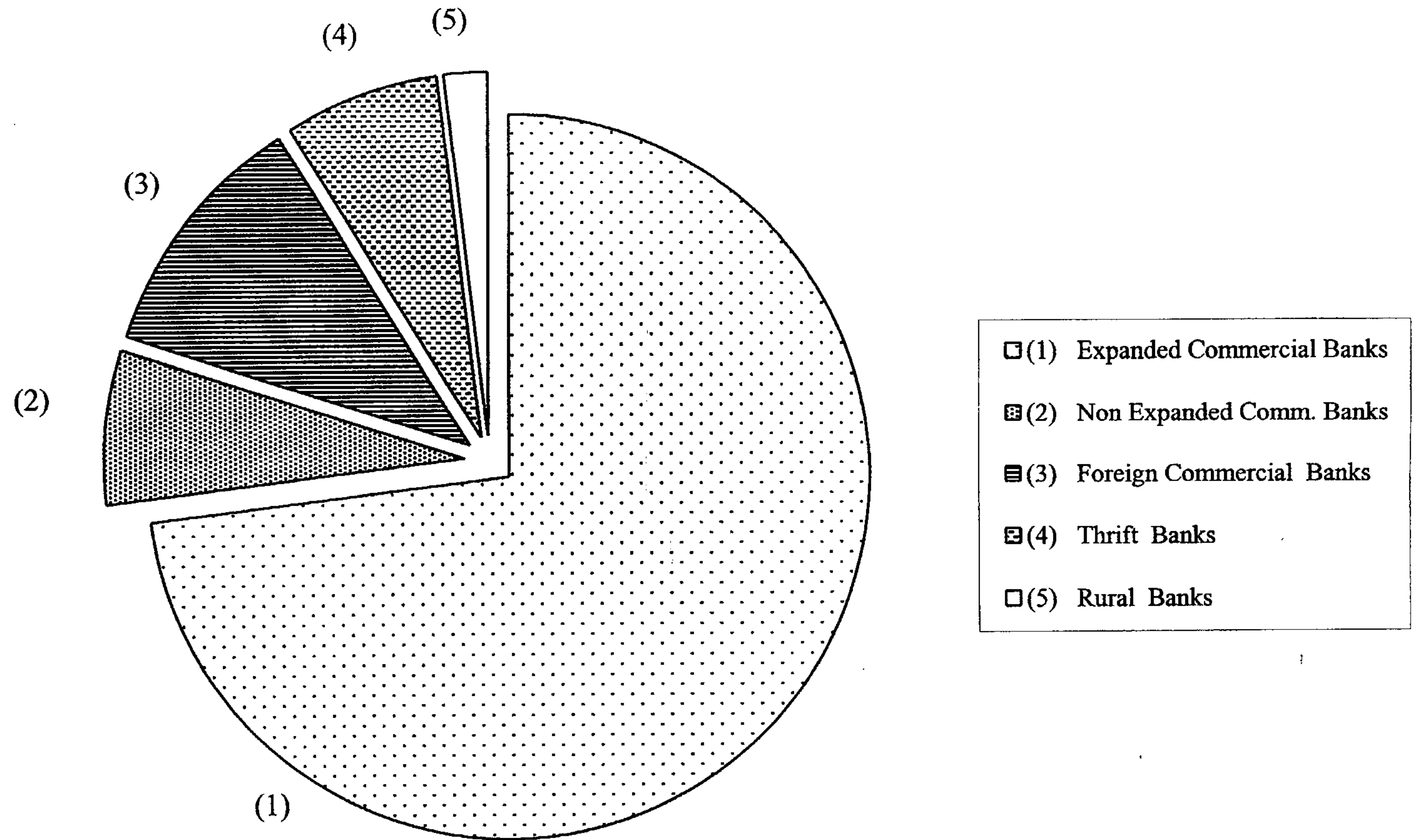
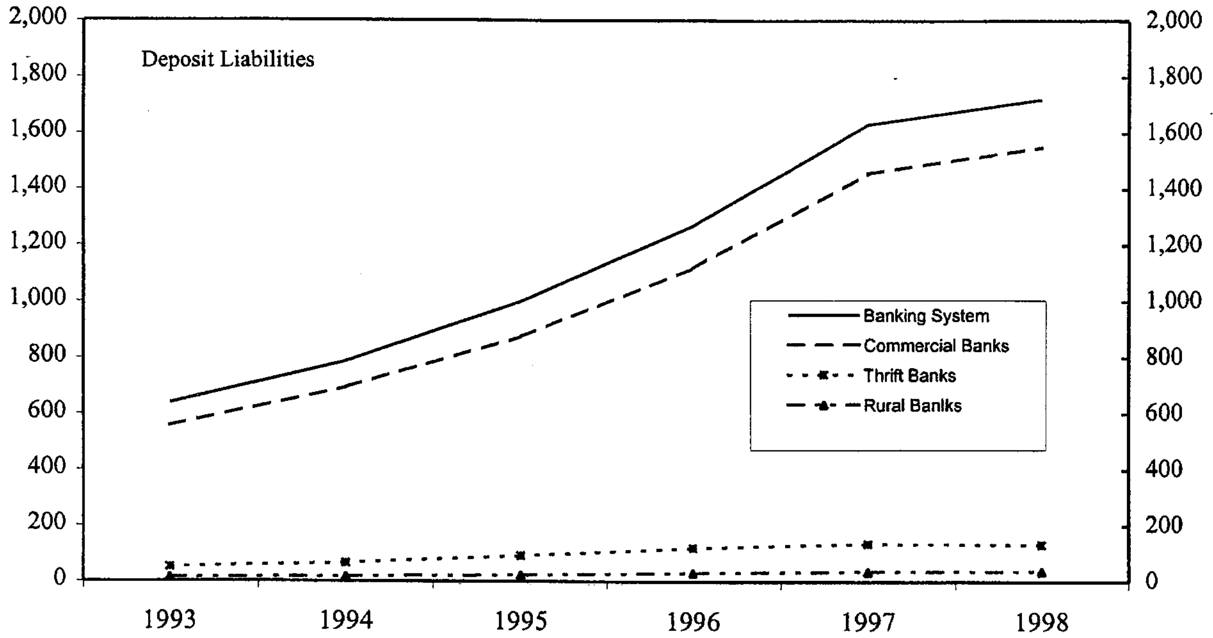
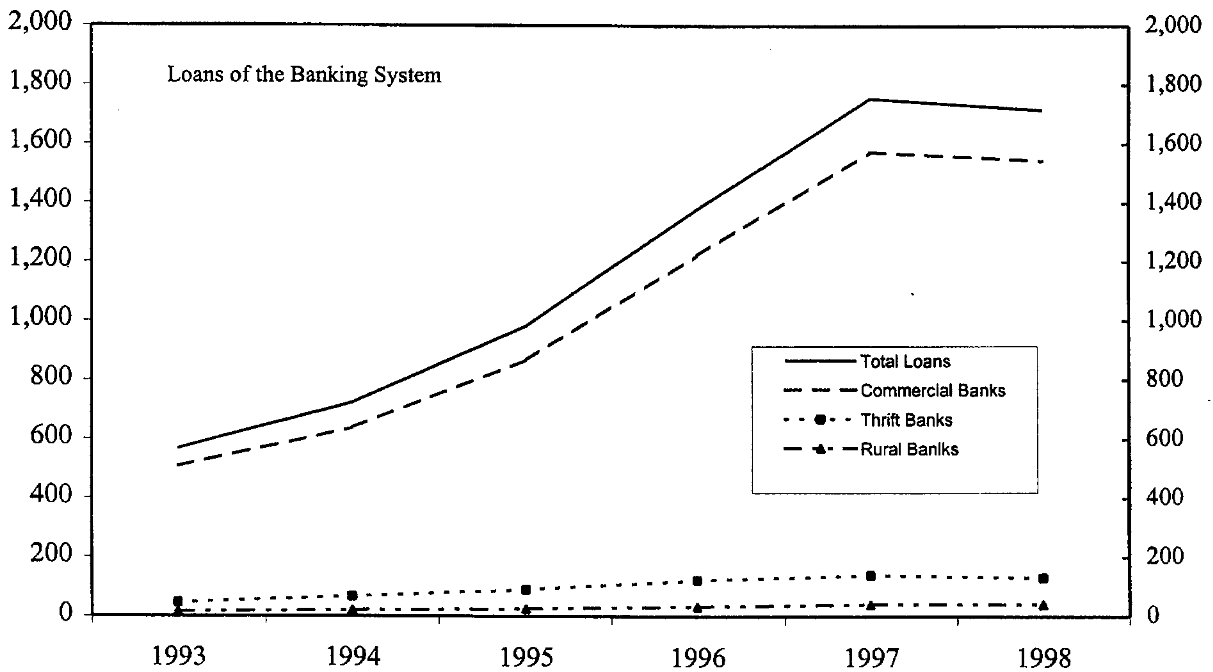
Figure VI.1
Philippines: Structure of the Banking System
(In percent of banking system assets)



Source: Bangko Sentral ng Pilipinas.

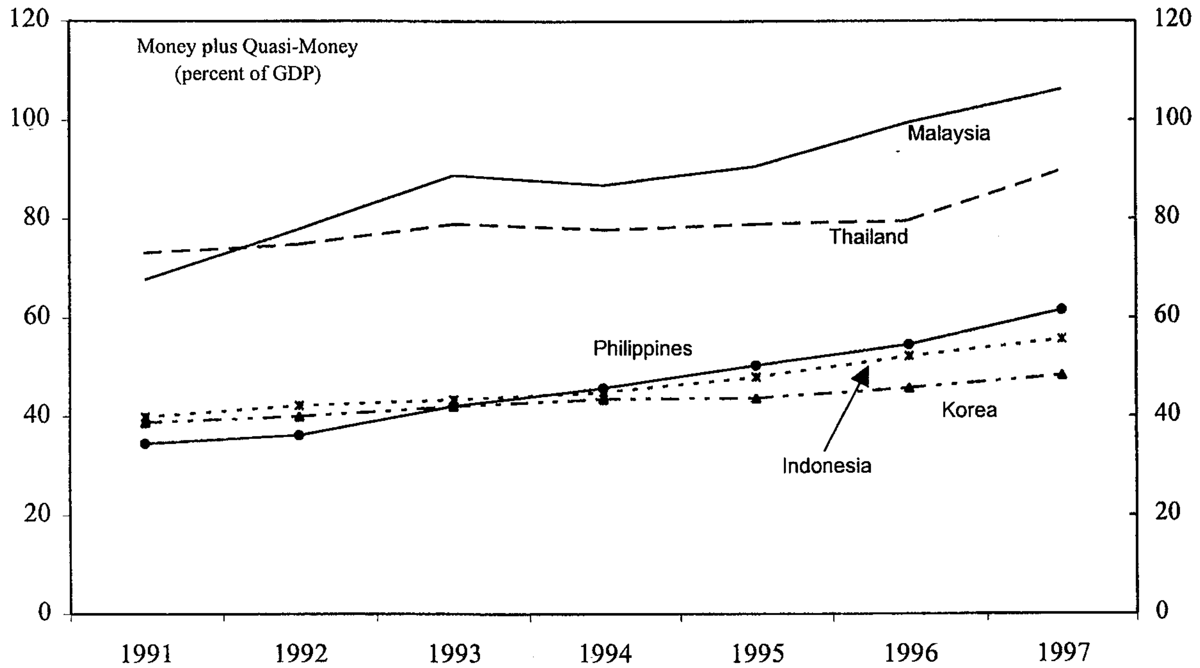
Figure VI.2
Philippines: Deposit Liabilities and Loans of the Banking System, 1993-98

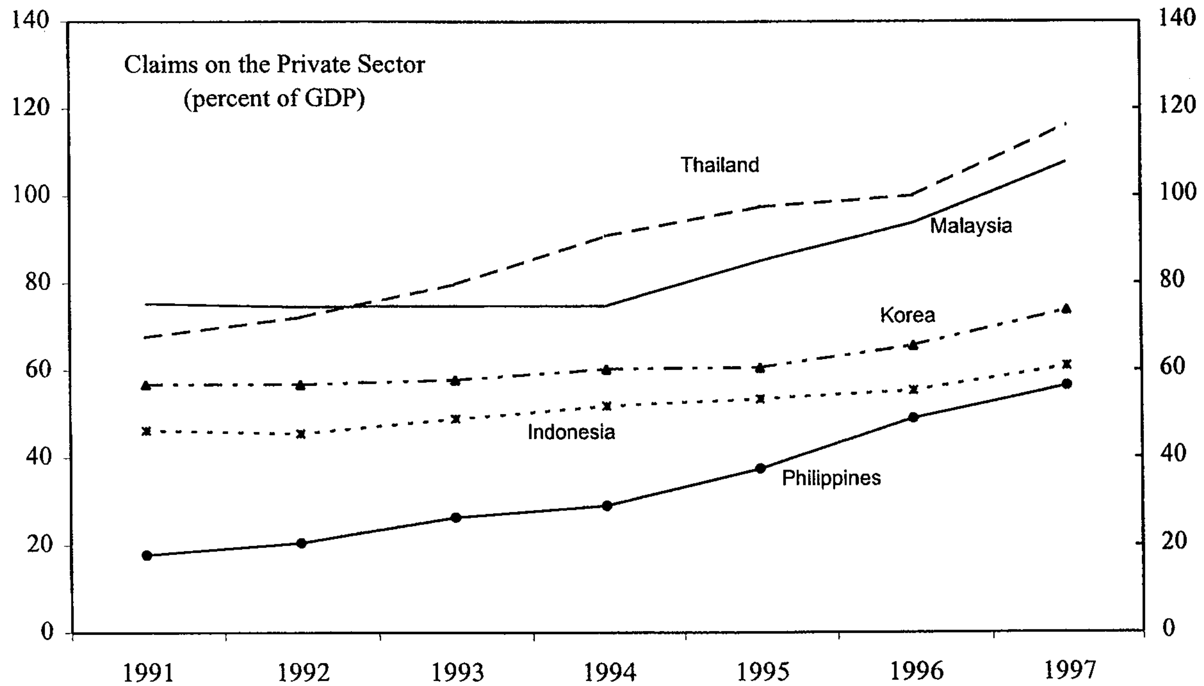




Sources: Bangko Sentral ng Pilipinas; and Fund staff estimates.

Figure VI.3
Indicators of Financial Intermediation in the Philippines and other Asian Countries

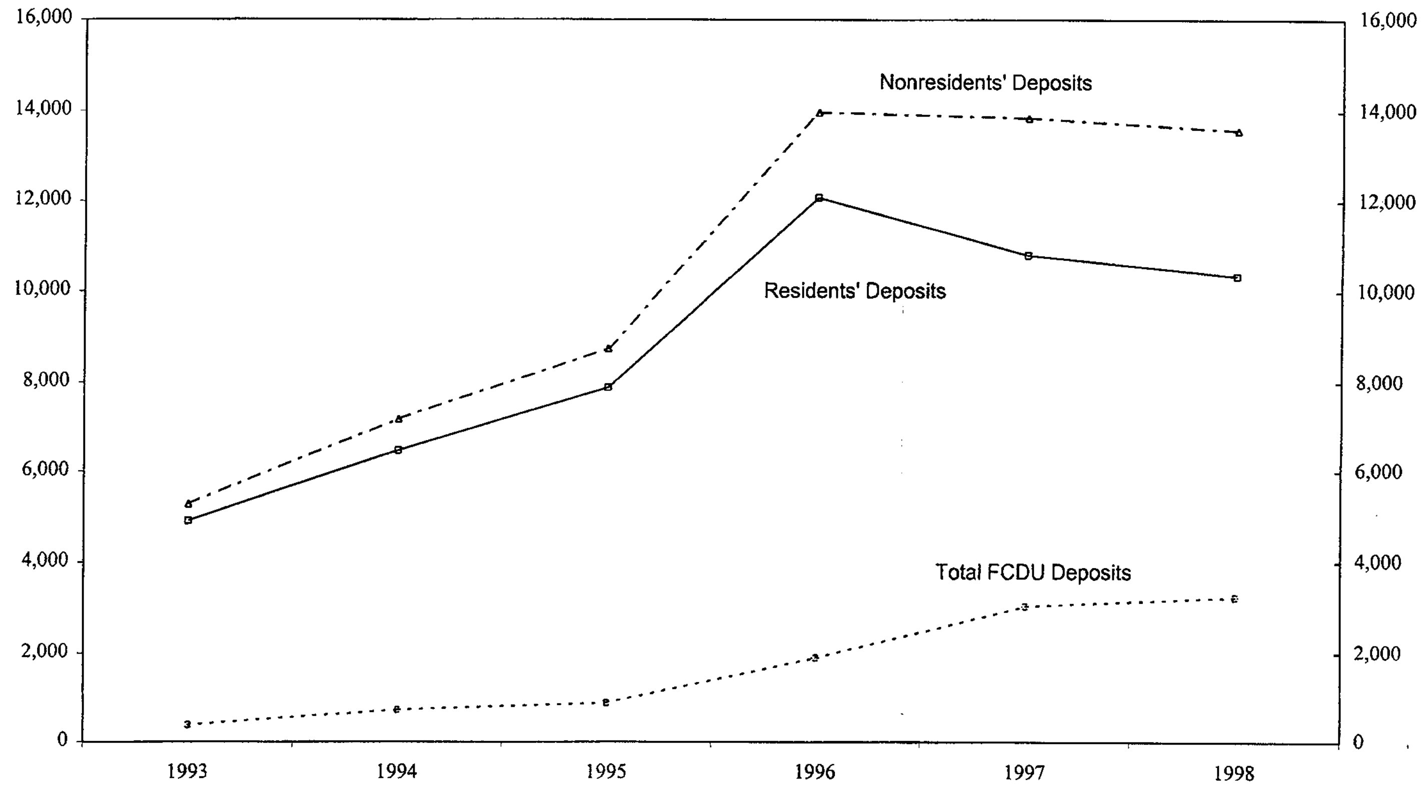




Sources: IMF, International Financial Statistics.

Figure VI.4

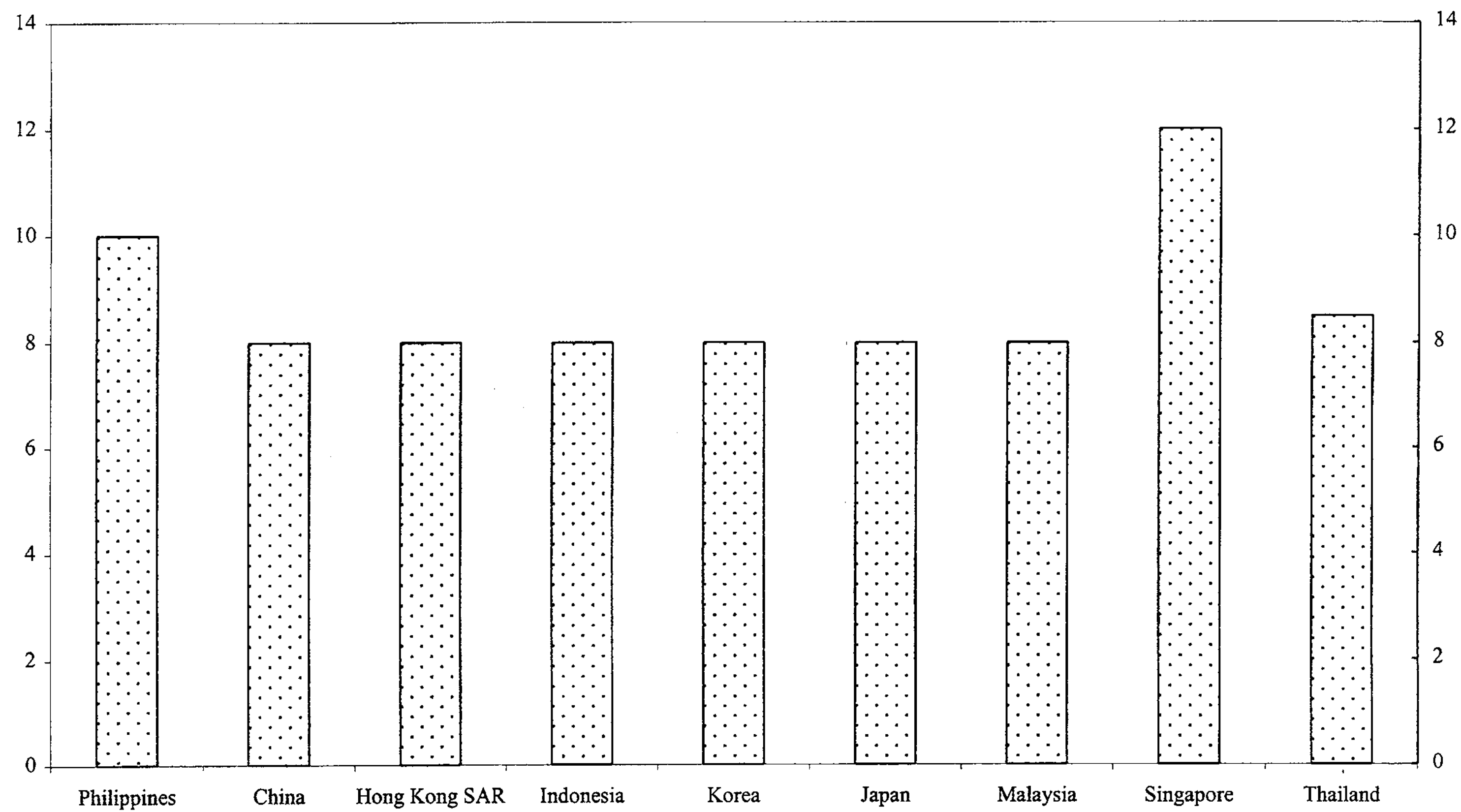
Philippines: Deposits in Commercial Banks' Foreign Currency Deposit Units (FCDUs),1993-98 1/



Sources: Bangho Sentral ng Pilipinas; and Fund staff estimates.

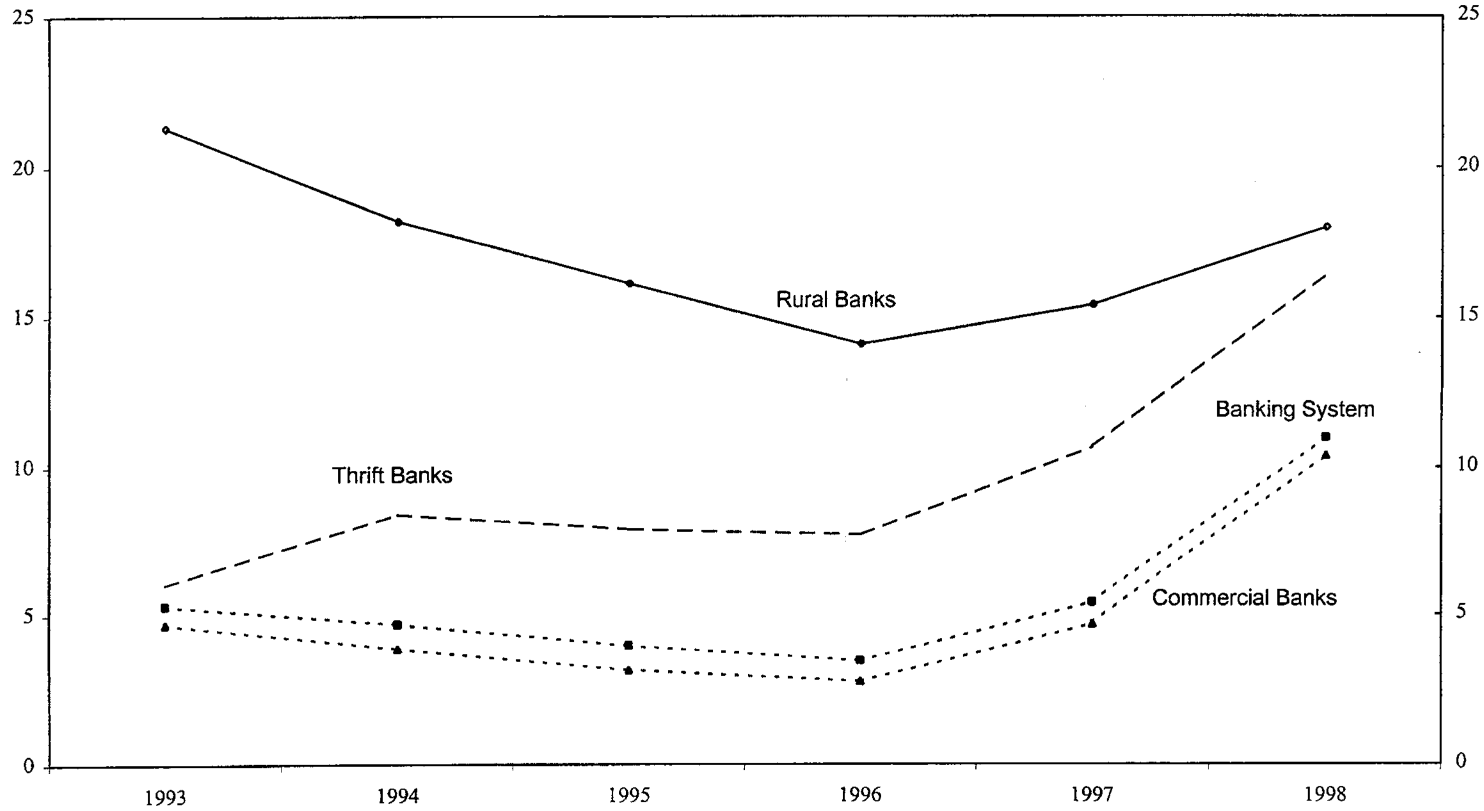
1/ December data, except 1998 (June).

Figure VI.5
Selected Asian Countries: Capital Adequacy Requirements
(In percent)



Sources: National central banks.

Figure VI.6
Philippines: Nonperforming Loans of the Banking System, 1993-98
(In percent of total loans)



Source: Bangko Sentral ng Pilipinas.

VII. EQUITY, GROWTH, AND ECONOMIC POLICIES

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VII. Equity, Growth, and Economic Policies[1]

A. Overview

1. **Equity considerations are playing an increasingly important role in the operational work of the Fund.** According to Fischer (1999), this is because "we accept the view that poverty in the midst of plenty is not socially acceptable" and because equitable adjustment programs are more likely to be sustainable. In the case of the Philippines, the importance of equity considerations is heightened by the persistence of significant poverty, in part a consequence of the weak and uneven growth performance discussed in Chapter II.

2. **This chapter presents key trends in equity in the Philippines and evidence on how growth and economic policies have influenced these trends.**[2] While the focus is on measures of poverty incidence, Section B also considers measures of income distribution, human development and governance to arrive at a broad view of trends in equity. The discussion of economic policies in Section C begins with evidence on the impact of economic growth on equity, followed by a discussion of specific economic policies that can have an impact on equity (in particular, fiscal policies, external sector policies, and policies towards the agricultural sector).

3. **The main conclusion of the chapter is that while continued economic growth is a *sine qua non* for gains in equity, more targeted interventions may be needed, particularly in rural areas.** The conclusion that growth helps equity is based on consideration of the cross-country evidence as well as an analysis of time series and cross-regional data for the Philippines. However, this analysis also reveals that growth by itself may not be sufficient to achieve the desired reduction in poverty, particularly in rural areas.

B. Trends in Equity

4. **Indicators of poverty have shown a decline since 1985 but remain high in absolute terms, particularly in rural areas** (Table VII.1).

- Preliminary figures from the recent Family Income and Expenditure Survey (FIES) indicate that in 1997, incidence of poverty (the percent of families classified as "poor") was 32 percent and 16½ percent of families lived below a subsistence threshold. Indicators of poverty in rural areas have shown a much slower rate of decline, and in 1997 remained considerably above the average for all areas.

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[1]Prepared by Prakash Loungani.

[2]The discussion draws extensively on the work of Fund staff, particularly Gerson (1998), as well as on manuscripts provided by Philippine scholars Arsenio Balisacan and Solita Collas-Monsod, particularly Balisacan (1998), Collas-Monsod (1998), and Collas-Monsod and Monsod (1998).

- Balisacan (1998) calculates an adjusted measure of incidence that embeds a "consistency" feature for a poverty norm, namely that the poverty threshold is the same across various population subgroups and time periods in terms of the implied standard of living. The measures of incidence based on FIES, in contrast, are based on poverty thresholds that differ by region, areas and years. The adjusted measure of incidence (which will be used further in the next section) shows the same broad pattern as the official measure.

Table VII.1. Philippines: Indicators of Poverty
(All Areas and Rural Areas)

Indicator	1985	1988	1991	1994	1997
Incidence of poverty—all areas	44.2	40.2	39.9	35.5	32.1
Rural areas	50.7	46.3	48.6	47.0	44.4
Subsistence incidence—all areas	24.4	20.3	20.4	18.1	16.5
Rural areas	30.0	25.3	26.4	25.6	24.8
Adjusted measure of incidence	41.5	35.0	35.5	32.2	...

Source: National Statistical Office; Balisacan (1998).

5. **The aggregate figures on poverty incidence conceal a great deal of spatial variation**. The National Capital Region (Metro Manila) has consistently had the lowest incidence of poverty—7 percent in 1997—and subsistence incidence (less than 1 percent); outside of the capital region, the poverty incidence ranged from 17 percent to 59 percent (Figure VII.1, top panel). As might be expected, there is a strong positive correlation between the incidence of poverty in a region and the share of families in the region that are rural (Figure VII.1, bottom panel).

6. **Income inequality has not changed much over the last two decades, and over the most recent period (1994 to 1997) inequality has actually increased a bit** (Figure VII.2). Over the last two decades, the richest twenty percent of the population has received a little over half the country's total income, whereas the poorest twenty has received about 5 percent. Understanding the reasons for the recent increase in income inequality requires an analysis of the detailed "raw" data underlying the FIES (which were only released earlier this month).

7. **Recent advances in equity research (Sen (1999)) have emphasized that poverty should be seen as the deprivation of basic capabilities**. Premature mortality, significant undernourishment, and widespread illiteracy are examples of deprivations that directly

impoverish human life. Hence, the allocation of economic resources as well as arrangements for social provision must give some priority to removing these disadvantages.

8. **A variety of indices have been developed by the United Nations Development Program (UNDP) to measure differences across countries in the degree of human development and material well-being; the Philippines tends to be placed in the middle of the group of developing countries, roughly consistent with its per capita income.**

- The Human Development Index (HDI), measured on a scale of 0 to 1, is a composite of three measures: health, as proxied by life expectancy; knowledge, as proxied by functional literacy; and standard of living, as proxied by real per capita income. The Philippine HDI for 1995 was 0.672, placing it in the UNDP's "medium" human development category. The Philippines ranks 98th out of 174 countries for which the index is computed and 89th in per capita GDP; the "negative gap" between the GDP rank and the HDI rank suggests that there is some "potential of redirecting resources to human development" (UNDP (1999)).

- A related measure, the Human Poverty Index (HPI) attempts to measure the extent of deprivation of the most materially deprived people in the country; it is derived as a composite of the following features: a short life (as proxied by the percentage of people expected to die before age 40); a lack of basic education (proxied by the percentage of adults who are illiterate); and lack of access to public and private resources (proxied by the percentage of people without access to health services and safe water, and the percentage of underweight children under five). In 1995, the HPI calculated for the Philippines indicated that 17.7 percent of the population was affected by the forms of deprivation included in the measure, roughly comparable to the HPI for China and Indonesia.

9. **Corruption is inequitable**. The benefits from corruption tend to accrue to the better-connected individuals in society, who belong mostly to the high-income groups (Tanzi (1995)). Recent work by IMF staff (Gupta, Davoodi and Alonso-Terme (1998)) demonstrates that high and rising corruption increases income equality and poverty by: (1) reducing economic growth; (2) lowering the progressivity of the tax system; (3) reducing the effectiveness of social spending and the formation of human capital; and (4) perpetuating an unequal distribution of asset ownership and unequal access to education. An important implication of these results is that policies that reduce corruption will also reduce income inequality and poverty.

10. **Cross-country surveys of perceptions of corruption place the Philippines in the middle of the group of emerging market economies**. Transparency International's Corruption Perceptions Index measures the level of corruption as perceived by business people, risk analysts, investigative journalists and the general public. The index focuses on corruption in the public sector and defines corruption as the abuse of public office for private

gain. In 1998, the Philippines ranked 55th out of 85 countries for which the index was computed.[3]

C. Impact of Growth and Economic Policies on Equity

Growth-oriented policies and equity

11. **The relative efficacy of growth-oriented and redistributive policies in promoting equity continues to be a matter of discussion and debate.** Countries adopt different strategies to promote equity. Some focus on *redistributive policies*, for example by actively promoting the use of public resources to raise the share of income going to the bottom tier of the distribution or by imposing highly progressive taxes to reduce the share going to the top tier. Some of the support for redistributive policies is based on the belief that growth has an adverse effect on equity in the early stages of development (the so-called "Kuznets curve"). Other countries rely on *growth* to help low-income families. Underlying this second strategy is a concern that policies that focus too overtly on redistribution may have an adverse impact on growth.

12. **Recent cross-country empirical evidence provides little support for the view that growth is detrimental to equity (Summers (1999)); however, the Philippines appears to be an exception.**

- Deininger and Squire (1998) find scant evidence of a Kuznets curve for most countries; indeed, periods of growth are just as likely to improve equity as to reduce it. The study uses a much larger data set, covering 91 countries over more than 30 years (1960 to 1992), and better econometric methods than many of the previous studies in the literature. *However, the Philippines is one of five countries where the data do support the presence of a Kuznets curve.*

- More generally, the cases of Japan, the "Asian tigers," and China provide evidence of enormous reductions in poverty as a result of sustained and rapid growth. Deininger and Squire find that growth produced rising incomes for the bottom fifth of the population in all but a handful of the economies in their study.

13. **In contrast, analysis of Philippine time series data on poverty incidence points to the importance of growth in improving equity.** One way to measure the relative importance of redistributive policies and growth-oriented policies is by performing some counterfactual experiments using the adjusted poverty incidence measure discussed earlier. In particular, the poverty measure can be decomposed into two components:

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[3]Nine case studies of the nature and extent of corruption in the Philippines, and the steps being taken to combat it, are presented in Coronel (1998).

(1) the "growth" component is the change in the measure due to a change in per capita income growth, holding the distribution of income constant (at some reference level);

(2) the "redistribution" component is the change in the poverty measure due to a change in the distribution of income, holding per capita income constant (at some reference level).

The results of the decomposition for the Philippine case are given in Table VII.2. The results show that over the period 1985–94 as a whole, the growth component has been responsible for essentially all the decline in poverty; the redistribution component has actually been responsible for a slight increase in poverty over the period. Even for sub-periods, the growth component has been dominant in periods when the change in per capita growth has been significant; in these periods, the redistribution component has augmented the favorable impact of growth on poverty.

Table VII.2: Philippines: Decomposition of Poverty Incidence into Growth and Redistribution Components

Period	Change in Incidence of Poverty	Growth Component	Redistribution Component
1985–88	-6.5	-6.2	-0.3
1988–91	-0.5	-3.1	3.6
1991–94	-3.3	-1.1	-2.2
1985–94	-9.3	-10.3	1.0

Source: Balisacan (1998)

14. **Philippine regional data also support the view that growth contributes to a reduction in poverty incidence, but the effect is weak in rural areas.**

- This conclusion is based on panel regression estimates using data on regional poverty incidence and regional real income from FIES for 1988, 1991, 1994, and 1997. These data are used to compute the growth in poverty incidence and real income growth for 13 regions over three periods (1998 to 1991, 1991 to 1994, and 1994 to 1997), giving a total of 39 observations. FIES also reports poverty incidence for urban and rural

areas within each region, which allows for a test of whether the response of poverty to growth is different between the two groups.

- The regression estimates, reported in Table VII.3, show that the higher the real income growth in a region, the faster is the decline in poverty incidence. In particular, a one percent increase in regional income leads to about a 0.4 percent decline in poverty incidence (regression 1). This relationship continues to hold after accounting for year fixed effects, that is, factors that were common to all regions in a given year (regression 2). Poverty responds much more to growth in urban areas than in rural areas. In urban areas, the estimated elasticity is 0.8 (regression 3), whereas in the rural areas it is only 0.2 and not precisely estimated (regression 4). The use of an alternate, and arguably more relevant, measure of rural income growth—gross value added in agriculture and forestry—raises the estimated elasticity to 0.3, but once again it is not estimated precisely.

Table VII.3: Regional Poverty Incidence and Regional Growth
(Regression Estimates)

		Independent variables			
Regression #	Sector of the economy	Intercept	Real Income	Year fixed effects?	R^2
1.	All areas	-0.02 (0.03)	**-0.44** (0.20)	no	0.11
2.	All areas	0.05 (0.04)	**-0.45** (0.25)	yes	0.25
3.	Urban areas	0.06 (0.04)	**-0.80** (0.26)	yes	0.46
4.	Rural areas	0.12 (0.05)	**-0.23** (0.28)	yes	0.22
5.	Rural areas	0.13 (0.05)	**-0.33** (0.28)	yes	0.23

Notes:
(a) The variables are specified in growth rates; hence, the estimated coefficients can be interpreted as elasticities.
(b) Numbers reported in parentheses are standard errors.

These results suggest that continued while growth can be expected to alleviate poverty, it may not be sufficient (as indicated by the relatively low R^2 of the regressions). The remainder of the discussion in this section focuses, therefore, on other economic policies that could have an impact on equity (in particular, policies towards the agricultural sector, fiscal policies, and external sector policies).

Agrarian reforms and equity

15. **The poor performance of Philippine agriculture in the last two decades has severely constrained the gains in poverty alleviation**. Some of the factors responsible for the poor performance include:

- **Heavy regulation of the agricultural sector**. As noted in Chapter II, beginning in the 1970s, price controls on rice and other products were imposed, and imports of wheat and soybeans was monopolized. Controls on the production, marketing and processing of coconuts—long the country's most important crop in terms of export earnings and employment—were put in place. Fertilizer and pesticide imports were controlled through licensing requirements. While many of these restrictions have been relaxed or eliminated under the Aquino and Ramos administrations, reforms in this area have not yet been completed and important regulations remain in effect that restrict the ability of farmers to increase their earnings or acquire inputs at the lowest possible prices.

- **Uncertainty concerning the implementation of land ownership reform under the government's Comprehensive Agrarian Reform Program (CARP)**. Launched in 1987, CARP was intended to redistribute about three-quarters of all agricultural land to landless farmers and farm workers. However, the program has been plagued by bottlenecks owing to a lack of financing for the enormous costs of the program as well as cumbersome administrative requirements. Uncertainty about CARP has discouraged planting and the flow of private investments into agriculture, and encouraged conversion of agricultural lands into non-agricultural uses (Medalla and Centeno (1995)); agricultural land increased at annual rate of 3.6 percent a year in the 1970s, but only 0.8 percent a year in the 1980s and early 1990s. Since the Government is now the only buyer and seller of a large chunk of agricultural land subject to agrarian reform in the country, the agricultural land market is distorted and the collateral value of agricultural land has been adversely affected, thus further reducing the already inadequate access to formal credit in rural areas (World Bank (1999)).

- **A sharp fall in investments in agriculture**, both private (as a consequence of the bias against agriculture introduced by the overvalued real exchange rate and the heavy

regulation of the sector) and public (especially rural roads, irrigation and agricultural R&D).[4]

Equitable fiscal policies

16. **Fiscal policies can contribute to improvements in equity**. The main ingredients of equitable fiscal policy are: (i) implementation of a fair and efficient system of taxation—ideally a system of easily administered taxes, moderate tax rates, and a minimum number of exemptions; (ii) provision of adequate social expenditures, particularly on education and health, to increase equality of opportunity.

17. **In the Philippines, the Comprehensive Tax Reform Program (CTRP) and expansion of the VAT are likely to increase the contribution of the tax system to equity**. While there is little evidence to date of the effects on these tax changes on equity, they are likely to improve equity for the following reasons:

- The extension of the VAT has increased the taxation of many services which are consumed largely by the upper income groups in the population.

- The reform of the income tax system is intended to ensure that families living below the poverty line have no income tax liability. In addition, the reform is intended to bring into the tax net many individuals, mostly wealthy individuals, who were previously outside the net.

- The net impact of corporate tax reforms on equity is difficult to predict. Certain features of the reform, such as the tax on employee fringe benefits, would improve the progressivity of the system. Other features, such as elimination of corporate tax breaks and investment incentives, may have an impact on equity only through their likely impact on growth.

- The impact of the increase in excise taxes on cigarettes and alcohol is likely to be regressive, though the effect is dampened to some extent by the higher tax imposed on premium brands.

In addition, better tax administration can be expected to improve equity by ensuring sufficient revenues for critical social expenditures, and providing a more transparent and uniform treatment of taxpayers.

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[4]In general, the amount of budget spending devoted to agriculture is quite moderate (1–2 percent of GNP in recent years). However, agriculture is supported through substantial tax privileges and by the National Food Authority (which regulates the rice market and protects domestic farmers from being undercut by cheaper imports).

18. **Education has gained a larger share of total expenditures in recent years; however, concerns about poor quality of educational resources and lack of equity in their distribution remain valid**. Since 1994 the share of education in total expenditures has risen, to about 25 percent at present, roughly the same share as in Malaysia and Thailand (Figure VII.3). However, concerns about the intrasectoral and regional allocation of educational resources, as well as the efficiency of educational expenditures remain as valid as ever. In particular:

- The increased expenditures have gone largely for higher personnel costs, while expenditures on maintenance and other operating expenditures have remained at levels that are incompatible with the provision of quality education (World Bank (1999)).

- There are significant differences in the regional distribution of educational resources and consequently in educational outcomes. For instance, in 1997 the National Capital Region accounted for about 10 percent of total enrollment in public educational institutions but received 34 percent of the education budget. As a consequence of this uneven distribution of resources, poorer regions tend to have higher proportions of inexperienced teachers and lower completion rates.

- The share of educational resources devoted to elementary education has declined sharply over time, whereas the share devoted to tertiary education had increased. A reallocation of spending toward elementary education could contribute to a significant improvement in the quality of schooling and higher retention rates for lower-income students, especially in rural areas, and in the process help equity.

19. **Spending on health and nutrition is relatively low in the Philippines by ASEAN standards, biased towards personal health care (rather than preventive care interventions), and inefficient in its inter-regional allocation of resources**.

- Health is underfunded in the Philippines relative to other ASEAN countries (Figure VII.4, bottom panel).

- Despite the conventional wisdom that preventive care interventions should have the first claim on resources because of their substantial positive externalities, such programs receive only between 10–15 percent of the Department of Health's budget.

- Spending is allocated in a manner that does not target the poorest segments of the population.

External sector policies and equity

20. **In principle, realistic exchange rates and an outward-oriented trade policy are presumed to be consistent with growth, reduced poverty and improved equity in the**

medium- to long-run. Evidence from a recent cross-country study by Sarel (1998) finds partial support for this view. He finds that real exchange rate overvaluation leads to a more unequal income distribution, especially in poorer countries. He concludes that the government should try at least not to contribute to such overvaluation, and be prepared to take corrective measures when such overvaluation occurs. Sarel does not find any link between openness to international trade and changes in the income distribution.

21. **In the Philippines, exchange and trade policies historically have contributed to inequity through a number of channels; changes in many of these policies during the 1990s should have a favorable impact on equity, at least in the medium- to long-run.**

- As noted in Chapter II, the Philippines followed a policy favoring import substitution until the tariff reforms of the early-1990s. Trade policies over this period penalized the primary and agricultural sectors—where the poor are predominantly employed—in favor of the manufacturing sector. For instance, estimates of the effective rate of protection (ERP) indicate that in 1985 the average ERP for manufacturing was 43 percent higher than that of agriculture.

- Even within manufacturing, an overvalued exchange rate coupled with fiscal and other incentives encouraged the substitution of capital for labor.

The shift to outward-oriented policies and market determination of exchange rates should, in principle, contribute to a increase in equity; however, there is as yet little reliable evidence on this issue.

D. Conclusions

22. **Sustained growth, combined with targeted interventions in some areas, are required to make further gains in equity in the Philippines**. Poverty rates remain high, particularly in the rural areas, and the income distribution is highly unequal. While poverty is responsive to growth, attaining the government's targets for poverty alleviation (poverty incidence of 20 percent by 2004) is likely to require targeted interventions in the rural areas, as well as equitable fiscal and external sector policies.

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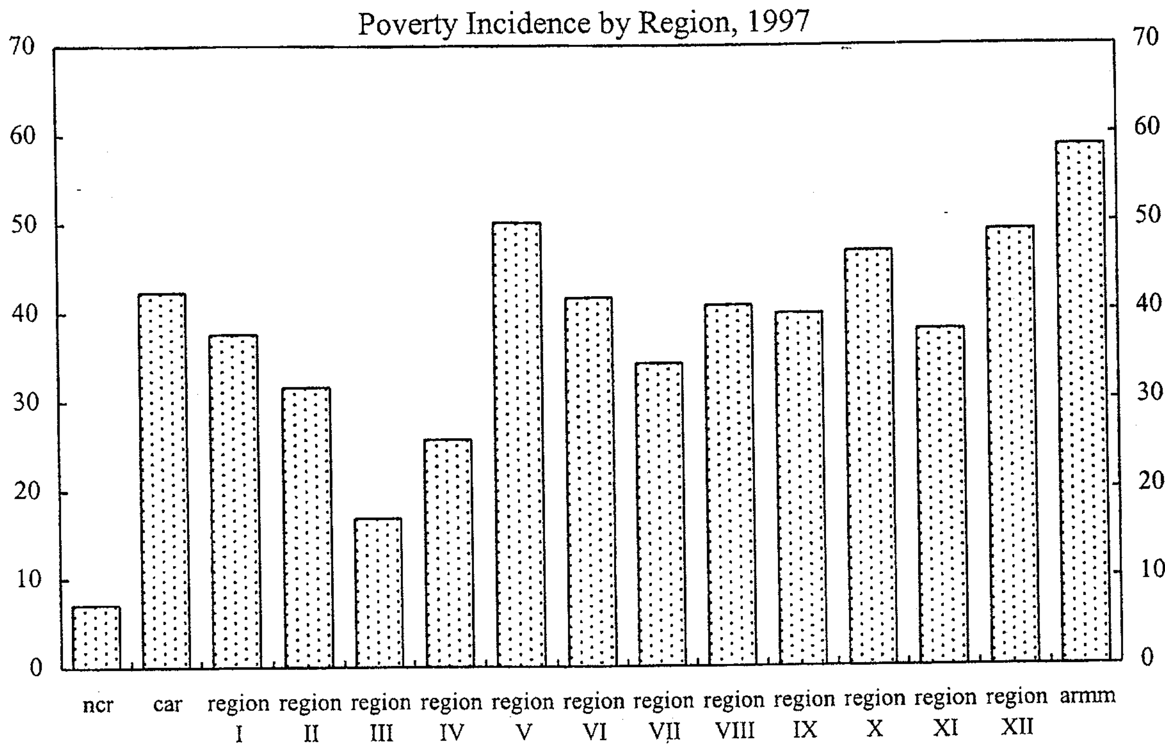
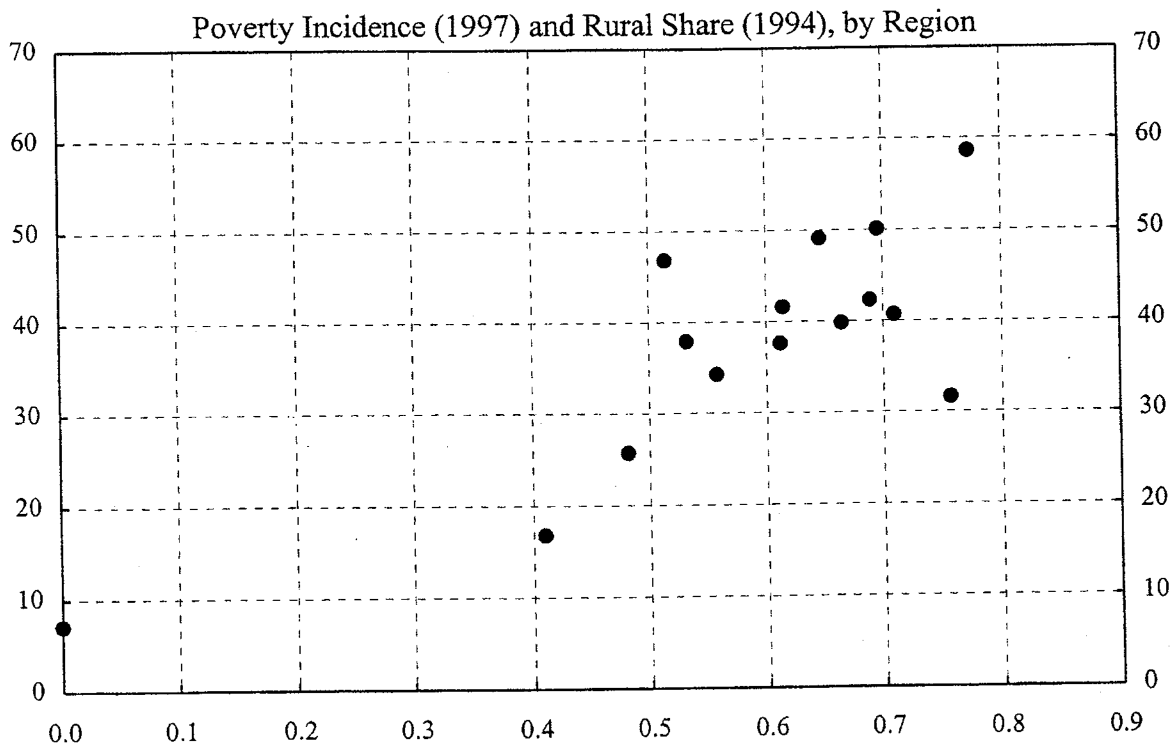
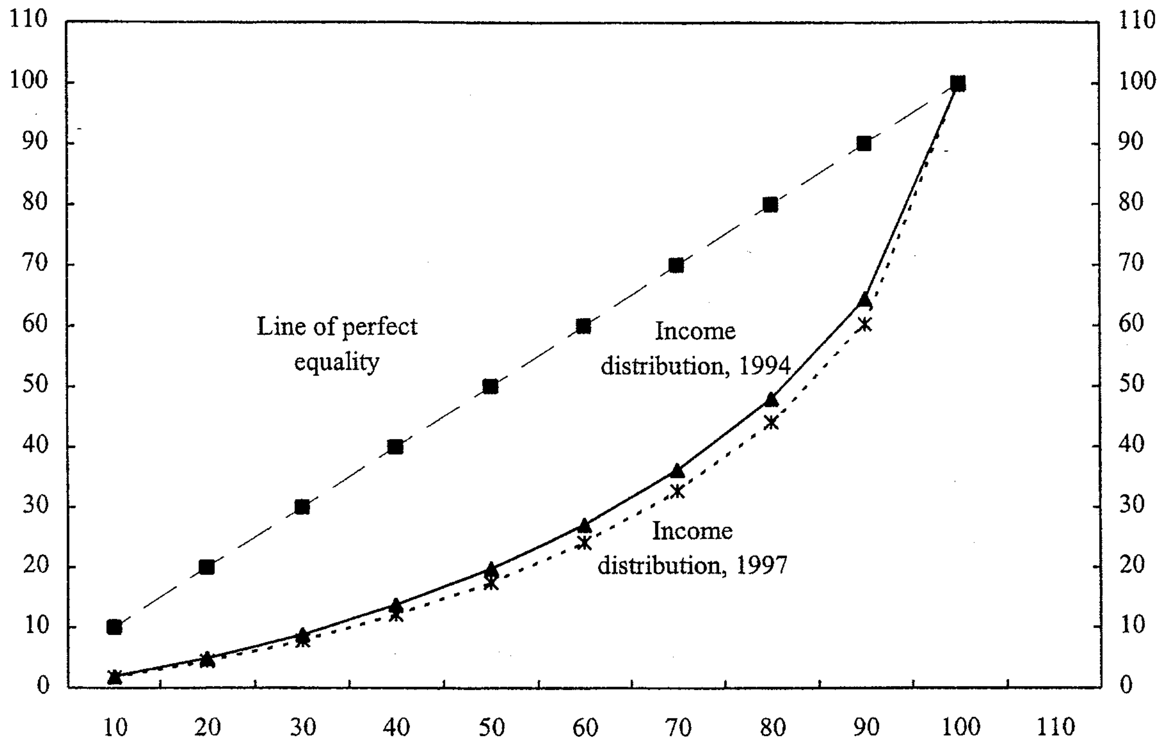
Figure VII.1
Philippines





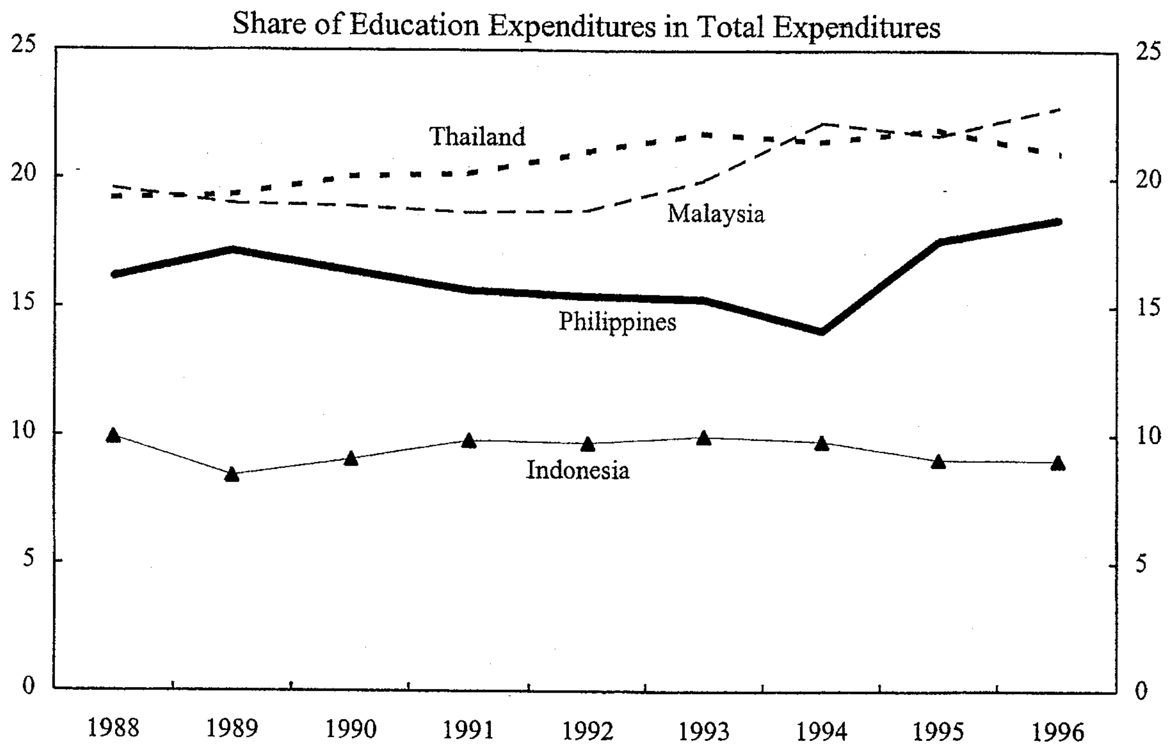
Source: Family Income and Expenditure Survey, National Statistics Office, Philippines.

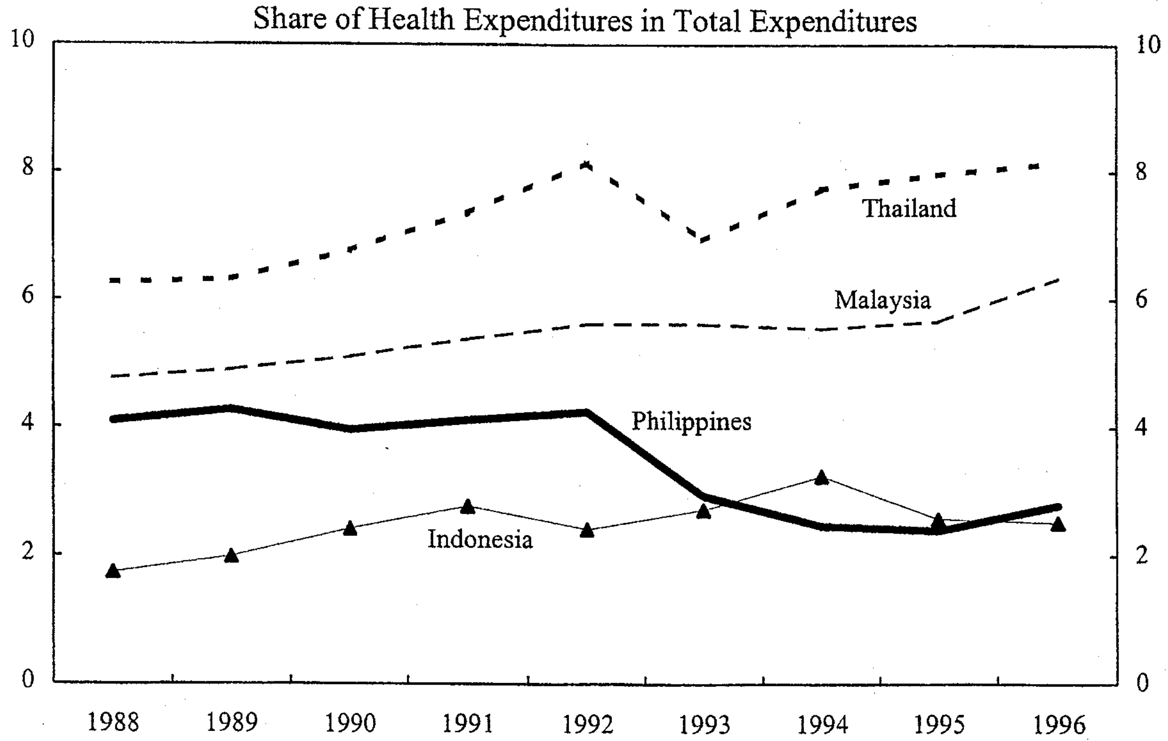
Figure VII.2
Philippines



Source: Family Income and Expenditute Survey, National Statistics Office, Philippines.

Figure VII.3
Philippines





Source: IMF, Government Finance Statistics.