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Philippines: 2004 Post Program Monitoring Discussions—Staff Report; Public Information Notice on the Executive Board Discussion, and Statement by the Executive Director for the Philippines

In the context of the Post-Program Monitoring Discussions with the Philippines, the following documents have been released and are included in this package:

- the staff report for the Post-Program Monitoring Discussions, prepared by a staff team of the IMF, following discussions that ended on **July 8, 2004,** with the officials of the Philippines on economic developments and policies. **Based on information available at the time of these discussions, the staff report was completed on August 11, 2004**. The views expressed in the staff report are those of the staff team and do not necessarily reflect the views of the Executive Board of the IMF.

- a Public Information Notice (PIN) summarizing the **views of the Executive Board as expressed during its August 27, 2004 discussion** of the staff report that completed the Post-Program Monitoring consultation.

- a statement by the Executive Director for the Philippines.

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

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PHILIPPINES

Report for the July 2004
Post-Program Monitoring Discussions

Prepared by the Asia and Pacific Department

(In consultation with other departments)

Approved by Masahiko Takeda and Michael Hadjimichael

August 11, 2004

- Post-Program Monitoring discussions were held in Manila during June 25–July 8. The staff team comprised Messrs. Takeda (Head), Gordon, Cerisola, Haksar (Resident Representative), Baqir, Ishi (all APD), Burgess (PDR), Fletcher (FAD), and Schellekens (MFD). Ms. Perry (FAD) joined part of the mission to evaluate and advise on tax measures. An MFD mission (Messrs. Quintyn and Josefsson) overlapped with the staff visit. Ms. Amador (OED) also joined the discussions.

- The mission met with senior government officials including Executive Secretary Romulo, Finance Secretary Amatong, Bangko Sentral ng Pilipinas (BSP) Governor Buenaventura, Budget and Management Secretary Boncodin, Economic and Planning Secretary Neri, Energy Secretary Perez, and Trade and Industry Secretary Purisima, as well as with academics, financial market participants, and business representatives.

- The Article IV Consultation discussions were concluded on March 5, 2004. At that time, Executive Directors noted that the Philippines faced key areas of weakness and vulnerability. Despite important economic reforms in recent years and favorable macroeconomic performance, there was an urgent need for the authorities to implement comprehensive reforms in the fiscal, banking, and power sectors. Absent such reforms, the economy’s vulnerabilities would increase.

- The Philippines’ outstanding borrowing from the Fund is currently 64 percent of quota, well below the 100 percent level at which Post-Program Monitoring (PPM) would normally end. The authorities see benefits from continuing with PPM until the fiscal position improves.

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

- The Philippines’ statistical base is hampered by several deficiencies. Efforts are being made to improve the balance of payments and fiscal statistics. A data ROSC has been prepared and the authorities have authorized its publication.

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Executive Summary

President Arroyo has won a new term. The President has announced various initiatives to foster job creation and reduce poverty, while committing to balancing the budget. The new mandate provides an opportunity to move boldly with regard to fiscal and structural reforms.

The high level of risks requires prompt implementation of reforms. Financial markets have shown recent stability and the authorities deserve credit for managing the economic risks associated with the pre-election period. Nevertheless, the global interest rate cycle has turned and large external financing requirements make the Philippines vulnerable to sudden changes in investor sentiment. There is also the potential for downgrades from credit rating agencies if reforms do not proceed decisively.

Monetary policy should remain vigilant. Inflation has picked up in 2004 due to adverse supply shocks. The challenge for the monetary authorities is to signal that only the first-round effects of these shocks will be tolerated. The 2005 inflation forecast should be reassessed once markets have reacted to the new fiscal package, and monetary policy tightened if inflation is expected to be higher than can be justified due to first-round effects.

There was debate about the size of the initial fiscal adjustment. The authorities are formulating a significant package of tax measures, and staff argued that the bulk of the additional revenues should be saved, thereby front-loading the medium-term deficit reduction effort. Such a strategy would boost market confidence and exploit the likely greater potential to enact tax measures at the beginning of the new administration's term. However, the authorities argued that a large initial deficit reduction was unlikely to be politically feasible.

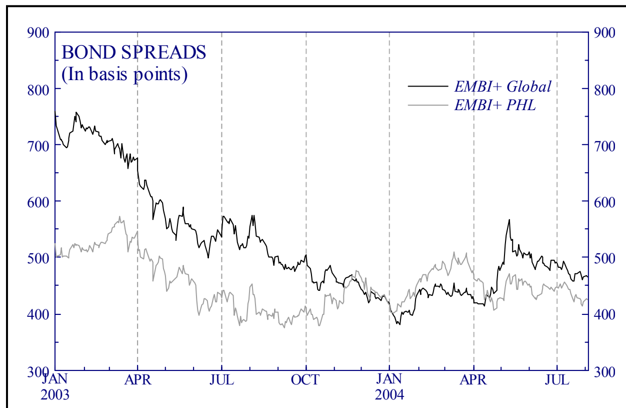
The nature and quality of the revenue measures being contemplated is critical. The proposed gross income tax (GIT) is a particular concern, since the tax may introduce significant distortions and will have an uncertain impact on revenue. Staff also urged the authorities to resist proposals for new tax amnesties, given the harmful impact that such amnesties have on taxpayer compliance, as well as to consider raising the VAT rate which is low by international standards.

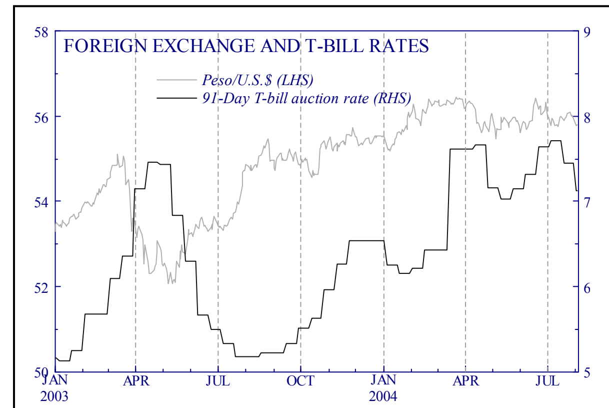
The authorities are considering power sector reforms. If granted, the petition recently filed to significantly increase average generation tariffs will do much to restore the financial health of the sector. The approval of the Transco franchise bill by Congress will also be critical in promoting much needed investments. More generally, reducing regulatory uncertainty is essential for attracting investors and the success of power sector reforms.

Financial sector reform is also an element in the policy package. Asset quality problems in the banking system continue to be an important concern and the current strategy of inducing banks to offload NPAs on a voluntary basis needs to be accompanied by greater pressure on the banks to make them recognize latent losses and, if necessary, inject more capital. The new administration and Congress should also strengthen legal protection for bank supervisors. This should be followed by the implementation of a restructuring strategy for the banking sector.

I. Introduction

1. **President Arroyo has won the election and a new six-year term.** Final results of the May 10 election showed President Arroyo with 40 percent of the votes, a three point margin over the runner-up. Her coalition also secured the Vice Presidential post and won majorities in both houses of Congress. President Arroyo announced a 10-point agenda in her inaugural speech which included various anti-poverty initiatives, combined with a promise to balance the budget. Further details about her economic plans were provided in the State of the Nation Address delivered on July 26 (Box 1).





2. **Financial markets have shown recent stability, but await implementation of reforms.** During the first quarter of 2004, markets were roiled by concerns about possible policy discontinuity after the election and that the new administration might be disinclined to implement long-overdue reforms. However, the exchange rate and sovereign bond spreads have been more stable since April, when victory by President Arroyo began to look likely. Financial markets have as yet shown little reaction to the President's announcements about her economic plans, and appear to be on hold until concrete details emerge.

II. Recent Development

3. **GDP growth has been robust, but inflation has risen largely due to adverse cost factors.** The first quarter GDP outturn of 6.4 percent (y/y) was boosted by strong agriculture and a pre-election surge in consumption, and a more moderate growth rate of 4.9 percent is expected for 2004 as a whole. Despite the good growth performance, the unemployment rate rose to 13.7 percent in the second quarter, up from 12.2 percent a year ago. Although the Bangko Sentral ng Pilipinas (BSP) raised the liquidity reserve requirement by 2 percentage points to 10 percent in February, inflation has continued to rise, reaching 6.0 percent in July (y/y) on account of higher food, fuel and transportation prices.[1] Average inflation was

[1] The authorities have recently introduced a 2000-based CPI, which shows inflation at 6.6 percent in July (y/y). While the inflation target continues to be defined in terms of headline inflation, the authorities have also recently started to publish an official measure of core inflation. To date, the core measure has moved quite closely with the CPI. This is due to (continued)

4.3 percent during the first seven months of 2004, compared to 3.0 percent in 2003, but within the inflation target of 4–5 percent.

4. **External developments have been generally positive.** Exports grew by 8½ percent in the first half of 2004 (y/y), a significant improvement on the 2.9 percent increase recorded in 2003 (full year), and providing an offset to the higher oil import bill. Remittances have increased only modestly, by 2.6 percent (y/y) in the first half of 2004, partly due to developments in the Middle East where a large number of Philippine overseas workers are employed. Almost two thirds of planned 2004 public sector external commercial borrowing of $4 billion has been raised to date. The BSP intervened to support the peso in February and March, but has since rebuilt international reserves back to the end-2003 level, while unwinding over half of the $0.7 billion oversold nondeliverable forwards (NDF) position accumulated in the first quarter. As of end-June, adjusted gross reserves were $14.7 billion, or 113 percent of short-term debt by remaining maturity.

5. **Fiscal performance has been broadly on track.** Through June, the National Government deficit (authorities' definition) was on course to meet the 2004 target of 4.2 percent of GDP, compared to 4.6 percent of GDP in 2003 (Table 2).[2] By contrast, the nonfinancial public sector deficit is expected to remain at about 5¾ percent of GDP in 2004 due to increasing losses at the National Power Corporation (NPC) and shrinking cash surpluses at the public pension funds, while nonfinancial public sector debt is projected to remain at about 100 percent of GDP.[3] Although the amount of government domestic borrowing in 2004 to date has been much the same as last year, domestic treasury bill rates have trended up in line with the pick-up in inflation.

III. Outlook and Vulnerability

6. **Near-term risks arise primarily from the large external financing requirement.** One source of risk is that U.S. inflation or growth surprises on the upside, triggering a sharper than expected tightening by the Fed, with destabilizing effects on global financial markets. In this environment, risk aversion would rise, with more serious consequences for emerging markets such as the Philippines with weaker fundamentals. Even without such an event, the Philippines has already been put on notice by the ratings agencies that downgrades may follow should the new administration not proceed with bold implementation of reforms. Moreover, while the domestic economy has weathered the effects of higher oil prices to date, additional increases going forward could weaken growth and further increase inflation. By contrast, the Philippines appears less vulnerable to a possible hard landing in China, since

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the recent increase in headline inflation being primarily a result of rising meat, fish, and transportation prices, all of which are included in the core measure.

[2] Budget performance in 2004 has benefited from windfall proceeds from the recovery of the Marcos wealth amounting to 0.3 percent of GDP.

[3] Debt statistics have been adjusted downward by staff by about 5 percent compared to the data presented during the 2003 Article IV Consultation to net out some intra-public sector claims which are included in the public sector debt statistics. An upcoming STA mission on Government Financial Statistics will investigate this issue further.

exports to China are largely inputs for processing and re-export, and are thus not closely linked to the strength of Chinese domestic demand.

7. **Over the medium term, the Philippines' growth prospects rest squarely on the pace of reform.** Strong implementation of reforms will improve the prospects for growth and hence poverty reduction (Table 5). In addition to reducing the deficit, fiscal measures will create room for increased public spending on infrastructure. Power sector reform will remove the specter of supply shortages over the medium-term. By contrast, should the new administration be unable to fully implement its reform agenda, financing requirements and hence vulnerabilities would remain high over the medium term, and growth is forecast to trend down to about 4 percent by the end of the decade (Table 6). Such growth would only be about 2 percent in per capita terms and would likely do little to improve the lives of the estimated 40 percent of the population with incomes below $2 a day.

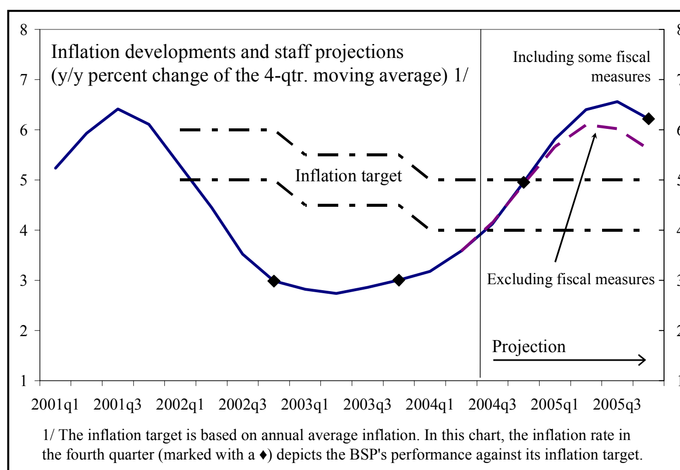
IV. POLICY DISCUSSIONS

8. **The discussions focused on the conduct of macroeconomic policies and the reform imperatives for the new administration.** Economic reforms have proceeded haltingly over the last few years, and staff emphasized that the election victory presented the government with a unique opening to jump start the reform process. Moreover, while the recent pickup in inflation bore watching, the relatively robust economic growth provided a conducive environment to undertaking reforms. Staff were encouraged by the efforts being made by the authorities to formulate a comprehensive economic package, including tax measures and raising power tariffs, but stressed that financial markets and potential investors were looking for early evidence of implementation. The quality of some of the proposed revenue measures also required scrutiny, while other measures had yet to be clearly specified and there was uncertainty about what they might entail.

9. **The authorities viewed the current opportunity for reform in similar terms.** The need to address fiscal and structural problems had long been recognized by the authorities and had been much-discussed with the Fund in recent years. However, critical economic reform bills had repeatedly been delayed by political resistance, perhaps reflecting a lack of a sense of urgency about the country's economic problems. The election victory provided a new opportunity to work with Congress and dialogue was already underway with the legislators who were key to pushing through the necessary bills. Nonetheless, the authorities cautioned that it was unrealistic to expect quick passage of every reform bill that came before Congress. Indeed, by promulgating separate bills rather than an omnibus piece of legislation, they hoped to avoid opposition to a particular measure jeopardizing the entire reform package.

A. A. Monetary Policy

10. **The key question facing the authorities was how much extra inflation to countenance on account of recent supply shocks.** Based on current trends, staff projected average inflation to rise above the authorities' 4–5 percent target range in 2005. While there were considerable uncertainties in the outlook, the breach of the target was likely to exceed the amount that could be justified by first-round effects of food and oil price shocks. This raised the question of whether monetary policy needed to be tightened and how best to signal to the public that second-round effects of supply shocks would not be accommodated.



1/ The inflation target is based on annual average inflation. In this chart, the inflation rate in the fourth quarter (marked with a ♦) depicts the BSP's performance against its inflation target.

11. **In view of current uncertainties, the authorities were holding interest rates steady.** Staff argued that there was a case for monetary tightening given that world interest rates were rising, while the increases in indirect taxation and power prices being considered as part of the reform package would exert further upward pressure on inflation. In response, the authorities noted that the still considerable slack in the economy limited the potential for second-round effects of supply shocks, while food prices were expected to ease in the months ahead due to improved availability. Inflationary pressures would also be dampened were the peso to strengthen in response to sentiment-boosting reforms. The authorities agreed that possible second round effects might at some stage require monetary tightening, but for the time being had left monetary policy on hold. Nonetheless, staff urged the authorities to review the 2005 inflation forecast in the next few months once markets had reacted to the reform package, with a view to tightening monetary policy if necessary.

12. **There was considerable discussion about the inflation-targeting communication strategy.** Consistent with the forward-looking nature of inflation targeting, staff recommended that the BSP announce ex ante how much of a breach of the 2005 inflation target it was willing to tolerate due to the recent supply shocks. The authorities responded that they had already informed the public that the upturn in inflation was due to special factors and was likely to be temporary. More generally, the BSP was cautious about publicizing precise quantitative estimates of inflation effects. This would be beyond the practice of most inflation-targeting central banks, and would likely be too technical for the informed layperson, who was the BSP’s target audience. Were the inflation target to be missed, the BSP’s preferred strategy was to invoke the specified escape clauses, and to explain deviations ex post.[4] The authorities agreed, however, that should they announce an adjustment to the inflation target for 2005, an ex ante explanation to the public in quantitative terms would be warranted.

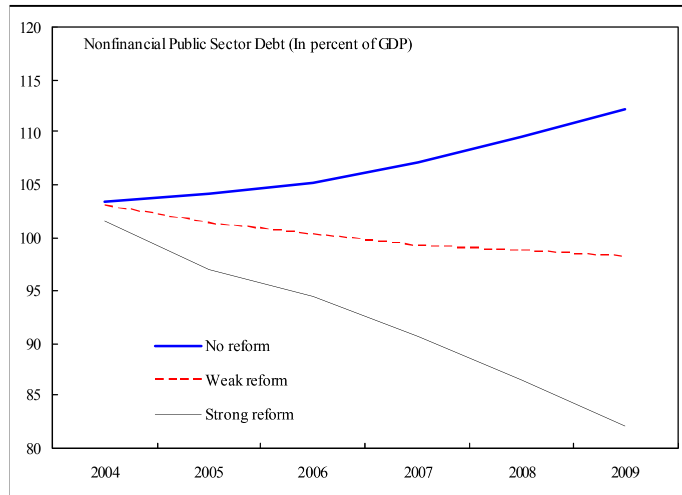
B. Fiscal Policy

13. **With her election victory, President Arroyo has recommitted to balancing the budget.** The precise commitment is not yet clear, but if this means eliminating the National Government deficit by 2009, as was her first administration’s objective, this would imply a fiscal adjustment of 4½ percentage points of GDP compared to the 2003 outturn. Other

[4] The BSP’s inflation targeting framework allows for the following escape clauses when actual inflation deviates from the target: (a) volatility in the prices of unprocessed food; (b) volatility in the prices of oil products; (c) significant government policy changes that directly affect prices such as changes in the tax structure, incentives and subsidies; and (d) natural factors affecting the major part of the economy.

things equal, such an adjustment would reduce the nonfinancial public sector deficit from 5¾ percent of GDP in 2003 to 1¼ percent of GDP by 2009 (Table 5).[5]

14. **While the authorities had yet to commit to annual deficit targets, staff argued that the deficit reduction should be front-loaded.** In particular, reducing the deficit in linear fashion—by about ¾ percentage point of GDP each year during 2004-09—seemed insufficiently ambitious. For one, markets would be looking for strong initial evidence of the authorities' ability to tackle the fiscal problem. Second, fiscal measures were likely to be easiest in the opening period of the new administration. These factors argued for a strong upfront reform effort, and to this end, staff advocated a reduction in the nonfinancial public sector deficit of 2½ percentage points of GDP by 2005. If achieved, such a reduction would make the 2009 deficit target easier to attain, as well as place the ratio of nonfinancial public sector debt to GDP on a clear downward path. By contrast, if the fiscal adjustment effort was to flag, as under the weak reform scenario shown in Table 6, debt would decline more slowly.



15. **The authorities did not consider the upfront deficit adjustment recommended by staff to be politically feasible.** In their view, three revenue measures—increasing alcohol and tobacco excises, increasing petroleum excises, and introducing a telecom franchise tax—had a reasonable chance of being passed by Congress over the next six months.[6] Taken together these measures would imply additional revenue on a full year basis of roughly P 60 billion (1.2 percent of GDP). Moreover, in June, NPC had submitted a petition to the Energy Regulatory Commission (ERC) to increase the average generation tariff hike by P 1.87 per KwH, which, if granted in full, would generate additional public sector revenue of about P 70 billion in 2005 (1.4 percent of GDP). However, it was unclear whether so large a rate increase would be approved (see ¶ 22 below). Moreover, some of the additional public sector revenue would be spent to cover higher interest obligations and to restore the level of capital expenditure. Although the authorities had yet to commit to a particular 2005 target, these factors taken together suggested that a more realistic reduction in the nonfinancial public sector deficit compared to 2003 was about 1 percentage point of GDP.

16. **The authorities' thinking on other revenue measures was still at a formative stage.** Options included scaling back tax incentives and making further efforts to strengthen

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[5] This would entail increasing the nonfinancial public sector primary surplus from 0.5 percent of GDP in 2003 to 4.8 percent of GDP by 2009.

[6] The petroleum excise measure would face least resistance if world prices were to soften so that the tax could be raised without any increase in pump prices.

tax compliance. Repealing nonstandard VAT exemptions and zero-ratings was also an option,[7] although the authorities were less inclined to raise the VAT rate itself. In addition, the authorities were considering the introduction of a gross income tax (GIT), which would involve a sharp reduction in deductions in exchange for a lower tax rate. Support for this reform arose from concerns that some current deductions, such as travel, representation and advertising, allowed too much scope for tax-official discretion, and were being widely abused. The form that the GIT might take was still being studied, but the intention was to sharply limit deductions, for example, to the direct costs of goods sold (Box 2). Concerns about poor compliance were also prompting calls for a tax amnesty so as to bring evaders into the tax net.

17. **Staff raised doubts about the quality of some of these additional measures, particularly the GIT.** While there was scope to simplify the corporate income tax by tightening loopholes and limiting tax official discretion, a GIT seemed ill-advised, particularly given the uncertainty attached to the likely revenue impact. Restricting deductions to a narrow definition like the costs of goods sold would discriminate against industries where costs of goods sold were a small part of business expenses. Equity across industries would require different tax rates, or even different tax bases, which would belie the objective of simplification. In any case, under a GIT, there would still be ample room for tax officials to exercise discretion in determining which deductions were permissible, and for taxpayers to disguise non-deductible costs as deductible ones. The authorities responded that if a GIT were to be introduced, its design would attempt to address some of these issues. Staff also urged the authorities to strongly resist proposals for new tax amnesties, which had been tried repeatedly in the Philippines, and as shown by international experience, were likely to do more harm to future compliance than they raised in initial revenue.

18. **In the staff's view, a higher VAT rate was an attractive revenue-raising option.** At 10 percent, the VAT rate in the Philippines was not high by international standards, and there was widespread international evidence that raising the VAT rate would significantly increase tax revenues, even for a country with low VAT efficiency like the Philippines. However, the authorities expressed concern that a higher rate would only increase the tax burden on already honest tax payers. While they did not rule out raising the rate, they preferred to continue to concentrate their efforts on strengthening administration and improving VAT compliance.

19. **The authorities explained their plans to rationalize expenditure, including through civil service reform.** A plan was being formulated to eliminate redundant civil service positions in conjunction with a voluntary early retirement scheme, although it was too early to predict the effect on civil service employment. The reform would be facilitated by the establishment of a comprehensive personnel information system. Staff supported these plans, but argued that growth of the public sector wage bill could also be contained by tilting future wage increases to positions that were most understaffed and underpaid relative to the private sector. The authorities were also considering a proposal to tighten restrictions on the congressional allocations made to legislators to spend on preferred projects (currently

[7] Nonstandard exemptions include exemptions for legal services and petroleum products. Services paid for in foreign currency are zero-rated.

amounting to about ½ percent of GDP), so that these funds were better focused in high-priority areas.

20. **Reform of the public pension system was also important to ensuring fiscal sustainability.** The Social Security System (SSS), the public pension fund for nongovernment employees, was facing a long-run actuarial deficit that was expected to deplete its assets by 2015. Staff therefore welcomed current attempts to extend the life of the fund by increasing contribution rates and cutting costs. The Government Service Insurance System (GSIS), the pension fund for government employees, was also facing long-run financial difficulties. Although it had recently run cash surpluses, asset management had been sub-optimal, with all assets invested domestically, including poorly-monitored loans to employees. Staff therefore supported the intention to professionalize asset management, but expressed concerns about GSIS's current plans to expand its policy lending.

C. Power Sector

21. **The new administration faces a large unfinished agenda of power sector reforms.** The Electric Power Industry Reform Act (EPIRA) passed in 2001 contained an ambitious blue-print for power sector restructuring, but implementation has proved difficult. The privatization program has made little headway, while populist influences on tariff setting have created a perception of regulatory uncertainty and have left the NPC unable to cover costs (Box 3). Preliminary estimates suggest that without a significant tariff increase, NPC's total deficit will amount to at least P 60 billion in 2004 (1.2 percent of GDP). Yet substantial investment in the power sector is necessary to avoid future shortages, and given the lengthy gestation periods for power plant construction, time is of the essence in getting the private sector involved. The new administration is attaching top priority to quickening the pace of power sector reform.

22. **The discussions revealed considerable agreement on the need for a substantial power tariff hike.** NPC's recent P 1.87 per KwH tariff petition would translate into an almost 20 percent increase in the average price paid by end-users in the Manila area. However, the authorities expressed concerns that so large an increase could result in a backlash from consumers. In this context, the authorities were investigating whether life-line tariffs, the discounted rate for minimum usage, could be better targeted to protect those on low incomes. A sharp tariff hike would also have an adverse effect on industrial competitiveness which would undermine efforts to attract FDI.[8] Nevertheless, the authorities noted that the NPC tariff petition included a provision for time of use pricing, which would reduce the effect on industry. This would further be mitigated once a revision to the tariff structure under consideration is introduced to end the current situation of industry cross-subsidizing residential consumers. Staff recognized the constraints on too large a tariff increase, but noted that the need to reduce the public sector deficit implied that the less

[8] Power rates for industrial users in the Philippines are currently about the same as in Malaysia, and much higher than in Thailand, Indonesia, and Singapore.

revenue raised from electricity consumers, the more revenue government would have to raise elsewhere.[9]

23. **Privatization was also essential to encourage investment and minimize risks of supply shortages**. The bill authorizing the franchise of the National Transmission Corporation (Transco) has languished in Congress since September 2002 and staff argued that its speedy passage would send a clear signal that the authorities welcomed private sector participation in the power sector. The authorities concurred, noting that the franchise bill would be refiled as soon as possible. Moreover, with the election over, there was renewed interest from foreign investors in Transco and bidding would shortly be reopened. The authorities also intended to privatize 70 percent of NPC's generation assets by end-2005, with a number of small plants having already been sold. Staff welcomed these plans, but noted that reducing regulatory uncertainty would be essential for attracting investors to the power sector and avoiding future supply shortages.

D. Banking Sector

24. **The quality of the assets in the banking system continued to be an important concern.** Banks have high nonperforming assets (NPAs) and low profitability, while true capital adequacy is obscured by weaknesses in accounting practices, particularly with regard to the valuation of foreclosed assets ("real and other properties owned or acquired" or ROPOAs). There were also concerns that deficiencies in the way banks classify loans understate the level of distressed assets. Staff analysis indicated that once allowance was made for these factors, the banking system's capital adequacy fell well short of regulatory requirements, and of providing the system with enough scope to buffer major shocks such as an abrupt rise in interest rates. Recapitalization of banks is urgent both to increase the resilience of the banking system and to enhance its ability to contribute to economic growth.[10] The authorities broadly agreed with staff's analysis, but pointed out that the weakness lay in particular banks.

25. **Staff welcomed recent steps to strengthen the regulatory and supervisory framework, but argued that the NPA resolution strategy should be accompanied by greater pressure on banks to enhance the strength of their finances and adopt best accounting practices.** Amendments made to the Philippine Deposit Insurance Corporation (PDIC) Charter in July had resulted in a number of enhancements to the bank resolution framework, such as allowing for the seamless take-over of banks under receivership. Regulations had also been issued to improve banks' credit risk management, strengthen documentary requirements and compliance, and enhance investor protection through

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[9] NPC's financial position will also be assisted by interest savings from a possible transfer to the national government of all or part of NPC's debt (about P 500 billion in total). The amount and timing of the transfer has yet to be decided. Such a transfer should facilitate NPC privatization, but will leave the public sector debt and deficit unchanged.

[10] Staff analysis, using bank level data, has shown low capitalization to be one of the reasons why banks in the Philippines have been slow to expand their lending.

securities custodianship and registry requirements.[11] By contrast, there had been little progress to date in resolving NPAs under the Special Purpose Vehicle (SPV) framework. The authorities were still hopeful that deals would take place before the framework expired in April 2005. However, staff argued that significant NPA sales were more likely if the BSP put pressure on banks to enhance valuation and provisioning of nonperforming assets, especially ROPOAs, while enforcing the adoption of international accounting standards so that the resulting losses become reflected in the banks' financial statements. To revitalize the current strategy and allow supervisors to apply greater pressure, staff advocated a two-pronged approach, consisting of strengthening the legal powers of the BSP and PDIC and the implementation of a restructuring strategy (Box 4).

26. **Lack of legal protection for supervisors has been a long-standing problem in the Philippines.** At present, BSP and PDIC supervisors, rather than their institutions, are primarily liable for regulatory actions that are contested in court. The authorities had hoped to provide adequate legal protection to PDIC supervisors through the recent amendments, but this had not been passed by Congress. The next battleground would be amending the BSP Charter and the authorities were already trying to convince Congress that supervisors in the Philippines were inadequately protected compared with international best practice. There was also a need to grant supervisors a waiver from the deposit secrecy law. In addition, the BSP wanted the power to write down the shareholder capital of noncompliant banks as part of the prompt corrective action framework, and would attempt to convince legislators that this was another area where the Philippines lagged international best practice.

27. **Legal amendments should be followed by the implementation of a restructuring strategy.** The basis of such strategy would be a thorough diagnosis of the capital needs of individual banks that would lay the foundation for future enforcement actions. Staff argued that once the condition of the banking system was fully transparent, viable but undercapitalized banks should be required to present a rehabilitation plan. If such plans were deemed insufficient, the bank would need to be intervened. With losses imposed on existing owners, new investors could be attracted. Part of this strategy could be achieved through a continuation of the current policy in favor of mergers and consolidation. As a last resort, an incentive-based public recapitalization scheme with safeguards could be set up to encourage private capital injections.

V. Staff Appraisal

28. **The election victory provides a chance to break from the past and to boldly implement reforms.** Seizing the current opportunity for reforms will set the stage for higher growth, lower unemployment, and reduced poverty. In this light, staff welcomes the authorities' current efforts to formulate a substantive package of reforms and looks forward to the announcement of a clear set of measures that removes uncertainties about the intended reforms. Moreover, given the past history of delays in implementing reforms, early endorsement by legislators of the administration's reform package is of critical importance.

[11] In addition, the establishment of the Financial Sector Forum in July 2004 had the potential to improve the cooperation and exchange of information among the supervisory and regulatory agencies and avoid regulatory gaps.

29. **Although financial markets have shown recent stability, vulnerabilities remain sizeable.** Economic growth has been relatively strong and the authorities deserve credit for skillfully managing the economic risks associated with the pre-election period. Nonetheless, unless fiscal policy is decisively restored to a sustainable path, the situation could quickly unravel, particularly given continued large external financing requirements which make the Philippines vulnerable to sudden changes in sentiment toward emerging markets. If reforms do not proceed at a brisk pace, there is the potential for downgrades from the credit rating agencies, which could limit market access and negatively affect the economy.

30. **Monetary policy may need to be tightened in the period ahead.** A breach of the 2005 inflation target is in prospect due to higher food and oil prices, combined with prospective hikes in indirect taxes and power tariffs. The global interest cycle has also turned. On the other hand, there is some slack in the economy, and the peso is currently not a source of inflationary pressure. The BSP should reassess its inflation forecast once markets have responded to the new fiscal package, and tighten monetary policy if inflation is expected to exceed that which can be attributed solely to the first round effects of the recent supply shocks.

31. **The commitment to reducing the fiscal deficit is welcome, but adjustment should be front-loaded.** Given the high and unsustainable level of public debt, the new administration has rightly committed to balancing the budget. To this end, the authorities are considering an ambitious fiscal package centered on tax measures, combined with a large NPC tariff increase. In the staff's view, the bulk of these additional revenues should be saved, thereby front-loading fiscal adjustment. Reducing the deficit early on recognizes that tax measures will be easiest at the beginning of the new administration. Moreover, a large upfront adjustment will put public debt on a clearly sustainable path and create room for a recovery in private sector investment.

32. **The nature and quality of the fiscal measures is critical.** Staff fully supports current proposals to increase alcohol, tobacco, and petroleum excises and to repeal nonstandard VAT exemptions and zero-ratings. Staff would also urge the authorities to raise the VAT rate, which is low by international standards. In addition, recent efforts to strengthen tax administration have borne fruit and should be continued. However, the suggested introduction of GIT carries substantial revenue risks, and has the potential to introduce significant distortions, complicate tax administration, and still leave ample room for discretion by revenue officials. A better avenue for tax reform would be to scale back the extensive system of tax incentives, which is the largest source of complexity.

33. **Over the medium term, other reforms are necessary to ensure fiscal sustainability.** Staff welcomes current proposals to streamline the civil service, including through voluntary retirement, and underscores the critical importance of steps being taken to shore up the finances of the pension funds. Staff would, however, encourage the authorities to strongly resist proposals for new tax amnesties, given the potentially harmful effect on taxpayer compliance over time.

34. **Important reforms are being proposed in the power sector, but again implementation will be key.** Stemming NPC losses is a critical challenge for the new administration that will be difficult to meet without a sizable increase in generation tariffs. Adverse effects on industry will be mitigated by time of use pricing, while life-line tariffs should be carefully targeted to shield vulnerable consumers. The administration is appropriately giving priority to Congress passing the Transco franchise bill, which will be pivotal in promoting much needed investment. More generally, reducing regulatory uncertainty is essential for attracting investors and for the success of power sector reforms.

35. **Priority should also be attached to financial sector reform.** Asset quality problems in the banking system continue to be an important concern. At present, the system is fragile and ill-equipped to contribute to economic growth. To revitalize the system, the current strategy of inducing banks to offload NPAs on a voluntary basis needs to be accompanied by greater pressure from supervisors. Staff also urges the new administration and Congress to strengthen legal protection for BSP and PDIC supervisors. Legal amendments should be followed by the implementation of a restructuring strategy for the banking sector.

36. **Further strengthening of statistics is necessary in the period ahead.** Staff welcomes the authorities' commitment to redress data shortcomings and encourages them to intensify efforts to implement the recommendations made in the data ROSC.

Box 1. The New Administration's Policies

In her inaugural speech on June 30, President Arroyo announced a 10-point plan to guide her second six-year term:

- Create more than 6–10 million jobs, support 3 million entrepreneurs, and develop 1–2 million hectares of land for agribusiness.
- Ensure that everyone of school age is in school in an uncrowded classroom and in surroundings conducive to learning.
- Balance the budget.
- Link the entire country via a network of transport and digital infrastructure.
- Provide power and water to all barangays (neighborhoods).
- Decongest Metro Manila.
- Develop the Subic-Clark corridor into the most competitive international service and logistic center in the region.
- Computerize the electoral process.
- Bring peace to Mindanao.
- Reconcile the divisive issues generated by EDSA I, II, and III (the popular revolts that overthrew President Marcos, President Estrada and almost President Arroyo herself, respectively).

More details of the administration's policies were revealed in the State of the Nation Address (SONA) delivered by President Arroyo at the opening of the new session of Congress on July 26, 2004, and in policy speeches preceding the SONA. Key elements include:

- The recognition that the most urgent problem facing the country was the chronic budget deficit which had led to a squeeze on infrastructure investment and programs necessary for societal peace.
- Key fiscal priorities included expanding revenues, spending more on infrastructure and social programs, and finding budgetary savings.
- The administration was proposing 8 legislative revenue measures aimed at raising P 80 billion (1.6 percent of GDP), including: (i) a gross income tax system; (ii) some as yet unspecified changes to the VAT; (iii) a telecom franchise tax; (iv) indexation of excises on alcohol and tobacco products; (v) indexation of excises on petroleum products; (vi) rationalization of fiscal incentives; (vii) introduction of a targeted tax amnesty; and (viii) the creation of a performance driven framework for revenue agencies.
- The government expected to raise another P 20 billion through administrative measures such as increasing efficiency and cutting costs, increasing specific charges and fees, raising duties on petroleum products, and increasing profit transfers from government corporations.
- The need for cheap power in the near term could best be achieved by privatization of electricity assets and the President reiterated as a priority that Congress pass the much-delayed Transco franchise bill so as to facilitate the sale of the national electricity grid.
- Government agencies needed to be re-engineered to reduce waste and corruption. Already 80 offices under the Office of the President had been abolished and another 30 would soon be abolished. Congress was urged to pass a law on government reengineering with "silver parachutes" to facilitate the needed reduction in staffing levels.
- Other key priorities included spending on critical social needs such as health, clean water and education. The President also stressed the need to advance land reform and renewed her call for Congress to pass the "farmland as collateral" bill.

Box 2. Revenue Raising Options

While gross income taxation (GIT) proposals in various forms have circulated in the Philippines for over a decade, it is still unclear what form the new administration's GIT proposal will take. However, the most common previous proposals have been to alter business income taxes so that only the direct costs of production would be deductible. For example, overhead expenses such as advertising costs and wages for administrative personnel might not be deductible. The tax base and/or tax rate might also vary across industries to reflect differing cost structures. GIT proponents claim that the elimination of many deductions will simplify the tax system, reduce opportunities for discretion among corrupt tax officials, allow for a reduction in business income tax rates, and increase revenue.

However, GIT proposals are unlikely to be simpler or reduce corruption, since there will still be many opportunities to debate the deductibility of expenses. A GIT system would also likely be more distortionary, since it would have widely differential effects on different sectors. Moreover, attempts to address this deficiency through differing rates and/or bases would undermine the original rationale for the GIT – simplicity and ease of administration. If the number of excluded deductions is sufficiently large, the GIT may also be ruled under some counties' tax law as a turnover tax rather than as an income tax. As a result, multinationals (potentially including U.S. companies) would be unable to offset GIT payments against their home country income tax liability, which could negatively affect foreign direct investment.

Several factors argue for an increase in the VAT rate. In particular, the VAT has important efficiency and administrative advantages over other revenue sources, and it is moderately progressive in the Philippines due to exemptions for most agricultural goods and small traders. At 10 percent, the current Philippine VAT rate is low. For example, the average standard rate is 14 percent in Latin America and 20 percent in Eastern Europe. Although the average rate in Asia is only 11 percent, other countries in the region either have access to substantial oil revenue (Indonesia and Vietnam) or have a much lower debt service burden than the Philippines. A higher VAT rate has also proven to be a reliable revenue-raiser (see table), even in countries with low initial efficiency ratios (such as the Philippines where the efficiency ratio is 0.31).

Opponents of a VAT rate increase in the Philippines argue that it will put honest taxpayers at a further disadvantage, given the significant evasion of the VAT. There is evidence of VAT evasion in the Philippines, including the low efficiency ratio. However, it is not clear that tax evasion would be any greater for the VAT than for other available revenue enhancers.

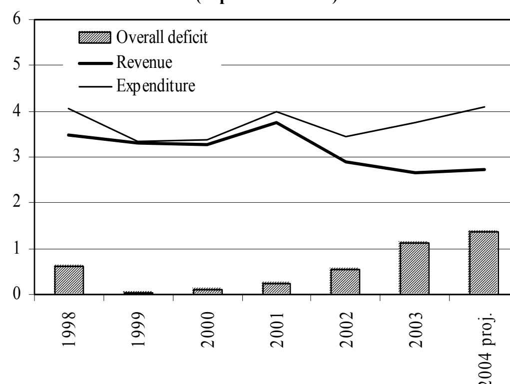
Changes in VAT Rates and Revenue: Experience with Single Rate VATs in Asia and Latin America

Country	Old rate	New rate	Year of change (n)	VAT Revenue (In percent of GDP) n-1	n	n+1	n+2	% Change in VAT rate	% Change in Revenue	Elasticity	Initial efficiency ratio
	A	B	C	D	E	F	G	H=(B-A)*100/A	I=(G-D)*100/D	J=I/H	K=D/A
Bolivia	10	13	March 1, 1992	2.9	4.3	4.6	5.3	30	82	2.7	0.29
Chile	16	18	July 1, 1990	7.5	7.8	7.6	8.2	13	9	0.7	0.47
Dominican Rep.	6	8	June 1, 1992	1.5	2.1	2.6	2.6	33	68	2.0	0.25
Ecuador	6	10	Early 1986	1.6	2.7	2.7	2.6	67	60	0.9	0.27
Ecuador	10	12	Between 3/99 and 9/00	3.2	5.2	6.4	6.3	20	99	4.9	0.32
El Salvador	10	13	Between 1/95 and 9/95	4.4	4.9	5.2	5.3	30	21	0.7	0.44
Guatemala	7	10	January 1, 1996	2.8	3.7	3.7	3.7	43	30	0.7	0.40
Japan	3	5	April 1, 1997	1.5	1.8	2.0	2.1	67	40	0.6	0.49
Average								38	51	1.7	0.37

Sources: Fund staff documents and estimates.

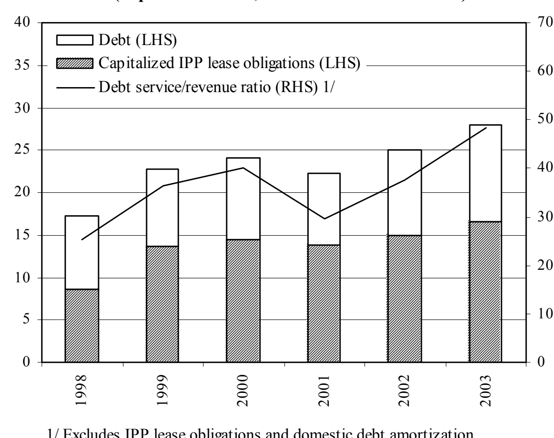
Box 3. Financial Problems in the Power Sector

Losses of the state-owned power sector have reached unprecedented levels in recent years. The financial position of NPC has deteriorated from being almost in balance in 1999-2000 to a loss of 1 percent of GDP in 2003, and is projected to further deteriorate to 1¼ percent of GDP in 2004. NPC's liabilities, including debt and capitalized Independent Power Producer (IPP) lease obligations, have increased from 17 percent of GDP in 1998 to 28 percent of GDP in 2003, with debt service[1] rising to nearly 50 percent of NPC's revenue.



The deteriorating NPC financial conditions mainly reflect past policy decisions, as well as loss of market share.

1) **Politicization of NPC tariff setting:** In May 2002, the NPC board, bowing to political pressures, decided that the purchased power adjustment (PPA)—the automatic power tariff adjustment mechanism reflecting changes in fuel and IPP power purchase costs—be capped at P 0.4 per KwH, resulting in a P 0.85 per KwH decline in NPC tariffs.



1/ Excludes IPP lease obligations and domestic debt amortization.

2) **Legacy of over-contracting of IPPs:** As a quick solution to the power crisis in the early 1990s, the government aggressively invited private participation in the sector, incurring higher than envisaged costs from IPP power purchase contracts (due to take or pay clauses), as growth in electricity demand turned out to be lower than expected. NPC's poor financial condition has been exacerbated by power purchase costs from some of these IPPs not being allowed to be passed on to NPC tariffs.

3) **Loss of market share:** Meralco, the largest private distributor in the country and NPC's main customer, has been shifting its power purchase from NPC to its own IPPs, resulting in a drop in NPC's sales by 14 percent in 2002.

To restore the financial viability of NPC, an increase in its generation tariff is essential, but who should bear the burden? NPC's losses are partly accounted for by sunk costs including those arising from over-contracting with IPPs. Therefore, on efficiency grounds, the entire cost should not necessarily be borne by electricity consumers. What is envisaged under EPIRA is that electricity consumers pay up to the price determined in a competitive electricity generating market, and both electricity consumers and taxpayers share the costs exceeding the market price. However, this is not a practical approach at this stage, given the lack as yet of a competitive market. Therefore, in practice, the authorities need to address the question of burden sharing by asking who can afford the costs and what division of the costs is politically feasible.

[1] Excludes IPP lease obligations and domestic debt amortization.

Box 4. Strengthening the Philippine Banking System

The asset quality problems of the Philippine banking system remain an important concern. With continued high nonperforming asset ratios (around 25 percent) and low provision coverage ratios (around 30 percent), asset quality concerns continue to weigh on the soundness of the banking system. Lackluster profitability, in turn, constrains the ability of the system to strengthen its capital base through retained earnings, thereby completing the vicious circle. Furthermore, in the staff's view, weaknesses in accounting practices, particularly with regard to the valuation of foreclosed assets, and concerns about loan classification practices, obscure the extent of capital adequacy.

Remedial efforts have thus far not been effective. The authorities' approach has centered around the provision of tax, regulatory and other incentives through the Special Purpose Vehicle (SPV) Act, combined with the notion that asset disposal to private SPVs occurs on a purely voluntary basis. However, banks have not been willing to recognize the latent losses on their portfolios, which, at least for some banks, imply substantial recapitalization needs.

More forceful efforts are needed so that the system can be strengthened. There are compelling reasons for action at this juncture. First, the system is fragile and not well equipped to contribute to future growth momentum. As cross-country experience suggests, regulatory forbearance based on the expectation that the system will eventually grow out of its problems is likely to be counterproductive. Second, delaying action may significantly inflate the ultimate resolution costs. Third, the comprehensive reforms being planned by the new administration provide a ready opportunity to take financial sector measures.

Among the key components of a more forceful strategy are:

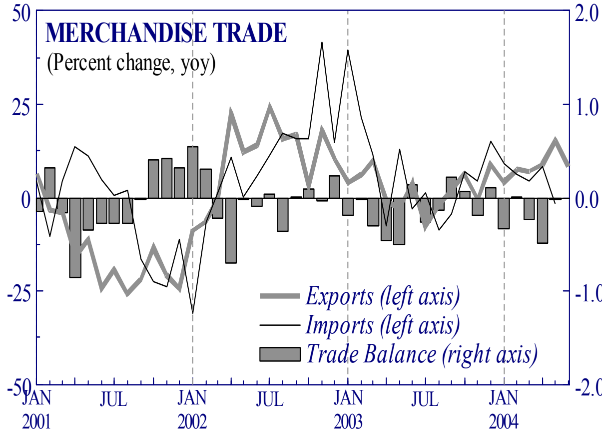
- **Enhancements to the legal and regulatory framework**, to enable supervisors to exert greater pressure on banks. As a matter of priority, the legal powers of the BSP and PDIC need to be enhanced, including by ensuring adequate legal protection and enabling them to write down banks' shareholder capital.

- **A thorough diagnosis of the banking system**, applied to individual bank portfolios and based on international accounting standards. This would lay the foundation for future enforcement actions. Particular attention will need to be paid to the valuation of loans and foreclosed assets, to connected lending, and to the condition of state banks.

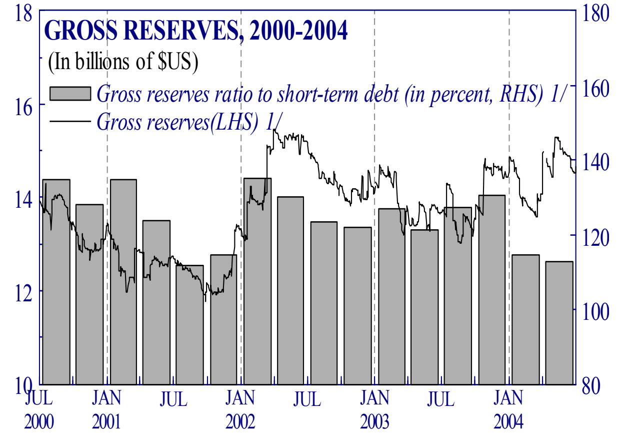
- **The implementation of a restructuring strategy**, whereby nonviable banks are liquidated or merged with viable banks, and viable but undercapitalized banks are allowed an adjustment period to come up with additional capital or else be intervened. Before any new investors are attracted, the capital of existing shareholders should be written down. As a last resort, a public incentive scheme could be considered to bring in private capital. In support of bank restructuring, a corporate restructuring strategy needs to be worked out, including by passing the Corporate Recovery Act.

Figure 1. Philippines: External Developments

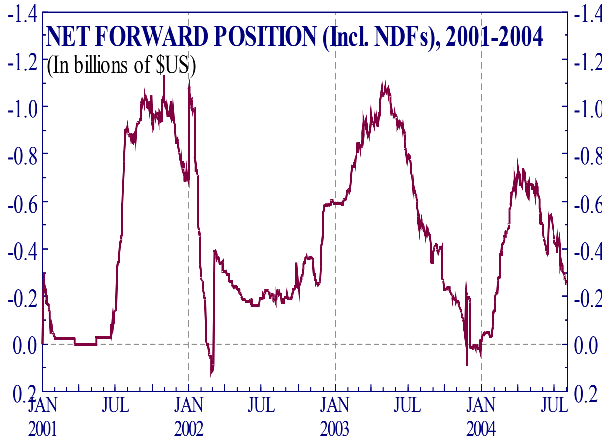
Export growth has picked up...



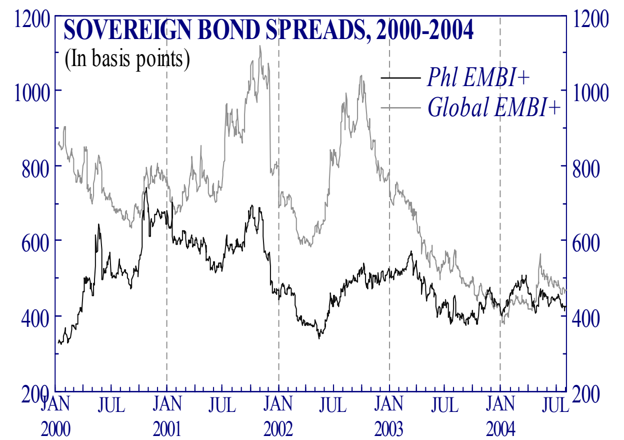
...and gross reserves have been rebuilt to end 2003 levels.



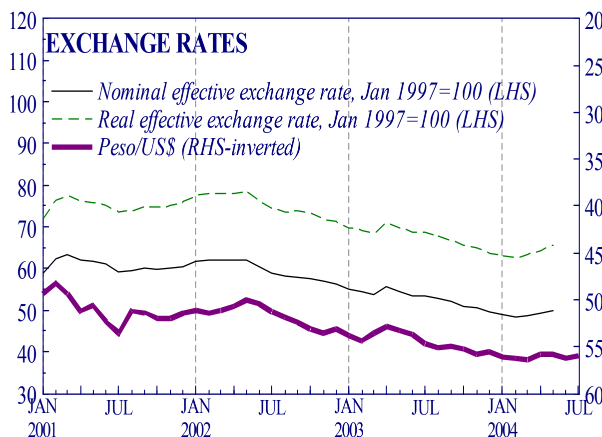
The BSP has recently unwound part of the oversold NDF position...



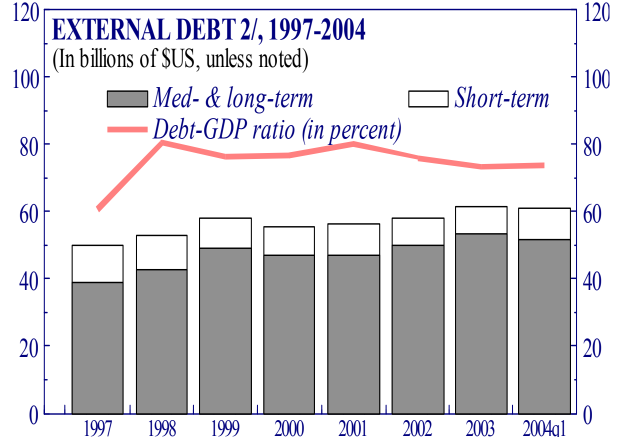
...and sovereign spreads have improved...



...while the peso has stabilized.

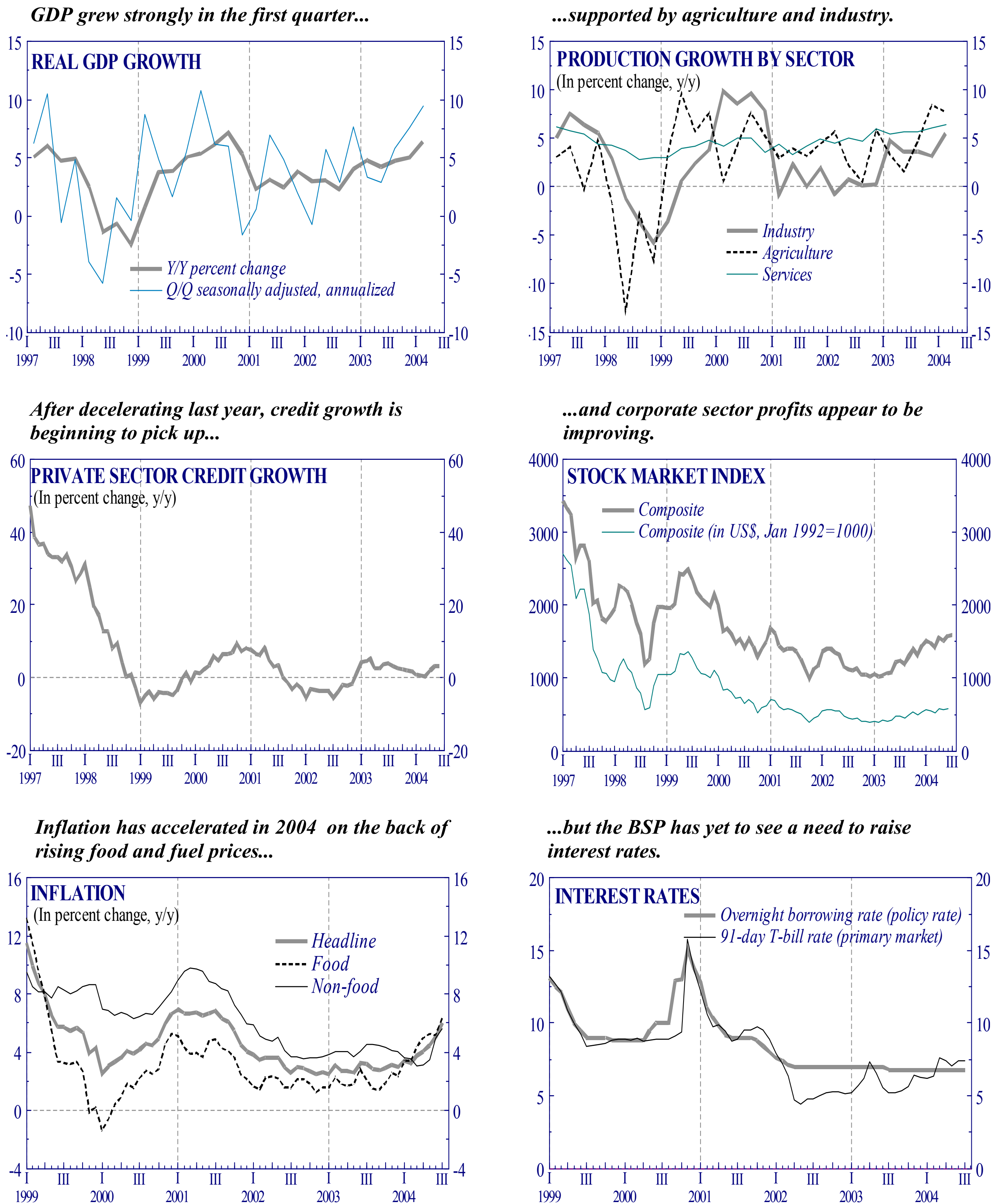


External debt, however, remains high.



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

Figure 2. Philippines: Domestic Developments

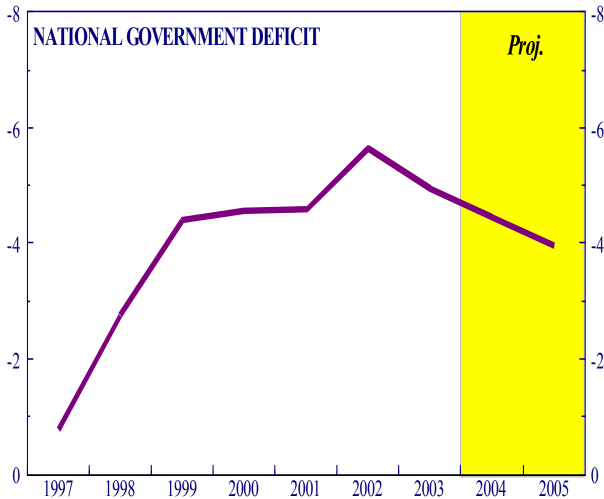


Sources: Data provided by the Philippine authorities; and CEIC; and staff estimates.

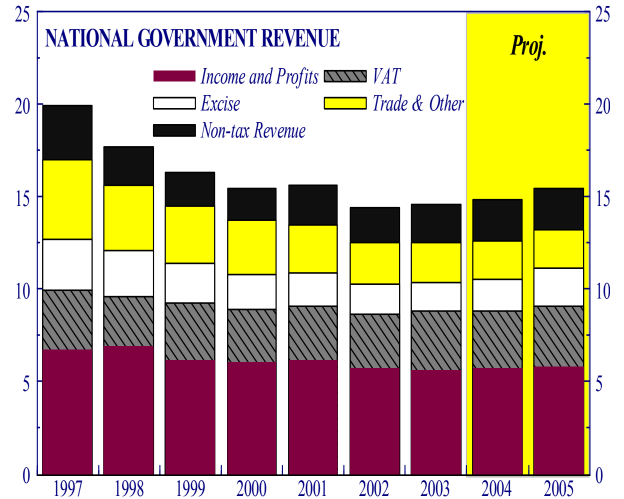
Figure 3. Philippines: Fiscal Sector

(In percent of GDP)

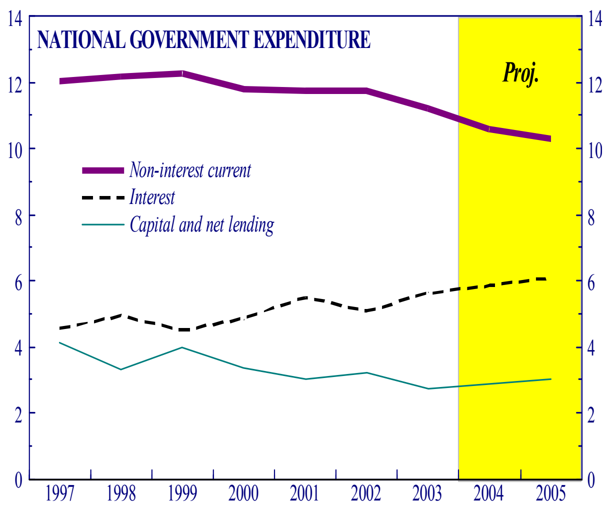
The national government deficit improved in 2003...



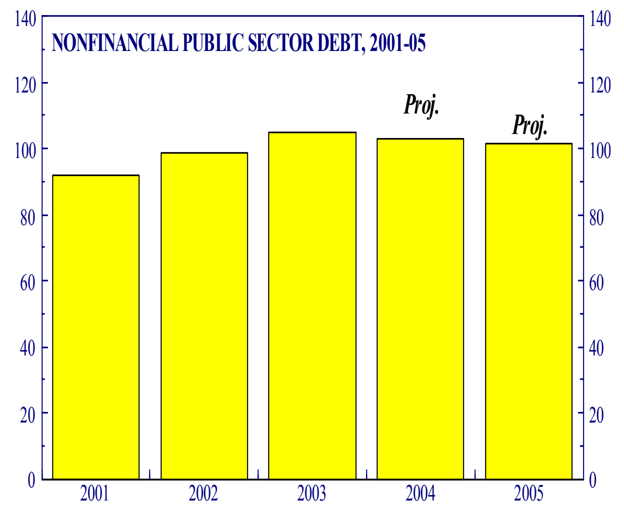
...as the trend decline in revenue was arrested...



...and non-interest spending was compressed.



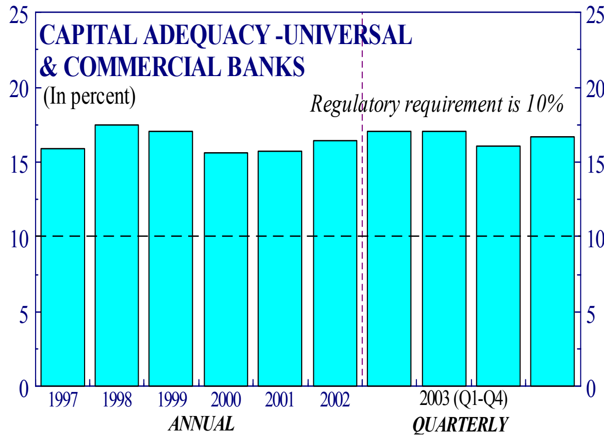
However, public debt rose in 2003, partly reflecting NPC's deteriorating financial condition.



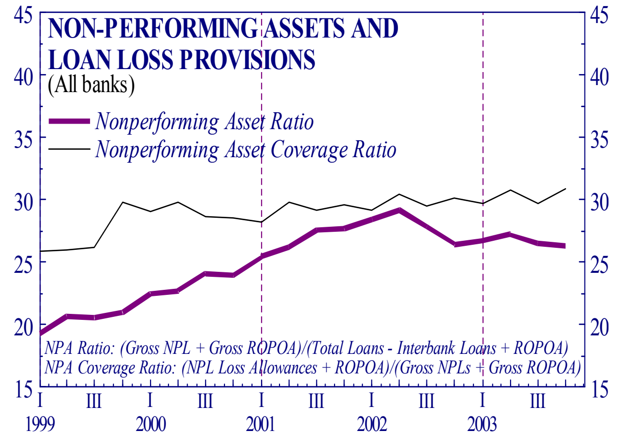
Sources: Data provided by the Philippine authorities; and Fund staff estimates and projections.

Figure 4. Philippines: Banking Sector

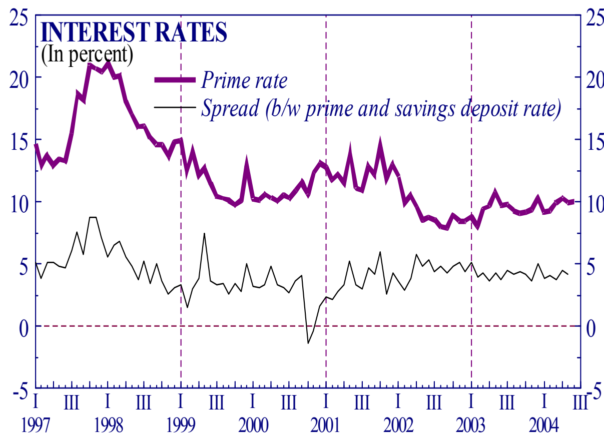
Reported capital adequacy exceeds the regulatory requirement...



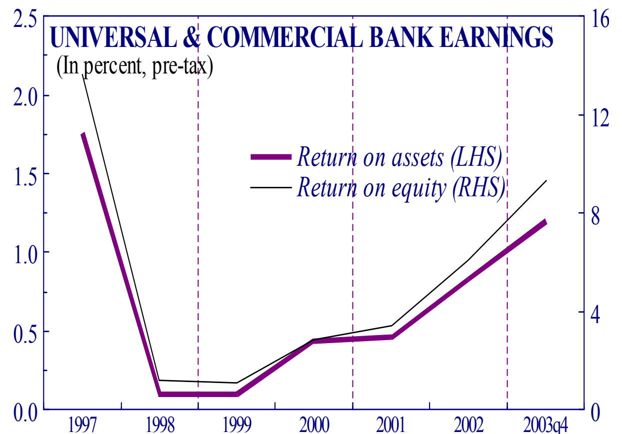
...however, asset quality problems remain a serious concern.



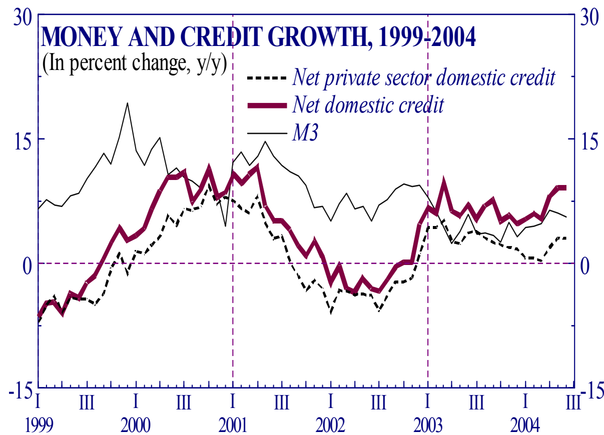
Intermediation spreads have remained steady...



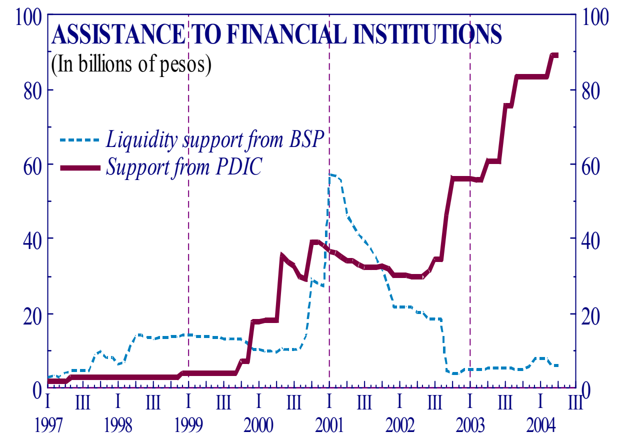
...and profitability has picked up somewhat, but remains low.



Bank credit is growing largely on account of government borrowing...



...while substantive liquidity support from PDIC suggests continued weakness in some banks.



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

Table 1. Philippines: Selected Economic Indicators, 2000–05

Nominal GNP (2003): $85.2 billion
Population (2003, est.): 81.1million
GNP per capita (2003, est.): $1,051
IMF quota: SDR 879.9 million

	2000	2001	2002	2003	Staff Proj. 2004	Staff Proj. 2005
GDP and prices (percentage change)						
Real GDP	4.4	1.8	4.3	4.7	4.9	4.5
Nominal GDP (in billions of pesos)	3,355	3,631	3,960	4,300	4,735	5,253
CPI (annual average)	4.4	6.1	3.0	3.0	5.0	6.2
CPI (end year)	6.7	4.1	2.5	3.1	6.1	5.1
Investment and saving (percent of GDP)						
Gross investment	21.2	19.0	17.6	16.6	17.4	17.9
National saving	29.4	20.8	23.3	21.5	20.2	20.0
Public finances (percent of GDP)						
National government balance (authorities definition)	-4.0	-4.0	-5.3	-4.6	-4.1	-3.6
National government balance 1/	-4.5	-4.6	-5.6	-5.0	-4.4	-3.9
Nonfinancial public sector balance 2/	-4.7	-4.8	-5.7	-5.8	-5.7	-4.8
Revenue and grants 3/	...	23.0	20.9	20.9	21.1	22.3
Expenditure 4/	...	27.8	26.5	26.7	26.8	27.0
Nonfinancial public sector debt 5/	93.5	92.0	98.6	104.8	102.8	100.6
Monetary sector (percentage change, end of period)						
Broad money (M3)	4.6 6/	6.8	9.5	3.3	6.1 7/	...
Base money, reserve requirements adjusted	-4.5 6/	3.1	6.4	3.0	11.8 7/	...
Interest rate (91-day Treasury bill, end of period, in percent)	12.9	8.9	5.2	6.5	7.1 8/	...
Credit to the private sector	8.1	-3.0	1.2	1.8	3.1 7/	...
External sector						
Export value (percent change)	9.0	-16.2	10.0	2.7	7.4	6.7
Import value (percent change)	14.5	-4.5	6.2	6.4	10.0	7.3
Current account (percent of GDP)	8.2	1.9	5.7	4.9	2.8	2.0
Capital and financial account (US$ billions, excluding errors and omissions)	3.0	1.7	1.2	-2.5	-0.5	1.3
Foreign direct investment (net)	1.5	1.1	1.7	0.2	0.2	0.4
Other	1.6	0.6	-0.5	-2.6	-0.7	0.9
Errors and omissions and trade credit (US$ billions)	-9.8	-3.2	-4.9	-1.3	-2.5	-2.5
Overall balance (US$ billions)	-0.5	-0.2	0.7	0.1	-0.6	0.7
Monitored external debt (percent of GDP) 9/	75.6	81.6	77.8	79.2	74.6	71.2
Debt-service ratio (percent of exports)	14.7	19.1	19.9	20.8	21.9	22.8
Reserves, adjusted (US$ billions) 10/	13.4	13.2	14.3	14.7	13.7	14.3
Reserves / Short-term liabilities, adjusted 11/	128.1	114.3	123.9	126.9	104.0	103.6
Exchange rate (period averages)						
Pesos per U.S. dollar	44.2	51.0	51.6	54.2	55.8 8/	...
Nominal effective exchange rate (January 2, 2003 =100)	108.8	109.0	100.1	95.1	89.6 8/	...
Real effective exchange rate (January 2, 2003 =100)	104.3	107.9	100.2	95.6	93.1 8/	...

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

1/ Fund definition. Excludes privatization receipts of the national government, and includes net deficit from restructuring the central bank.
2/ Includes the national government, Central Bank-Board of Liquidators, 14 monitored government-owned enterprises, social security institutions, and local governments.
3/ The sum of all nonfinancial public sector revenue net of intra-public sector payments. It is assumed that 80 percent of Bureau of Treasury revenue represents interest and dividends from other parts of the nonfinancial public sector. Privatization receipts are excluded.
4/ Defined as difference between nonfinancial public sector revenue and balance.
5/ Gross debt net of sinking fund and social security institutions' holdings of national government securities. May include other debt held by other parts of the nonfinancial public sector. This issue is being reviewed by an STA mission.
6/ Adjusted for the estimated effects of Y2K. For base money only, adjusted for changes in reserve requirements.
7/ As of May 2004.
8/ As of August 5, 2004.
9/ Defined as external debt plus liabilities of foreign banks in the Philippines to their headquarters, branches and agencies, some external debt not registered with the central bank and private capital lease agreements.
10/ Gross reserves less gold and securities pledged as collateral against short-term liabilities.
11/ Reserves as a percent of short-term debt (including medium- and long-term debt due in the following year). Both reserves and debt were adjusted for pledged assets.

Table 2. Philippines: National Government Cash Accounts, 2001–05

(In percent of GDP; unless otherwise noted)

	2001	2002	2003	2004			2005
				Jan-Jun	Auth. Prog.	Staff Proj.	Staff Proj.
Revenue and grants	15.7	14.4	14.6	14.6	14.4	14.9	15.4
Tax revenue	13.5	12.5	12.5	12.4	12.7	12.6	13.2
Bureau of Internal Revenue	10.7	10.0	9.9	9.7	10.1	9.9	10.4
Bureau of Customs	2.6	2.4	2.5	2.6	2.4	2.6	2.7
Other offices	0.1	0.1	0.1	0.2	0.2	0.1	0.1
Nontax revenue	2.2	1.9	2.1	2.2	1.8	2.2	2.2
Of which : Central Bank-Board of Liquidators	0.2	0.1	0.1	0.1	0.1	0.1	0.1
Of which : Recovery of Marcos wealth	...	...	...	0.3	0.3	0.3	0.3
Expenditure and net lending	20.3	20.0	19.6	18.2	18.9	19.3	19.3
Current expenditures	17.3	16.8	16.8	15.5	16.4	16.4	16.3
Personnel services	6.6	6.7	6.4	6.0	6.1	6.2	6.1
Maintenance and operations	2.4	2.1	1.8	1.5	1.8	1.8	1.8
Allotments to local government units	2.5	2.8	2.7	2.4	2.4	2.5	2.3
Subsidies	0.2	0.1	0.3	0.1	0.1	0.2	0.2
Interest	5.5	5.1	5.6	5.5	6.0	5.8	6.0
National government	4.8	4.7	5.3	5.1	5.6	5.4	5.6
Central Bank-Board of Liquidators	0.7	0.4	0.4	0.4	0.4	0.4	0.4
Capital and equity expenditure	2.9	3.1	2.6	2.7	2.4	2.7	2.9
Net lending 1/	0.1	0.1	0.1	0.0	0.2	0.1	0.1
Balance	-4.6	-5.6	-5.0	-3.7	-4.5	-4.4	-3.9
Balance including purchase of NPC Securities	-4.9	-6.6	-5.5	-4.7	-4.5	-5.6	-3.9
On the authorities' presentation 2/	-4.0	-5.3	-4.6	-3.4	-4.2	-4.1	-3.6
Financing	4.6	5.6	5.0	3.7	4.5	4.4	3.9
Net external financing	0.6	2.8	3.3	0.9	-0.1	1.3	1.5
Net domestic financing	4.0	2.9	1.6	2.8	4.7	3.1	2.4
Memorandum Items:							
Nonfinancial public sector balance 3/	-4.8	-5.7	-5.8	…	…	-5.7	-4.8
Consolidated public sector balance 3/	-4.7	-5.5	-5.5	…	…	-5.6	-4.7
Primary national government balance	0.9	-0.6	0.7	…	…	1.4	2.1
National government debt 4/	65.7	71.1	78.0	…	…	77.5	75.9
(percent of NG revenues)	419.1	494.2	533.6	…	…	521.1	491.8
Nonfinancial public sector debt 5/	92.0	98.6	104.8	…	…	102.8	100.6
(percent of NFPS revenues)	399.4	472.3	502.0	…	…	487.7	452.2
National government gross financing requirements 6/	21.4	23.2	23.7	…	…	23.9	22.1
Of which: Domestic	19.5	18.2	18.1	…	…	19.9	17.9
Foreign	1.9	5.1	5.6	…	…	4.0	4.2
GDP (in billions of pesos)	3,631	3,960	4,300	2,368	4,713	4,735	5,253

Sources: Philippine authorities; and Fund staff projections.

1/ Excludes purchase of NPC securities.
2/ Includes privatization receipts as revenue and excludes the operations of the Central Bank-Board of Liquidators (CB-BOL).
3/ Excludes privatization receipts from revenue.
4/ Excludes contingent/guaranteed debt, but includes onlent debt.
5/ Nonfinancial public sector includes the national government, CB-BOL, 14 monitored government-owned enterprises, social security institutions, and local governments. Debt is gross and net of sinking fund and social security institutions' holdings of national government securities. Other debts held by other parts of the nonfinancial public sector may, however, be included. This issue is being reviewed by an STA mi
6/ Defined as the deficit, plus amortization of medium- and long-term debt, plus the stock of short-term debt at the end of the last period.

Table 3. Philippines: Balance of Payments, 1999-2005

(In billions of U.S. dollars)

	1999	2000	2001	2002	2003	2004	2005
					Est.	Staff Projections	
CURRENT ACCOUNT BALANCE	**7.2**	**6.3**	**1.3**	**4.4**	**3.9**	**2.3**	**1.9**
Trade Balance	5.0	3.8	-0.7	0.4	-0.8	-1.8	-2.2
Exports, f.o.b.	34.2	37.3	31.2	34.4	35.3	37.9	40.5
Imports, f.o.b.	29.3	33.5	32.0	34.0	36.1	39.8	42.6
Services (net)	-2.7	-2.4	-2.1	-1.0	-1.2	-1.0	-1.2
Receipts	4.8	4.0	3.1	3.1	3.0	3.6	3.9
Payments	7.5	6.4	5.2	4.1	4.2	4.7	5.1
Income	4.5	4.4	3.7	4.5	5.2	4.6	4.5
Receipts, of which:	8.1	7.8	7.2	7.9	8.4	8.8	9.1
Workers remittances	6.8	6.1	6.0	7.2	7.6	7.9	8.2
Payments	3.6	3.4	3.5	3.5	3.2	4.2	4.5
Interest payments	2.8	3.0	2.9	2.5	2.6	3.6	3.8
Transfers (net)	0.5	0.4	0.4	0.5	0.6	0.7	0.7
Receipts	0.6	0.6	0.5	0.6	0.7	0.7	0.8
Payments	0.1	0.1	0.1	0.1	0.1	0.1	0.1
CAPITAL AND FINANCIAL ACCOUNT	**4.1**	**3.0**	**1.7**	**1.2**	**-2.5**	**-0.5**	**1.3**
Capital Account	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Financial Account	4.1	3.0	1.7	1.2	-2.5	-0.5	1.3
Direct Investment	1.8	1.5	1.1	1.7	0.2	0.2	0.4
Portfolio Investment	6.9	0.2	1.1	1.1	-0.7	1.5	3.4
Equity	1.4	-0.2	0.4	0.4	0.4	0.2	0.2
Debt	5.5	0.4	0.7	0.7	-1.1	1.2	3.2
Other Investment (excluding trade credit)	-4.5	1.3	-0.5	-1.6	-2.0	-2.2	-2.6
ERRORS AND OMISSIONS (incl. trade credit)	**-7.7**	**-9.8**	**-3.2**	**-4.9**	**-1.3**	**-2.5**	**-2.5**
OVERALL BALANCE	**3.6**	**-0.5**	**-0.2**	**0.7**	**0.1**	**-0.6**	**0.7**
OVERALL FINANCING	**-3.6**	**0.5**	**0.2**	**-0.7**	**-0.1**	**0.6**	**-0.7**
Monetisation of gold and revaluation	0.0	0.0	0.1	0.9	1.1	0.0	0.2
Change in Net international reserves (increase =-)	-3.6	0.5	0.0	-1.6	-1.2	0.6	-0.9
BSP Gross Reserves (increase =-)	-4.2	0.1	-0.6	-0.5	-0.7	1.7	-0.6
Fund credit (net)	0.3	0.3	0.0	-0.4	-0.6	-0.5	-0.3
Change in other BSP liabilities	0.3	0.1	0.7	-0.7	0.1	-0.7	0.0
Memorandum items:							
Current account/GDP	9.5	8.2	1.9	5.7	4.9	2.8	2.0
Short-term debt (original maturity)	9.0	8.4	9.1	8.0	8.2	8.3	8.7
Short-term debt (residual maturity)	12.0	12.1	14.0	13.4	13.7	14.6	15.2
Gross reserves	15.1	15.0	15.6	16.2	16.9	15.1	15.7
Adjusted gross reserves 1/	13.6	13.4	13.2	14.3	14.7	13.7	14.3
(in percent of st. debt by res. maturity) 2/	129.4	128.1	114.3	123.9	126.9	104.0	103.6
Net international reserves	11.8	11.3	11.4	12.8	13.9	13.3	14.2
Monitored external debt (in billions) 3/	57.9	57.4	58.1	59.7	62.8	63.1	65.2
(in percent of GDP)	76.1	75.6	81.6	77.8	79.2	74.6	71.2
Debt service ratio 4/	17.0	14.7	19.1	19.9	20.8	21.9	22.8
Export value (percent change)	16.0	9.0	-16.2	10.0	2.7	7.4	6.7
Import value (percent change)	-1.0	14.5	-4.5	6.2	6.4	10.0	7.3
Gross external financing needs 5/	6.7	5.8	10.8	9.6	9.6	11.4	12.8

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

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

Table 4. Philippines: Monetary Survey, 2000-2004

	2000	2001	2002	2003				2004		
	Dec.	Dec.	Dec.	Mar.	Jun.	Sep.	Dec.	Mar.	Apr.	May
				(In billions of pesos)						
Net foreign assets	343	405	541	522	591	608	662	671	644	634
Central bank	430	449	538	512	519	552	626	620	630	641
Net international reserves	567	586	684	658	660	691	771	763	784	795
Medium and long-term foreign liabilities	138	136	146	146	141	139	145	143	154	154
Deposit money banks	-87	-44	4	10	72	56	37	51	14	-7
Net domestic assets	1,737	1,760	1,809	1,811	1,772	1,774	1,812	1,838	1,878	1,889
Net domestic credit	2,088	2,106	2,208	2,222	2,183	2,252	2,314	2,341	2,353	2,381
Public sector credit	581	645	727	732	719	794	807	845	850	877
National Government	426	532	590	583	567	616	620	649	648	675
Credits	575	690	749	735	725	779	807	849	848	878
Foreign exchange receivables	13	12	7	7	7	7	7	7	7	7
Treasury IMF Accounts	-41	-50	-50	-50	-58	-58	-58	-58	-58	-58
Deposits	-121	-120	-117	-110	-107	-112	-137	-150	-149	-153
Local government and others	104	97	132	144	147	174	184	195	200	200
Claims on CB-BOL 1/	51	15	6	5	4	4	4	2	2	2
Private sector credit	1,507	1,462	1,480	1,490	1,464	1,458	1,507	1,496	1,503	1,504
Other items net	-351	-347	-398	-410	-412	-478	-502	-504	-475	-492
Total liquidity	2,079	2,165	2,351	2,334	2,363	2,382	2,474	2,509	2,522	2,523
M4	2,013	2,111	2,298	2,279	2,300	2,310	2,401	2,435	2,448	2,447
M3 (peso liquidity)	1,427	1,525	1,670	1,635	1,647	1,641	1,725	1,713	1,712	1,733
Foreign currency deposits, residents	586	586	628	645	652	669	676	722	736	715
Other liabilities	66	54	53	54	63	72	73	74	74	76
				(12-month percent change)						
Net foreign assets	4.2	18.3	33.6	1.5	17.8	18.1	22.4	28.5	23.6	8.1
Net domestic assets	8.0	1.3	2.8	8.8	4.5	4.0	0.1	1.5	4.8	7.0
Net domestic credit	8.6	0.9	4.8	9.8	7.1	7.7	4.8	5.4	8.1	9.1
Public sector	9.9	10.9	12.9	20.3	14.6	18.6	11.0	15.5	21.1	21.3
Idem, adjusted 2/	4.4	10.7	11.5	18.7	13.1	17.3	9.9	14.1	19.3	19.1
Private sector	8.1	-3.0	1.2	5.2	3.8	2.6	1.8	0.4	2.0	3.1
Idem, adjusted 2/	2.4	-3.5	0.6	4.4	2.8	2.1	1.7	-0.2	1.1	2.1
M4	6.7	4.9	8.9	7.6	7.7	6.4	4.5	6.8	8.9	7.0
M3	4.6	6.8	9.5	4.6	5.9	3.4	3.3	4.8	6.5	6.1
Memorandum items:										
				(In billions of pesos; unless otherwise stated)						
Gross domestic credit from deposit money banks	1,999	2,085	2,151	2,165	2,152	2,220	2,322	2,386	2,420	2,453
Private sector	1,492	1,451	1,470	1,480	1,454	1,449	1,498	1,487	1,494	1,495
(12-month percent change)	8.1	-2.7	1.3	5.3	3.7	2.6	1.9	0.4	2.0	3.2
Public sector	507	634	681	685	698	771	824	899	926	958
(In percent of total gross credit)	25	30	32	32	32	35	36	38	38	39
o/w in dollars	200	228	253	273	263	319	364	379	406	407
				(In billions of US dollars)						
Net foreign assets	6.9	7.9	10.2	9.8	11.0	11.1	11.9	11.9	11.5	11.4
Central bank	8.6	8.7	10.1	9.6	9.7	10.0	11.3	11.0	11.3	11.5
Deposit money banks	-1.7	-0.9	0.1	0.2	1.3	1.0	0.7	0.9	0.2	-0.1
Foreign currency deposits residents	11.7	11.4	11.8	12.0	12.1	12.2	12.2	12.8	13.2	12.8
Dollar-denominated credit to residents	10.8	10.2	9.9	10.2	8.9	9.4	9.9	11.1	11.7	11.7
Public sector	4.0	4.4	4.8	5.1	4.9	5.8	6.6	6.7	7.3	7.3
Private sector	6.8	5.8	5.2	5.1	4.0	3.6	3.3	4.3	4.4	4.4
				(In percent; unless otherwise stated)						
Dollar denominated credit / dollar deposits	92.0	89.4	84.0	84.7	73.4	77.1	81.0	86.3	88.9	91.3
Dollar denominated credit to public sector / dollar deposits	34.1	38.8	40.3	42.3	40.3	47.7	53.9	52.4	55.2	56.9
Exchange rate (peso per dollar; end-period)	50.0	51.4	53.1	53.5	53.7	54.9	55.6	56.4	55.9	55.8

Source: Philippine authorities and CEIC

1/ The Central Bank-Board of Liquidators was established in 1993 to absorb the debts of the old central bank.
2/ Adjusted for exchange rate valuation effects.

Table 5. Philippines: Medium-Term Outlook, 2002–09
(Strong reform scenario)

	2002	2003	2004	2005	2006	2007	2008	2009
			Projections					
			(Percentage change)					
GDP and prices								
Real GDP	4.3	4.7	4.9	4.5	4.8	5.0	5.2	5.4
CPI (year average)	3.0	3.0	4.9	6.3	4.7	4.3	3.8	3.5
			(In percent of GDP, unless otherwise indicated)					
Investment and saving								
Gross investment	17.6	16.6	17.4	18.7	19.0	19.5	20.0	21.0
National saving	23.3	21.5	20.2	21.3	21.2	21.3	21.7	22.5
Foreign saving	5.7	4.9	2.8	2.6	2.2	1.8	1.7	1.5
Public finances								
Nonfinancial public sector balance 1/	-5.7	-5.8	-5.5	-3.4	-3.0	-1.9	-1.5	-1.2
Primary balance	0.2	0.5	1.3	3.5	3.6	4.7	4.7	4.8
Revenue and grants 2/	20.9	20.9	21.3	23.3	23.4	23.8	24.2	24.3
Expenditure (primary) 3/	20.7	20.4	20.0	19.9	19.8	19.2	19.4	19.5
Interest	5.8	6.3	6.8	6.8	6.7	6.5	6.2	6.0
Nonfinancial public sector gross financing requirements	28.2	30.2	29.5	26.9	24.4	22.3	21.6	19.2
Domestic	22.8	23.4	24.8	21.6	19.4	18.3	17.7	15.0
Foreign currency	5.4	6.7	4.7	5.3	5.0	4.1	3.9	4.2
National government balance (authorities definition)	-5.3	-4.6	-3.9	-2.3	-1.9	-0.9	-0.5	0.0
National government balance 4/	-5.6	-5.0	-4.2	-2.6	-2.2	-1.2	-0.7	-0.2
Nonfinancial public sector debt 5/	98.6	104.8	101.5	96.9	94.2	90.3	86.2	81.9
External sector								
Export value (percent change)	10.0	2.7	7.2	6.8	7.4	7.6	7.8	8.0
Import value (percent change)	6.2	6.4	9.9	6.7	7.8	7.9	7.7	7.8
Trade balance	0.5	-1.0	-2.2	-2.1	-2.2	-2.4	-2.4	-2.4
Current account	5.7	4.9	2.8	2.6	2.2	1.8	1.7	1.5
FDI (net, US$ billions)	1.7	0.2	0.2	0.7	1.0	1.1	1.2	1.3
Reserves, adjusted (US$ billions) 6/	14.3	14.7	13.9	15.1	16.5	17.9	19.2	20.8
Reserves / Short-term liabilities, adjusted 7/	123.9	126.9	105.5	112.6	122.1	137.3	142.0	158.7
Gross external financing requirements (US$ billions) 8/	9.6	9.6	11.4	12.2	12.6	13.0	12.6	13.2
Monitored external debt 9/	77.8	79.2	74.2	68.4	65.1	62.5	59.6	57.0
Debt service ratio (in percent of exports of G&S)	19.9	20.8	21.9	22.3	21.2	20.0	17.6	17.2

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

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

Table 6. Philippines: Medium-Term Outlook, 2002–09
(Weak reform scenario)

	2002	2003	2004	2005	2006	2007	2008	2009
			Projections					
			(Percentage change)					
GDP and prices								
Real GDP	4.3	4.7	4.9	4.5	4.3	4.2	4.1	4.0
CPI (year average)	3.0	3.0	5.0	6.2	4.8	4.3	4.0	4.0
			(In percent of GDP, unless otherwise indicated)					
Investment and saving								
Gross investment	17.6	16.6	17.4	17.9	17.7	17.5	17.0	16.5
National saving	23.3	21.5	20.2	20.0	19.4	18.6	17.5	16.3
Foreign saving	5.7	4.9	2.8	2.0	1.7	1.1	0.5	-0.2
Public finances								
Nonfinancial public sector balance 1/	-5.7	-5.8	-5.7	-4.8	-4.7	-4.4	-4.4	-4.4
Primary balance	0.2	0.5	1.0	2.2	2.5	2.9	3.1	3.2
Revenue and grants 2/	20.9	20.9	21.1	22.3	22.2	22.4	22.6	22.7
Expenditure (primary) 3/	20.7	20.4	20.0	20.0	19.7	19.5	19.6	19.4
Interest	5.8	6.3	6.7	7.0	7.2	7.3	7.5	7.6
Nonfinancial public sector gross financing	28.2	30.2	29.8	28.6	26.9	26.0	26.6	24.5
Domestic	22.8	23.4	25.1	22.4	20.3	19.8	18.8	16.3
Foreign currency	5.4	6.7	4.7	6.2	6.6	6.2	7.8	8.3
National government balance (authorities definition)	-5.3	-4.6	-4.1	-3.6	-3.4	-3.3	-3.2	-3.1
National government balance 4/	-5.6	-5.0	-4.4	-3.9	-3.7	-3.6	-3.4	-3.3
Nonfinancial public sector debt 5/	98.6	104.8	102.8	100.6	99.6	98.6	97.9	97.4
External sector								
Export value (percent change)	10.0	2.7	7.4	6.7	6.7	6.2	5.9	5.5
Import value (percent change)	6.2	6.4	10.0	7.3	6.5	6.5	6.5	6.4
Trade balance	0.5	-1.0	-2.2	-2.4	-2.3	-2.4	-2.7	-3.1
Current account	5.7	4.9	2.8	2.0	1.7	1.1	0.5	-0.2
FDI (net, US$ billions)	1.7	0.2	0.2	0.4	0.4	0.4	0.3	0.3
Reserves, adjusted (US$ billions) 6/	14.3	14.7	13.7	14.3	15.0	15.7	16.8	17.4
Reserves / Short-term liabilities, adjusted 7/	123.9	126.9	104.0	103.6	105.4	106.3	104.8	104.7
Gross external financing requirements (US$ billions) 8/	9.6	9.6	11.4	12.8	13.6	14.6	15.6	17.7
Monitored external debt 9/	77.8	79.2	74.6	71.2	69.7	69.1	69.4	70.0
Debt-service ratio (in percent of exports of G&S)	19.9	20.8	21.9	22.8	22.5	22.2	21.4	22.0

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

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

Table 7. Philippines: Banking Sector Indicators, 1999–2004
(End of year unless otherwise indicated)

	1999	2000	2001	2002	2003	2004 Mar.
apital						
Total capital accounts to total assets	14.5	13.6	13.6	13.4	13.1	12.7
Net worth-to-risk assets ratio	17.5	16.2	16.1	16.7	16.7	..
Capital adequacy ratio (solo basis)	...	...	14.7	15.5	16.3 1/	..
Capital adequacy ratio (consolidated basis)	...	...	15.7	16.9	17.8	..
sset quality						
NPL ratio 2/	14.6	16.6	19.0	16.6 7/	16.1	16.5
NPA ratio 3/	21.0	24.0	27.7	26.4 7/	26.1	26.9
Distressed asset ratio 4/	24.4	27.7	31.7	31.0 7/	31.1	31.6
NPL coverage ratio 5/	45.2	43.7	45.3	50.2 7/	51.5	51.0
NPA coverage ratio 6/	29.8	28.6	29.6	30.1 7/	30.9	30.4
rnings						
Net interest income to average earning assets	4.5	3.9	3.8	3.8	3.7	3.8
Return on assets	0.4	0.4	0.4	0.8	1.1	1.1
Return on equity	2.9	2.6	3.2	5.8	8.5	8.6
Cost-to-income ratio 8/	72.2	81.8	80.7	71.4	68.8	69.3
quidity						
Liquid assets to total assets	26.4	29.0	30.0	32.3	32.3	33.6

urce: Philippine authorities; and Fund staff calculations.

1/ Data as of 30 June 2003.
2/ Nonperforming loans (NPL) over total loan portfolio excluding interbank loans (TL).
3/ NPL plus "real and other properties owned or acquired" (ROPOA) over TL plus ROPOA.
4/ NPL plus ROPOA plus current restructured loans over TL plus ROPOA.
5/ Loan loss reserves over NPLs.
6/ Allowances for probable losses on NPAs over NPAs.
7/ Change in series largely due to new NPL definition in 2002.
8/ Operating expenses (net of bad debts and provisions) to total operating income.

Table 8. Philippines: Indicators of Financial Obligations to the Fund, 2002–09

	2002	2003	2004	2005	2006	2007	2008	2009
Fund repurchases and charges								
In millions of U.S. dollars	461.8	652.9	500.4	336.1	198.3	191.9	33.9	0.0
In percent of exports of goods and services	1.2	1.7	1.2	0.8	0.4	0.4	0.1	0.0
In percent of total debt service due	6.2	8.2	5.3	3.4	1.9	1.7	0.3	0.0
In percent of quota	40.5	53.1	38.6	25.9	15.2	14.7	2.6	0.0
In percent of adjusted gross official reserves	3.2	4.4	3.7	2.4	1.3	1.2	0.2	0.0
Fund credit outstanding								
In millions of U.S. dollars	1686.0	1126.7	717.9	401.6	216.6	30.4	0.0	0.0
In percent of quota	140.9	91.6	55.3	30.9	16.6	2.3	0.0	0.0
In percent of GNP	2.1	1.3	0.8	0.4	0.2	0.0	0.0	0.0
In percent of total external debt	2.8	1.8	1.1	0.6	0.3	0.0	0.0	0.0

Source: Fund staff projections.

PHILIPPINES: DEBT SUSTAINABILITY ANALYSIS

The sustainability of the Philippines' nonfinancial public sector (NFPS) debt depends largely on the strength of future reforms (Table A1). Under a baseline scenario of weak reforms, debt would stabilize at around 100 percent of GDP. This stabilization would be achieved by an adjustment in the primary balance of 2¾ percent of GDP over 2004-09 and an assumed average real GDP growth of 4¼ percent. However, in the absence of reform (Alternative Scenario 2), debt would continue to climb under the assumption of a largely unchanged primary deficit and somewhat slower real GDP growth (average of 4 percent). Conversely, strong reforms (Alternative Scenario 3) would put debt on a steep downward path. This scenario assumes that a stronger primary balance adjustment of 4½ percent of GDP (with a little more than half occurring in 2005) would improve debt dynamics both directly and indirectly, assuming that improved confidence and private sector investment would raise average real GDP growth to 5 percent.

Future shocks could also adversely affect debt dynamics. With weak reform, debt sustainability would remain highly susceptible to adverse developments: the Bounds Tests indicate considerable sensitivity of the projected debt-ratio to shocks, especially to the exchange rate and growth. In contrast, debt dynamics would be more resilient if stronger and more front-loaded reforms were adopted.

Fiscal consolidation would facilitate a reduction in external vulnerability. Under the baseline scenario, involving modest fiscal consolidation, external debt would stabilize at about 70 percent of GDP from 2006-2009 (Table A2) but would remain highly sensitive to any exchange rate depreciation (Bounds Tests 3 and 6) as well as a deterioration in the current account balance (Bounds Test 4). A more ambitious reform agenda, involving front-loaded fiscal consolidation, would facilitate a significant reduction in external vulnerability. A recovery in foreign direct investment and equity inflows, an improved outlook for exports, and relatively lower interest rates, would enable the government to reduce its external borrowing while still maintaining an adequate level of reserves. External debt would fall to 57 percent of GDP by 2009 (Alternative Scenario A2). In the absence of ambitious reforms, the external position would continue to weaken. The government would need to borrow substantially to finance a rising fiscal deficit and to prop up official reserves. External debt would rise to 77 percent of GDP by 2009 (Alternative Scenario A3).

Table A1. Philippines: Nonfinancial Public Sector Debt Sustainability Framework, 2001-2009
(Weak reform scenario; in percent of GDP, unless otherwise indicated)

	Actual		Prel.			Projections						
	2001	2002	2003			2004	2005	2006	2007	2008	2009	
						I. Baseline Projections						**Debt-stabilizing primary balance 6/**
1 **Nonfinancial public sector debt 1/**	92.0	98.6	104.8			102.8	100.6	99.6	98.6	97.9	97.4	1.8
o/w foreign-currency denominated	42.0	45.3	67.4			62.9	60.5	58.2	57.0	57.0	56.7	
2 Change in nonfinancial public sector debt	-1.5	6.7	6.2			-2.1	-2.1	-1.0	-1.0	-0.7	-0.6	
3 Identified debt-creating flows (4+7+12)	-1.2	-0.6	0.1			-3.3	-3.2	-2.0	-1.9	-1.6	-1.4	
4 Primary deficit	-1.4	-0.2	-0.5			-1.0	-2.2	-2.5	-2.9	-3.1	-3.2	
5 Revenue and grants 2/	23.0	20.9	20.9			21.1	22.3	22.2	22.4	22.6	22.7	
6 Primary (noninterest) expenditure	21.6	20.7	20.4			20.0	20.0	19.7	19.5	19.6	19.4	
7 Automatic debt dynamics	0.3	-0.5	0.6			-2.2	-0.9	0.5	1.0	1.5	1.8	
8 Contribution from interest rate/growth differential	-0.9	-1.8	-1.5			-2.9	-3.1	-1.4	-0.6	0.0	0.3	
9 Of which contribution from real interest rate	0.6	1.9	2.8			1.7	1.0	2.6	3.3	3.7	3.9	
10 Of which contribution from real GDP growth	-1.5	-3.7	-4.3			-4.6	-4.1	-4.0	-3.9	-3.7	-3.6	
11 Contribution from exchange rate depreciation	1.2	1.3	2.1			0.7	2.2	1.9	1.5	1.5	1.5	
12 Other identified debt-creating flows	0.0	0.0	0.0			0.0	0.0	0.0	0.0	0.0	0.0	
13 Privatization receipts (negative)	0.0	0.0	0.0			0.0	0.0	0.0	0.0	0.0	0.0	
14 Recognition of implicit or contingent liabilities	0.0	0.0	0.0			0.0	0.0	0.0	0.0	0.0	0.0	
15 Other (specify, e.g. bank recapitalization)	0.0	0.0	0.0			0.0	0.0	0.0	0.0	0.0	0.0	
16 Residual, including asset changes (2-3)	-0.4	7.3	6.1			1.2	1.0	1.0	1.0	0.9	0.9	
Nonfinancial public sector debt-to-revenue ratio 1/	399.4	472.3	502.0			487.7	452.2	449.0	439.7	432.4	429.9	
Gross financing need 3/	28.2	28.2	30.2			29.8	28.6	26.9	26.0	26.6	24.5	
in billions of U.S. dollars	20.0	21.7	23.9			25.2	26.1	26.1	26.6	28.7	27.9	
Key Macroeconomic and Fiscal Assumptions				10-Year Historical Average	10-Year Standard Deviation							Projected Average
Real GDP growth (in percent)	1.8	4.3	4.7	3.6	1.9	4.9	4.5	4.3	4.2	4.1	4.0	4.3
Average nominal interest rate on public debt (in percent)	7.2	6.9	7.0	7.4	0.6	7.1	7.6	7.8	8.0	8.2	8.4	7.9
Average real interest rate (nominal rate minus change in GDP deflator, in percent)	0.8	2.4	3.3	0.0	1.7	2.1	1.4	3.0	3.7	4.2	4.4	3.1
Inflation rate (GDP deflator, in percent)	6.4	4.5	3.7	7.4	1.8	5.0	6.2	4.8	4.3	4.0	4.0	4.7
Growth of real primary spending (deflated by GDP deflator, in percent)	-1.3	0.1	2.9	3.4	6.0	3.2	4.3	2.6	3.5	4.2	3.4	3.5
Primary deficit	-1.4	-0.2	-0.5	-2.7	1.8	-1.0	-2.2	-2.5	-2.9	-3.1	-3.2	-2.5
						II. Stress Tests for Public Debt Ratio						**Debt-stabilizing primary balance 6/**
A. Alternative Scenarios												
A1. Key variables are at their historical averages in 2004-09 4/						100.4	97.4	94.2	90.6	87.1	83.6	-1.6
A2. No reform scenario						103.3	104.2	105.2	107.1	109.5	112.2	3.0
A3. Strong reform scenario						101.5	96.9	94.2	90.3	86.1	81.8	-0.2
B. Bound Tests												
B1. Real interest rate is at baseline plus two standard deviations in 2004 and 2005						106.1	107.3	106.3	105.4	104.8	104.3	1.9
B2. Real GDP growth is at baseline minus two standard deviations in 2004 and 2005						107.5	111.1	111.7	112.4	113.6	114.9	2.1
B3. Primary balance is at baseline minus two standard deviations in 2004 and 2005						106.5	108.0	107.0	106.1	105.5	105.0	1.9
B4. Combination of B2-B3 using one standard deviation shocks						108.2	111.7	110.8	109.9	109.4	109.1	2.0
B5. One time 30 percent real depreciation in 2004 5/						136.9	134.5	133.6	133.0	132.8	132.9	2.7
B6. 10 percent of GDP increase in other debt-creating flows in 2004						112.8	110.6	109.6	108.7	108.1	107.8	2.0

1/ Nonfinancial public sector includes the national government, CB-BOL, 14 monitored government-owned enterprises, social security institutions, and local governments. Debt is gross and net of sinking fund and social security institutions holdings of national government securities. Other debts held by other parts of the nonfinancial public sector may, however, be included. This issue is being reviewed by an STA mis
2/ Revenue is the sum of all nonfinancial public sector revenue net of intra-public sector payments. It is assumed that 80 percent of Bureau of Treasury revenue represents interest and dividends from other parts of the nonfinancial public sector.
3/ Defined as public sector deficit, plus amortization of medium and long-term public sector debt, plus short-term debt at end of previous period.
4/ The key variables include real GDP growth; real interest rate; and primary balance in percent of GDP.
5/ Real depreciation is defined as nominal depreciation (measured by percentage fall in dollar value of local currency) minus domestic inflation (based on GDP deflator).
6/ Assumes that key variables (real GDP growth, real interest rate, and primary balance) remain at the level in percent of GDP/growth rate of the last projection year.

Table A2. Philippines: External Debt Sustainability Framework, 1999-2009
(In percent of GDP, unless otherwise indicated)

	Actual							Projections						
	1999	2000	2001	2002	2003			2004	2005	2006	2007	2008	2009	
								I. Baseline Projections						**Debt-stabilizing non-interest current account 7/**
External debt	76.1	75.6	81.6	77.8	79.2			**74.6**	**71.2**	**69.7**	**69.1**	**69.4**	**70.0**	**0.7**
Change in external debt	-5.1	-0.5	6.0	-3.9	1.4			-4.5	-3.4	-1.5	-0.7	0.3	0.6	
Identified external debt-creating flows (4+8+9)	-24.8	-8.7	1.0	-14.3	-8.1			-6.9	-5.8	-5.2	-4.4	-3.7	-2.9	
Current account deficit, excluding interest payments	-13.2	-12.2	-5.9	-9.0	-8.1			-7.0	-6.2	-6.0	-5.6	-5.0	-4.4	
Deficit in balance of goods and services	-3.0	-1.8	3.9	0.8	2.5			3.4	3.7	3.7	3.9	4.3	4.7	
Exports	51.2	54.4	48.3	48.8	48.3			49.2	48.4	48.7	49.1	49.3	49.5	
Imports	48.3	52.5	52.2	49.6	50.9			52.5	52.1	52.4	53.0	53.6	54.2	
Net non-debt creating capital inflows (negative)	-4.1	-1.6	-2.1	-2.8	-0.7			-0.6	-0.7	-0.7	-0.6	-0.5	-0.4	
Automatic debt dynamics 1/	-7.6	5.1	9.0	-2.6	0.7			0.6	1.1	1.4	1.7	1.8	1.9	
Contribution from nominal interest rate	3.7	4.0	4.0	3.3	3.2			4.2	4.2	4.3	4.5	4.5	4.6	
Contribution from real GDP growth	-2.4	-3.4	-1.4	-3.3	-3.5			-3.6	-3.1	-2.9	-2.8	-2.7	-2.6	
Contribution from price and exchange rate changes 2/	-8.9	4.5	6.4	-2.6	1.0			...	...	...	...	...	...	
Residual, incl. change in gross foreign assets (2-3) 3/	19.7	8.3	5.0	10.5	9.5			2.4	2.4	3.8	3.8	4.0	3.5	
External debt-to-exports ratio (in percent)	148.5	139.1	169.1	159.4	163.7			151.9	147.0	143.2	140.8	140.8	141.6	
Gross external financing need (in billions of US dollars) 4/	6.7	5.8	10.8	9.6	9.6			11.4	12.8	13.6	14.6	15.6	17.7	
in percent of GDP	8.8	7.6	15.1	12.5	12.1			13.5	13.9	14.0	14.2	14.5	15.5	
Key Macroeconomic Assumptions						10-Year Historical Average	10-Year Standard Deviation							Projected Average
Real GDP growth (in percent)	3.4	4.4	1.8	4.3	4.7	3.8	1.9	4.9	4.5	4.3	4.2	4.1	4.0	4.3
GDP deflator in US dollars (change in percent)	12.4	-5.5	-7.8	3.3	-1.3	0.4	10.6	1.6	3.6	1.8	1.3	1.3	1.3	1.8
Nominal external interest rate (in percent)	5.3	5.2	5.0	4.3	4.3	5.0	0.5	5.7	6.0	6.4	6.8	6.9	7.0	6.4
Growth of exports (US dollar terms, in percent)	5.5	5.8	-16.7	8.8	2.4	10.2	15.8	8.4	6.7	6.7	6.3	6.0	5.6	6.6
Growth of imports (US dollar terms, in percent)	-7.3	8.5	-6.8	2.3	6.1	8.1	16.8	10.1	7.4	6.7	6.6	6.6	6.5	7.3
Current account balance, excluding interest payments	13.2	12.2	5.9	9.0	8.1	4.8	5.9	7.0	6.2	6.0	5.6	5.0	4.4	5.7
Net non-debt creating capital inflows	4.1	1.6	2.1	2.8	0.7	3.2	2.0	0.6	0.7	0.7	0.6	0.5	0.4	0.6
								II. Stress Tests for External Debt Ratio						**Debt-stabilizing non-interest current account 7/**
A. Alternative Scenarios														
A1. Key variables are at their historical averages in 2005-09 5/								**74.6**	**72.3**	**70.0**	**67.4**	**65.1**	**62.3**	**-2.8**
A2. Strong Reform Scenario 6/								**74.2**	**68.4**	**65.1**	**62.5**	**59.6**	**57.0**	**-1.7**
A3. No Reform Scenario 6/								**75.1**	**73.0**	**71.8**	**72.3**	**74.2**	**76.8**	**1.7**
B. Bound Tests														
B1. Nominal interest rate is at historical average plus two standard deviations in 2005 and 2006								**74.6**	**71.2**	**69.5**	**68.8**	**69.2**	**69.8**	**0.7**
B2. Real GDP growth is at historical average minus two standard deviations in 2005 and 2006								**74.6**	**74.6**	**76.8**	**76.5**	**77.4**	**78.5**	**0.8**
B3. Change in US dollar GDP deflator is at historical average minus two standard deviations in 2005 and 2006								**74.6**	**94.9**	**123.4**	**126.1**	**130.2**	**134.4**	**1.4**
B4. Non-interest current account is at historical average minus two standard deviations in 2005 and 2006								**74.6**	**84.4**	**96.0**	**95.6**	**96.3**	**97.4**	**1.1**
B5. Combination of B1-B4 using one standard deviation shocks								**74.6**	**92.1**	**113.2**	**112.5**	**113.2**	**114.3**	**1.2**
B6. One time 30 percent nominal depreciation in 2005								**74.6**	**101.7**	**102.0**	**103.3**	**105.9**	**108.6**	**1.1**

1/ Derived as $[r - g - \rho(1+g) + \varepsilon\alpha(1+r)]/(1+g+\rho+g\rho)$ times previous period debt stock, with r = nominal effective interest rate on external debt; ρ = change in domestic GDP deflator in US dollar terms, g = real GDP growth rate, e = nominal appreciation (increase in dollar value of domestic currency), and a = share of domestic-currency denominated debt in total external debt.
2/ The contribution from price and exchange rate changes is defined as $[-\rho(1+g) + \varepsilon\alpha(1+r)]/(1+g+\rho+g\rho)$ times previous period debt stock. ρ increases with an appreciating domestic currency ($\varepsilon > 0$) and rising inflation (based on GDP deflat
3/ For projection, line includes the impact of price and exchange rate changes.
4/ Defined as current account deficit, plus amortization on medium- and long-term debt, plus short-term debt at end of previous period.
5/ The key variables include real GDP growth; nominal interest rate; dollar deflator growth; and both non-interest current account and non-debt inflows in percent of GDP.
6/ The implied change in other key variables under this scenario is discussed in the text.
7/ Long-run, constant balance that stabilizes the debt ratio assuming that key variables (real GDP growth, nominal interest rate, dollar deflator growth, and both non-interest current account and non-debt inflows in percent of GDP) remain at their levels of the last projection year.

PHILIPPINES: FUND RELATIONS
(As of June 30, 2004)

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

II. **General Resources Account**:	SDR Million	% Quota
Quota	879.90	100.0
Fund holdings of currency	1,421.48	161.55
Reserve position in Fund	87.43	9.94

III. **SDR Department**:	SDR Million	% Allocation
Net cumulative allocation	116.60	100.00
Holdings	0.91	0.78

IV. **Outstanding Purchases and Loans**:	SDR Million	% Quota
Stand-by arrangements	460.74	52.36
Extended arrangements	168.27	19.12

V. **Financial Arrangements**:

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

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

	Forthcoming				
	2004	2005	2006	2007	2008
Principal	142.07	214.87	125.78	125.78	20.50
Charges/Interest	9.30	12.51	7.84	4.39	2.24
Total	151.36	227.38	133.62	130.17	22.73

VII. **Exchange Arrangement**:

The value of the Philippine peso is determined in the interbank foreign exchange market; the Bangko Sentral participates in the market in order to limit fluctuations in the exchange rate.

From November 1995 to June 1997 the peso was effectively fixed at around P 26.2–P 26.4 per U.S. dollar. On July 11, 1997, the peso depreciated to P 29.45 per U.S. dollar following an announcement by the central bank that the peso would be allowed to find its own level. Since then, it has gradually depreciated; during the last few months, it has fluctuated around P 55–56 per U.S. dollar.

VIII. **Article IV Consultation**:

The Philippines is on the standard 12-month cycle. The 2003 Article IV Consultation was discussed by the Executive Board on March 5, 2004. At that time, Directors noted that while the Philippines had undertaken important economic reforms in recent years, key areas of weakness and vulnerabilities remained, in particular in the fiscal, banking, and power sectors. Directors observed that absent comprehensive reforms, the economy's vulnerabilities would further increase. They, therefore, underscored the urgent need for the authorities to implement comprehensive reforms, in order to set the economy on a high and sustainable growth trajectory, reduce the still pervasive poverty, improve debt sustainability, and the economy's resilience to adverse shocks. They also urged the authorities not to loosen policies in the pre-election environment.

IX. **FSAP and ROSC Participation**:

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

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

STA: ROSC Data Module mission was conducted in September 2003 and draft report was submitted to the authorities for their comments in January 2004.

X. **Technical Assistance**:

An MFD mission visited the country in May–June 1999 to review money and banking statistics. In April 1999, MFD missions on banking reform and payments systems reform visited Manila. MFD also provided assistance in banking reforms during missions in September 1999, and April, June, October, and December 2000. An MFD mission on banking supervision visited Manila during August/September 2002. A resident banking supervision advisor was stationed in Manila in May 2003, to assist the BSP in the implementation of a new supervisory model. Subsequent MFD missions took place in August 2003 on banking supervision and central bank accounting, in April 2004 on bank restructuring, and in June 2004 on banking system capitalization.

STA missions in May–June 1999 and November 2000 reviewed money and banking statistics. A PDR/STA mission in April 1999 worked on improving short-term debt monitoring systems. In November 2000, an STA mission conducted follow-up work on external debt and balance of payments statistics. An STA staff member participated in the October 2000 mission, assisting in real sector and balance of payments issues, and a follow-up mission took place in January 2002. In February 2002, an STA mission reviewed monetary and financial statistics. An STA peripatetic mission visited Manila in July-August 2003 and January-February 2004 to provide technical assistance in balance of payments and international investment position statistics and in implementing the recommendations made by the ROSC Data Module mission.

An FAD mission visited Manila in December 1999 to provide assistance on computerization of tax administration with further follow–up missions in April and September 2000. In April 1999, an FAD mission provided advice on expenditure control and budget system reform, with a follow-up mission in September 2001. A mission to provide a briefing to the new tax commissioner took place in April–May 2001. An FAD mission reviewed VAT and excise administration in December 2001.

In November 1999, LEG assisted in reviewing draft Securities and Exchange Commission rules. In October 2000, LEG provided comments on a draft insolvency law pending before congress. A legal expert visited Manila to discuss anti-money laundering initiatives in March 2002.

A BCS mission visited Manila in December 1998 to assess the current status of information technology (IT) development and requirements for additional technical assistance relating to implementation of an economic time series database system (followed up by placement of a resident advisor to the BSP who completed his term in early 2000).

XI. **Resident Representative**:

A Resident Representative has been stationed in Manila since January 1984. Mr. Vikram Haksar assumed the post of Resident Representative in September 2002.

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

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

Philippines: Progress on Structural Reform Agenda

Main Objectives	Recent Progress
Banking Sector	
• Strengthen measures to address money laundering activities	• The Anti-Money Laundering Law was approved in September 2001. The AMLC has been created and IRRs were signed in April 2002. • The law amending the Anti-Money Laundering Act (AMLA) was signed on 7 March 2003. The amendments, which seek to strengthen the existing anti-money laundering regime and align them with international best practice, include the following: (i) lowering the threshold for covered transactions from P 4.0 million to P 500,000; (ii) authorizing the BSP to inquire or examine deposits or investment with any banking institution without court order in the course of a periodic or special examination; and (iii) removing the provision prohibiting the retroactivity of the law. • With the approval of the law incorporating the amendments to the AMLA, the Financial Action Task Force (FATF) sanctions on noncomplying countries were not imposed on the Philippines. However, the Philippines remained on the list of noncooperative countries and territories (NCCT), pending the implementation of the AMLA. The authorities submitted an implementation plan to the FATF Review Group in January 2004.
• Strengthen banks by raising capital and encouraging consolidation.	• BSP required banks to report their accounts on a consolidated basis starting September 2001, but weaknesses in the reporting framework complicate supervision on a consolidated basis. • The BSP issued amendments to its risk-based capital framework to incorporate market risk (March 2004) and expand coverage to quasi-banks (September 2003). • Guidelines were issued on the capital treatment of credit-linked notes and similar credit derivative products (January 2004). • Rules and regulations were issued regarding the development and implementation of internal credit risk rating systems (July 2004).
• Tighten provisioning requirements and regulatory oversight.	• Starting October 1997, general loan loss provisions were required over and above existing provisioning requirements for classified accounts. • Provisioning requirements were rationalized with further differentiation depending on security, risk and status.

Philippines: Progress on Structural Reform Agenda

Main Objectives	Recent Progress
	• The BSP has issued regulations regarding the management of large exposures, credit risk concentrations, single borrower's limits, connected and/or related party transactions, and other governance-related measures. • With regard to foreclosed assets, banks are required to reappraise values every two years beginning January 2002. Provisioning levels, however, remain low.
• Level the playing field between foreign currency and peso intermediation.	• Regulatory issuances also included guidelines on the conversion and transfer of foreign currency-denominated loans, and foreclosed assets on the books of FCDUs/EFCDUs to peso loans and foreclosed assets on the books of regular banking unit.
• Deal effectively with problem banks.	• The General Banking Act of 2000 increased the BSP's capacity to take prompt corrective action. In July 2004, the PDIC's charter was amended to strengthen its ability to deal with problem banks. • Rehabilitation of the Philippine National Bank (PNB) has made significant progress. PNB has professionalized its management, and has recently started to book modest profits. • Stress testing is being undertaking to determine how banks would react to various scenarios. The results of these tests are relayed to concerned banks, who may then be required to take remedial action. Prompt corrective actions currently in place include monetary penalties, assignment of resident examiners and other non-monetary penalties. • Weaknesses remain, particularly with regard to the legal protection of BSP and PDIC staff as well as the lack of legal power to write down shareholder capital as part of the intervention process.
• Provide legal framework to encourage banks to sell nonperforming assets to third parties.	• The Special Purpose Vehicle (SPV) Act was passed in January 2003. The implementing rules and regulations (IRR) of the SPV Act were approved in March 2003. Banks and quasi-banks have been reminded of the timelines for availing of the tax incentives under the SPV law. • In March 2004, the Securitization Act was passed, providing scope for a strengthening of the SPV framework. • The BIR issues Revenue Regulations in connection with the SPV tax incentives in June 2004.

Philippines: Progress on Structural Reform Agenda

Main Objectives	Recent Progress
	• As of June 2004, 39 Certificates of Eligibility have been issued by the BSP to 16 banks, creating scope for NPA transfers totaling P3 billion. Six SPVs have thus far registered with the SEC. Actual NPA transfers have, however, remained limited.
• Improve the legal protection of BSP and PDIC supervisors.	• The amended PDIC Charter provides for additional legal protection, in the form of advance indemnification for litigation costs and expenses for acts done in the performance of official functions and duties, but falls short of providing full legal protection.
Fiscal and Governance Reforms	
• Improve operations of the Bureau of Internal Revenue (BIR).	• Taxpayer compliance control systems have been improved and computerization program reinvigorated. BIR has introduced several measures: (i) stepped up tax compliance verification (or "tax mapping"); (ii) strengthened audit and related enforcement programs; (iii) organizational adjustments; and (iv) intensified use of third-party information.
• Rationalize fiscal incentives.	• Several proposals to alter the fiscal incentives system were filed in the last Congress, and a proposal was included in the package of measures proposed to the President. However, it is unclear whether legislation will be approved that will actually scale back incentives significantly. A review of the entire fiscal incentives system is also being undertaken to identify incentives that overlap, result in 'double-dipping,' are obsolete, and/or have inconsistent objectives.
• Reform financial sector taxation.	• The Documentary Stamp Tax (DST) law rationalizing the taxation of debt and equity instruments was signed into law as Republic Act No. 9243 on February 17, 2004. The VAT on financial transactions and the taxation of FCDU/OBUs, both of which took effect in 2003, were both recently repealed by law.
• Improve expenditure management.	The following measures are being undertaken: • Adoption of the Organizational Performance Indicators Framework – this would enable agencies to focus on strategic programs and projects and establish the linkage of their major final outputs (MFOs) with the sector/sub-sector and/or national objectives. Fourteen departments are currently being assisted to enable them to finalize their MFOs and the performance indicators for these MFOs. • Conduct of Agency Performance Reviews to determine the overall performance of the national government and to be used as basis for future

Philippines: Progress on Structural Reform Agenda

Main Objectives	Recent Progress
	resource allocation decisions. • Implementation of an eBudget System for a computerized processing of budget releases and preparation of accountability reports. • Grant of managerial flexibilities to certain agencies with a Maintenance and Other Operating Expenditures (MOOE) budget of P 50 million and below in the use of their appropriations subject to certain guidelines. In implementing the Government Procurement Reform Act (GPRA), the following are being undertaken: • Provision of training for different agencies to fully disseminate procurement reforms embodied in the GPRA. • Development of a generic procurement manual and a set of standard bidding documents for the use of government procurement officials and employees. • Full operationalization of the Government-Electronic Procurement System as the central portal providing information on various government procurement opportunities and information.
• Move forward the Government Re–engineering Program, including reductions in staff, abolition of agencies, and devolution of activities to local governments.	• A revised version of the Reengineering Bill, the Public Sector Institutional Strengthening Bill, is being worked out for refiling in the 13th Congress. The bill would: a) seek authority for the President to reorganize the Executive Branch, including GOCCs, subject to defined principles and parameters, b) organize an Executive Commission to oversee the implementation of the effort, and c) offer appropriate incentives for personnel who may be affected. • While awaiting the passage of the Reengineering Bill, the Presidential Committee on Effective Governance is completing the groundwork for the implementation of a function-based rationalization program. This would entail the conduct of a strategic review of the operations and organizations of the executive branch to identify functions, programs, activities, and projects that can either be scaled down, phased out, or abolished or where more resources would be channeled. Organizational units could also be abolished, deactivated, merged, or consolidated in the process.

Philippines: Progress on Structural Reform Agenda

Main Objectives	Recent Progress
Electric Power Sector Reform • Restructure electric power sector.	• The Electric Power Industry Reform Act of 2001 (EPIRA) was enacted in June 2001, followed by implementing regulations in February 2002, which together provide a framework for the restructuring of the power sector, including privatization of NPC assets and deregulation of the power market. • Power Sector Assets and Liabilities Management Corporation (PSALM) has been created to oversee privatization of NPC's transmission and generation assets. • Energy Regulatory Commission (ERC) has been established, to replace the Energy Regulatory Board. • Philippine Electricity Market Corporation (PEMC) has been established to launch and manage the Wholesale Electricity Spot Market.
Trade Liberalization • Reduce average tariffs to about 9 percent in 2000.	• The average tariff rates were reduced from 8.1 percent in 2000, to 7.7 percent in 2001, to 6.0 percent in 2002. However, the average tariff rates were adjusted upward to 6.2 percent in 2003 and 7.5 percent in 2004. • Current rating on the Fund's index of trade restrictiveness remains 4, on a scale of 1–10 (with 1 the most liberal, and 10 the most restrictive).
Enhance the Corporate Sector Regulatory Framework • Strengthen Securities and Exchange Commission (SEC) policies and procedures for debt restructuring.	• The Supreme Court issued Interim Rules of Procedure on Corporate Rehabilitation, effective December 2000. • With its quasi-judicial powers having been shifted to the courts, the SEC is taking steps to minimize debt restructuring incidents by: (1) imposing more stringent financial disclosure requirements, including bringing accounting standards up to international standards; (2) regulating external auditors more closely; (3) implementing the code of corporate governance, which applies to all corporations (domestic and foreign) whose securities are registered or listed. The code requires these corporations to formulate, submit (to SEC), and adopt a Manual of Corporate Governance. The Manuals are to be made

Philippines: Progress on Structural Reform Agenda

Main Objectives	Recent Progress
	available to directors and subject to inspection by stockholders, and to be adhered to under penalty of law. • The passage of the Securitization Bill in March would facilitate restructuring by permitting asset management companies to finance their acquisitions of distressed assets through capital markets and institutional investors. Securitization can also contribute to the development of corporate bond markets by overcoming the problems of the small size and low credit quality of most issuers.
• Prepare new bankruptcy law.	• A draft corporate recovery law was submitted to congress in 2001, which would strengthen creditor rights and smooth the foreclosure process. Enactment of the Corporate Recovery Bill aims to provide an improved reorganization framework and mechanism for debt resolution and debt workout. The draft law is being reviewed by the house committee on economic affairs.
• Improve governance of Philippine Stock Exchange (PSE).	• Steps are being taken to improve the compliance, enforcement and surveillance capabilities of the PSE. Demutualization was completed in August 2001, transforming the PSE into a publicly-held corporation with diverse ownership, governed by a majority of non-brokers, and managed by an independent and professional group. • On 15 December 2003, PSE became a listed corporation with its introductory listing on the bourse. • The Rules Governing Trading of PSE Shares became effective on December 30, 2003. The PSE was directed by the SEC to observe immediately the limitations set by the Securities Regulation Code including those restricting any industry from owning more than 20 percent of the PSE's outstanding capital stock.

**Statement by Michael Callaghan, Executive Director for the Philippines and Cyd Amador, Advisor to Executive Director
August 27, 2004**

Key points

- The government has set an ambitious and comprehensive policy agenda, the key elements of which are strong fiscal adjustments and an accelerated pace of reforms in the banking and energy sectors.

- Disciplined fiscal policy is the anchor for continued macroeconomic stability. It is central to the authorities' economic program aimed at fostering sustained, strong growth and addressing the social needs of the population. The authorities are committed to staying the course on fiscal consolidation.

- The authorities also recognize that strong up-front actions are needed on the structural front to improve the economy's growth prospects and help insulate it from adverse shocks.

- The new administration has acted decisively in advancing a comprehensive reform agenda. However, progress will require building legislative support as well as developing a broader social consensus. This will require careful prioritization of reform initiatives to ensure that momentum is maintained.

Our authorities would like to thank the staff for a concise and insightful report. They appreciated the opportunity to engage with staff in constructive policy dialogues, which took place in an atmosphere of candor and openness. There was broad agreement on the need for prompt policy adjustments and strong structural measures. The ongoing dialogue with the Fund has had a strong influence in shaping the country's policy framework and has contributed to institutional development as well as enhancing technical capabilities and data systems. Information provided by staff on international best practices has been particularly useful. Post-program monitoring has served as a good vehicle for maintaining close rapport with the Fund.

The success of the administration's economic policy blueprint is predicated on strong popular support.

The new administration announced early in its term a policy blueprint that will guide it as it pursues sustained, strong growth and tackles the long-standing problems facing the economy, including reducing unemployment and poverty. An immediate challenge is to decisively build upon the recent improvement in the fiscal front by moving more boldly on fiscal and

power sector reforms. The authorities also recognize that stronger up-front actions are needed on a wide range of structural reforms to generate momentum for brisker and more balanced economic growth.

Many of these reforms will need the strong support of the legislature. In July, the administration came into office with a fresh mandate and broad political support. This holds the prospect that key policy initiatives will not be hampered by legislative gridlock as in the past. However, the required policy measures are contentious, and to ensure that the reform momentum is maintained, the legislative timetable needs to be carefully handled. Consequently, the authorities are taking a pragmatic approach in pursuing the reform package. They are working on a prioritization of the tax bills and other reform initiatives in order to avoid overcrowding the legislative agenda. They have strengthened their efforts to promote broad ownership of the reforms by involving early on the Legislative-Executive Development Advisory Council (LEDAC)—comprised of executive and legislative officials—as the vehicle to monitor legislative developments more closely and to push through Congress bills certified as priorities by the executive branch. The authorities are also keenly aware of the importance of clearly articulating the need for reform with a view to building a wider social consensus in support of the reform strategy. Toward this end, the administration has continued its consensus-building activities—including consultations and town-hall meetings at the grass-roots level (*Pulong Bayan*)—to, among other things, stress the urgency of addressing decisively and durably the country's economic problems and underscore the benefits of reforms as well as the adjustments costs that these could entail.

Macroeconomic performance remains favorable.

The Philippines has maintained a comparatively stable macroeconomic performance. There has been a strengthening in output and export growth. Inflation, while on the rise, has been broadly consistent with the target, and the exchange rate has stabilized as business and consumer sentiment has improved. International reserves continue to provide a comfortable buffer against external shocks. Private sector credit activity is gradually gaining traction.

Monetary policy continues to be alert to signs of inflationary pressures.

Prudent monetary policy coupled with a flexible exchange rate system have kept inflation outcomes consistent with the target and have helped anchor inflation expectations. Inflationary pressures are on the rise due to high oil and food prices, but there is still considerable underutilized capacity and soft spots in domestic demand remain. The Bangko Sentral bank is closely monitoring the possible second round effects of price pressures with a view to taking the appropriate forward-looking policy response. Policy adjustment, if warranted, will be made to ensure price stability while providing support to the economy's growth objective.

Staff have suggested that the central bank publish *ex ante* quantitative estimates of inflation effects. The Bangko Sentral already observes a high degree of transparency in communicating its monetary policy stance. At this time, the monetary authorities do not

consider a more quantitative presentation of the first- and second-round effects of price pressures to be a useful exercise, especially as this could complicate and therefore cloud the policy message to the public. They also think that it could mislead markets by conveying a false sense of precision in the monetary policy process. Moreover, they note that this goes well beyond the practice of other central banks pursuing inflation targeting. Nonetheless, the Bangko Sentral, in its public statements, has gradually introduced a broad decomposition of supply- and demand-side influences on the inflation outcome, while at the same time clarifying the role of monetary policy in responding to such factors or shocks. The monetary authorities will continue to improve upon their communication strategy with a view to better articulating their policy intentions and responses.

Fiscal policy reform is pivotal to sound macroeconomic management.

Our authorities recognize that containing the budget deficit is crucial to continued macroeconomic stability, anchoring market expectations and maintaining overall policy credibility.

The government is committed to staying the course on fiscal consolidation. Some hard-won gains have been made of late, with the government holding fast to fiscal discipline during the election period and the attendant pressures for populist spending. This has underscored the government's determination to remain steadfast in the implementation of prudent economic policies.

However, stronger progress is clearly needed to decisively address the country's fiscal problems. In this regard, the government is pursuing a comprehensive set of initiatives aimed at expanding the revenue base, streamlining expenditures while ensuring that funding for priority development programs is sustained, and achieving fiscal consolidation over the medium term. Specifically, the authorities have reiterated their commitment to achieve balanced budget by 2009 and reduce the consolidated public sector deficit to 3 percent of GDP also by that time.

The authorities recognize the critical importance of tax policy reform, since improvements in tax administration and expenditure restraint alone would be unable to deliver a durable improvement in the fiscal accounts. While administrative measures aimed at raising tax collection efficiency have borne fruit and will continue to be pursued to strengthen the porous tax system (including through more intensive audit and upgraded information management systems), the authorities have started to actively push legislation for measures aimed at broadening the tax base and further improving collection efficiency. The revenue bills that have been filed in the new Congress include: rationalization of fiscal incentives; additional tax on telecommunications companies; increase and indexation of excises on tobacco and alcohol products; increase in petroleum excises; shift to a simplified tax system to enhance compliance; and targeted tax amnesty (to establish tax base and audit trail). The authorities are also considering step increases of the VAT, which will depend on the target increment of VAT collections; abolishing non-standard VAT exemptions; and creating a performance-driven system for revenue agencies that would help stamp out corruption.

They also plan to revive the Fiscal Responsibility Bill, which will ensure that no new expenditures are approved without the corresponding revenue measure.

The new administration only came into office on July 26 and is still fleshing out the details of its reform initiatives. In doing so, it is open to all views and will carefully consider staff's comments, particularly with respect to the gross income tax and tax amnesty.

Well aware that the adoption of many of these measures can be politically challenging, the authorities have started work to prioritize the tax bills to focus the legislative agenda and ensure a reasonable chance that the bills will be promptly enacted by Congress. The measures that will be pushed first include those: increasing and indexing sumptuary excises, raising petroleum excises, and rationalizing fiscal incentives. They expect to have these measures approved by Congress by the end of the year, which will demonstrate the credibility of the authorities' commitment to tax policy reform.

The government will continue to implement administrative measures to improve expenditure management, including through civil service reform aimed at abolishing government agencies with overlapping functions, which is already underway. It has also started to raise fees and charges, and is considering raising petroleum import duties and capturing more of the profits of government-owned and -controlled corporations.

Stronger public finances will help the government deliver on its commitment to create more jobs and provide better social services including in education, health and poverty reduction. These will also help the government build much-needed new infrastructure and upgrade existing ones, therefore redressing the country's weak infrastructure that has been a serious deterrent to stronger investment. Making advances in these areas is important to ensuring public support for the broader reform agenda.

High debt ratios are a drag on the economy. More testing conditions in global financial markets may be expected going forward, exerting further pressure on the country's debt dynamics. Sustained fiscal consolidation is central to reducing this debt burden. At the same time, the government has taken advantage of favorable financing conditions to ease debt service payments and lengthen the maturity of the debt stock, including through a bond exchange in February. A credible medium-term fiscal consolidation program will also enhance market confidence and encourage non-debt creating flows, therefore lowering the country's dependence on foreign borrowing.

High priority is attached to structural reforms critical to macroeconomic stability and robust growth.

The government has made promising progress on various structural reform initiatives, but more timely implementation of the reform agenda would underscore the government's resoluteness in building stronger foundations for sustained, strong growth and self-insuring the economy against unanticipated shocks.

There is a long list of needed reforms. The authorities have prioritized the reform efforts by focusing on those deemed critical to sustaining macroeconomic stability and fostering sustained growth. These reforms center on the development of an efficient power sector, a strong and stable financial sector, an investor-friendly environment, and good governance. The authorities have also set social development goals that are aimed at making economic gains more inclusive. Priorities include the creation of jobs, expansion of health care, improvements in education, and provision of affordable housing. Implementing this broad reform program will occupy a large part of the administration's efforts and require considerable political skills.

There is a critical need to act more forcefully to restructure the power sector in order to reduce the drain on public finances and ensure adequate power supply. Some progress has been made to put the power sector on a sturdier footing. The privatization of the generating assets of National Power Corporation (NPC) is proceeding well, with three power plants sold in 2004 thus far. The Energy Regulatory Commission is currently reviewing NPC's petition for a rise in generation tariffs, and a decision is expected to be reached this September. The authorities have urged lawmakers to accelerate passage of reforms to further open up the power sector; in particular, they have prioritized the franchise bill for the National Transmission Corporation to facilitate the privatization of the power transmission network.

Comprehensive measures to strengthen the financial system are needed to address potential vulnerabilities. The authorities consider financial sector reform to be an integral component of the reform process. In addition to the recent steps taken to strengthen the regulatory and supervisory framework mentioned in the report, the authorities have pressed forward with initiatives directed at developing a deeper and broader domestic capital market, including through the establishment of the fixed income exchange in the third quarter of 2004. The exchange will help ensure an efficient, transparent and secure platform for the secondary trading of private and public fixed-income securities. They have also enhanced the framework for coordinating the supervision and regulation of the financial system through the Financial Sector Forum (FSF). Closer and enhanced coordination among financial regulatory agencies will improve supervision over the activities of financial conglomerates as well as the coverage of entities that operate in the grey areas of supervisory boundaries. The Bangko Sentral will also continue to vigorously lobby for stronger protection against lawsuits and greater authority to take over distressed banks as part of its charter amendments. The staff rightly point out that a more appreciable improvement in the asset quality of the banking system would depend on the banks taking greater advantage of the opportunities presented by the Special Purpose Vehicle Act, whose tax incentives are due to expire in April next year. There are indications that the disposition of NPAs through SPVs could pick up, with six banks having submitted their proposals to the Bangko Sentral.

Rekindling private (including foreign) investment is imperative if the country's long-term growth prospects are not to dim. The authorities realize that more needs to be done to put in place a congenial business environment that will promote investment and sustain confidence, including by fostering a predictable legal environment for upholding property rights and enforcing contracts. As part of their efforts to improve the clarity of the regulatory

environment, our authorities will continue to push for the passage of the bankruptcy law and the improvement of governance of the stock exchange.

Conclusion

Our authorities recognize the importance of policy discipline and sustained reform initiatives. The details of their economic plans, including the legislative priorities, are being developed and will soon be announced. However, articulating the policy and reform agenda is only the initial phase; the key is strong and prompt implementation of initiatives predicated on responsible macroeconomic and structural policies. As staff note, the authorities view the current period to be a "unique opening" to advance more decisively the reform process. At this critical juncture, they fully intend to employ all the resources they have at hand to consolidate the process of sustained and balanced growth. The days ahead will be a crucial test of the will and strength of the administration.

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IMF Concludes 2004 Post-Program Discussion with the Philippines

On August 27, 2004, the Executive Board of the International Monetary Fund (IMF) concluded Post-Program Monitoring discussions on the Philippines based on information available through that date.[1]

Background

Financial markets conditions came under increasing pressure in the first quarter of 2004 as uncertainty regarding the May 10 elections clouded investor sentiment. Conditions have since stabilized as markets look to implementation of reform measures announced in President Arroyo's state of the nation address on July 26.

The economy grew a robust 6.4 percent in the first quarter of 2004 over the same period last year. Strong growth in agriculture and a pre-election surge in consumption supported the first quarter GDP outturn. Conditions also improved in the manufacturing sector on the back of a recovery in exports. However, despite the good growth performance, unemployment rose to 13.7 percent in the second quarter. Meanwhile, inflation has accelerated and reached 6.0 percent (year on year,1994-based CPI) in June from 3.1 percent (y/y) at end-2003. Higher food, fuel, and transportation prices have contributed to the pick-up in inflation. With a view to draining excess peso liquidity the Bangko Sentral ng Pilipinas (BSP) raised liquidity reserve requirements for banks earlier in the year but has held policy rates steady.

External developments have been positive. Exports grew by 8½ percent through June (y/y), a significant improvement on the 2.9 percent increase recorded in 2003 (full year), and to date have offset a higher oil import bill. Remittances have increased only modestly, by 2.6 percent (y/y) in the first half of 2004, partly due to developments in the Middle East where a significant

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

number of Filipino overseas workers are employed. Reflecting in part public sector borrowing, gross reserves of the BSP were $16.2 billion at end-June 2004.

Fiscal performance has been broadly on track. Through June, the National Government deficit (authorities definition) was on course to meet the 2004 target of 4.2 percent of GDP, compared to 4.6 percent of GDP in 2003. By contrast, the nonfinancial public sector deficit is expected to remain at about 5¾ percent of GDP in 2004 due to increasing losses at the National Power Corporation (NPC) and shrinking cash surpluses at the public pension funds, while nonfinancial public sector debt is projected to remain above 100 percent of GDP. Although in 2004 to date the amount of government domestic borrowing has been much the same as last year, domestic treasury bill rates have trended up in line with the pick up in inflation.

The banking sector continues to remain saddled with high levels of nonperforming assets, which are backed by relatively low reserve coverage, and profitability continues to be constrained. With low capitalization and weak credit demand, banks have preferred to invest in government securities instead of expanding credit.

The economic outlook for the Philippines depends importantly on the pace of implementation of the authorities' reform program. The staff expects GDP growth to moderate to 4.9 percent for 2004 as a whole while average inflation will likely be close to the upper end of the authorities target range of 4–5 percent.

Executive Board Assessment

Executive Directors agreed with the thrust of the staff appraisal. They welcomed the robust growth performance of the Philippine economy, and commended the authorities for their success in maintaining economic stability during the preelection period. Directors noted, however, that over the last few years the pace of reforms has been slow. As a result, the large external financing requirements and high public indebtedness leave the Philippine economy vulnerable to a sudden deterioration in investor sentiment and/or a sharp increase in global interest rates, with potentially adverse implications for access to capital markets and for the stability of the public finances and the economy.

Directors underscored that the favorable growth performance, combined with the recent renewal of the government's political mandate, present the administration with a unique opening to break from the past by addressing long-standing economic weaknesses and boldly pursuing a vigorous and far-reaching agenda of economic reforms. Seizing this opportunity will be crucial for addressing the Philippine economy's vulnerabilities to external shocks while helping to underpin investor confidence and improve debt dynamics. This will lay the basis for stronger and more sustained economic growth and job creation, and contribute to significant poverty reduction over the medium term. Directors accordingly welcomed the authorities' commitment to formulate a substantive package of fiscal and structural reforms, particularly in the energy and banking sectors, and encouraged them to develop, present, and implement specific action plans in these areas at an early stage. They endorsed the authorities' clear articulation of the need for reforms, which hopefully will help to build the legislative support and social consensus critical for successful implementation of the reform package.

Directors agreed that putting public finances back on a sustainable path is an essential element of the reform package, and welcomed the authorities' commitment to balancing the budget by

2009. They emphasized that the high and rising level of public debt underscores the importance of saving the bulk of the revenue gains from the tax measures under consideration. Directors also generally considered that a front-loaded reduction in the fiscal deficit will help to bring public debt on a clearly sustainable path, and create room for a much-needed recovery in private investment. They expressed concern that were the bulk of the additional revenue from the new tax measures to be spent, the 2009 target would be harder to achieve.

Directors emphasized that the nature and quality of the fiscal measures will also be critical. They welcomed the current proposals to increase alcohol, tobacco, and petroleum excises and to rationalize tax incentives. Directors also supported the authorities' ongoing efforts to strengthen tax administration, particularly Value Added Tax (VAT) compliance. They called on the authorities to consider raising the VAT rate, which is low by international standards. Directors welcomed the authorities' intention to revive the Fiscal Responsibility Bill, which aims to ensure that no new expenditures are approved without the corresponding revenue measures. While recognizing the authorities' intentions to simplify the tax system, Directors generally concurred that the proposed introduction of gross income taxation carries revenue risks, could introduce significant distortions in the tax system, and could in fact complicate tax administration and continue to provide undue room for discretion by revenue officials. In addition, the proposed new tax amnesties could hamper taxpayer compliance over time. In view of these concerns, Directors welcomed the authorities' intention to carefully consider the staff's advice in formulating their new tax policies.

Directors considered the rationalization of public expenditure as equally important in placing public finances on a sustainable footing over the medium term. They welcomed the current proposals to streamline the civil service, including through eliminating redundant positions and voluntary early retirement, as well as the concrete steps being taken to shore up the finances of the pension funds. Directors also noted the importance of ensuring that expenditure on social programs is protected.

Directors stressed the importance of continued prudent monetary policy management in underpinning a stable macroeconomic environment conducive to the implementation of reforms. They commended the BSP for its conduct of monetary policy in recent years under its inflation-targeting framework. The inflation outlook appears uncertain at this juncture, particularly as regards to the potential impact of the reform package. Directors noted that the recent acceleration in inflation stemming from adverse supply-side shocks, along with prospective increases in power tariffs and indirect taxes, risks breaching the official inflation target in 2005. They accordingly welcomed the authorities' intention to stand ready to tighten monetary policy if it appears that inflation would exceed the target by more than what can be attributed to the first-round impact of the food and oil price shocks. More generally, Directors stressed the importance of the BSP maintaining a high degree of transparency in communicating its monetary policy stance. Some Directors suggested that one way to further strengthen transparency could be to announce the extent to which the central bank would allow the inflation rate to exceed the envisaged target for 2005 before taking corrective measures. However, other Directors cautioned that ex ante announcements of acceptable deviations from the target could cloud the policy message for markets and the public.

Directors underscored the importance of the steps under consideration to further reform the power sector, and urged their steadfast implementation in order to restore the sector's financial viability and reduce its drain on public finances. They recognized that arresting the NPC's

losses will be a difficult goal to meet without further significant increases in power tariffs, which are already high by regional standards. In this regard, Directors supported the authorities' intention to implement time-of-use pricing to mitigate the impact of the envisaged tariff increases on international competitiveness as well as to consider better targeting of life-line tariffs in order to shield vulnerable consumers. Directors indicated that these measures will need to be complemented by efforts to support the independence of the Energy Regulatory Commission in making decisions regarding tariff rates. They also stressed the need to accelerate the privatization of power generation and transmission assets. In particular, the prompt enactment of the Transco franchise bill by Congress and reduction of regulatory uncertainty will be pivotal for attracting private investment in the power sector and minimizing risks of supply shortages over the medium term.

Directors underscored the need to accelerate banking sector reform. They expressed concerns about the quality of the assets in the banking system, which has left the system with low capitalization and not fully able to support economic growth. While welcoming the recent steps taken to strengthen the regulatory and supervisory framework, including the financial reform package that was announced by the BSP in late August, Directors observed that the current strategy of inducing banks to voluntarily off-load nonperforming assets needs to be supported by stepping up the supervisory pressure on them to improve their balance sheets and to adopt best accounting practices so that latent loan losses are better recognized. Provision of stronger legal protection for supervisors will be critical for enhancing their ability to exert supervisory pressure. Directors urged the authorities to muster the political support needed for legal amendments to the charters of the BSP and the Philippine Deposit Insurance Corporation that would support the authorities' implementation of a comprehensive restructuring strategy for the banking system. The authorities were also encouraged to advance their implementation of Anti-Money Laundering/Combating Financing of Terrorism measures.

Directors welcomed the completion and publication of the data module of the Report on the Observance of Standards and Codes and encouraged the authorities to intensify efforts to implement the recommendations made in it.

Directors expressed support for the authorities' intention to continue a close and constructive relationship with the Fund through post-program monitoring.

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

Philippines: Selected Economic Indicators, 2000-2005

	2000	2001	2002	2003	2004		2005
					IMF staff projections August 2004		
Growth and prices (in percent change)							
GDP growth	4.4	1.8	4.3	4.7	4.9		4.5
CPI inflation (average)	4.4	6.1	3.0	3.0	5.0		6.2
Public finances (in percent of GDP)							
National government balance 1/	-4.5	-4.6	-5.6	-5.0	-4.4		-3.9
Nonfinancial public sector balance 2/	-4.7	-4.8	-5.7	-5.8	-5.7		-4.8
Revenue and grants 3/	...	23.0	20.9	20.9	21.1		22.3
Expenditure 4/	...	27.8	26.5	26.7	26.8		27.0
Money and credit (in percent change)							
Broad money (M3) 5/	4.6	6.8	9.5	3.3	6.4	6/	...
Credit to the private sector (net)	8.1	-3.0	1.2	1.8	4.2	6/	...
Interest rate (91-day Treasury bill, end period, in percent)	12.9	8.9	5.2	6.5	7.4	7/	...
Balance of payments (in percent of GDP)							
Trade balance	5.0	-1.0	0.5	-1.0	-2.2		-2.4
Current account balance	8.2	1.9	5.7	4.9	2.8		2.0
Gross international reserves							
In billions of U.S. dollars	15.0	15.6	16.2	16.9	16.0	8/	...
Adjusted, in billions of U.S. dollars 9/	13.4	13.2	14.3	14.7	14.4	8/	...
Adjusted, in percent of short-term liabilities 10/	128.1	114.3	123.9	126.9	...		...

Sources: The Philippine authorities; IMF staff estimates.

1/ IMF definition. Excludes privatization receipts of the national government, and includes operations of Central Bank-Board of Liquidators.
2/ Includes the national government, Central Bank-Board of Liquidators, 14 monitored government-owned enterprises, social security institutions, and local governments.
3/ The sum of all nonfinancial public sector revenue net of intra-public sector payments. It is assumed that 80 percent of Bureau of Treasury revenue represents interest and dividends from other parts of the nonfinancial public sector. Privatization receipts are excluded.
4/ Defined as difference between nonfinancial public sector "revenue and grants" and "balance".
5/ For 2000, adjusted for the estimated effects of Y2K.
6/ As of July 2004, preliminary.
7/ Auction rate as of August 30, 2004.
8/ As of end-July 2004.
9/ In addition to monitoring the level of gross international reserves (GIR), the IMF also monitors Adjusted Reserves, which are calculated by subtracting from GIR the value of the BSP's foreign assets that have been pledged as collateral for short-term liabilities. These pledged assets (gold and other securities) remain foreign reserve assets of the BSP and so are considered part of GIR. However, they are not as readily usable as other components of GIR since pledged assets must be set aside while the short-term liabilities they secure remain outstanding.
10/ Short-term liabilities include medium- and long-term debt due in the following year, and exclude loans backed by gold and securities pledged as collateral.