March 2005
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Philippines: 2004 Article IV Consultation and Post-Program Monitoring Discussions—Staff Report; Staff Statement; Statement by the Executive Director for the Philippines; and Public Information Notice on the Executive Board Discussion

Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. In the context of the 2004 Article IV consultation and post-program monitoring discussions with the Philippines, the following documents have been released and are included in this package:

- the staff report for the 2004 Article IV consultation and post-program monitoring discussions, prepared by a staff team of the IMF, following discussions that ended on November 17, 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 February 4, 2005. The views expressed in the staff report are those of the staff team and do not necessarily reflect the views of the Executive Board of the IMF.
- a staff statement of March 4, 2005 updating information on recent developments.
- a Public Information Notice (PIN) summarizing the views of the Executive Board as expressed during its March 7, 2005 discussion of the staff report that concluded the Article IV consultation.
- a statement by the Executive Director for the Philippines.

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

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

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INTERNATIONAL MONETARY FUND

PHILIPPINES

Staff Report for the 2004 Article IV Consultation and Post-Program Monitoring Discussions

Prepared by the Asia and Pacific Department

(In consultation with other departments)

Approved by Masahiko Takeda and Michael Hadjimichael

February 4, 2005

- **Discussions were held in Manila during November 4–17, 2004.** The mission met with key government officials, including Finance Secretary Amatong, Bangko Sentral ng Pilipinas (BSP) Governor Buenaventura, Budget Secretary Boncodin, Energy Secretary Perez, Trade and Industry Secretary Purisima, several legislators including Senate President Drilon and House Speaker de Venecia, other senior officials and representatives of the private sector and labor unions. The team comprised Messrs. Takeda (Head), Gordon, Haksar (Resident Representative), Singh, Baqir, and Ishi (all APD), Fletcher (FAD), and Schellekens (MFD). Mr. Burgess (PDR) assisted with the preparation of this report. Ms. Amador (OED) also joined the discussions.

- **The previous Article IV Consultation was 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 has accepted the obligations under Article VIII**, maintaining an exchange system free of restrictions on payments and transfers for current international transactions.

- **The authorities are attempting to strengthen the statistical base, which suffers from several deficiencies that hamper surveillance.** The data ROSC published in August 2004 identified national accounts and balance of payments statistics as particularly weak. The authorities are recompiling balance of payments and public sector debt statistics with the assistance of STA.

- **The authorities see benefits from continuing Post Program Monitoring (PPM) until the fiscal position strengthens**, even though outstanding borrowing from the Fund has fallen well below 100 percent of quota. The next PPM mission is expected to take place in mid-2005.

- **The authorities published the staff report for the August 2004 PPM discussions for the first time.** The authorities will make a decision on whether to publish this staff report closer to the Board meeting.

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GLOSSARY OF ABBREVIATIONS AND TERMS

AFTA ....Asean Free Trade Area
AML.....................Anti-Money Laundering
AsDB....................Asia Development Bank
BIR.......................Bureau of Internal Revenue
BOL......................Board of Liquidators
BPO......................Business Process Outsourcing
BSP ....Bangko Sentral ng Pilipinas
CPSD....................Consolidated Public Sector Deficit
DBM ....Department of Budget and Management
FTA ....Free Trade Agreement
GRT......................Gross Receipts Tax
GSIS ....Government Social Insurance System
EPIRA ....Electric Power Industry Reform Act
ERC......................Energy Regulatory Commission
FATF....................Financial Action Task Force
FCDU...................Foreign Currency Depository Unit
FSSA ....Financial System Stability Assessment
LGUs....................Local Government Units
MDG ....Millennium Development Goals
MERALCO ....Manila Electric Company
MTPDP ....Medium-Term Philippine Development Plan
NDF......................Nondeliverable Forwards
NFPS....................Nonfinancial Public Sector
NG........................National Government
NPA......................Nonperforming Assets
NPL ....Nonperforming Loans
NPC......................National Power Corporation
PCA......................Prompt Corrective Action
PDIC ....Philippine Deposit Insurance Corporation
PPM......................Post Program Monitoring
SPV ....Special Purpose Vehicle
TRANSCO...........National Transmission Corporation
y/y ....Year-on-year

EXECUTIVE SUMMARY

The Philippines faces long-standing problems in the fiscal, power and banking sectors. The nonfinancial public sector deficit has been 5½ percent of GDP in recent years, while the level of public debt rose above GDP in 2003. The primary cause of the fiscal problem has been a significant decline in the ratio of tax revenue to GDP. A sharp increase in the losses of the public power utility has also played a role. In addition, the banking system is undercapitalized with one-quarter of assets nonperforming. Exposure to government securities has also significantly increased. Large external financing requirements and high debt levels make the Philippines vulnerable to changes in market sentiment and global financial market conditions.

Since taking office in July 2004, the new administration has formulated a set of reforms to address these problems. Progress with implementing these reforms is being made. Congress has passed two of President Arroyo's proposed tax measures, including a bill increasing alcohol and tobacco excises, which is expected to yield about 0.2 percent of GDP in annual revenue. A VAT rate hike (which would yield 0.5 percent of GDP) is under discussion in Congress. In the banking sector, the disposal of nonperforming assets has begun. In the power sector, a 40 percent hike in generation tariffs (yielding 0.7 percent of GDP) has been provisionally awarded, while the sale of a large generation plant has also been announced. In the mining sector, the Supreme Court's decision that foreign control of mining projects is not unconstitutional has opened the way for FDI.

However, the major part of the reform effort that is necessary remains unfinished, and, as evidenced by the recent sovereign ratings downgrade, there are risks that the quality and implementation of reforms will disappoint financial markets. The Philippines is also at risk should global markets prove to be less liquid than they were in 2004 and interest rates were to rise. These vulnerabilities will remain high until the fiscal and structural problems are solved.

In this light, staff advocated that:

- **fiscal consolidation efforts be significantly front-loaded,** so as to send a strong signal to markets about the commitment to tackling the fiscal problem. This will require the passage of further tax measures with a clear revenue impact, such as raising the VAT rate, and that much of the additional revenue be saved.

- **power sector reforms be accelerated,** with priority given to the privatization of transmission and generation assets.

- **the BSP raise interest rates,** so as to guide inflationary expectations down.

- **passage of the amendments to the BSP Charter be expedited,** so as to strengthen bank supervision and facilitate recapitalization of the banking sector.

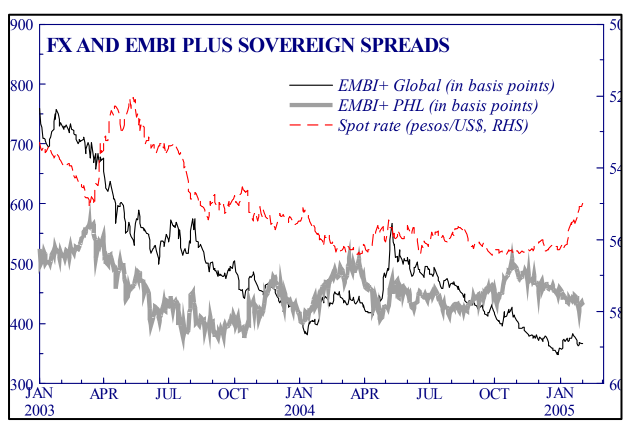
I. Introduction and Background

1. **In early 2004, the Philippines stood at a critical point**. Nonfinancial public sector (NFPS) debt had risen above GDP, and the fiscal deficit, already 5½ percent of GDP in 2003, looked set to increase further, reflecting the failure to reverse a significant decline in tax revenue and mounting losses at the National Power Corporation (NPC). Substantive revenue measures were required, but were precluded by the upcoming May 2004 elections. Poor asset quality in the banking system was also a serious concern. Moreover, considerable uncertainty surrounded the election, which promised to be closely-fought and threatened to lead to populist policies.

2. **The 2003 Article IV Consultation was concluded in March 2004 against this backdrop of heightened uncertainty**. During the discussions, the Fund stressed the urgency of implementing comprehensive reforms to address the economy's vulnerabilities and achieve a sustainable fiscal position. Three sets of actions, many of which echoed Fund advice in past consultations, were identified as critical: tax measures, such as raising excises and VAT; power sector reforms, including higher electricity tariffs and privatization; and strengthening the banking system, particularly through empowering supervisors to deal with distressed institutions. The authorities recognized the need for these actions, but noted that the speed of implementation was being affected by the lead-up to the elections. At a minimum, they endeavored to avoid fiscal policy slippages in the pre-election period.

3. **One year later, progress is being made in implementing reforms**. In the power sector, a 40 percent hike in generation tariffs (yielding revenue of 0.7 percent of GDP) has been provisionally awarded to NPC, and the authorities have announced the sale of a large generation plant. In the fiscal sector, tight control has been maintained over the budget, and a tax measure increasing excises on alcohol and tobacco (yielding 0.2 percent of GDP) has been passed by Congress (Table 1). In the banking sector, banks have begun to use the special purpose vehicle (SPV) framework to dispose of a portion of nonperforming assets, and legal amendments that would strengthen bank supervision have been submitted to Congress. In the mining sector, a recent Supreme Court ruling allowing foreign control of mining projects has opened the way for FDI.

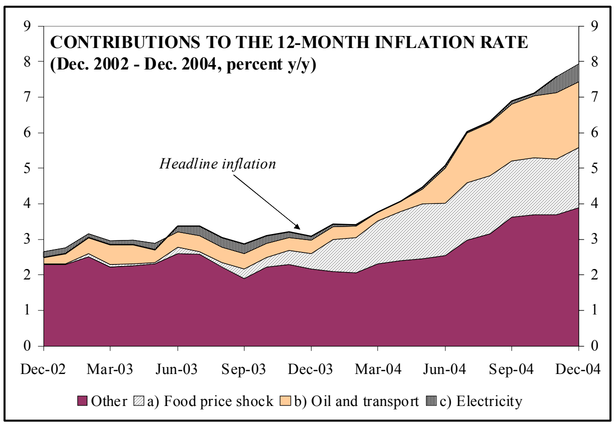
4. **Nonetheless, much more remains to be done.** While financial markets have been relatively stable since the election, the reforms implemented to date are a small part of the total reform effort required, and market sentiment will remain brittle until more substantive progress is made. Indeed, one rating agency downgraded the sovereign rating in January 2005 on the grounds that the tax reforms to date were inadequate. The Philippines will remain vulnerable to sudden shifts in investor confidence and market conditions as long as the public sector deficit and debt levels remain high, and other structural problems remain unresolved.



II. Recent Economic Developments

5. **GDP growth has exceeded expectations, but unemployment remains high.** With exports staging a recovery, and consumption boosted by overseas remittances and the election, GDP grew by a little over 6 percent in 2004, up from 4¾ percent in 2003. On the production side, the growth drivers were strong performances by agriculture and services such as telecommunications, business process outsourcing (BPO) and tourism. Employment increased by 3.6 percent in 2004, mainly reflecting the rapid creation of services sector jobs. Even so, unemployment averaged 11.8 percent, up from 11.4 percent a year earlier.[1]

6. **Inflation has risen above the target range.** The rate of inflation (1994 base) climbed to 7.9 percent (y/y) in December, from 3.1 percent (y/y) in December 2003, causing average inflation to increase to 5.5 percent, above the BSP's target range of 4–5 percent.[2] The primary cause was a succession of supply shocks, led by a jump in meat and fish prices, and followed by the surge in world oil prices, and, more recently, the hike in power tariffs. Nonetheless, some signs have emerged of more broad-based inflationary pressures, including a rise in core inflation.[3] The Bangko Sentral ng Pilipinas (BSP) has so far kept policy rates on hold, preferring to wait for more definitive evidence that inflation is becoming generalized before taking monetary policy action.



7. **The fiscal deficit is set to edge down.** The national government deficit (authorities' definition) is estimated to have declined to 3.8 percent of GDP in 2004, below the budget target of 4.2 percent of GDP, and down from 4.6 percent of GDP in 2003. Revenue is estimated to have remained broadly unchanged as a share of GDP, while primary spending has been compressed. The major sources of expenditure savings were personnel services, due to the absence of a general wage increase for the second consecutive year, and transfers to local government units (LGUs) staying fixed in nominal terms as a result of the re-enactment

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[1] Poverty also remains high, with almost one sixth of the population living on less than $1 a day, and the achievement of a number of MDG targets is in doubt, particularly those relating to child malnutrition and maternal mortality (Annex VII).

[2] Inflation measured using the recently introduced 2000 based CPI rose to 8.6 percent in December 2004 (y/y) and averaged 6.0 percent for the year.

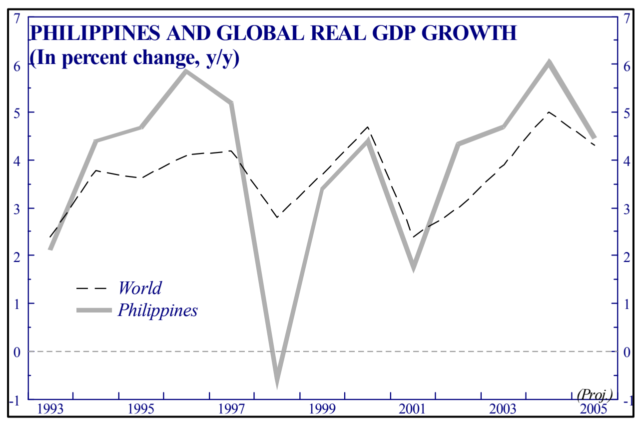
[3] The official measure of core inflation has risen approximately in tandem with headline inflation, reaching 7.6 percent (y/y) in December (1994 base). Alternative measures of core inflation also show a similar acceleration (Figure 2).

of the 2003 budget. However, with NPC losses expanding from 1.1 percent of GDP in 2003 to 1.5 percent of GDP in 2004, the NFPS deficit is estimated to have only declined to 5.3 percent of GDP in 2004, compared to 5.6 percent of GDP in 2003.

8. **The balance of payments proved fairly resilient in 2004.** Strong growth of exports, tourism receipts, and remittances more than offset higher oil imports, causing the current account surplus to increase slightly to an estimated 4½ percent of GDP in 2004.[4] For much of the year, this surplus looked insufficient to finance net capital outflows and negative errors and omissions, and a loss of foreign exchange reserves was expected. However, in the fourth quarter, the weak U.S. dollar took pressure off the peso and allowed the BSP to make modest purchases of foreign exchange.[5] As a result, reserves, adjusted for pledged assets, ended the year up slightly at $15 billion (119 percent of short-term debt by residual maturity). The BSP was also able to wind down the oversold non-deliverable forward (NDF) position of about $0.8 billion built up during the pre-election uncertainties in early 2004.

III. Near-term Outlook and Risks

9. **A number of uncertainties weigh on the near-term outlook.** The rapid growth in 2004 is unlikely to be sustained, particularly given slowing global demand in the information technology sector. Thus, GDP is expected to grow at a more moderate 4¾ percent in 2005. One source of downside risk is that the ongoing depreciation of the U.S. dollar could become disorderly and lead to even weaker global growth. Another is that oil prices might retrace the path back toward US$60 per barrel.[6] Equally, there is an upside to the 2005 growth projection should oil prices drop from their current level. There is further upside if implementation of reforms proves to be particularly strong, although the benefits will mostly accrue over the medium term.



[4] While there have been recent improvements in the quality of balance of payments data, remaining reporting gaps and misclassifications continue to make the data difficult to interpret (Annex VI).

[5] During this period, the peso-dollar exchange rate was relatively stable. However, the authorities' stated objective is inflation targeting and BSP intervention is aimed at smoothing out undue short-term fluctuations rather than maintaining a particular exchange rate.

[6] A $10 per barrel increase in oil prices is estimated to lead to a decline of ¾ percentage points in the Philippines' growth and a deterioration in the current account balance of about 1¼ percent of GDP.

10. **The major source of vulnerability arises from the large external debt and financing requirements.** Vulnerabilities are likely to rise in 2005 even in the absence of adverse shocks due to the less benign external environment of rising global interest rates and tighter liquidity, which could lead to more discrimination by foreign investors and more difficulty in meeting the sizable public sector external commercial borrowing needs (estimated by staff at $4–4½ billion (5-6 percent of GDP) if reserves are to be maintained at comfortable levels). The high level of external debt makes the economy extremely vulnerable to a sharp rise in global interest rates; staff estimate that an increase in rates of 100 basis points would add about $0.3 billion to interest payments in 2005. External financing difficulties could also be triggered by the markets losing patience with the speed at which the Philippines is implementing reform.

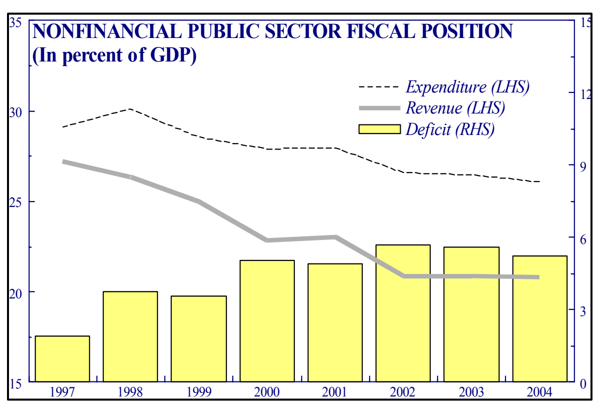
IV. Report on Policy Discussions

11. **Staff reiterated the need for rapid progress in implementing comprehensive economic reforms.** Staff welcomed the new administration's reform plans, as well as the broad awareness of the fiscal problem among the politicians who met with the mission. However, staff expressed concern that implementation of reforms was proceeding slowly and that markets might lose patience. Some of the past fiscal problems had political economy roots (Box 1) and staff hoped that the authorities would be able to capitalize on the administration's strengthened majorities in Congress to take bold upfront actions. Such a strategy would recognize that reforms would only become more difficult as the term of the administration progressed and politicians became distracted by the next election.

12. **The authorities, by contrast, considered reforms to be proceeding at a reasonable pace.** Substantive progress had already been made with power sector reforms. With regard to tax reforms, the new Congress had only started working in July, and given the time taken to forge political consensus on individual measures, it was necessary to be realistic as to what was achievable. In any case, although only one tax measure was passed during 2004, a number of bills were set to be passed early in 2005.

A. Fiscal Policy

13. **The fiscal problems in the Philippines stem primarily from a long-term decline in the revenue effort.** NFPS revenue fell by 6 percentage points of GDP between 1997 and 2003 due to weak tax administration, nonindexation of excises to inflation, and the failure to combine trade liberalization with offsetting revenue measures, as well as the government's decision in 2002 to cap increases in electricity tariffs.[7] Over the past two years, the



[7] One response to the revenue decline has been a squeeze on capital spending, which has fallen from almost 4 percent of GDP in the late 1990s to about 2¾ percent of GDP in 2004.

authorities have attempted to strengthen tax administration, including through registration checks, prosecution of tax evaders, lifestyle checks, dismissal of corrupt tax officials, and computerized matching of VAT receipts. However, while these efforts have arrested the decline in the tax to GDP ratio, they have yet to cause any increase. Staff therefore welcomed the new administration's goal of raising significant additional revenue through new tax measures, as well as the extra revenue that will accrue to NPC as a result of the tariff increase.

14. **Staff recommended that the NFPS deficit be reduced by about 2 percentage points of GDP in 2005**. The proposed 2005 budget aims to reduce the national government deficit to 3.6 percent of GDP, primarily via spending restraint, again including no general wage increase.[8] Combined with lower NPC losses, staff projected that the NFPS deficit would decline by about 1 percent of GDP to 4½ percent of GDP in 2005. Staff argued that, while desirable, this adjustment would not significantly reduce debt levels or vulnerabilities (Annex 1). The authorities agreed that there was a need to front load fiscal adjustment and hoped that revenue from the new tax measures, which are not included in the 2005 budget, might make this possible. Some of this revenue would be needed to cover new expenditure in priority areas such as infrastructure spending. Nonetheless, staff recommended that a sufficient portion be saved so as to lower the NFPS deficit to 3½ percent of GDP in 2005. An initial adjustment of this size would provide a powerful signal of the authorities' commitment to fiscal consolidation.

15. **However, with most of the tax measures still being debated by Congress, the prospects for front-loaded fiscal adjustment are uncertain.** To date, only one tax measure with a clear revenue impact—higher alcohol, cigarette, and tobacco excises yielding about 0.2 percent of GDP—has been passed. Staff therefore looked forward to early action on other fronts. Petroleum excises are low by international standards, but the authorities noted the difficulty of raising them in the current environment of high oil prices.[9] Staff have long advocated increasing the VAT rate, which is also relatively low, and the authorities seemed more open to this possibility than in earlier discussions. Indeed, they have since decided to seek an immediate increase in the VAT rate from 10 to 12 percent.

16. **Rationalizing fiscal incentives could be a substantial revenue raiser**. The authorities were proposing various initiatives in this regard, of which staff strongly supported the proposal to eliminate incentives from a large number of disparate economic laws, including those given to cooperatives (yielding a potentially substantial amount of revenue) and a proposal to remove nonstandard VAT exemptions such as for petroleum products (yielding 0.2–0.3 percent of GDP). Another proposal being considered aimed at

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[8] This deficit reduction is part of the administration's plan to balance the national government budget and reduce the public sector deficit to 1 percent of GDP by 2010.

[9] The authorities did, however, raise duties on oil and petroleum imports by Executive Order from 3 to 5 percent from January 1, 2005, which is expected to yield annual revenue of 0.1 percent of GDP.

consolidating many different investment incentives into a single law, but potentially could result in a net expansion of incentives. The authorities acknowledged that the draft bill for this proposal contained some new incentives, but noted that it would also place a 20-year limit on incentives that were currently open-ended.

17. **Staff raised concerns about other tax measures under consideration.** As in the past, staff opposed the proposed tax amnesty because of the likely adverse effects on compliance, and expressed doubts about whether the scheme to improve incentives for revenue collectors would yield significant revenue benefits. Staff also voiced concerns that the proposed franchise tax on telecom companies might be introduced in conjunction with a VAT exemption for the industry, thus preventing commercial users of telecom services from claiming VAT credits and breaking the VAT chain. However, this proposal has been set aside for the time being, as has the earlier proposal to introduce a Gross Income Tax.

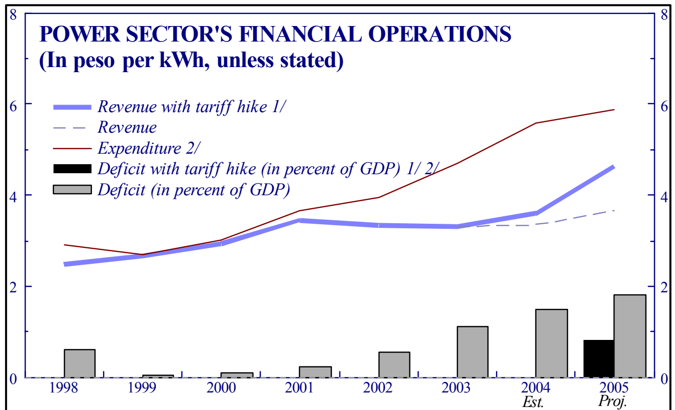
18. **The authorities are proceeding with civil service reform**. An executive order issued in October 2004 ordered public agencies to prepare rationalization plans. Personnel in positions designated as redundant will have the option to either avail of severance payments or be re-assigned. Preliminary estimates indicated that perhaps 2–4 percent of public employees would be affected, with severance payments costing 0.1–0.3 percent of GDP. While supporting the authorities' goal of improving public service delivery, staff argued that awarding generous severance payments to those already near retirement would reduce the possible gains to the budget. The authorities agreed that some additional limitations on severance benefits were needed and were working with the World Bank on the specifics.

19. **Strengthening public pension funds was another priority.** The pension funds are currently running small cash surpluses. However, weak asset management, high benefit replacement rates, and insufficient contribution rates could cause pension funds to be depleted as early as 2015. Reform of the pension funds was therefore essential to avoid aggravating the long-term outlook for public finances. The authorities agreed on the need to address this issue and have established a working group to consider reform options.

B. Power Sector

20. **The Philippines has launched an ambitious program of power sector reform.** The Electric Power Industry Reform Act (EPIRA) of 2001 aims at restructuring the electricity market and privatizing power sector assets so as to encourage greater competition and attract private investment. However, up until recent months, the reform program has been stalled, with pro-consumer tariff decisions undermining the financial viability of NPC, and privatization biddings for the transmission company, Transco, failing on two occasions.

21. **Progress with strengthening NPC's financial position has recently been more encouraging.** NPC was granted a provisional P 0.98 per kWh average tariff increase by the Energy Regulatory Commission (ERC) in September.[10] The tariff increase is estimated to yield about 0.7 percent of GDP in annual revenue. The government has also decided to absorb P 200 billion in NPC debts from the beginning of 2005. This measure will shift a share of the burden of NPC losses, which partly reflect sunk costs, to the general taxpayer rather than the electricity consumer. Lower interest costs, together with the tariff hike, will help NPC bring down its deficit from 1½ percent of GDP in 2004 to ¾ percent of GDP in 2005.



1/ Includes the September 2004 tariff hike. 2/ Includes P200 billion NPC debt transfer.

22. **Privatization of power sector assets, however, continues to proceed slowly.** In October, the authorities terminated bilateral negotiations with potential investors for the Transco concession, and announced a reopening of competitive bidding. Staff expressed concern that this change in the privatization strategy might send the wrong signal to investors. The authorities explained that they remained firmly committed to privatizing Transco, but had recognized that competitive bidding, even though it had failed once before, would be more transparent. The authorities also aim to privatize 70 percent of generation assets by end-2005, which, together with the introduction of the wholesale spot market (expected in mid-2006), will pave the way for the launch of a competitive electricity market. To date, the privatization of one large and five small power plants (in total worth about $570 million) has been announced. The authorities indicated that under EPIRA, privatization proceeds would have to be used to retire power sector debt.

23. **Strengthening the regulatory environment is also key to the success of power sector reform.** Staff welcomed the transparent manner in which the ERC had conducted the process of awarding NPC a tariff increase. Other positive regulatory steps included the ERC's review of the generation rate adjustment mechanism for distribution utilities to allow them more timely cost recovery. Cross subsidies among consumer classes are also being phased out to improve efficiency in electricity consumption. More generally, the authorities agreed that a rules-based regulatory framework would facilitate privatization and help to ensure adequate investment in new power supply capacity.

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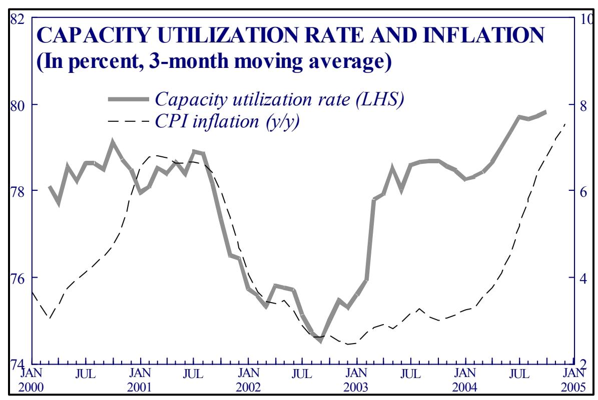
[10] The tariff award remains provisional until the ERC makes a final ruling on recent objections raised by consumer groups, who thereafter could appeal to the courts.

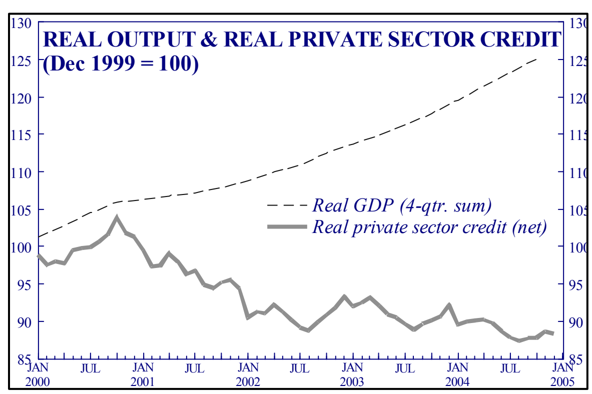
C. Monetary Policy

24. **The BSP emphasized the role that supply factors had played in increasing inflation.** The jump in inflation had been driven by supply side factors for which monetary policy was not the appropriate policy response. The BSP had instead called for administrative measures to ease supply bottlenecks in importation and distribution. The authorities also noted that the oil shock had had a relatively large effect in the Philippines because there was no attempt to use subsidies or other measures to reduce the pass through of international oil prices to domestic inflation.

25. **The authorities' view was that the stage for tightening policy had not yet been reached.** To strengthen the transparency of the inflation targeting framework, the BSP had announced the criteria it would use to decide the need for a monetary policy response. These included inflation pressures over and above those generated by supply shocks; emerging demand side pressures on inflation; and the risk of prolonged exchange market pressure. The BSP's judgment was that, as yet, none of these criteria had been clearly met. They considered the evidence for second round effects of supply side shocks to be weak. They also noted that the increase in core inflation was likely to be temporary. On the demand side, they noted that although consumption was growing rapidly, growth of private credit remained moderate. In any case, high unemployment and the absence of wage pressures were suggestive of continued slack in the economy.

26. **Staff argued that the balance of risks suggested a need for policy tightening.** In the staff's assessment, the increase in several measures of core inflation was suggestive of initial price pressure spreading to other sectors. In addition, the level of core inflation remained well above the BSP's target range and about a third of the increase in the headline inflation rate since end-2003 was due to factors other than identifiable supply side factors. Indicators of demand side pressure and slack also suggested that the situation might be turning. In this context, staff noted that capacity utilization was rising, and although this was a short time series (only recently having begun to be compiled), it had tended to co-move with inflation in the past. Also, while credit growth remained low, it had decoupled from GDP growth in recent years.





27. **Staff also noted that continued high inflation, even if entirely supply-driven, might affect inflationary expectations.** Inflation promised to remain above the target at least until 2006 and the recent upward shift in the yield curve was suggestive of higher inflationary expectations for longer periods. Moreover, concerns about the macroeconomic

framework remain paramount in the minds of market participants, given the overriding fiscal problem. In this light, a rate increase would send a positive signal about the BSP's commitment to the inflation target. The authorities observed that bond markets were illiquid at longer tenors and downplayed the information content of the yield curve. Nonetheless, they were paying close attention to the risk of a deterioration in inflation expectations.

D. Financial Sector Policy

28. **Staff welcomed the priority being given to financial sector reform**. Revised frameworks for supervisory enforcement and corporate debt restructuring were being proposed that would do much to improve the resilience of the financial system. Clear rules regarding the trust funds business had been established that were expected to increase transparency and confidence in the system, while efforts had also been made to enhance the internal credit risk rating systems of banks. In addition, the authorities were appropriately emphasizing domestic capital market development to provide alternate forms of finance for the private and public sectors.

29. **Concerns about banking system capitalization add urgency to these reforms**. Previous staff analysis has indicated that deficiencies in accounting and loan classification practices cause capital adequacy to be overstated in the Philippines, and particularly so for certain banks. Financial markets share these concerns; a number of large banks were recently downgraded by an international rating agency because of the latent losses on their nonperforming assets (NPAs). In addition, the large assistance that continues to be provided by the Philippines Deposit Insurance Corporation (PDIC) to several banks raises further questions about the capacity of these banks to absorb losses.

30. **While the SPV framework is gaining some traction, more pressure needs to be exerted on banks to raise fresh capital.** A number of transactions have been concluded or are near conclusion, resulting in the likely disposal of P 30 billion in NPAs out of a total stock of roughly P 500 billion. The authorities expressed optimism about several other deals that were in the pipeline. Nonetheless, staff pointed out that the asset disposal process has moved slowly so far and that more pressure needed to be exerted on banks to recognize latent losses and inject fresh capital. The authorities concurred, but noted that major progress with the NPA resolution strategy would first require strengthening the powers of bank supervisors.

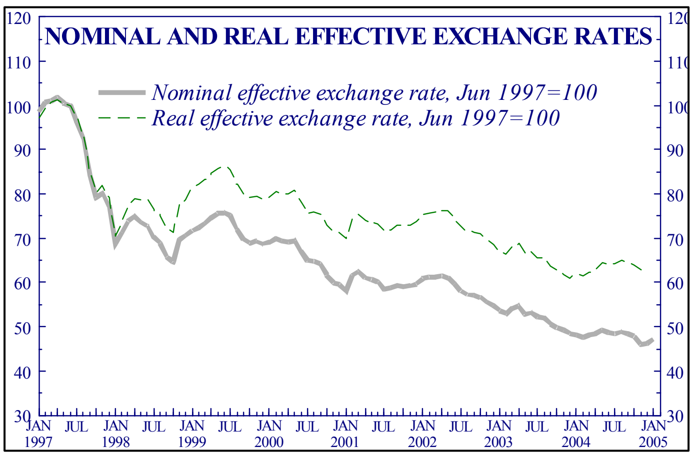
31. **The proposed amendments to the BSP Charter are therefore fundamental to strengthening the banking system.** Pressuring owners to inject fresh capital requires providing bank supervisors with adequate legal protection, and enhancing the prompt corrective action and bank resolution frameworks, so that the threat of intervention becomes credible. Staff were encouraged to see changes along these lines in the proposed amendments to the BSP Charter, and the authorities were hopeful the legislators would respond more positively to such amendments than they had done in the past.

32. **Current macroeconomic uncertainties further underscore the need for adequate capital buffers.** Both regular bank units and foreign currency deposit units (FCDUs) have

large exposure to government securities. These exposures are long-term and fixed-rate, which creates a potential vulnerability should rates rise.[11] Staff encouraged the BSP to strengthen its monitoring of interest-rate risks, which provide a further need for banks to increase their capital. The authorities considered interest rate risks to be manageable at this juncture, but acknowledged the need for further enhancing data collection efforts in this area.

E. Medium-Term Outlook

33. **Over the medium term, economic reforms are necessary to invigorate growth.** While agriculture and services have been buoyant in recent years, industry has shown less vigor with manufacturers facing fierce competition from within the region. In the staff's view, however, competitiveness, as measured by the real effective exchange rate, is not the major obstacle to growth. Instead, a take-off in activity will likely require strong fiscal and structural reforms to improve the business climate (Box 2), thereby increasing investment, and hence productivity and GDP growth. The authorities' Medium-term Philippine Development Plan, 2004-2010 (MTPDP) takes a similar position, recognizing that sustained and accelerated growth will require both addressing the fiscal problem and enhancing competitiveness through measures to boost productivity, improve infrastructure, reduce corruption, and simplify business procedures.



34. **The level of growth attained will depend on how fast and thoroughly the government can implement reforms.** While investor sentiment would be considerably boosted by comprehensive reforms, the authorities' MTPDP projections that growth could rise to 7–8 percent appear optimistic. Staff, by contrast, project that under strong reforms, growth would trend up to 6 percent, while under a moderate reform scenario—where the reform

MTPDP MACROECONOMIC TARGETS

	2004	2005	2006	2007	2008	2009	2010
GDP Growth (%)	4.9-5.8	5.3-6.3	6.3-7.3	6.5-7.5	6.8-7.8	7.0-8.0	7.0-8.0
Exports of goods and services ($Bn)	43.1	47.4	52.3	58.2	65.4	74.3	84.3
Investment-to-GDP 1/	20.1	20.3	21.4	22.5	24.1	25.8	27.7
Inflation (%)	4.0-5.0	4.0-5.0	4.0-5.0	3.0-4.0	3.0-4.0	3.0-4.0	3.0-4.0
NG Deficit/GDP	4.2	3.6	2.9	2.0	1.1	0.2	0.0
CPSD/GDP 2/	6.7	6.0	5.3	4.6	3.9	3.0	1.0

Source: Medium Term Philippine Development Plan, 2004-2010.

1/ Fighting target is to achieve investment-to-GDP ratio of 28 percent in 2 years.
2/ Consolidated Public Sector Deficit.

[11] Based on a stress testing exercise, staff calculate that an interest rate shock of 300 basis points could reduce the capital adequacy ratio of a sample of 11 large banks, currently 13½ percent, by as much as 3 percentage points if all securities were marked to market.

momentum is not only slower, but dissipates by the middle of the administration's term—growth of about 4 percent is more likely. Under the strong reform scenario, the authorities would achieve their balanced budget objectives by 2010, and nonfinancial public sector debt would fall to 73 percent of GDP, which while still relatively high is almost 30 percentage points lower than the present level (Table 6). By contrast, under a moderate reform scenario, the NFPS deficit would fall no lower than 4 percent of GDP, and while debt would edge down, vulnerabilities would remain high (Table 7 and Annex I).

35. **The case for reform might resonate with a wider audience in the Philippines if presented in terms of improved social outcomes.** It was suggested during the August 2004 PPM Board discussion that political and public support for strong reforms might be enhanced by presenting the benefits in terms of tangible indicators such as employment creation and poverty reduction. Staff made a presentation to the authorities along these lines (Box 3). Of particular note was the finding that GDP growth of 4–4½ percent per annum (the staff's moderate reform scenario) seemed insufficient to halt the upward trend in unemployment.[12] Indeed, a decline in the unemployment rate was likely to require growth rates of at least 6 percent. Some simple calculations suggested that strong reforms could also imply substantial benefits in terms of poverty reduction, as well as more room within the budget for socially beneficial spending.

F. Other Issues

36. **While remaining committed to the multilateral trading system, the authorities intend to pursue regional and bilateral trade agreements where appropriate**.[13] The authorities recently announced that some of the major elements of a bilateral free trade agreement (FTA) with Japan have been concluded, including phased tariff reductions for a number of products (including some agricultural products) and the easing of restrictions on the employment of Philippine nationals in Japan. Discussions are also taking place within the ASEAN framework on FTAs with China and India. Staff analysis indicates that the recent ending of the Multi-Fiber Agreement will have negative effects on the Philippines, but these should be relatively moderate given that garments and textiles account for less than 7 percent of total exports.

37. **The Philippines continues to be classified as noncooperative with regard to its AML framework.** The authorities noted that the AML framework, as amended in

[12] Employment prospects also depend on the sectoral composition of GDP growth. Although the agriculture sector has grown at record rates in recent years, the sector has created few new jobs. Employment in the services sector, in contrast, has grown rapidly.

[13] Even though average tariff rates are low in the Philippines, agricultural tariffs are among the highest in the region. The Philippines also maintains a number of nontariff barriers, including quantitative restrictions on rice imports and special tax incentives for the automobile industry. Following a number of selective tariff increases in 2004, the average tariff rate has increased to 7.5 percent from 6.2 percent in 2003.

March 2003, was now consistent with international standards. The Financial Action Task Force would soon evaluate implementation under the revised framework, and the authorities hoped that this would lead to the Philippines being removed from the noncooperative list.

V. Staff Appraisal

38. **Progress is beginning to be made with reforms.** President Arroyo's election victory in May 2004 provided an opportunity to implement the comprehensive program of reforms that is so urgently needed to address the economy's vulnerabilities and achieve public debt sustainability. Reforms have proceeded slowly since the administration took office in July. However, a number of recent developments, including the provisional tariff increase awarded to NPC and the passage of the bill raising alcohol and tobacco excises, provide some encouragement that the administration's efforts will succeed.

39. **Nonetheless, with the major part of the reform agenda still unfinished, vulnerabilities remain high.** The favorable economic performance recorded in 2004 owes much to the strength of foreign demand and the abundance of global liquidity. These conditions are not guaranteed to continue in 2005, particularly if oil prices were to spike up again or if the ongoing correction to the U.S. dollar were to become disorderly. Even with benign global conditions, the Philippines could find it difficult to meet its large external borrowing needs should the reform momentum falter.

40. **Fiscal consolidation efforts are welcome, but should be front-loaded.** Despite tight controls over expenditure, only limited progress was achieved in 2004 toward the administration's goals of cutting the public sector deficit to 1 percent of GDP by 2010 (while balancing the national government budget). Nonetheless, the authorities deserve credit for not attempting to limit the domestic pass through of higher global oil prices in 2004 since the fiscal costs would not have been affordable. For 2005, staff recommend a reduction in the NFPS deficit of about 2 percentage points of GDP. This would send a strong signal to markets about the commitment to tackling the fiscal problem, while recognizing that fiscal measures will only become more difficult as the term of the administration progresses.

41. **However, the prospects for front-loaded fiscal adjustment remain uncertain.** The NFPS deficit is expected to decline to about 4½ percent of GDP in 2005, reflecting the targeted cut in the national government deficit and lower NPC losses as a result of the higher electricity tariff. This is a reduction of about 1 percentage point of GDP over 2004, but assumes a further squeezing of government spending that may not be sustainable. On the other hand, this projection does not incorporate revenue from the various tax measures that are still being considered. A substantial revenue yield from these measures is therefore essential. This would allow additional spending in priority areas and the more aggressive deficit reduction recommended by staff.

42. **High quality tax measures should therefore be the first priority.** To date, only one tax measure with a clear revenue impact has been passed by Congress. Staff look forward to the passage of more substantive revenue-raising measures in the first few months of 2005. In this context, staff welcome the favorable consideration being given to the higher VAT rate. The repeal of special tax exemptions, such as the VAT exemption of petroleum, also

represent an important potential source of revenue. Further steps should also be taken to improve tax administration such as improved audit strategies and increased prosecution of evaders.

43. **Durable fiscal consolidation will also require restructuring government and strengthening the pension schemes.** The authorities are making commendable efforts to reform the civil service and improve the delivery of services, but will need to ensure that the severance packages paid are not overly generous. Staff also look forward to the development of reforms that will place public pensions on a sustainable footing.

44. **Progress has been made with power sector reforms, but much more remains to be done.** The significant increase in NPC's generation tariffs provisionally awarded in September is an important step forward, as is the recently announced sale of a large power plant. The government is attaching high priority to power sector privatization and plans to sell the transmission assets as soon as possible and the majority of generation assets by the end of 2005. It will also be important to build a track record of adherence to a predictable rules-based energy regulatory framework so as to improve the investment climate.

45. **The case for tightening monetary policy continues to build**. Although supply shocks are the root cause of the inflation target having been missed in 2004, there are a number of signs that price pressures have spread. Moreover, the persistence of above-target inflation for a prolonged period, which seems likely, invites an upward revision to inflationary expectations. While the BSP continues to weigh the evidence for inflation having become more generalized, the staff's view is that the balance has tipped, and that an increase in rates is required to guide inflationary expectations down. The BSP has also clearly communicated to the public that its policy will be guided by its inflation objective, and that it will not attempt to defend any particular level of the exchange rate. Staff welcomes this commitment to continuing to manage the exchange rate flexibly.

46. **Major challenges lie ahead in the financial sector.** Banks are beginning to use the special purpose vehicle framework to dispose of nonperforming assets, while amendments to the BSP Charter, critical for strengthening bank supervision, have been submitted to Congress. Steps have also been taken to strengthen the regulation of the banks' trust operations. By facilitating the consolidation and recapitalization of the banking system, these measures will reduce existing vulnerabilities and enable the banking system to fully contribute to economic growth. However, attempts to empower bank supervisors have repeatedly failed in the past, and it remains to be seen whether the current amendments will be accepted.

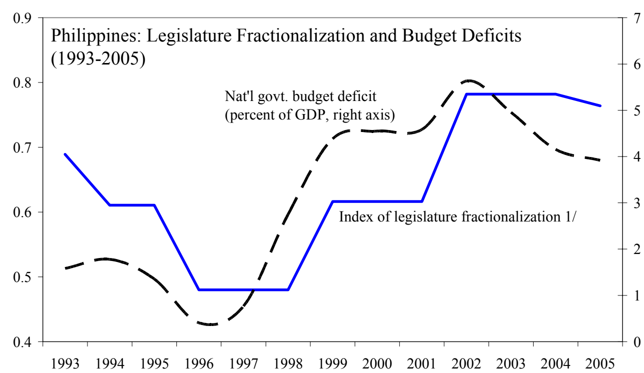
47. **The authorities are making welcome efforts to strengthen statistics**. Staff look forward to further implementation of the recommendations of recent Fund technical assistance on balance of payments and public debt statistics.

48. **It is recommended that the next Article IV Consultation with the Philippines be held on the standard 12-month cycle**.

Box 1. The Political Economy of Fiscal Reforms in the Philippines

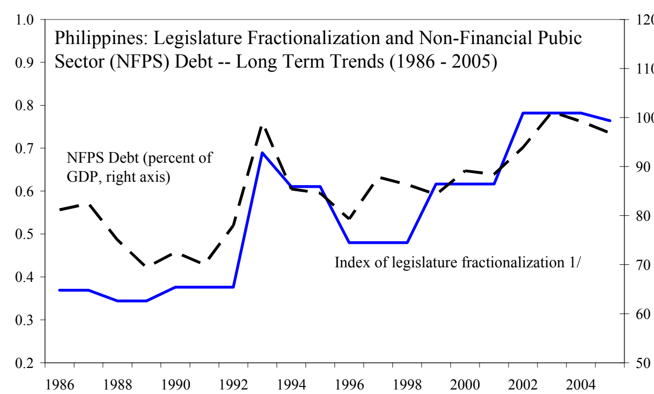
The Philippines' current fiscal problems can be attributed both to tax policy changes and, until recently, weakening tax administration, but the more fundamental factors are argued to be political. When President Arroyo declared on August 23, 2004, that the country was in the midst of a fiscal crisis, her comments were interpreted as an effort to generate the needed political will among congressmen to reverse the revenue decline. Several local analysts—including a widely publicized paper by 11 economists from the University of Philippines School of Economics—have described a declining political will to tackle pervasive corruption. The authors argued that the costs of national debt are broad-based and not felt directly by individuals or particular interest groups, which otherwise might have pressured their elected representatives into action. They emphasized that in such a situation the President has to convince congress members to place the national good above that of their particular constituencies and undertake the needed painful measures.

A recent and rapidly growing literature in economics has examined the role of political economy factors in explaining fiscal outcomes. One recurring theme in this literature is that political fractionalization is likely to lead to poor fiscal discipline. By fractionalization is meant lack of political cohesion in the legislature, as indicated, for instance, by the lack of effective control of the legislature by any one political party and the incidence of weak coalition governments (as opposed to single party majority governments). In environments where no one political party or group is able to fully internalize the consequences of fiscal decisions, needed but painful decisions can end up being delayed.



1/ Measures the probability that two randomly selected politicians from the lower house of the legislature belong to different political parties. Source: World Bank Database of Political Institutions and staff estimates. Deficit for 2005 corresponds to the proposed government budget.

Political fractionalization has a bearing on fiscal trends in the Philippines. The first text chart plots an index of political fractionalization used commonly in the political economy literature—based on the party shares in the legislature, it measures the probability that any two randomly selected legislators will belong to different political parties. The chart shows that the improvement in the fiscal balance in the Ramos presidency of the early 1990s coincided with a more cohesive legislature, and that the increased fragmentation produced by the 1998 election coincided with the decline in the fiscal position. The second chart takes a longer perspective and plots the evolution of non-financial public sector debt against the same index of fragmentation. Public debt grew in periods where fractionalization rose.

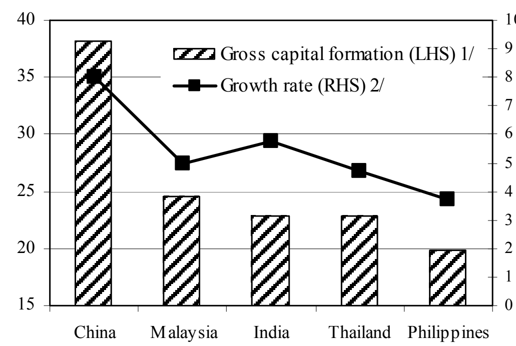


1/ Measures the probability that two randomly selected politicians from the lower house of the legislature belong to different political parties. Source: World Bank Database of Political Institutions and staff estimates. Deficit for 2005 corresponds to the proposed government budget.

Box 2. Assessing the Investment Climate in the Philippines

The growth performance of the Philippines has lagged behind other Asian countries. Average growth in the Philippines in 1999-2003 was four percent, which is 1–4 percentage points lower than in the selected Asian developing countries shown in the charts. The Philippines' relatively lower growth performance appears to be at least partly explained by lower capital formation.

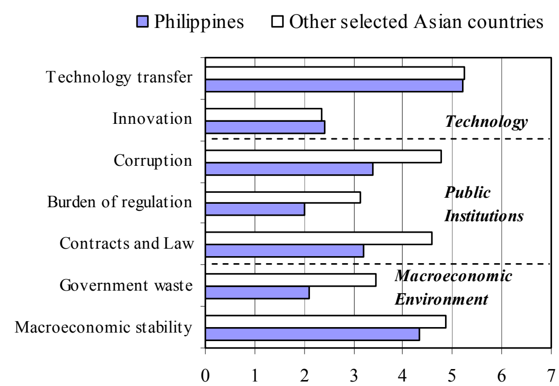
Investment and Growth



1/ 1999-2002 average, in percent of GDP.
2/ 1999-2003 average, percent change.
Source: World Bank; and staff calculations.

Improving the investment climate is therefore key. To analyze the investment climate in different countries, the World Economic Forum's *Growth Competitiveness Index* (GCI) provides comprehensive data on the investment climate. The 2004 GCI placed the Philippines' competitiveness ranking at the 76th (out of 104), far behind Thailand's 34th and China's 46th. The detailed GCI breakdown (2003 data) shows that the Philippines fares poorly relative to the comparator group in terms of the quality of public institutions (corruption, regulatory and contracts environment) and the macroeconomic environment (government waste and macroeconomic stability). By contrast, the Philippines is competitive in terms of technology indicators (which measure the capacity of technological adoption from abroad and innovation). An alternative source of data, the World Bank's *Doing Business in 2005,* shows that the labor market is less flexible in the Philippines than in the same comparator group, although it should be noted that labor market flexibility is relatively high in the sample of countries considered.

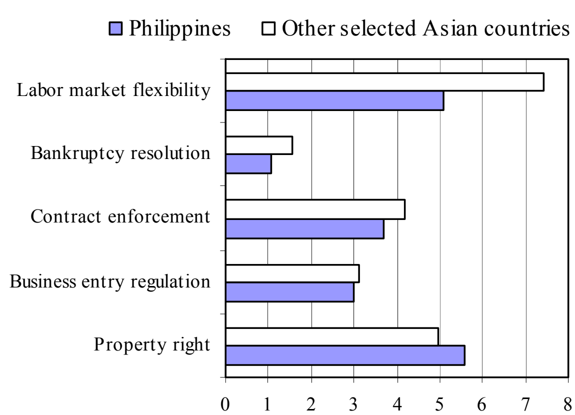
Growth Competitiveness Indicators



Note: Indicators range from 1 (worst) to 7 (best).
Sources: World Economic Forum (2003); and staff calculations.

Bold and sustained actions are called for to address weaknesses in the investment climate. The recently-formulated Medium-Term Philippine Development Plan (MTPDP) 2004–10 specifically recognizes that the Philippines faces weaknesses regarding macroeconomic and fiscal instability, corruption, excessive bureaucracy and regulation, and labor market inflexibility. The MTPDP calls for a number of measures to address these weaknesses, including balancing the budget by 2010, addressing corruption and simplifying business procedures, and introducing more flexibility in the Labor Code.

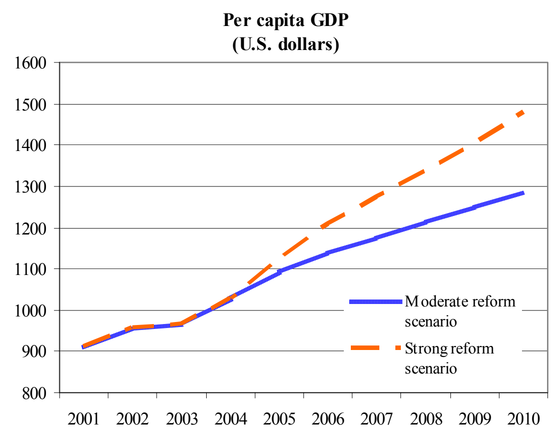
Doing Business Indicators

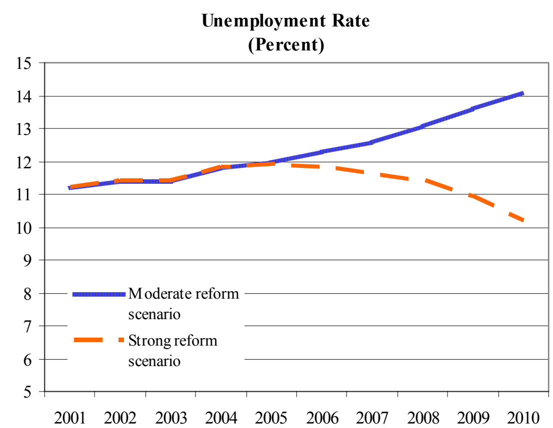


Note: The scale indicates 0 (worst) and 7 (OECD average).
Source: World Bank (2004); and staff calculations.

Box 3. Benefits of Reform

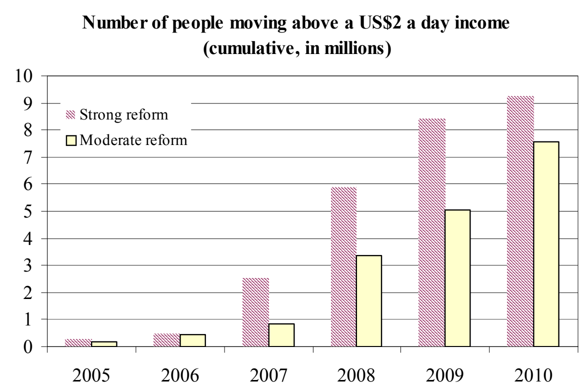
In past analysis, staff have framed the benefits of up-front fiscal consolidation and strong reforms in terms of faster GDP growth and better debt dynamics. For example, staff projections for the Philippines are that under current policies, which constitute a moderate-reform scenario, GDP growth will trend down towards 4 percent over the medium term, reducing the nonfinancial public sector debt to 93 percent of GDP. Alternatively, if the government manages to improve the investment climate through needed reforms and is successful in balancing the budget by 2010, growth could accelerate to 6 percent. As a result, public debt would decline to about 73 percent of GDP. However, spelling out the benefits of reform in terms of social outcomes or outlays may resonate better with the public and help to build a broader constituency for reform.





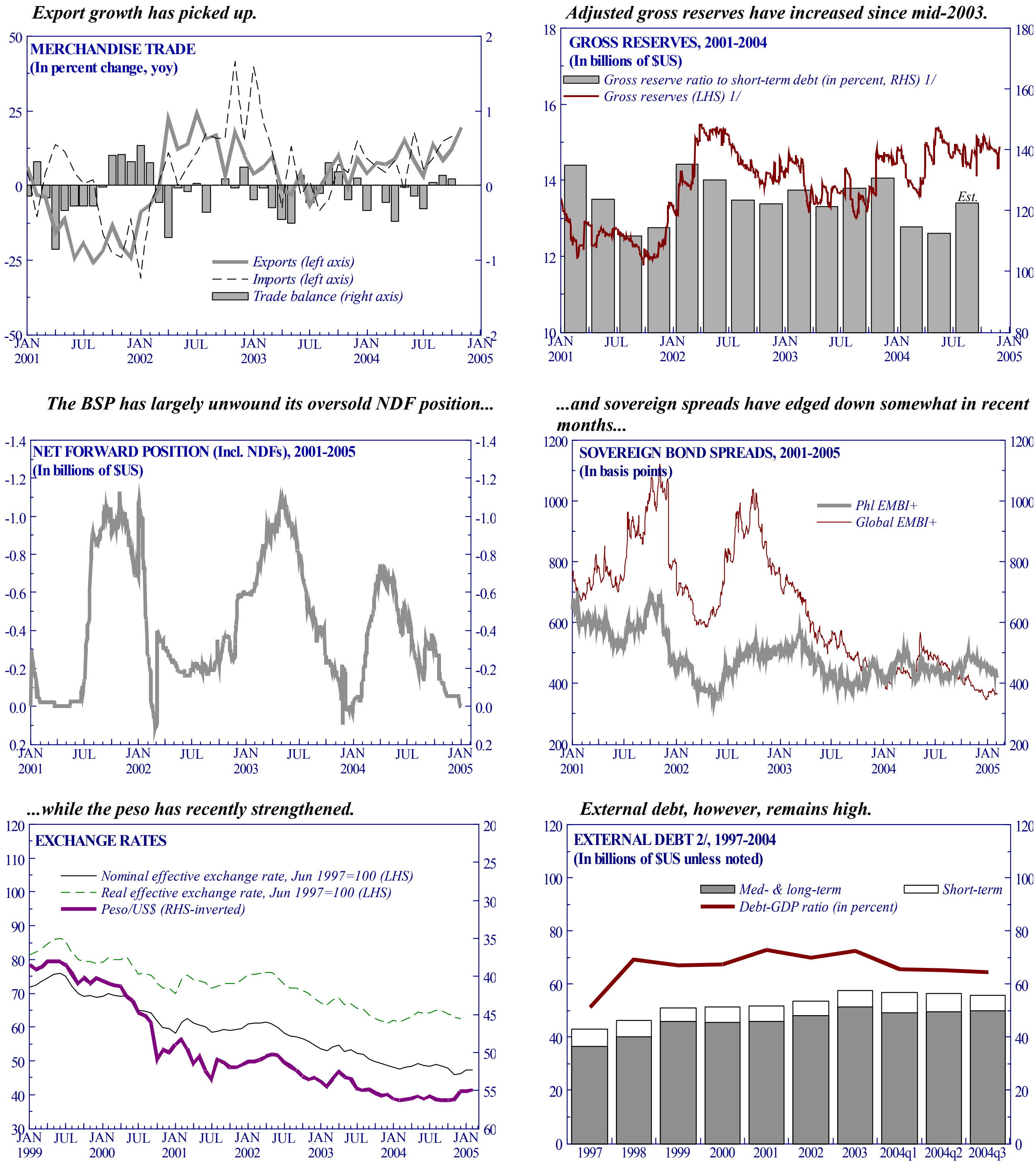
Strong reforms would create an additional 1.7 million jobs. Staff estimates indicate that faster growth under the strong-reform scenario would create 1.7 million additional jobs by 2010, reversing the rising trend in unemployment and bringing it back to below 11 percent. This assumes a labor force growing at 3.5 percent per year and an elasticity of job creation of 0.7, in line with historical averages.

Faster growth would raise average incomes and move an additional 2 million people out of poverty. Assuming population growth of 2 percent a year, average income would be US$170 higher in real terms by 2010 under the strong-reform scenario. Based on the 2000 Family Income and Expenditure survey and assuming no change in the income distribution, this improvement in average incomes would move two million additional people currently living under US$2 a day out of poverty.



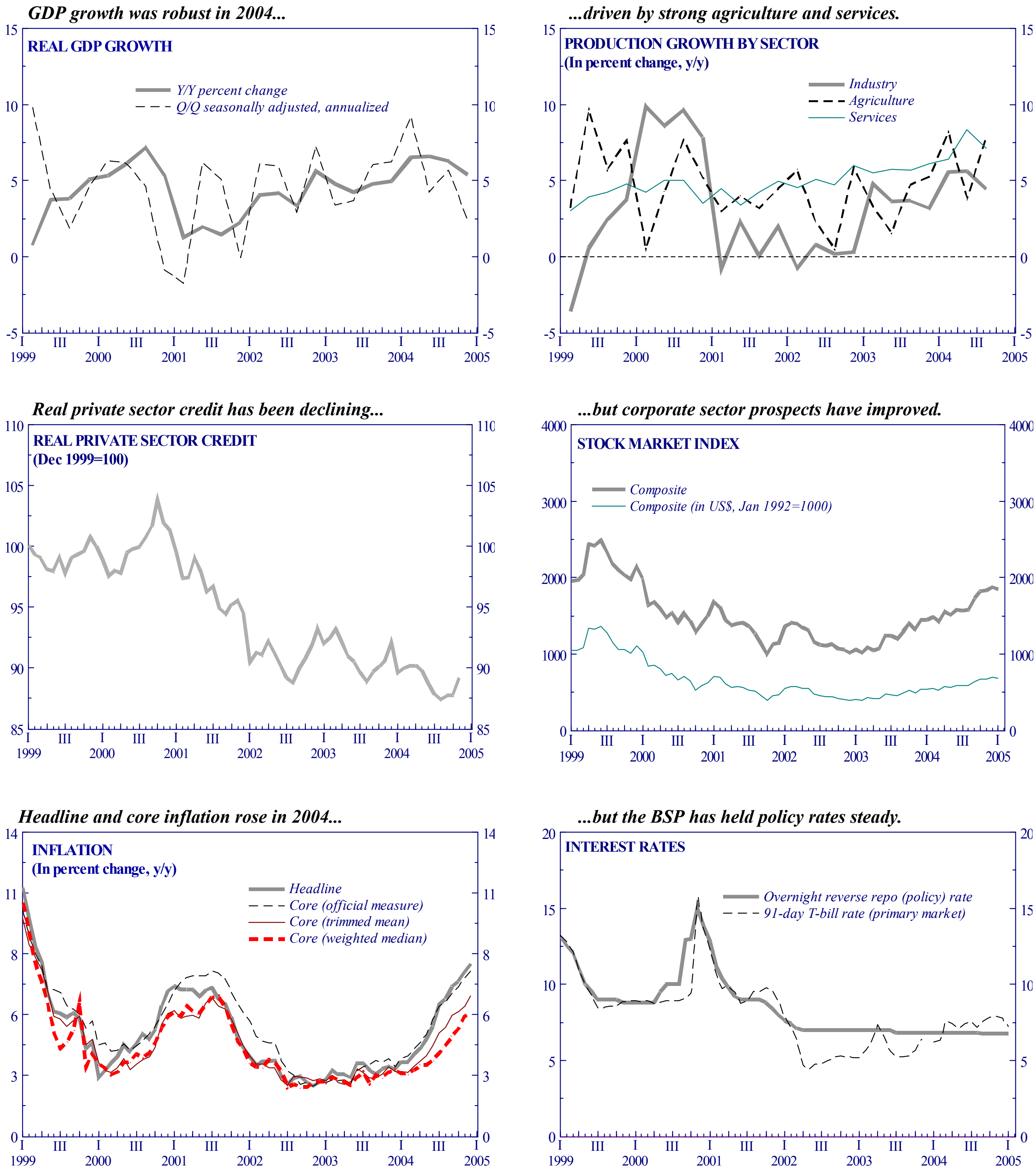
The decline in social and capital spending could be reversed. Higher revenue under the strong-reform scenario would provide resources for P 130 billion in additional public spending by 2010 without compromising the government's fiscal consolidation targets. This would allow, for instance, the recruitment of an additional 200,000 teachers and 20,000 health workers, an increase in infrastructure spending of 40 percent, and the purchase of an extra 15 million textbooks every year.

Figure 1: Philippines: External Developments, 1997–2005



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

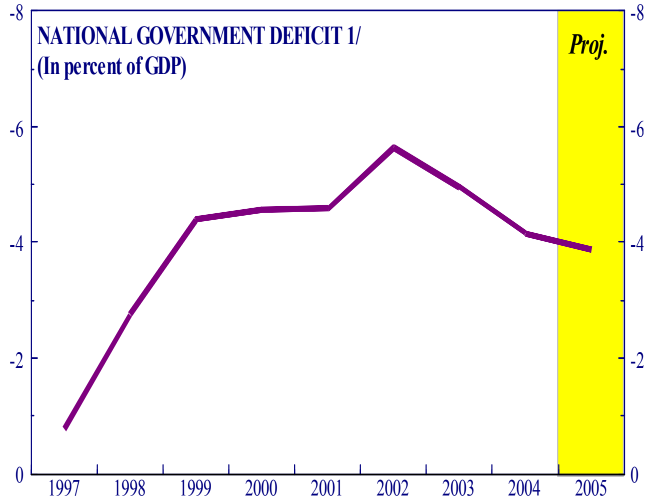
Figure 2: Philippines: Domestic Developments, 1999–2005



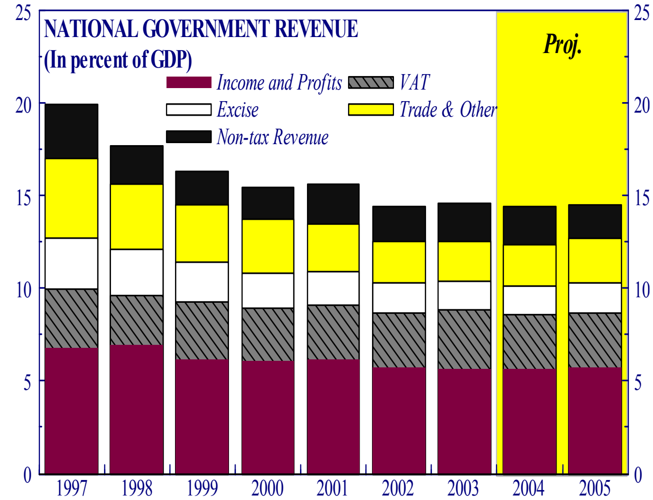
Sources: Data provided by the Philippine authorities; and CEIC; and Fund staff estimates.

Figure 3: Philippines: Fiscal Sector, 1997–2005

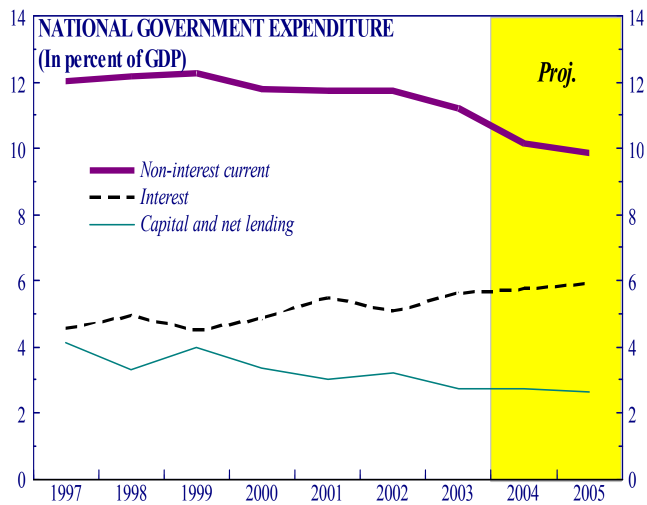
The national government deficit was reduced further in 2004...



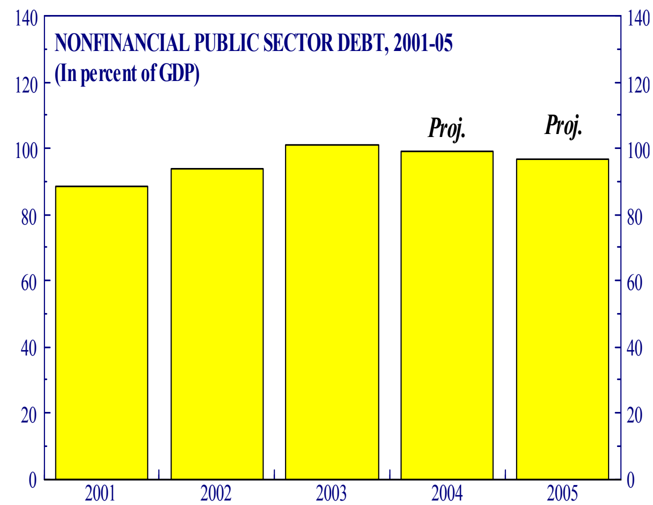
...as revenue was broadly stable...



...and non-interest spending was compressed.



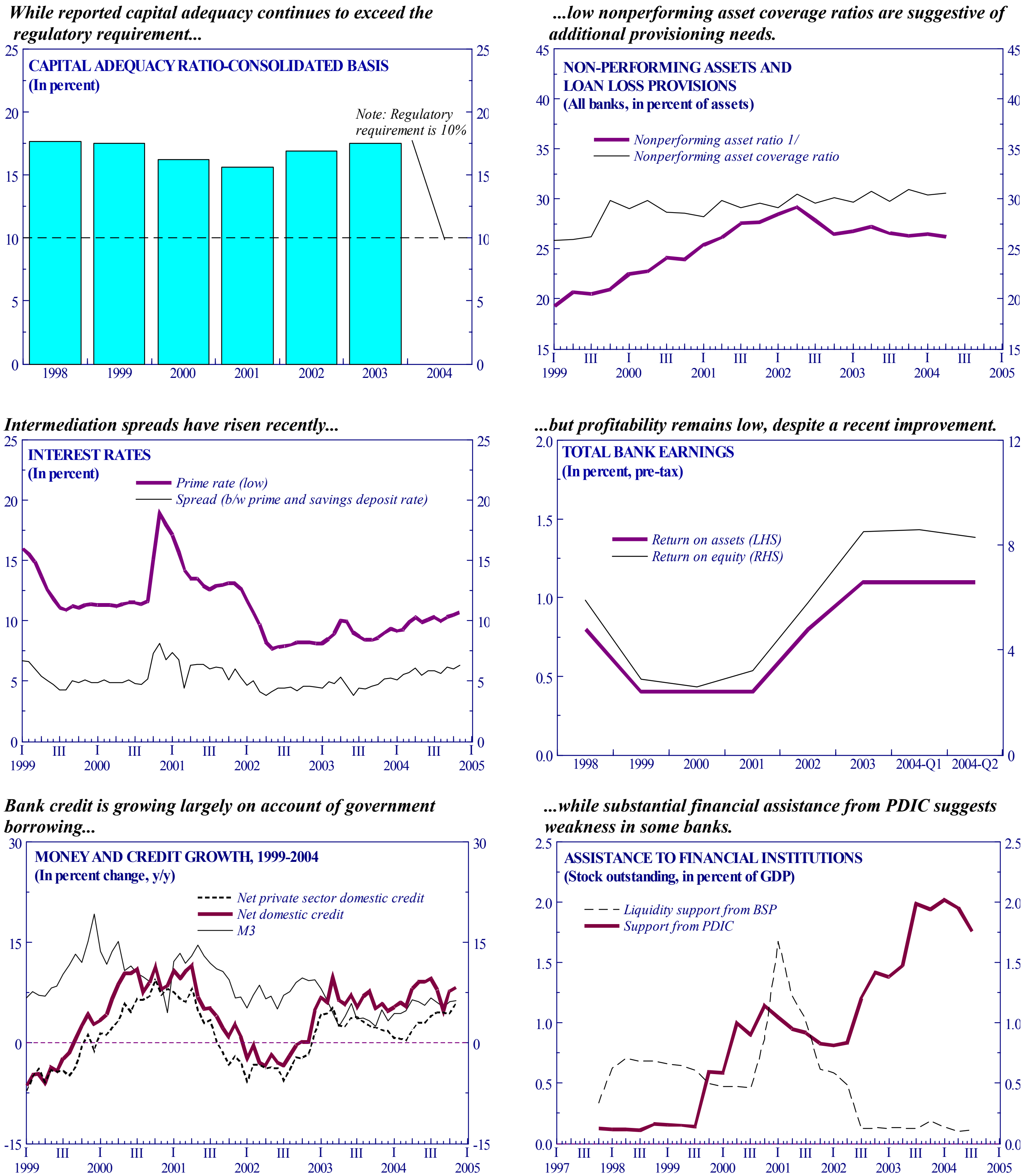
However, public debt is expected to have been largely unchanged, since public sector deficits remain high.



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

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

Figure 4: Philippines: Banking Sector, 1997–2005



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

1/ Nonperforming loans plus foreclosed assets over total loans plus foreclosed assets.

Table 1. Status of Revenue Measures Proposed by New Administration

Measure	Status	Yield 1/	Description/Staff View
Higher alcohol and tobacco excises	Signed into law in December 2004	0.2	The rates of increase vary by product but, on average, imply roughly a 10 percent increase in retail prices. There is no automatic indexation, but the excises will be increased by 6–8 percent every two years until 2011. Staff support higher excises but also argued for indexation.
Incentives for tax administrators	Signed into law in January 2005	Unclear	Allows tax and customs administrators to keep a percentage of revenue in excess of target (although the Bureau of Internal Revenue can already keep 5 percent of its excess revenue). Staff expressed concern that this measure might promote an excessive focus on revenue collection at the expense of other desirable objectives (speedy processing of returns, fair administration of tax laws, etc.). The authorities responded that such concerns could be addressed through the operational indicators specified in the implementing regulations.
Higher oil import tariff	Adopted by Executive Order; starting January 2005	0.1	Increases the oil import tariff on petroleum from 3 to 5 percent. Staff support higher taxes on petroleum but would have preferred higher excises to higher tariffs.
Tax amnesty	Approved by House; some opposition in Senate	Small short-term gain; possible long-term loss	Forgives all taxes from 2003 and prior years in exchange for payment of 3 percent of net worth plus 25 percent of tax due (excluding interest and penalties) from existing final assessments or cases pending in court. Staff oppose, arguing that repeated amnesties hurt taxpayer compliance.
Higher VAT rate	Approved by House; in committee in Senate	0.5	Raises the VAT rate from 10 to 12 percent. Staff strongly support a higher rate for the VAT, which is moderately progressive given the exemption of small businesses and unprocessed food (disproportionately consumed by low-income households).
Repeal of some VAT exemptions	Approved out of committee in House; in committee in Senate	0.2–0.3	Staff support this measure, which repeals several nonstandard VAT exemptions, including petroleum.
Consolidation of fiscal incentives	Approved by House; in committee in Senate	Direction unclear; modest impact either way.	Staff support goals of consolidating different fiscal incentives into a single, more transparent law and repealing small incentives embodied in 19 different laws. However, the House version of the bill does not significantly reduce the largest incentives (e.g. tax holidays for exporters and exemptions for cooperatives) and may even result in a net expansion of incentives.
Simplified net income tax for businesses	Has not yet garnered significant support in Congress	Unclear	Disallows some normally deductible business expenses, such as those for administration, and would cut the corporate tax rate from 32 to 28 percent. Staff oppose on the grounds that will increase distortions and complicate administration.
Higher petroleum excises	Set aside for now	0.4–0.5	Staff support raising petroleum excises, which are low by international standards. This translates into roughly a 10 percent increase in retail prices, but the poor would be shielded due to small or no increases on kerosene and liquefied petroleum gas.
Telecommunications tax	Set aside for now	0.2	Replaces the VAT on telecommunications companies with a 7 percent turnover tax. Staff oppose, since it would likely increase distortions. Spectrum fees should be increased instead.

Sources: Philippine authorities; and Fund staff estimates.
1/ In percent of GDP.

Table 2. Philippines: Selected Economic Indicators, 2000–2005

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	2004 Staff Est.	2005 Staff Proj.
GDP and prices (percentage change)						
Real GDP	4.4	1.8	4.3	4.7	6.1	4.7
Nominal GDP (in billions of pesos)	3,355	3,631	3,960	4,300	4,843	5,399
CPI (1994 base; annual average)	4.3	6.1	3.0	3.0	5.5	6.8
CPI (1994 base; end year)	6.7	4.1	2.5	3.1	7.9	5.4
Investment and saving (percent of GDP)						
Gross investment	21.2	19.0	17.6	16.6	17.2	17.4
National saving	29.4	20.8	23.3	20.9	21.7	20.9
Public finances (percent of GDP)						
National government balance (authorities definition)	-4.0	-4.0	-5.3	-4.6	-3.8	-3.5
National government balance 1/	-4.5	-4.6	-5.6	-5.0	-4.2	-3.9
Nonfinancial public sector balance 2/	-4.7	-4.9	-5.7	-5.6	-5.3	-4.4
Revenue and grants 3/	...	23.0	20.9	20.9	20.7	21.7
Expenditure 4/	...	28.0	26.6	26.5	25.9	26.1
Nonfinancial public sector debt 5/	...	88.4	93.9	101.1	99.2	96.8
Monetary sector (percentage change, end of period)						
Broad money (M3)	4.6 6/	6.8	9.5	3.3	9.2	...
Base money, reserve requirements adjusted	-4.5 6/	3.1	6.4	3.0	8.6 7/	...
Interest rate (91-day Treasury bill, end of period, in percent)	12.9	8.9	5.2	6.5	7.8	7.4 8/
Credit to the private sector	8.1	-3.0	1.2	1.8	4.7	...
External Sector						
Export value (percent change)	9.0	-16.2	10.3	1.2	11.5	7.2
Import value (percent change)	14.5	-4.5	6.2	6.2	10.3	8.1
Current account (percent of GDP)	8.2	1.9	5.7	4.2	4.5	3.5
Capital and Financial account (US$ billions, excluding errors and omissions)	3.0	1.6	1.2	-2.5	0.6	0.8
Foreign direct investment (net)	1.5	1.1	1.7	0.2	0.2	0.6
Other	1.5	0.5	-0.5	-2.6	0.3	0.2
Errors and omissions and trade credit (US$ billions)	-9.8	-3.2	-4.8	-0.8	-4.2	-4.2
Overall balance (US$ billions)	-0.5	-0.2	0.7	0.1	0.2	-0.1
Monitored external debt (percent of GDP) 9/	75.6	81.6	77.8	79.2	72.3	67.5
Debt-service ratio (percent of exports)	14.7	19.1	19.9	21.1	20.0	18.2
Reserves, adjusted (US$ billions) 10/	13.4	13.2	14.3	14.7	15.1	14.9
Reserves / Short-term liabilities, adjusted 11/	128.1	114.3	119.5	122.4	118.7	109.2
Exchange rate (period averages)						
Pesos per U.S. dollar	44.2	51.0	51.6	54.2	56.3	55.1 12/
Nominal effective exchange rate (Jan 2, 2003 =100)	120.1	109.4	107.4	95.1	83.8	86.4 12/
Real effective exchange rate (Jan 2, 2003 =100)	112.2	106.7	107.0	95.6	91.5	...

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/ Debt is consolidated (net of intra-nonfinancial public sector holdings of debt). Data on local government debt are not available for 2001; it is assumed that these debts were the same as a share of GDP as in 2002.
6/ Adjusted for the estimated effects of Y2K. For base money only, adjusted for changes in reserve requirements.
7/ As of November, 2004.
8/ Auction result on January 17.
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 med- and long-term debt due in the following year). Both reserves and debt were adjusted for pledged assets.
12/ As of end-January.

Table 3. Philippines: National Government Cash Accounts, 2001–05
(In percent of GDP; unless otherwise noted)

	2001	2002	2003	2004 Auth. Prog.	2004 Prel.	2005 Proposed Budget	2005 Moderate Reform 1/
Revenue and grants	15.7	14.4	14.6	14.4	14.5	14.9	14.5
Tax revenue	13.5	12.5	12.5	12.7	12.3	13.2	12.7
Bureau of Internal Revenue	10.7	10.0	9.9	10.1	9.7	10.5	9.9
Bureau of Customs	2.6	2.4	2.5	2.4	2.5	2.6	2.7
Other offices	0.1	0.1	0.1	0.2	0.2	0.2	0.2
Nontax revenue	2.2	1.9	2.1	1.8	2.1	1.7	1.8
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	0.2	0.2	0.2
Expenditure and net lending	20.3	20.0	19.6	18.9	18.6	18.8	18.4
Current expenditures	17.3	16.8	16.8	16.4	15.8	16.3	15.8
Personnel services	6.6	6.7	6.4	6.1	5.8	5.6	5.8
Maintenance and operations	2.4	2.1	1.8	1.8	1.7	1.9	1.6
Allotments to local government units	2.5	2.8	2.7	2.4	2.4	2.4	2.2
Subsidies	0.2	0.1	0.3	0.1	0.2	0.1	0.2
Interest	5.5	5.1	5.6	6.0	5.7	6.3	5.9
National government	4.8	4.7	5.3	5.6	5.4	5.9	5.5
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	2.4	2.7	2.4	2.5
Net lending 2/	0.1	0.1	0.1	0.2	0.1	0.1	0.1
Balance	-4.6	-5.6	-5.0	-4.5	-4.2	-3.9	-3.9
On the authorities' presentation 3/	-4.0	-5.3	-4.6	-4.2	-3.8	-3.6	-3.5
Financing	4.6	5.6	5.0	4.5	4.2	3.9	3.9
Net external financing	0.6	2.8	3.3	-0.1	1.7	-0.1	1.2
Net domestic financing	4.0	2.9	1.6	4.7	2.5	4.0	2.6
Memorandum Items:							
Nonfinancial public sector balance 4/	-4.9	-5.7	-5.6	…	-5.3	…	-4.4
Consolidated public sector balance 4/	-4.8	-5.6	-5.2	…	-5.1	…	-4.3
Primary national government balance	0.9	-0.6	0.7	1.5	1.6	2.4	2.0
National government debt 5/	62.9	66.7	71.7	…	71.6	…	70.9
(percent of NG revenues)	401.4	463.4	490.4	…	494.9	…	488.1
Nonfinancial public sector debt 6/	88.4	93.9	101.1	…	99.2	…	96.8
(percent of NFPS revenues)	384.0	449.7	484.3	…	479.8	…	446.9
National government gross financing requirements 7/	21.4	23.2	23.7	…	24.4	…	23.0
Of which: Domestic	19.5	18.2	18.1	…	20.3	…	19.0
Foreign	1.9	5.1	5.6	…	4.1	…	3.9
GDP (in billions of pesos)	3,631	3,960	4,300	4,713	4,843	5,122	5,399

Sources: Philippine authorities; and Fund staff projections.

1/ Unlike the proposed budget, this scenario incorporates the effects of higher alcohol and tobacco excises, the higher oil import tariff, and the assumption of P 200 billion in NPC's debt. It is assumed that the latter will mainly reduce national government interest income rather than increase interest expense, since the vast majority of the assumed debt was owed to the national government.
2/ Excludes purchase of NPC securities and other onlending.
3/ Includes privatization receipts as revenue and excludes the operations of the Central Bank-Board of Liquidators (CB-BOL).
4/ Excludes privatization receipts from revenue.
5/ Consolidated (net of national government debt held by the sinking fund) and excludes contingent/guaranteed debt.
6/ Nonfinancial public sector includes the national government, CB-BOL, 14 monitored government-owned enterprises, social security institutions, and local governments. Debt is consolidated (net of intra-nonfinancial public sector holdings of debt). Data on local government debt are not available for 2001; it is assumed that these debts were the same as a share of GDP as in 2002.
7/ Defined as the deficit, plus amortization of medium- and long-term debt, plus the stock of short-term debt at the end of the last period, plus market financing on behalf of NPC.

Table 4. Philippines: Balance of Payments, 2000-2005
(In billions of U.S. dollars)

	2000	2001	2002	2003	2004 Staff Est.	2005 Staff Proj.
CURRENT ACCOUNT BALANCE	**6.3**	**1.3**	**4.4**	**3.3**	**3.9**	**3.3**
Trade Balance	3.8	-0.7	0.4	-1.3	-1.0	-1.4
Exports, f.o.b.	37.3	31.2	34.4	34.8	38.8	41.6
Imports, f.o.b.	33.5	32.0	34.0	36.1	39.9	43.1
o/w: oil and related products	3.9	3.4	3.3	3.8	4.9	5.7
Services (net)	-2.4	-2.1	-1.0	-1.2	-1.1	-1.2
Receipts	4.0	3.1	3.1	3.0	3.5	3.7
Payments	6.4	5.2	4.1	4.2	4.6	5.0
Income	4.4	3.7	4.5	5.2	5.4	5.3
Receipts, *of which:*	7.8	7.2	7.9	8.4	9.2	9.5
Workers remittances	6.1	6.0	7.2	7.6	8.3	8.6
Payments	3.4	3.5	3.5	3.2	3.8	4.2
Interest payments	3.0	2.9	2.5	2.6	2.9	3.3
Transfers (net)	0.4	0.4	0.5	0.6	0.6	0.6
Receipts	0.6	0.5	0.6	0.7	0.7	0.7
Payments	0.1	0.1	0.1	0.1	0.1	0.1
CAPITAL AND FINANCIAL ACCOUNT	**3.0**	**1.6**	**1.2**	**-2.5**	**0.6**	**0.8**
Capital Account	0.0	0.0	0.0	0.0	0.0	0.0
Financial Account	3.0	1.6	1.2	-2.5	0.6	0.8
Direct Investment	1.5	1.1	1.7	0.2	0.2	0.6
Portfolio Investment	0.2	0.6	1.1	-0.7	0.6	1.5
Equity	-0.2	0.4	0.4	0.4	0.4	0.4
Debt	0.4	0.2	0.7	-1.1	0.3	1.1
Other Investment (excluding trade credit)	1.3	-0.1	-1.6	-2.0	-0.3	-1.3
ERRORS AND OMISSIONS (incl. trade credit)	**-9.8**	**-3.2**	**-4.8**	**-0.8**	**-4.2**	**-4.2**
OVERALL BALANCE	**-0.5**	**-0.2**	**0.7**	**0.1**	**0.2**	**-0.1**
OVERALL FINANCING	**0.5**	**0.2**	**-0.7**	**-0.1**	**-0.2**	**0.1**
Monetisation of gold and revaluation	0.0	0.2	0.9	1.1	0.5	0.2
Change in Net international reserves (increase =-)	0.5	0.0	-1.6	-1.2	-0.7	-0.1
BSP Gross Reserves (increase =-)	0.0	0.6	-0.5	-0.7	0.8	0.2
Fund credit (net)	0.2	-0.1	-0.4	-0.6	-0.5	-0.3
Change in other BSP liabilities	0.3	0.7	-0.7	0.1	-1.1	0.0
Memorandum items:						
Current account/GDP	8.2	1.9	5.7	4.2	4.5	3.5
Short-term debt (original maturity)	8.4	9.1	8.0	8.2	8.2	8.5
Short-term debt (residual maturity)	12.1	14.0	13.8	14.1	13.7	14.6
Gross reserves	15.0	15.6	16.2	16.9	16.0	15.8
Adjusted gross reserves 1/	13.4	13.2	14.3	14.7	15.1	14.9
(in percent of st. debt by res. maturity) 2/	128.1	114.3	119.5	122.4	118.7	109.2
Net international reserves	11.3	11.4	12.8	13.9	14.6	14.7
Monitored external debt (in billions) 3/	57.4	58.1	59.7	62.8	62.5	63.4
(in percent of GDP)	75.6	81.6	77.8	79.2	72.3	67.5
Debt service ratio 4/	14.7	19.1	19.9	21.1	20.0	18.2
Export value (percent change)	9.0	-16.2	10.3	1.2	11.5	7.2
Import value (percent change)	14.5	-4.5	6.2	6.2	10.3	8.1
Gross external financing needs 5/	5.8	10.8	9.6	10.1	10.2	10.4
GDP (in billions)	75.9	71.2	76.7	79.3	86.4	94.0

Sources: Philippine authorities and Fund staff projections

1/ Gross reserves less gold and securities pledged as collateral against short term liabilities.
2/ As a percent of short-term debt excluding pledged assets of the central bank.
3/ Monitored external liabilities are defined as external debt plus liabilities of foreign banks in the Philippines to their agencies, headquarters, branches, and some external debt not registered with the central bank and private capital lease agreements.
4/ In percent of goods and nonfactor 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 5. Philippines: Monetary Survey, 2000-2004

	2000	2001	2002	2003				2004			
	Dec.	Dec.	Dec.	Mar.	Jun.	Sep.	Dec.	Mar.	Jun.	Sep.	Dec.
				(In billions of pesos)							
Net foreign assets	343	405	541	522	591	608	662	671	604	682	716
Central bank	430	449	538	512	519	552	626	620	624	650	679
Net international reserves	567	586	684	658	660	691	771	763	780	790	809
Medium and long-term foreign liabilities	138	136	146	146	141	139	145	143	156	140	130
Deposit money banks	-87	-44	4	10	72	56	37	51	-20	32	37
Net domestic assets	1,737	1,760	1,809	1,811	1,772	1,774	1,812	1,838	1,917	1,845	1,996
Net domestic credit	2,088	2,106	2,208	2,222	2,183	2,252	2,314	2,341	2,383	2,360	2,526
Public sector credit	581	645	727	732	719	794	807	845	874	836	949
National Government	426	532	590	583	567	616	620	649	673	636	757
Credits	575	690	749	735	725	779	807	849	866	879	923
Foreign exchange receivables	13	12	7	7	7	7	7	7	7	7	7
Treasury IMF Accounts	-41	-50	-50	-50	-58	-58	-58	-58	-65	-65	-65
Deposits	-121	-120	-117	-110	-107	-112	-137	-150	-136	-185	-109
Local government and others	104	97	132	144	147	174	184	195	199	199	191
Claims on CB-BOL 1/	51	15	6	5	4	4	4	2	2	1	1
Private sector credit	1,507	1,462	1,480	1,490	1,464	1,458	1,507	1,496	1,508	1,524	1,577
Other items net	-351	-347	-398	-410	-412	-478	-502	-504	-465	-515	-530
Total liquidity	2,079	2,165	2,351	2,334	2,363	2,382	2,474	2,509	2,521	2,527	2,711
M4	2,013	2,111	2,298	2,279	2,300	2,310	2,401	2,435	2,447	2,463	2,649
M3 (peso liquidity)	1,427	1,525	1,670	1,635	1,647	1,641	1,725	1,713	1,740	1,728	1,884
Foreign currency deposits, residents	586	586	628	645	652	669	676	722	707	735	766
Other liabilities	66	54	53	54	63	72	73	74	74	64	62
				(12-month percent change)							
Net foreign assets	4.2	18.3	33.6	1.5	17.8	18.1	22.4	28.5	2.2	12.1	8.0
Net domestic assets	8.0	1.3	2.8	8.8	4.5	4.0	0.1	1.5	8.2	4.0	10.2
Net domestic credit	8.6	0.9	4.8	9.8	7.1	7.7	4.8	5.4	9.1	4.8	9.2
Public sector	9.9	10.9	12.9	20.3	14.6	18.6	11.0	15.5	21.6	5.3	17.6
Idem, adjusted 2/	4.4	10.7	11.5	18.7	13.1	17.3	9.9	14.1	19.7	4.9	17.0
Private sector	8.1	-3.0	1.2	5.2	3.8	2.6	1.8	0.4	3.0	4.6	4.7
Idem, adjusted 2/	2.4	-3.5	0.6	4.4	2.8	2.1	1.7	-0.2	2.1	3.9	4.1
M4	6.7	4.9	8.9	7.6	7.7	6.4	4.5	6.8	6.4	6.6	10.3
M3	4.6	6.8	9.5	4.6	5.9	3.4	3.3	4.8	5.6	5.3	9.2
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	2,444	2,476	2,558
Private sector	1,492	1,451	1,470	1,480	1,454	1,449	1,498	1,487	1,499	1,514	1,566
(12-month percent change)	8.1	-2.7	1.3	5.3	3.7	2.6	1.9	0.4	3.1	4.5	4.6
Public sector	507	634	681	685	698	771	824	899	945	962	992
(In percent of total gross credit)	25	30	32	32	32	35	36	38	39	39	39
				(In billions of US dollars)							
Net foreign assets	6.9	7.9	10.2	9.8	11.0	11.1	11.9	11.9	10.7	12.1	12.7
Central bank	8.6	8.7	10.1	9.6	9.7	10.0	11.3	11.0	11.1	11.5	12.1
Deposit money banks	-1.7	-0.9	0.1	0.2	1.3	1.0	0.7	0.9	-0.4	0.6	0.6
Foreign currency deposits residents	11.7	11.4	11.8	12.0	12.1	12.2	12.2	12.8	12.6	13.0	13.6
Dollar-denominated credit to residents	10.8	10.2	9.9	10.2	8.9	9.4	9.9	11.1	11.7	11.5	11.2
Public sector	4.0	4.4	4.8	5.1	4.9	5.8	6.6	6.7	7.2	7.0	6.7
Private sector	6.8	5.8	5.2	5.1	4.0	3.6	3.3	4.3	4.5	4.5	4.5
				(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	93.0	88.5	82.5
Dollar denominated credit to public sector / dollar deposits	34.1	38.8	40.3	42.3	40.3	47.7	53.9	52.4	56.9	53.8	49.4
Exchange rate (peso per dollar; end-period)	50.0	51.4	53.1	53.5	53.7	54.9	55.6	56.4	56.2	56.3	56.3

Source: Philippine authorities, CEIC, and Fund staff estimates.
1/ The Central Bank-Board of Liquidators was established in 1993 to absorb the debts of the old central bank.
2/ Adjusted for exchange rate valuation effects.

Table 6. Philippines: Medium-Term Outlook, 2001-2010
(Strong reform scenario)

	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010
				Staff Est.			Staff Proj.			
	(Percentage change)									
GDP and prices										
Real GDP	1.8	4.3	4.7	6.1	4.9	5.1	5.2	5.4	5.7	6.0
GDP per capita (US$)	909	957	967	1,029	1,127	1,207	1,273	1,334	1,403	1,479
CPI (1994 base; year average)	6.1	3.0	3.0	5.5	7.0	5.4	4.2	3.5	3.5	3.5
	(Percent; unless otherwise indicated)									
Labor										
Employment (million)	29.2	30.1	30.5	31.6	32.7	33.8	35.1	36.4	37.9	39.4
Employment (percentage change)	6.2	3.1	1.4	3.6	3.4	3.6	3.6	3.8	4.0	4.2
Unemployment rate	11.2	11.4	11.4	11.8	11.9	11.8	11.6	11.4	10.9	10.2
	(In percent of GDP, unless otherwise indicated)									
Investment and saving										
Gross investment	19.0	17.6	16.6	17.2	17.4	18.1	19.0	20.0	21.3	22.3
National saving	20.8	23.3	20.9	21.7	21.4	21.1	21.5	21.8	22.5	22.9
Foreign saving	-1.9	-5.7	-4.2	-4.5	-4.0	-3.0	-2.5	-1.8	-1.2	-0.6
Public finances										
Nonfinancial public sector balance 1/	-4.9	-5.7	-5.6	-5.3	-3.4	-2.4	-1.7	-1.4	-1.2	-0.9
Primary balance	1.3	0.1	0.7	1.6	3.2	3.8	4.3	4.3	4.3	4.3
Revenue and grants 2/	23.0	20.9	20.9	20.7	22.4	22.9	23.6	23.9	24.0	24.0
Expenditure (primary) 3/	21.7	20.8	20.1	19.1	19.3	19.1	19.3	19.6	19.7	19.8
Interest	6.2	5.8	6.3	6.8	6.5	6.2	6.0	5.7	5.4	5.1
Nonfinancial public sector gross financing	...	27.3	28.9	29.0	25.9	24.7	22.1	21.7	18.7	18.6
Domestic	...	21.9	22.2	25.1	21.9	19.6	17.7	16.3	12.9	13.3
Foreign currency	...	5.4	6.7	3.9	4.1	5.1	4.4	5.4	5.8	5.3
National government balance (authorities definition)	-4.0	-5.3	-4.6	-3.8	-2.5	-1.7	-0.9	-0.5	-0.2	0.1
National government balance 4/	-4.6	-5.6	-5.0	-4.2	-2.8	-2.0	-1.1	-0.7	-0.4	-0.1
Nonfinancial public sector debt 5/	88.4	93.9	101.1	99.2	93.1	88.6	84.7	81.0	76.9	72.7
External sector										
Export value (percent change)	-16.2	10.3	1.2	11.5	8.1	7.2	8.1	8.3	8.4	8.5
Import value (percent change)	-4.5	6.2	6.2	10.3	8.7	8.4	8.5	9.1	9.1	9.2
Trade balance	-1.0	0.5	-1.6	-1.2	-1.4	-1.9	-2.1	-2.4	-2.7	-3.1
Current account	1.9	5.7	4.2	4.5	4.0	3.0	2.5	1.8	1.2	0.6
FDI (net, US$ billions)	1.1	1.7	0.2	0.2	0.9	1.5	1.4	1.3	1.4	1.5
Reserves, adjusted (US$ billions) 6/	13.2	14.3	14.7	15.1	16.3	17.8	18.5	19.3	19.9	20.4
Reserves / Short-term liabilities, adjusted 7/	114.3	119.5	122.4	118.7	119.4	126.7	131.8	132.0	132.5	131.3
Gross external financing requirements (US$ billions) 8/	10.8	9.6	10.1	10.3	9.8	11.4	12.2	12.8	14.0	15.2
Monitored external debt 9/	81.6	77.8	79.2	72.3	65.8	61.4	58.1	55.7	53.2	50.9
Debt service ratio (in percent of exports of G&S)	19.1	19.9	21.1	20.0	17.9	18.4	17.8	16.4	15.8	14.7

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/ Debt is consolidated (net of intra-nonfinancial public sector holdings of debt). Data on local government debt are not available for 2001; it is assumed that these debts were the same as a share of GDP as in 2002.

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: Medium-Term Outlook, 2001-2010
(Moderate reform scenario)

	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010
				Staff Est.			Staff Proj.			
	(Percentage change; unless otherwise indicated)									
GDP and prices										
Real GDP	1.8	4.3	4.7	6.1	4.7	4.5	4.3	4.2	4.1	4.0
GDP per capita (US$)	909	957	967	1,029	1,095	1,140	1,177	1,214	1,250	1,288
CPI (1994 base; year average)	6.1	3.0	3.0	5.5	6.8	4.9	4.0	4.0	4.0	4.0
	(Percent; unless otherwise indicated)									
Labor										
Employment (million)	29.2	30.1	30.5	31.6	32.6	33.7	34.7	35.7	36.7	37.7
Employment (percentage change)	6.2	3.1	1.4	3.6	3.3	3.2	3.0	2.9	2.8	2.8
Unemployment rate	11.2	11.4	11.4	11.8	12.0	12.3	12.6	13.1	13.6	14.1
	(In percent of GDP, unless otherwise indicated)									
Investment and saving										
Gross investment	19.0	17.6	16.6	17.2	17.4	17.4	17.0	17.0	16.5	16.0
National saving	20.8	23.3	20.9	21.7	20.9	20.1	19.6	18.9	18.0	17.5
Foreign saving	-1.9	-5.7	-4.2	-4.5	-3.5	-2.7	-2.6	-1.9	-1.5	-1.5
Public finances										
Nonfinancial public sector balance 1/	-4.9	-5.7	-5.6	-5.3	-4.4	-4.0	-3.9	-4.1	-4.2	-4.3
Primary balance	1.3	0.1	0.7	1.6	2.2	2.7	2.9	2.7	2.7	2.6
Revenue and grants 2/	23.0	20.9	20.9	20.7	21.7	21.6	21.6	21.6	21.6	21.5
Expenditure (primary) 3/	21.7	20.8	20.1	19.1	19.4	18.9	18.7	18.8	18.9	18.9
Interest	6.2	5.8	6.3	6.8	6.7	6.7	6.7	6.8	6.9	6.9
Nonfinancial public sector gross financing	...	27.3	28.9	29.0	27.2	27.4	26.3	27.4	25.8	27.5
Domestic	...	21.9	22.2	25.1	23.0	22.1	21.5	21.5	19.3	21.4
Foreign currency	...	5.4	6.7	3.9	4.2	5.4	4.8	6.0	6.5	6.1
National government balance (authorities definition)	-4.0	-5.3	-4.6	-3.8	-3.5	-3.1	-2.9	-3.0	-3.0	-3.1
National government balance 4/	-4.6	-5.6	-5.0	-4.2	-3.9	-3.4	-3.2	-3.3	-3.3	-3.3
Nonfinancial public sector debt 5/	88.4	93.9	101.1	99.2	96.8	95.0	94.3	93.6	93.1	92.6
External sector										
Export value (percent change)	-16.2	10.3	1.2	11.5	7.2	6.3	6.2	6.0	6.0	6.0
Import value (percent change)	-4.5	6.2	6.2	10.3	8.1	6.6	5.1	7.0	6.4	5.7
Trade balance	-1.0	0.5	-1.6	-1.2	-1.5	-1.7	-1.2	-1.7	-1.8	-1.7
Current account	1.9	5.7	4.2	4.5	3.5	2.7	2.6	1.9	1.5	1.5
FDI (net, US$ billions)	1.1	1.7	0.2	0.2	0.6	0.6	0.5	0.5	0.4	0.4
Reserves, adjusted (US$ billions) 6/	13.2	14.3	14.7	15.1	14.9	14.8	14.7	14.7	14.6	14.3
Reserves / Short-term liabilities, adjusted 7/	114.3	119.5	122.4	118.7	109.2	104.6	102.2	95.3	90.2	84.9
Gross external financing requirements (US$ billions) 8/	10.8	9.6	10.1	10.2	10.4	11.9	12.4	13.3	14.7	15.3
Monitored external debt 9/	81.6	77.8	79.2	72.3	67.5	65.1	63.6	62.9	62.5	61.8
Debt service ratio (in percent of exports of G&S)	19.1	19.9	21.1	20.0	18.2	19.6	20.0	19.4	19.8	19.2

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/ Debt is consolidated (net of intra-nonfinancial public sector holdings of debt). Data on local government debt are not available for 2001; it is assumed that these debts were the same as a share of GDP as in 2002.
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 8. Philippines: Banking Sector Indicators, 1999–2004
(End of year unless otherwise indicated)

	1999	2000	2001	2002		2003	2004 Q1	2004 Q2
Capital adequacy								
Total capital accounts to total assets	14.5	13.6	13.6	13.4		13.1	12.7	12.8
Net worth to risk assets ratio	17.5	16.2	16.1	16.7		16.7	16.4	16.8
Capital adequacy ratio (solo basis)	..	..	14.5	15.5		16.0	..	..
Capital adequacy ratio (consolidated basis)	..	..	15.6	16.9		17.5	..	..
Asset quality								
NPL ratio 1/	14.6	16.6	19.0	16.6	8/	16.1	16.3	15.9
NPA ratio 2/	21.0	24.0	27.7	26.5	8/	26.1	26.5	26.2
Distressed asset ratio 3/	24.4	27.7	31.7	31.0	8/	30.9	31.1	31.0
NPL coverage ratio 4/	45.2	43.7	45.3	50.2	8/	51.5	51.0	51.9
NPA coverage ratio 5/	29.8	28.6	29.6	30.1	8/	30.9	30.4	30.6
Net NPL to total capital 6/	28.3	34.5	37.6	28.9	8/	27.4	27.9	26.4
Net NPA to total capital 7/	56.3	69.6	78.9	73.3	8/	72.4	74.1	71.8
Profitability								
Net interest income to average earning assets 9/	4.5	3.9	3.8	3.8		3.7	3.8	3.9
Return on assets	0.4	0.4	0.4	0.8		1.1	1.1	1.1
Return on equity	2.9	2.6	3.2	5.8		8.5	8.6	8.3
Cost-to-income ratio	72.2	81.8	80.7	71.4		68.9	69.3	70.7
Liquidity								
Liquid assets to total assets	26.4	29.0	30.0	32.3		32.3	33.6	34.9

Source: Philippine authorities and Fund staff calculations.

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

Table 9. Philippines: Indicators of Financial Obligations to the Fund, 2002-2009

	2002	2003	2004	2005	2006	2007	2008	2009
Fund repurchases and charges								
In millions of U.S. dollars	461.8	653.0	502.3	347.9	205.0	198.2	35.0	0.0
In percent of exports of goods and services	1.2	1.7	1.2	0.8	0.4	0.4	0.1	0.0
In percent of total debt service due	6.2	8.2	5.9	4.2	2.2	1.9	0.3	0.0
In percent of quota	40.5	53.0	38.6	25.9	15.2	14.7	2.6	0.0
In percent of adjusted gross official reserves	3.2	4.4	3.3	2.3	1.4	1.3	0.2	0.0
Fund credit outstanding								
In millions of U.S. dollars	1686.0	1128.8	720.6	415.6	223.9	31.4	0.0	0.0
In percent of quota	140.9	91.6	55.3	30.9	16.6	2.3	0.0	0.0
In percent of GNP	2.1	1.3	0.8	0.4	0.2	0.0	0.0	0.0
In percent of total external debt	2.8	1.8	1.2	0.7	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 moderate reforms, debt would remain high at around 93 percent of GDP. This is predicated on an assumed average real GDP growth of 4¼ percent over 2005–10 and a primary balance adjustment of 1 percent of GDP in 2005–06. The recent increases in electricity rates, alcohol and tobacco excises, and oil import tariffs, as well as tight control of spending in 2005 should be sufficient to achieve such an adjustment. However, if policy slippages cause the primary balance to be essentially unchanged (Alternative Scenario 2), debt would continue to climb, assuming that this also leads to somewhat slower real GDP growth (average of 3¾ percent over 2005–10). Conversely, strong reforms (Alternative Scenario 3) would put debt on a firmly downward path. This scenario assumes that a stronger primary balance adjustment of 2¾ percentage points of GDP over 2005–07 (with the major part occurring in 2005) would improve debt dynamics both directly and indirectly, assuming that improved confidence and higher private sector investment would raise average real GDP growth to 5¼ percent.

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

Strong front-loaded fiscal consolidation would also facilitate a more rapid reduction in external vulnerability. Under the baseline scenario involving moderate reforms external debt would decline gradually to about 62 percent of GDP by 2010 (Table A2), broadly consistent with what could be expected if key macroeconomic variables remained at their historical averages from 2005–10 (Alternative Scenario A1). However, gross external financing requirements would continue to increase, both in US$ terms and relative to GDP, in part due to a declining projected current account surplus. The external debt position would also remain highly sensitive to exchange rate shocks (Bounds Tests 3 and 6) as well as a deterioration in the current account balance (Bounds Test 4). A more ambitious reform agenda (Alternative Scenario A2), involving front-loaded fiscal consolidation, would facilitate a more rapid decline in external debt. A recovery in foreign direct investment and equity inflows, and relatively lower interest rates, would enable the government to reduce its external borrowing while still maintaining an adequate level of reserves. This would enable external debt to fall to 51 percent of GDP by 2010.

Table A1. Philippines: Nonfinancial Public Sector Debt Sustainability Framework, 2001-2010
(Moderate reform scenario; in percent of GDP, unless otherwise indicated)

	Actual			Est.			Projections						
	2001	2002	2003	2004			2005	2006	2007	2008	2009	2010	
							I. Baseline Projections						Debt-stabilizing primary balance 7/
1 **Nonfinancial public sector debt 1/**	88.4	93.9	101.1	99.2			96.8	95.0	94.3	93.6	93.1	92.6	1.4
o/w foreign-currency denominated	...	61.8	68.6	64.6			60.7	57.6	56.1	54.9	53.5	51.2	
2 Change in nonfinancial public sector debt	-0.7	5.5	7.3	-2.0			-2.4	-1.8	-0.8	-0.7	-0.5	-0.5	
3 Identified debt-creating flows (4+7+12)	-1.3	-0.3	1.5	-5.7			-3.5	-2.9	-1.8	-1.5	-1.3	-1.2	
4 Primary deficit	-1.3	-0.1	-0.7	-1.6			-2.2	-2.7	-2.9	-2.7	-2.7	-2.6	
5 Revenue and grants 2/	23.0	20.9	20.9	20.7			21.7	21.6	21.6	21.6	21.6	21.5	
6 Primary (noninterest) expenditure	21.7	20.8	20.1	19.1			19.4	18.9	18.7	18.8	18.9	18.9	
7 Automatic debt dynamics	0.6	-0.1	1.7	-3.7			-1.3	-0.2	1.1	1.2	1.4	1.4	
8 Contribution from interest rate/growth differential	-0.6	-1.5	-1.1	-4.5			-3.5	-1.8	-0.7	-0.5	-0.3	-0.1	
9 Of which contribution from real interest rate	0.9	2.0	3.0	1.0			0.6	2.2	3.1	3.2	3.3	3.3	
10 Of which contribution from real GDP growth	-1.4	-3.5	-4.1	-5.5			-4.2	-4.0	-3.8	-3.6	-3.5	-3.5	
11 Contribution from exchange rate depreciation	1.2	1.4	2.8	0.8			2.3	1.7	1.8	1.6	1.6	1.6	
12 Other identified debt-creating flows	-0.6	-0.1	0.6	-0.4			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	0.0	
14 Recognition of implicit or contingent liabilities	0.0	0.0	0.0	0.0			0.0	0.0	0.0	0.0	0.0	0.0	
15 Other (cash build-up)	-0.6	0.0	0.6	-0.4			0.0	0.0	0.0	0.0	0.0	0.0	
16 Residual, including asset changes (2-3)	0.6	5.8	5.7	3.7			1.2	1.1	1.0	0.9	0.8	0.7	
Nonfinancial public sector debt-to-revenue ratio 1/	384.0	449.7	484.3	479.8			446.9	440.5	436.8	433.8	431.6	429.6	
Gross financing need 3/	27.2	27.3	28.9	29.0			27.2	27.4	26.3	27.4	25.8	27.5	
in billions of U.S. dollars	19.4	21.0	22.9	25.1	10-Year Historical Average	10-Year Standard Deviation	25.6	27.5	27.7	30.4	30.1	33.6	Projected Average
Key Macroeconomic and Fiscal Assumptions													
Real GDP growth (in percent)	1.8	4.3	4.7	6.1	3.8	1.9	4.7	4.5	4.3	4.2	4.1	4.0	4.3
Average nominal interest rate on public debt (in percent)	7.6	7.2	7.3	7.6	7.4	0.5	7.5	7.6	7.7	7.8	7.9	8.0	7.8
Average real interest rate (nominal rate minus change in GDP deflator, in percen	1.2	2.7	3.6	1.5	0.3	2.1	1.0	2.7	3.7	3.8	3.9	4.0	3.2
Inflation rate (GDP deflator, in percent)	6.4	4.5	3.7	6.1	7.1	2.1	6.5	4.9	4.0	4.0	4.0	4.0	4.6
Growth of real primary spending (deflated by GDP deflator, in percent)	-1.2	-0.3	1.5	0.7	2.6	5.7	6.4	1.5	3.5	4.8	4.4	4.2	4.1
Primary deficit	-1.3	-0.1	-0.7	-1.6	-2.4	1.9	-2.2	-2.7	-2.9	-2.7	-2.7	-2.6	-2.6
							II. Stress Tests for Public Debt Ratio						Debt-stabilizing primary balance 7/
A. Alternative Scenarios													
A1. Key variables are at their historical averages in 2005-10 4/							96.8	93.9	91.0	88.0	84.9	81.8	-1.4
A2. No reform scenario 5/							98.6	99.3	100.3	101.9	103.9	106.1	2.3
A3. Strong reform scenario 5/							93.1	88.6	84.7	81.0	76.9	72.7	-0.7
B. Bound Tests													
B1. Real interest rate is at baseline plus two standard deviations in 2005 and 2006							100.6	102.7	102.0	101.5	101.1	100.7	1.5
B2. Real GDP growth is at baseline minus two standard deviations in 2005 and 2006							101.3	104.8	105.6	106.6	107.8	109.0	1.7
B3. Primary balance is at baseline minus two standard deviations in 2005 and 2006							100.6	102.7	102.0	101.4	101.0	100.6	1.5
B4. Combination of B2-B3 using one standard deviation shocks							102.5	106.5	105.9	105.4	105.1	104.9	1.6
B5. One time 30 percent real depreciation in 2005 6/							129.6	127.8	127.4	127.1	127.1	127.2	2.1
B6. 10 percent of GDP increase in other debt-creating flows in 2005							106.8	105.0	104.3	103.8	103.4	103.1	1.6

1/ Nonfinancial public sector includes the national government, CB-BOL, 14 monitored government-owned enterprises, social security institutions, and local governments. Debt is gross and consolidated (net of intra-nonfinancial public sector holdings of debt). Data on local government debt are not available for 2001; it is assumed that these debts were the same as a share of GDP as in 2002.
2/ Revenue is the sum of all nonfinancial public sector revenue net of intra-public sector payments. It is assumed that 80 percent of Bureau of Treasury revenue represents interest and dividends from other parts of the nonfinancial public sector.
3/ 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/ The implied change in other key variables under this scenario is discussed in the text.
6/ Real depreciation is defined as nominal depreciation (measured by percentage fall in dollar value of local currency) minus domestic inflation (based on GDP deflator).
7/ 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, 2000-2010
(In percent of GDP, unless otherwise indicated)

		Actual				Prel.			Projections						
		2000	2001	2002	2003	2004			2005	2006	2007	2008	2009	2010	
									I. Baseline Projections						Debt-stabilizing non-interest current account 7/
1	**External debt**	75.6	81.6	77.8	79.2	72.3			**67.5**	**65.1**	**63.6**	**62.9**	**62.5**	**61.8**	**0.2**
2	Change in external debt	-0.5	6.0	-3.9	1.4	-6.9			-4.8	-2.4	-1.5	-0.7	-0.4	-0.7	
3	Identified external debt-creating flows (4+8+9)	-9.6	-1.2	-14.3	-7.5	-11.7			-7.7	-6.6	-6.2	-5.2	-4.7	-4.6	
4	Current account deficit, excluding interest payments	-12.2	-5.9	-9.0	-7.4	-7.5			-6.5	-6.1	-6.4	-5.7	-5.4	-5.4	
5	Deficit in balance of goods and services	-1.8	3.9	0.8	3.1	2.4			2.8	2.9	2.5	2.9	3.0	2.9	
6	Exports	54.4	48.3	48.8	47.7	49.0			48.3	48.2	48.6	49.0	49.5	50.0	
7	Imports	52.5	52.2	49.6	50.8	51.4			51.1	51.2	51.1	51.9	52.5	52.8	
8	Net non-debt creating capital inflows (negative)	-1.6	-2.1	-2.8	-0.7	-0.7			-1.0	-1.0	-0.9	-0.8	-0.7	-0.6	
9	Automatic debt dynamics 1/	4.2	6.9	-2.6	0.7	-3.5			-0.1	0.5	1.1	1.3	1.5	1.5	
10	Contribution from nominal interest rate	4.0	3.9	3.3	3.2	3.0			3.0	3.4	3.7	3.9	3.9	3.9	
11	Contribution from real GDP growth	-4.6	-3.5	-3.3	-3.5	-4.5			-3.1	-2.9	-2.6	-2.5	-2.4	-2.4	
12	Contribution from price and exchange rate changes 2/	4.8	6.4	-2.6	1.0	-2.0			...	...	...	...	...	...	
13	Residual, incl. change in gross foreign assets (2-3) 3/	9.2	7.2	10.5	8.9	4.8			2.9	4.2	4.6	4.5	4.3	3.9	
	External debt-to-exports ratio (in percent)	139.1	169.1	159.4	166.1	147.5			139.8	135.0	130.7	128.3	126.3	123.7	
	Gross external financing need (in billions of US dollars) 4/	5.8	10.8	9.6	10.1	10.2			10.4	11.9	12.4	13.3	14.7	15.3	
	in percent of GDP	7.6	15.1	12.5	12.7	11.8	10-Year Historical Average	10-Year Standard Deviation	11.0	11.8	11.7	12.0	12.6	12.5	Projected Average
	Key Macroeconomic Assumptions														
	Real GDP growth (in percent)	4.4	1.8	4.3	4.7	6.1	3.8	1.9	4.7	4.5	4.3	4.2	4.1	4.0	4.3
	GDP deflator in US dollars (change in percent)	-5.9	-7.8	3.3	-1.3	2.6	-0.6	9.7	3.9	1.8	0.9	1.0	1.0	1.0	1.6
	Nominal external interest rate (in percent)	5.2	5.0	4.3	4.3	4.1	4.9	0.6	4.5	5.3	6.1	6.4	6.5	6.5	5.9
	Growth of exports (US dollar terms, in percent)	5.8	-16.7	8.8	1.0	12.0	8.6	14.9	7.2	6.3	6.2	6.0	6.0	6.1	6.3
	Growth of imports (US dollar terms, in percent)	8.5	-6.8	2.3	5.9	10.3	6.6	15.7	8.1	6.5	5.1	6.9	6.3	5.7	6.4
	Current account balance, excluding interest payments	12.2	5.9	9.0	7.4	7.5	5.7	5.4	6.5	6.1	6.4	5.7	5.4	5.4	5.9
	Net non-debt creating capital inflows	1.6	2.1	2.8	0.7	0.7	2.3	1.4	1.0	1.0	0.9	0.8	0.7	0.6	0.8
									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 2005-10 5/								**70.9**	**69.5**	**68.0**	**66.4**	**64.6**	**62.4**	**-1.6**
	A2. Strong Reform Scenario 6/								**65.8**	**61.4**	**58.1**	**55.7**	**53.2**	**50.9**	**-2.9**
	B. Bound Tests														
	B1. Nominal interest rate is at historical average plus two standard deviations in 2005 and 2006								**68.5**	**66.6**	**65.1**	**64.5**	**64.1**	**63.4**	**0.2**
	B2. Real GDP growth is at historical average minus two standard deviations in 2005 and 2006								**70.6**	**71.3**	**70.2**	**70.0**	**70.0**	**69.8**	**0.3**
	B3. Change in US dollar GDP deflator is at historical average minus two standard deviations in 2005 and 2006								**89.9**	**114.5**	**116.1**	**118.9**	**122.0**	**124.7**	**0.7**
	B4. Non-interest current account is at historical average minus two standard deviations in 2005 and 2006								**79.2**	**87.9**	**86.5**	**86.1**	**86.0**	**85.7**	**0.6**
	B5. Combination of 1-4 using one standard deviation shocks								**88.3**	**107.1**	**105.2**	**104.5**	**104.2**	**103.5**	**0.6**
	B6. One time 30 percent nominal depreciation in 2005								**97.0**	**96.1**	**96.5**	**97.9**	**99.6**	**101.0**	**0.5**

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 deflator).
3/ For projection, line includes the impact of price and exchange rate changes.
4/ Defined as current account deficit, plus amortization on medium- and long-term debt, plus short-term debt at end of previous period.
5/ The key variables include real GDP growth; nominal interest rate; dollar deflator growth; and both non-interest current account and non-debt inflows in percent of GDP.
6/ 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: Progress on Structural Reform Agenda

Main Objectives	Developments
Banking Sector Reforms • Strengthen measures to address money laundering activities	• The Anti-Money Laundering Act (AMLA) or Republic Act (RA) No. 9160 was approved in September 2001. The law created the Anti-Money Laundering Council (AMLC) and the Implementing Rules and Regulations (IRR) was signed in April 2002. • On 7 March 2003, the law amending the AMLA (RA No. 9194) was signed by the President. The amendments, which seek to strengthen the existing anti-money laundering regime and align them with international best practice, include the following: 1) lowering the threshold for covered transactions from P 4.0 million to P 500,000; 2) 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 3) removing the provision prohibiting the retroactivity of the law. • With the approval of the amended AMLA, the Financial Action Task Force (FATF) sanctions on noncomplying countries were not imposed on the Philippines. The FATF noted the Philippines' substantial progress in money laundering investigation and prosecution as well as international cooperation, leading the Philippines towards the last stage of the delisting process. • The authorities submitted an implementation plan to the FATF Review Group in January 2004. • The BSP issued policy guidelines (Circular No. 436 dated 18 June 2004) requiring banks to incorporate minimum prescribed guidelines related to banking transactions and electronic fund transfers in their standard operating procedures manual and wider anti-money

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Main Objectives	Developments
	laundering program for compliance. • The BSP incorporated the Revised IRR of the amended AMLA in the 2003 Manual of Regulations of Banks and Non-bank Financial Institutions to effectively carry out the fight against money laundering (Circular No. 451 dated September 2004). • A draft bill is currently pending at the Committee of Banks, Financial Institutions and Currencies that seeks to amend section 2 of "The Secrecy of Bank Deposits Law" or RA No. 1405. The bill seeks to exempt government officials and employees from the prohibition against disclosure of or inquiry into deposits with any banking institutions. (As of 24 August 2004).
• Strengthen banks by raising capital and encouraging consolidation	• The BSP required banks to report their accounts on a consolidated basis starting September 2001, but weaknesses in the reporting framework complicates 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 include quasi-banks (September 2003). • The BSP issued guidelines on the capital treatment of credit-linked notes and similar credit derivative products (January 2004). • The BSP issued rules and regulations governing the use of banks' internal credit risk rating systems to ensure that banks' credit risk management processes are sound and effective. According to the rules, all universal and commercial banks must have in place a formal internal credit risk rating system for the underwriting and ongoing administration, initially, of corporate credit exposures (Circular No. 439 dated July 5, 2004). • Thrift banks which are authorized to operate and

Philippines: Progress on Structural Reform Agenda

Main Objectives	**Developments**
	are actually operating Foreign Currency Deposit Units (FCDUs) are given two years from March 7, 2002 within which to comply with the minimum capital requirement for FCDUs. This requirement can be substituted by a capital build-up program for a period of not more than five years or only up to December 31, 2007, subject to approval by the Monetary Board (Circular No. 449 dated September 6, 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. • 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 Philippine Deposit Insurance Company's (PDIC) charter was amended to strengthen its ability to deal with problem banks. • Rehabilitation of the Philippine National Bank

Philippines: Progress on Structural Reform Agenda

Main Objectives	Developments
	(PNB) has made significant progress. PNB has professionalized its management, and has recently started to book modest profits. • Stress testing of commercial banks 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. • The BSP, through its Legislative Liaison Research Committee (LLRC) is initiating legislative efforts to amend RA 7653 (otherwise known as the New Central Bank Act) to further expand and strengthen the legal protection afforded to BSP personnel.
• 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 IRR of the SPV Act was 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 issued Revenue Regulations in connection with the SPV tax incentives in June 2004. • As of September 2004, 68 Certificates of Eligibility (COE) have been issued by the BSP to 18 banks, creating a scope for Non-Performing Asset (NPA) transfers totaling P 4.5 billion. Three banks have pending applications for COEs with the BSP involving bank sale of 10.1 billion worth of NPAs. Thirty-six SPVs have thus far registered with the Securities and Exchange Commission (SEC), making them

Philippines: Progress on Structural Reform Agenda

Main Objectives	Developments
	eligible to acquire NPAs until April 8, 2005. Availment of incentives under the SPV Law to dispose of NPAs is finally gaining momentum after a slow start.
• Grant legal protection for the 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 these measures do not grant full legal protection. • A draft bill is pending in the Committee of Banks, Financial Institutions and Currencies, Constitutional Amendments and the Ways and Means that seeks to amend the New Central Bank Act to further achieve greater autonomy and enhance the BSP's exercise of its regulatory and supervisory functions.
• Further liberalize the banking system	• A proposed bill entitled "An Act to Liberalize the Operations of Rural Banks Amending for that Purpose", which seeks to amend RA No. 7353, otherwise known as the New Rural Banks Act of 1992, is currently pending at the committee level.
Fiscal and Governance Reforms	
• Improve operations of the Bureau of Internal Revenue (BIR)	• Taxpayer compliance control systems were improved and computerization program was reinvigorated through the following measures: 1) stepped up tax compliance verification (or "tax mapping"); 2) strengthened audit and related enforcement programs; 3) organizational adjustments; and 4) intensified use of third-party information.
• Rationalize fiscal incentives	• The government has proposed a law to 1) harmonize all investment incentives to avoid "double-dipping," 2) allow preferred activities

Philippines: Progress on Structural Reform Agenda

Main Objectives	Developments
	to draw their tax incentives from one law for administrative simplicity, and 3) focus the grant of tax incentives to a list of activities that best mirror the government's development priorities. The government has also proposed repealing special non-investment related incentives that have become costly, inefficient, non-transparent, and difficult to administer and monitor. However, the fiscal incentives bill passed by the House would not affect the largest incentives and may even result in a net expansion of incentives. • The government has also proposed repealing certain nonstandard VAT exemptions such as for petroleum. This reform is also currently under discussion in congress.
• Reform financial sector taxation	• The Documentary Stamp Tax (DST) law rationalizing the taxation of debt and equity instruments was signed into law under Republic Act No. 9243 on February 17, 2004. VAT on financial transactions and taxation of FCDU/OBUs, which took effect in 2003, were repealed recently by law.
• Improve expenditure management	• The Organizational Performance Indicator Framework (OPIF) is being implemented as a mechanism to enable agencies to focus on strategic programs and projects and establish the linkage of their programs and projects with their major final outputs (MFOs) and sector/sub-sector and/or national objectives. A series of workshops was conducted in 2004 to formulate the 2005 OPIF-based budgets of eleven departments, enabling these departments to finalize their MFOs, align their programs and projects and formulate outcome- based performance indicators for these MFOs. • The mid-year Agency Performance Reviews

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Main Objectives	Developments
	(APR) for FY 2004 was conducted on October 11-22, 2004. The results of the APR will determine the overall performance of the national government in terms of fund utilization, revenue generation, and output accomplishments. The results will be used as a basis for future resource allocation decisions. • The e-Budget and other new database systems are being rolled out in the Department of Budget and Management's (DBM) central offices starting December 15, 2004. The system automates the budget execution phase of the government's budget process, i.e., the processing of budget releases, transmittal to agencies, and preparation of accountability reports. • Starting March 2004, agencies with Maintenance and Other Operating Expenditure (MOOE) budgets of ₱50 million and below have been authorized to undertake the following without need of DBM approval: 1) staffing modifications; 2) use of savings; and 3) realignment of savings from personal services to MOOE/capital outlay (CO) and MOOE to CO only to augment an existing item, project, activity, or purpose in the agency's budget. These changes are intended to give these agencies more budget flexibility. For monitoring purposes, agencies have been required to submit quarterly reports of budgetary actions taken. On the implementation of the Government Procurement Reform Act (GPRA), the following measures are being undertaken: • Provision of training for different agencies to fully disseminate procurement reforms embodied in the GPRA. As of end-December 2004, 58.4 percent of National Government Agencies (NGAs); 40.1 percent of GOCCs;

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Main Objectives	Developments
	87.7 percent of LGUs; and 100 percent of SUCs were already trained on the GPRA. • Development of a generic procurement manual and a set of standard bidding documents for the use of government procurement officials and employees. A first draft of the Procurement Manual for Goods, Civil Works and Consulting Services has been completed. It is due for a final review prior to its release to procuring entities and to pilot testing for further enhancement. • Full operationalization of the Government-Electronic Procurement System as the central portal providing information on various government procurement opportunities and information. Presently, the G-EPS is operating all the three features in its "Pilot Phase,"- the Electronic Bulleting Board, the Supplier Registry and the Electronic Catalogue. Enhancement of the Pilot G-EPS is ongoing, including data migration and is targeted for implementation on the third quarter of 2005. The full implementation of the G-EPS, which includes features such as Virtual Store, Electronic Bidding and Electronic Payment is being targeted for implementation in the third quarter of 2006.
• Move forward the Government Rationalization and Reengineering Program, including reductions in staff, abolition of agencies, and devolution of activities to local governments	• Two bills were filed in the 13th Congress to seek authority for the President to reorganize the Executive Branch, subject to defined principles and parameters. The proposed bills also offer appropriate incentives for personnel who may be affected by the reengineering effort. The DBM is currently working on a refined version of the Reengineering Bill that would authorize the President to reengineer the executive branch and implement massive and transformational reforms in the bureaucracy. • While awaiting the passage of the

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Main Objectives	Developments
	Reengineering Bill, the DBM together with the Civil Service Commission (CSC), is pursuing a rationalization program that aims to have an immediate impact on the government's objective of improving public service delivery and institutional capacity through the rationalization of the functions and agencies of the executive branch. • Executive Order (EO) No. 366 dated 04 October 2004 has been issued directing all departments to conduct a strategic review of the operations and organizations of all their component units, including agencies and GOCCs/GFIs attached to or under their administrative supervision. The strategic review would enable them to identify the functions, programs, activities, and projects which: 1) can either be scaled down, phased out, or abolished; or 2) where more resources need to be channeled. Each department is required to prepare a Rationalization Plan. • Personnel who may be affected by the program would be given two options: 1) remain in government service and be placed in other agencies needing additional personnel or 2) avail of the retirement/separation benefits, if qualified, plus the applicable incentive. Those with temporary appointment attested by the CSC may opt to remain but are guaranteed tenure up to expiration of their appointment only. The DBM is currently finalizing the implementing regulations of EO 366 to guide departments/agencies in the implementation of said directive. The regulations would be issued by the DBM upon finalization of the program's communication plan.

Philippines: Progress on Structural Reform Agenda

Main Objectives	Developments
Electric Power Sector Reform • Restructure electric power sector	• The Electric Power Industry Reform Act (EPIRA) of 2001 was enacted in June 2001, followed by its implementing rules and regulations in February 2002. The EPIRA provides a framework for the restructuring of the power sector, including privatization of National Power Corporation (NPC) assets and deregulation of the power sector. • The Power Sector Assets and Liabilities Management Corporation has been created to oversee privatization of NPC's transmission and generation assets. • The Energy Regulatory Commission has been established to replace the Energy Regulatory Board. • Philippine Electricity Market Corporation has been established to launch and manage the Wholesale Electricity Spot Market. • One large and five small generation plants (in total worth about $ 570 million) were sold to private investors. • Cross subsidies among consumer classes have been partially removed. • The government has assumed P 200 billion in NPC debts.
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, and then 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.
Enhance the Corporate Sector Regulatory Framework • Strengthen Securities and	• The Supreme Court issued Interim Rules of

Philippines: Progress on Structural Reform Agenda

Main Objectives	Developments
Exchange Commission (SEC) policies and procedures for debt restructuring	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 system up to international standards; 2) regulating external auditors more closely and 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 available to directors and subject to inspection by stockholders, and to be adhered to under penalty of law. The passage of the Securitization Act in March 2004 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. • The SEC, with the BSP, IC and PDIC, established the Financial Sector Forum (FSF). The FSF is a voluntary cooperative endeavor of the concerned agencies to provide an institutionalized framework for coordinating supervision and regulation, while preserving each agency's mandate. The FSF will focus on the following three broad areas: 1) harmonization and coordination of supervisory and regulatory methods and policies, identification and filling in of gaps and elimination of overlapping functions in the current supervisory regime; 2) reporting and

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Main Objectives	Developments
	information exchange and dissemination, including developing comprehensive rules on disclosure to enhance transparency of firms, harmonizing regulatory reporting requirement to lighten the load of supervised institutions, creation of database linkages among the agencies; and 3) consumer protection and education to curb the proliferation of unlawful and unethical business practices as well as various financial scams. • In recognition of the need to provide a better legal framework, with clear and transparent rules that allows the widest possible participation by the investing public under proper safeguards, the Executive branch is pushing for the passage of a house bill that seeks to amend the Securities Regulation Code (Republic Act No. 8799). The bill is aimed at revising certain provisions of the Code in order to promote a more vibrant and healthy capital market. The pertinent provisions include, among others: the mandatory tender offers; minimum capital requirements; broker-director prohibition and limitation on ownership of an exchange. • Another bill being pressed in the 13th Congress is the Revised Investment Company Act. This bill proposes to undertake the following: 1) promote the application of fiduciary principles in investments and in the management and administration of investment companies; 2) prevent abuses and protect the interest of the investing public; and 3) establish the Investment Company Investors Protection Fund to compensate investors for financial injury for reasons other than market price decline in the investments portfolio of the company.
• Prepare new bankruptcy law	• The draft bill on corporate recovery was originally submitted to Congress in 2001.

Philippines: Progress on Structural Reform Agenda

Main Objectives	Developments
	Similar house bills were filed anew in the 13th Congress. Entitled the "Corporate Recovery Act", these bills are aimed at offering a comprehensive approach to the problems faced by enterprises when they, for whatever reason, can no longer pay their debts as they become due. It emphasizes on the survival of the enterprise while at the same time keeping paramount the rights of debtors and creditors to initiate formal debt relief proceedings.
• 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 30 December 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. • SEC approved in December 2004, PSE's new rules for listed companies under corporate rehabilitation. Listed companies are required to submit to the SEC and PSE copies of the petition for corporate rehabilitation, documents and proposed rehabilitation plan within 24 hours of its actual filing with the courts. Once the court approves the rehabilitation plan, the company would have to submit a comprehensive corporate disclosure on the effects of the plan on

Philippines: Progress on Structural Reform Agenda

Main Objectives	Developments
	the company's capital structure, within 48 hours from the court's approval. The Exchange will then lift the trading suspension on the company's shares, five days from the release of its comprehensive disclosure.
• Strengthen corporate governance	• The BSP implemented Circular No. 456 dated October 4, 2004 to ensure proper management of banking operations by defining the specific duties and responsibilities of the board of directors. Banks are required to have: 1) audit committee to provide oversight of the institution's financial reporting and control and internal and external audit functions; 2) corporate governance committee, tasked to review and evaluate the qualifications of all persons nominated to the board as well as those nominated to other positions requiring appointment by the board of directors, and ensure the board's effectiveness and due observance of corporate governance principles and guidelines. It shall oversee the periodic performance evaluation of the board and its committees and executive management, among others; and 3) risk management committee to be responsible for the development and oversight of the institution's risk management program.

PHILIPPINES: FUND RELATIONS
(As of December 31, 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	1,279.41	145.40
Reserve position in Fund	87.43	9.94

III. **SDR Department**:	SDR Million	% Allocation
Net cumulative allocation	116.60	100.00
Holdings	0.65	0.55

IV. **Outstanding Purchases and Loans**:	SDR Million	% Quota
Stand-by arrangements	397.85	45.21
Extended arrangements	89.09	10.12

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				
	2005	2006	2007	2008	2009
Principal	214.87	125.78	125.78	20.50	
Charges/Interest	14.51	9.23	5.31	2.85	2.58
Total	229.38	135.01	131.09	23.35	2.58

VII. **Exchange Arrangement**:

The value of the Philippine peso is determined in the interbank foreign exchange market; the Bangko Sentral intervenes in the market in order to smooth undue short-term fluctuations in the exchange rate.

From November 1995 to June 1997 the peso was effectively fixed at around P 26.2–P 26.4 per U.S. dollar. On July 11, 1997, the peso depreciated to P 29.45 per U.S. dollar following an announcement by the central bank that the peso would be allowed to find its own level. Since then, it has gradually depreciated; during the last few months, it has fluctuated around P 55–56½ 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, and 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. The update to the ROSC report was published in June 2004.

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

X. **Technical Assistance**:

An MFD resident banking supervision advisor has been stationed in Manila since May 2003, to assist the BSP in the implementation of a new supervisory model.

An 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 to provide a briefing to the new tax commissioner took place in April–May 2001. An FAD mission reviewed VAT and excise administration in December 2001. An FAD staff member participated in the July PPM mission to evaluate and advise on tax measures.

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

XI. **Resident Representative**:

A Resident Representative has been stationed in Manila since January 1984. Mr. 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: RELATIONS WITH THE WORLD BANK

A. World Bank Lending

As of December 31, 2004, the current Philippines portfolio consisted of 23 projects, amounting to $1.16 billion (net of cancellations), of which $505 million has been disbursed. Since the Bank started operations in the Philippines, it has committed $9.56 billion under IBRD loans and $239 million under IDA credits (less cancellations). Based on net commitments and by sector, the portfolio can be broken down as follows: Rural Development (34 percent); Education, Health & Social Development (18 percent); Transport (18 percent); Urban Development (13 percent); Energy (3 percent); Environment (12 percent); and Governance (2 percent).

The World Bank's current Country Assistance Strategy (CAS) for the Philippines focuses on accelerating growth and empowering the poor to participate more fully in development. The CAS sets forth a base case lending program of about $1.1 billion for the FY03–05 period, but the actual volume is anticipated to be much lower due to the Government's restraint on borrowing as a result of its tight fiscal situation. The Bank is now in the process of formulating a new CAS for the period FY06-08.

During FY04, the World Bank approved 4 loans for a total of $96.9 million: Judicial Reform ($21.9 million), Rural Power ($10 million), Laguna Lake Institutional Strengthening and Community Development ($5 million) and the Diversified Farm Income and Market Development ($60 million).

The World Bank has also been involved in non-lending activities. These activities focus on four themes emphasized by the Bank's current assistance strategy: ensuring effective delivery of public services; strengthening the environment for private sector development; building human resources; and managing natural resources, rural development, and regional concerns. Recent examples of non-lending outputs include Education Policy Notes, a Natural Disaster Management Study; a Natural Resource Management Study; and Discussion Briefs to help inform the next Philippine government on the development challenges faced by the new administration**.**

In addition to analytical work, the Bank also provides technical assistance to the Philippines, frequently supported by trust funds such as the Institutional Development Fund (IDF) and the World Bank-managed ASEM Trust Fund[14]. Technical assistance is being provided in such areas as: pension reform; strengthening various institutions for good governance; international competitiveness; strengthening public financial management capacity; city development strategies; sustainable development in mining; and corporate governance. Also, technical assistance funded by the Policy and Human Resource Development (PHRD) Grant

[1] Asia-Europe Meeting—The European Union's Asian crisis response fund, created in April 1998; intended to help eligible East Asian countries, including the Philippines, to recover from the regional financial crisis. The trust fund supports activities both in the financial, corporate and social sectors, as well as in the area of governance.

Facility helps the client prepare lending operations. Country and project specific grants were mobilized in FY04 amounting to about $8.2 million. Our grant portfolio as of December 31, 2004 consisted of 77 active grants, totaling about US$34.4 million, of which about US$9.8 million has been disbursed**.** In addition, during FY04, the Bank processed grants which would co-finance some of the new lending. These included: a $9 million GEF grant for the Rural Power Project; a $5 million grant from the Netherlands for the Laguna Lake Institutional Strengthening and Community Development Project; and a $12 million GEF grant for an Electric Cooperative System Loss Reduction Project to support the Rural Power Project.

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

Table 1. Philippines: Board Approvals for Loans between July 1, 2000 and December 31, 2004
(In millions of U.S. dollars)

Name	IBRD Amount	Effective Date
Land Administration Management Project (LIL)	4.79	1/9/01
Metro Manila Urban Integration Project	60.00	12/6/01
LGU Finance and Development 2	30.00	5/16/02
Social Expenditure Management-2	100.00	12/11/02
Kalahi Community Development Project	100.00	12/16/02
Second Agrarian Reform Communities Project	50.00	6/4/03
ARMM Social Fund	33.60	5/19/03
Judicial Reform	21.90	12/04/03
Rural Power	10.00	05/06/04
Laguna de Bay Institutional Strengthening and Community Participation	5.00	04/02/04
Diversified Farm Income and Market Development	60.00	10/29/04

B. Aid Consultative Group

The World Bank continues to be actively involved in donor coordination in the Philippines, as lead convener, co-convener with Government, or as a participant in donor meetings/dialogues. The last major aid coordination event was the 25th meeting of the Consultative Group (CG) held on November 7-8, 2003 in Cebu, Philippines where the World Bank co-chaired the meeting with the Department of Finance. The theme of the Consultative Group Meeting was "Securing Peace and Sustaining Development". Approximately 130 participants attended the meeting including Government representatives and twenty-four delegations from multilateral and bilateral agencies from the official development assistance (ODA) community. A meeting of the Philippines

Consultative Group and other stakeholders–to be called the 2005 Philippines Development Forum–is planned for March 7-8, 2005 in Davao City.

C. Financial Relations

IBRD/IDA lending operations as of December 31, 2004
(In millions of U.S. dollars)

	IBRD	IDA	Total
Total disbursed 1/	8,835	244	9,079
Total commitments 1/	9,562	239	9,802
Total undisbursed	608	0	608
Total repaid	6844	38	6882

IFC Investments as of June 30, 2004
(In millions of U.S. dollars)

Total commitments held by IFC and participants	847.4
Total commitments held by IFC alone	539.2

1/ Net of cancellations.

PHILIPPINES: RELATIONS WITH THE ASIAN DEVELOPMENT BANK

Since joining the Asian Development Bank (ADB) in 1966, the Philippines has received 192 loans for a total of $8.62 billion, and 311 technical assistance grants amounting to $137 million. Forty-eight percent of the loans were for projects in the energy and agriculture sectors. In 2004, two loans for the health sector development program were approved totaling $213 million. Ten technical assistance grants totaling $5.995 million were also approved in 2004.

ADB's private sector operations, which are made without government guarantee, amounted to $509.5 million, including 15 loans of $474.3 million and 18 equity investments of $35.2 million. The Philippines is one of the largest clients for such activities.

Table 1. Philippines: Cumulative AsDB Lending to the Philippines 1/

(As of December 31, 2004)

Sector	Number of Loans	Amount of Loans (In millions of U.S. dollars)	Percent
Energy	25	2,221.1	25.8
Agriculture and natural resources	62	1,915.7	22.2
Social infrastructure	41	1,612.4	18.7
Transport and communications	23	996.9	11.6
Finance	17	823.0	9.5
Others	3	296.0	3.4
Multisector	6	283.7	3.3
Private sector	15	474.3	5.5
Total	192	8,623.1	100.0

[1] Includes loans to private sector without government guarantee, but excludes 18 private equity investments of $35.2 million.

PHILIPPINES: STATISTICAL ISSUES

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

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

D. National Accounts

Despite the authorities' efforts to improve its quality, there are serious weaknesses in the national accounts. The problems are shown by large discrepancies between GDP estimated from the expenditure side and GDP from the production side (the official GDP estimates). The growth of GDP often shows contradictory movements between the expenditure and production sides, with the difference of the growth rates about 3 percent on average over the last two years.

The ROSC identified a number of causes for these problems[15].

- **Deaths and births of establishments are not adequately measured, a gap of growing importance given the rapid structural change in the economy in recent years**. Annual surveys are designed to pick up these changes but the latest data are from the 1998 National Statistical Office (NSO) annual survey of establishments. This implies that a large number of new establishments, in particular in the electronics and information technology industry, are not covered in the national accounts.

- **The compilation relies on an outdated benchmark year and fixed input-output ratios.** The estimates are derived by extrapolation of the 1988 benchmark year using fixed input-output ratios at 1985 prices. For example, GDP statistics for the electronic sector suggest that value added remained at 10 percent of exports over the past years in spite of industry evidence that the domestic component of exports has been rising sharply. A new benchmark I-0 constructed by the NSCB is scheduled to be released in September 2005.[16]

- **Statistical techniques in estimating GDP at constant prices are inadequate.** For most activities, not all components of the production accounts are compiled. Instead, only

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[15] Currently, the authorities are compiling new national accounts series based on the 1993 SNA guidelines.

[16] Industry representatives indicate that the domestic component has increased significantly, to around 30 percent in recent years.

value added at current prices is estimated, with the corresponding value added at constant prices estimated using a price deflator. For example, the national accounts constant price estimates for merchandise exports and imports are constructed at 1985 unit values (per kilo) multiplied with quantity data (in kilos) from the foreign trade statistics. Because of this inappropriate method, implicit deflators for electric machinery products are running suspiciously high compared with developments in world market prices.

E. Balance of Payments

Steps have been taken to improve the quality of the balance of payments accounts although significant weaknesses remain. The Fund has remained actively engaged in attempts to address this issue, with several balance of payments statistics technical assistance missions to the Philippines since 1995. There has been important progress over the past year, with a significant improvement in the measurement of imports to correct an underestimation of imports of electronic goods on a consignment basis. Nevertheless, errors and omissions remain sizable as a result of remaining reporting gaps and misclassifications, which make the data very difficult to interpret.[17] Data for external debt and reserves, on the other hand, are generally of good quality, although the data ROSC mission identified some weaknesses in these accounts.

Recent revisions to imports have narrowed the gap between national trade data and those of partner countries on a net basis. An interagency task force on import statistics was established in July 2002 to improve the measurement of activity in the electronics sector, which accounts for about 43 percent of trade flows. Results of surveys covering electronics sector raw material imports confirmed that imports were being routinely underestimated. Import figures have therefore been revised substantially, back to 2000.[18] As a result, the estimated trade balance for 2001 changed from a surplus of 3.8 percent of GDP to a deficit of 1 percent of GDP. A comparison of the revised figures with trade data of partner countries suggests that the revised trade balances of 2001–02 are being reasonably well measured. However, there remain substantial differences with partner country data on gross flows of exports and imports, with the latter about 15 percent higher than the corresponding national data.

The ROSC data module confirmed that significant problems remain, both in terms of gaps in coverage and compilation of statistics:

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[17] Errors and omissions and "trade credits" accounted for balance of payments outflows of US$4.4 billion (5.6 percent of GDP) in 2002. Trade credit data in the Philippines, which are calculated as the difference between export receivables (export shipments less export receipts) and import payables (import arrivals less import payments), are unreliable, as indicated by the continued accumulation of trade credit balances. They are therefore grouped with errors and omissions in the IMF presentation of the Philippines balance of payments accounts.

[18] Data from 1996–99 have not been revised and remain underestimated.

- Since deregulation in the early 1990s, international transactions have increasingly flowed through nontraditional channels that are not adequately covered by the statistical reporting system. The major gap relates to Foreign Currency Deposit Units (FCDUs), which account for about 70–75 percent of foreign exchange settlements, where because of strict secrecy rules banks are not mandated to report information. A number of steps are being taken to measure cross-border transactions that skirt the domestic banking system, such as flows through inter-company accounts.[19] A number of enterprise surveys, for example, have been introduced. However, these are conducted on a voluntary basis and will take time to implement fully. If the secrecy rules associated with FCDU accounts are not modified to facilitate the collection of data for statistical purposes, the quality of the balance of payments is likely to remain poor for some time.

- These problems have been compounded by a lack of resources devoted to the compilation of balance of payments statistics. The time that compilers (at the BSP) can devote to making full use of readily available data , or developing improved sources and methods, has been squeezed by noncompilation related tasks. As a result, progress in implementing the recommendations of various IMF technical assistance missions has been slow. With these concerns in mind, the periodicity of the release of balance of payments statistics has been switched from monthly to quarterly (effective with the release of third quarter data for 2003 in December 2003) and a decision made to establish a separate Department of Economic Statistics within the BSP.

F. Monetary Accounts

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

The ROSC identified a few shortcomings in coverage and quality of the monetary aggregates. The authorities have recently made progress on some fronts. They have introduced the Depository Corporations Survey which now includes operations of thrift and rural banks. They have also introduced uniform procedures for converting foreign currency denominated accounts to local currency in the monetary aggregates. However, weakness remain, including in the areas of treatment of non-operational banks, valuation of securities, and treatment of accrued interest in the monetary statistics aggregates. Practices in these areas need to be brought into line with international norms.

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

G. Fiscal Data

While the Philippines meets the requirements of fiscal transparency in many important respects, the recent fiscal and data ROSCs found areas that require strengthening. An important problem is that the budget is presented on an obligations basis, while the deficit is reported on a cash basis, complicating comparisons of budgets and outcomes. In addition, for levels of the public sector beyond the budgetary central (national) government, consolidated fiscal outturns for items other than the fiscal balance are generally available. Stock and flow information is also not generally well-reconciled.

PHILIPPINES: CORE STATISTICAL INDICATORS

(As of January 12, 2005)

	Exchange Rates	International Reserves	Reserve/ Base Money	Central Bank Balance Sheet	Broad Money	Interest Rates	Consumer Price Index	Exports/ Imports	Current Account Balance	Federal Government Balance	GDP/GNP	External Debt
Date of latest observation	Jan.12/05	Jan.12/05	Jan. 3/05	Oct./04	Oct./04	Jan.12/05	Dec./04	Nov./04/ Oct./04	June/04	Nov./04 1/ Q3/04 2/	Q3/04	Q3/04
Date received	Jan.12/05	Jan.12/05	Jan.6/05	Nov. 30	Nov. 30	Jan.12/05	Jan. 5	Jan. 11 5/ Dec.22	Sep. 23	Dec. 10 1/ Nov. 15 2/	Nov. 30	Dec. 30
Frequency of data 3/	D	D/M	D	M	M	D	M	M	M	M/Q	Q	Q
Frequency of reporting 4/	D	D	W	M	M	D	M	M	M	M/Q	Q	Q
Source of data 5/	C	A	A	N	A	A/C	N/C	N/C	A/N/C	A/A	A/C	A
Mode of reporting 6/	E	C	C/E	E	C	C/E	C/E	C/E	C/E	C/C	C/E	C
Confidentiality 7/	C	A	B	C	C	C	C	C	C	C/C	C	C

1/ National government.
2/ Public sector.
3/ D-daily, W-weekly, M-monthly, Q-quarterly, A-annually, O-other.
4/ D-daily, W-weekly, M-monthly, Q-quarterly, A-annually, V-irregularly in conjunction with staff visits, or O-other irregular basis.
5/ A-direct reporting by central bank, ministry of finance, or other official agency; N-official publication or press release; P-commercial publications; C-commercial electronic data provider; E-EIS; O-other (please explain).
6/ E-electronic data transfer, C-cable or facsimile, T-telephone, M-mail, V-staff visits, O-other.
7/ A-for use by the staff only, B-use by the staff and the Executive Board, C-unrestricted use, d-embargoed for a specific period and hereafter for unrestricted use, E-subject to other use restrictions.

Philippines: Millennium Development Goals

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

Philippines: Millennium Development Goals (continued)

	1990	1995	2001	2002
Goal 7. Ensure environmental sustainability				
Target 9: Integrate the principles of sustainable development into country policies and programs and reverse the loss of environmental reso				
23. Forested land area (percent of total land area)	22.4	...	19.4	...
24. Nationally protected area (percent of total land area)	...	4.9	4.9	...
25. GDP per unit of energy use (PPP$ per Kg oil equivalent)	6.8	6.6	7.6	...
26. Carbon dioxide emissions (metric tons per capita)	0.7	0.9	1.0	...
Target 10: Halve, by 2015, the proportion of people without sustainable access to safe drinking water and sanitation				
27. Access to an improved water source (percent of population)	87.0	...	86.0	...
28. Access to improved sanitation (percent of population)	74.0	...	83.0	...
Target 11: By 2020, to have achieved a significant improvement in the lives of at least 100 million slum dwellers				
29. Access to secure tenure (percent of population)	...	...	...	...
Goal 8. Develop a global partnership for development 1/				
Target 16: In cooperation with developing countries, develop and implement strategies for decent and productive work for youth				
30. Youth unemployment rate (percent of total labor force, ages, 15-24)	15.4	16.1	19.0	...
Target 18: In cooperation with the private sector, make available the benefits of new technologies, especially information and communicati				
31. Fixed telephone lines and cellular subscribers (per 1,000 population)	10.0	27.7	197.8	232.9
32. Personal computers (per 1,000 population)	3.5	9.6	21.7	27.7
Other social and demographic indicators				
General				
Surface area (sq. km.)	300,000	300,000	300,000	300,000
GDP per capital (1995 U.S. dollars)	1,091	1,085	1,182	1,209
Poverty headcount (percent of population)	...	40.6	...	...
Income distribution: lowest 20 percent	...	...	5.4	...
highest 20 percent	...	...	52.3	...
Demographic				
Population (million)	61.0	68.3	78.3	79.9
Population growth rate (percent)	2.3	2.3	2.2	2.1
Population density (per sq km)	204.7	229.2	262.7	268.1
Urban population (percent of total)	48.8	54.0	59.3	60.1
Life expectancy at birth (years)	65.6	67.7	...	69.8
Birth rate, crude (per 1,000 population)	32.4	29.7	...	25.6
Death rate, crude (per 1,000 population)	6.7	5.8	...	5.6
Labor force				
Total labor force (million)	24.6	28.1	33.3	34.2
Agriculture employment (percent of total)	45.2	44.1	37.4	n.a.
Industry employment (percent of total)	15.0	15.6	15.6	n.a.
Services employment (percent of total)	39.7	40.3	47.0	n.a.
Education				
Adult literacy (percent to population, ages 15 and above)	91.7	93.5	92.6	n.a.
Pupil-teacher ratio, primary school (percent)	32.9	n.a.	35.2	35.4
School enrollment (percent of age group, gross)				
Primary	111.3	114.1	112.5	112.1
Secondary	73.2	77.5	77.1	81.9
Tertiary	28.2	29.0	30.5	30.4

Sources: World Bank; and United Nations.

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

Statement by the IMF Staff Representative
March 7, 2005

1. This statement contains information about recent developments that has become available since the Staff Report was circulated to the Executive Board on February 7, 2005. This information does not alter the thrust of the staff appraisal.

2. **Financial markets have remained stable, despite Moody's downgrading the Philippines' long-term sovereign ratings by 2-notches in mid-February to B1**. The ratings agency noted that some improvement in tax collections had been made, but expressed concern about the outlook for reform as Congress grapples with politically difficult choices. Nonetheless, markets have remained firm in 2005 to date; the peso is up by 2 percent against the U.S. dollar, mainly as a result of increased portfolio inflows, while sovereign spreads on the EMBI+ Philippines index have declined broadly in line with the EMBI+ Global index. Appetite for the government's $1.5 billion sovereign bond issue at the end of January was strong.

3. **The budget deficit target for 2005 has been revised slightly downwards, but Congress continues to deliberate on the tax measures that would be required for a more front-loaded deficit reduction.** The authorities have lowered their target for the 2005 national government deficit (authorities' definition) from 3.6 to 3.4 percent of GDP to reflect the increases in excises on alcohol and tobacco products and other measures that were approved at the end of last year. The VAT bill passed by the House of Representatives in January increasing the standard rate from 10 to 12 percent has met with considerable opposition in the Senate and alternative VAT reforms such as widening the VAT base are being considered. Indeed, the House passed a bill this week that would eliminate some VAT exemptions, including for medical and legal services, but at the same time, introduce lower VAT rates for other sectors.

4. **The authorities have revised up the 2005 inflation target to 5–6 percent**. The government raised the target for average inflation from the earlier 4–5 percent to reflect the shift to the recently introduced 2000-based CPI and to factor in continuing supply-side pressure on inflation. In 2004, inflation averaged 0.5 percentage points higher on the basis of the new CPI than the 1994-based CPI due to changes in the components and weights in the basket. The new CPI based inflation was 8.5 percent (y/y) in February, up 0.1 percentage point from January, while core inflation rose slightly to 8.1 percent (y/y).

5. **The Philippines has been removed from the Financial Action Task Force's (FATF) list of Non-Cooperative Countries and Territories**. The FATF announced on February 11 that anti-money laundering (AML) measures were being effectively implemented to remedy earlier identified deficiencies.

6. **New appointments to the economic team have been announced**. The President has appointed Mr. Cesar Purisima (former Secretary of Trade and Industry) as Secretary of Finance and announced that Mr. Amando M. Tetangco, Jr. (currently Deputy Governor)

would become Governor of the Bangko Sentral ng Pilipinas at the end of Governor Buenaventura's term in July. Mr. Juan Santos has been appointed as the new Secretary of Trade and Industry and Mr. Raphael Lotilla as the new Secretary of Energy.

Statement by Jong Nam Oh, Executive Director for the Philippines and Cyd Amador, Senior Advisor to Executive Director March 7, 2005

Key Points

- While macroeconomic fundamentals remain sound, the strong implementation of high-quality measures is needed to address underlying weaknesses, particularly in the fiscal, power, and financial sectors.

- Fiscal consolidation remains the top priority. Disciplined fiscal policy has started to deliver results.

- Decisive implementation of well thought-out structural reforms should strengthen the prospects for medium-term growth and lead to a more participatory development process.

Our authorities wish to record their appreciation for a well-written and candid report, which highlights the progress made and the central policy challenges facing the economy. They also thank the staff for their rigorous analysis on various selected issues that appropriately focus on medium-term vulnerabilities, making a valuable contribution to the public policy debate underway regarding the measures needed to promote high economic growth. Close engagement between the staff and the authorities has enriched discussions on economic policy issues and prescriptions as well as development strategies. In addition, technical assistance from the Fund has helped in capacity building and knowledge transfer that, in turn, have strengthened domestic ownership in policy formulation and implementation.

Macroeconomic fundamentals remain sound. Strong implementation of high-quality measures is needed to address underlying weaknesses, particularly in the fiscal, power, and financial sectors.

Steady growth in economic activity is due in large part to the sound policy framework, with fiscal prudence at the front and center of the government's economic program. Sound macroeconomic performance is also evident in a healthy external account position, low interest rates, and a stronger peso. The base of growth has broadened as exports and investments have started to perk up.

While recognizing the headway made in sustaining macroeconomic stability and consolidating growth, the authorities are well aware that long-standing vulnerabilities remain that could undermine hard-won gains. The strong implementation of high-quality measures is critical to narrow fiscal imbalances and addresses weaknesses in the power and financial sectors. The Medium-Term Philippine Development Plan (2004-2010) sets out the policy directions of the government going forward. The plan rests on four economic imperatives, namely: macroeconomic stability anchored on medium-term fiscal consolidation to bring the public debt ratios on a decisive downward trend; financial sector reform; power sector restructuring and reform; and increased infrastructure, investments, exports and employment. The authorities are keenly aware of the need for prompt and bold action on these fronts and have been liaising closely with all stakeholders, including and importantly the legislators, to advance the cause for reform.

The authorities' explicit and strong commitment to fiscal consolidation at the very start of the administration's term set the tone for a determined plan to put the fiscal house in order. Palpable steps have been taken along the path of adjustment: important tax reform measures have been signed into law, power generation tariffs have been raised markedly, a major power plant has been sold, and the climate for foreign investment has been boosted by a judicial action to open up the mining industry.

Reform, however, is always work-in-progress and thus there is always unfinished business. The country is in the middle of urgent reforms. However, any meaningful reform plan would prosper only with public support. A critical challenge facing the authorities is to generate political and popular acceptance and drum up support over the long haul for a reform program to transform the economy. In this regard, the authorities have continued to raise public awareness of the issues at stake and encouraged public discussion on the urgency of the need for strong, united action to address pressing problems through a credible and coherent economic program. Discussions have highlighted the gravity of the problems confronting the economy, the dividends of strong reform and the costs of inaction and diluted or half-hearted reform efforts. As a result, there is wide recognition of the need for adjustment, and the public debate, especially on fiscal reform, is at a high level.

The costs of adjustments, however, needs to be considered to facilitate social and political consensus and keep at bay resistance to staying the course. This underlies the authorities' measured approach to reform. In striking up the tempo of reforms, they have carefully prioritized and sequenced reform measures to avoid having an overcrowded agenda while trying to minimize short-term economic dislocations and ensure that the burden-sharing of adjustments is equitable. By doing this, they hope to establish broad support that will help the reform drive gain traction and develop a sustainable momentum that over time should strengthen the incentives for the continued adoption of good policies.

Monetary policy continues to closely guard against threats to price stability.

The authorities see near-term inflation to be influenced primarily by supply factors, the direct effects of which cannot be addressed appropriately by monetary policy action. As in previous episodes of supply-driven inflation, they expect inflation to revert to manageable levels and ease back toward the target by next year. This and the absence of strong demand-side pressures explain the authorities' decision to keep monetary policy settings on the neutral mode. However, the authorities remain alert to inflationary pressures and stand ready to respond in a timely fashion to conditions that threaten price stability. They are closely monitoring potential second-round effects of supply-side shocks, including in inflation expectations, to ensure that these are well contained, and they are closely tracking demand indicators as the economy shifts to higher gear. Any monetary response will be undertaken promptly and at a measured pace, calibrated according to the extent of the underlying price pressures while helping ensure the sustainability of growth.

The country's export outlook has benefited from continued product and market diversification. A recent court ruling opening up the mining sector to foreign investment should help boost exports and revitalize the mining industry. Remittances from overseas Filipino workers remain robust. A flexible exchange rate system facilitates adjustments to external shocks and structural changes. However, the large external financing requirements render the country vulnerable to changes in global financial market conditions. Prudent external debt management serves as a cushion against reversals in market sentiment. The maturity structure of the external debt helps limit financing pressures, with short–term debt accounting for only about a tenth of total external debt, and medium- to long-term debt maturities averaging more than 17 years. The Bangko Sentral also continues to maintain a comfortable level of reserves to sufficiently cover short-term debt.

Fiscal consolidation remains the top priority. Adherence to a disciplined fiscal policy framework has started to deliver results.

The large fiscal deficit has been a major drag on growth and investor confidence. Fully cognizant of this, President Arroyo last August singled out the fiscal deficit as the economy's most urgent problem, generating broader public awareness of the gravity of the issue.

Of late, fiscal discipline has started to yield much-welcome results. The fiscal position was better than expected in 2004, with the National Government (NG) deficit at 3.8 percent of GDP compared to the target of 4.2 percent. Going forward, the cross-cutting challenge facing the authorities is to achieve fiscal consolidation in the medium term to bring the public debt to a more sustainable level while creating fiscal space to allow for much-needed development expenditures, including on infrastructure, public services and social programs that will not only provide short-term, palliative benefits to the poor but also help them become more productive by drawing them into the economic mainstream.

Raising the revenue effort is critical if significant progress is to be made in reducing the debt burden. An important element in this strategy is the fundamental reform of the tax structure. Positive steps in this direction include the rise in excise taxes on liquor and cigarettes and the enactment of the bill that seeks to ensure optimum performance in revenue collection agencies through a system of rewards and sanctions. Other new revenue-raising measures include the implementation of a pre-announced hike in import duties on fuel and increases in fees charged by government agencies. The authorities continue to push for legislation that will improve tax and revenue efforts. Tax measures in the legislative pipeline include a proposal to raise the value added tax, the rationalization of fiscal incentives for investments, and the elimination of a range of VAT exemptions. The authorities' advocacy for fundamental tax reform through a VAT increase is a strong signal of their recognition of the need to take decisive action to address the fiscal problem.

These tax policy reform measures complement efforts underway to strengthen the efficiency of tax administration and plug revenue leaks. The authorities also continue to rationalize and prune expenditures, while taking care to protect social programs. Measures include paring down the size of the bureaucracy, improving the management of government-owned and controlled enterprises (GOCCs), and implementing the devolution provision of the Local Government Code to enhance the effectiveness of public service delivery. The authorities are pushing for a separate legislative program aimed at spending restraint, comprising a fiscal responsibility bill, the rationalization of public pension schemes, and the removal of automatic guarantees for GOCCs. Prudent spending is expected to provide flexibility in raising infrastructure spending, which would help address a major hindrance to strong investments.

The authorities' phased-in and multi-pronged fiscal reform strategy should dispel the concern that there is a lack of urgency or ambition in coming to grips with the fiscal problem. The authorities recognize the need for an ambitious fiscal effort that will lead to significant deficit reduction over the medium term. As the staff notes, the authorities "agreed that there was a need to front load fiscal adjustment and hoped that revenue from new tax measures, which are not included in the 2005 budget, might make this possible". At the same time, they are taking care against overpromising and being overambitious in adjustments, because doing so runs the risk of overwhelming the capacity of the constituency to digest and tolerate a multitude of major reforms, possibly leading to backsliding or the abandonment of reform efforts. Thus far, the results speak for themselves, with the encouraging 2004 fiscal results, putting the NG deficit ahead of schedule compared to the authorities' initial fiscal consolidation plan. Looking ahead, the government remains fully determined to make progress on improving public finances, including and importantly through a meaningful turnaround in revenue performance. Ownership of the economic program is strong.

Decisive implementation of structural reforms should strengthen the prospects for medium-term growth and enable the development process to be more inclusive.

The authorities realize the urgent need to address stumbling blocks and structural challenges that hinder progress. Lifting the pace of structural reform is also necessary to reduce vulnerabilities and increase economic flexibility so that the Philippines is well-positioned to take advantage of the opportunities presented by globalization.

A vibrant economy requires a well-functioning and dynamic financial sector, one that can efficiently intermediate funds, manage risks, and support the requirements of strong, private sector-led growth. Slow but nevertheless steady progress has been made by banks in disposing of their non-performing assets (NPAs) through special purpose vehicles. Large NPAs have acted as an enormous drag on the banking system, contributing to lackluster loan growth and low profitability. Recently, the Bangko Sentral has made it more costly for banks to retain NPLs and idle assets in their books with the issuance of a circular that prescribes higher risk weights for NPLs and NPAs. This should compel banks to take more aggressive steps to reduce their NPAs.

With a view to promoting a stronger and more stable financial system, the Bangko Sentral continues to lobby in Congress for the passage of measures that will strengthen its supervisory and enforcement powers, prioritizing those amendments to the Bangko Sentral charter that will provide for more effective bank supervision and better legal protection of supervisory personnel, which is a long-standing issue as noted by the staff. Other important banking system reforms include the creation of a comprehensive and reliable credit information system for accurate assessments of creditworthiness, and the strengthening of corporate governance and transparency in banks. To nurture the domestic capital market, the authorities are pushing reform aimed at encouraging more domestic savings by improving the management of pension funds; establishing orderly and efficient securities trading and settlement through the setting up of appropriate market infrastructure; bringing transparency and accountability standards at par with international best practices; and coordinating and harmonizing supervisory and regulatory practices across financial services. At the same time, the Bangko Sentral has made it an equally important priority to broaden the access of the poor to financial services. Through its flagship program on microfinance, appreciable headway has been made to establish a supportive policy and regulatory environment that will encourage banks to lend to the poor in a sustainable way.

Key to balancing the budget is the successful restructuring of the energy sector. The government's success in advancing energy reform will also ensure efficient and reliable power supply and strengthen the economy's competitiveness. In the selected issues paper, staff helpfully recognizes the headway that has been made in this direction, calling the reform the first major attempt among Asian developing countries to build a fully liberalized and competitive power market. However, much remains to be done. The privatization of the National Power Corporation (NPC) through the sale of its generation assets and the concession of the transmission company (Transco) is among the most urgent of the authorities' reform efforts. It has been a laborious process but the authorities are determined to put an end to the fiscal drain imposed by NPC. This year, the government expects to award a concession contract to operate the Transco grid. On a positive note, the Philippines sold its first large generation plant in December last year, in addition to five small hydropower plants. Energy officials plan to front load the privatization of generation companies in 2005. The government's determination to put in place corrective fiscal measures is also manifest in its efforts to better reflect the cost of power generation, with the 98-centavo provisional average tariff increase awarded to NPC. As a social safety net, the same lifeline rate for small consumers remains in effect.

Sustained, respectable growth also hinges on the successful implementation of measures that will boost competitiveness and investor confidence. The authorities intend to persist with structural reforms that will improve the environment for private sector activity. This will open up economic opportunities and create employment, critical for a country where more than a tenth of its labor force is not gainfully employed. The authorities also continue to pursue an array of reforms aimed at creating a more business-friendly environment including reform to improve the adjudication process, simplify business procedures, and crack down on corruption, including by improving transparency. The benefits of good governance are well embraced by our authorities. They are pushing for measures that will improve public governance, including strengthening anti-corruption institutions like the Anti-Graft Commission and the Office of the Ombudsman as well as creating a data base that would facilitate the analysis of assets and liabilities and net worth of public officials and employees.

Our authorities are well aware that the current favorable conditions marked by macroeconomic stability offer a window of opportunity to press ahead decisively and boldly with reforms that will reduce key medium-term vulnerabilities, particularly in the fiscal, financial and energy sectors, while addressing the economy's social challenges. Our authorities also remain committed to pursuing sound macroeconomic policies. They hope that this strategy will render economic growth more robust and sustainable and lead to development gains that are more inclusive, helping make a meaningful dent against poverty.

INTERNATIONAL MONETARY FUND
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Public Information Notice (PIN) No. 05/35
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March 20, 2005

International Monetary Fund
700 19th Street, NW
Washington, D. C. 20431 USA

IMF Executive Board Concludes 2004 Article IV Consultation with the Philippines

On March 7, 2005, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with the Philippines.[1]

Background

Since taking office in July 2004, the new administration has formulated a set of reforms to address the Philippines' long-standing problems in the fiscal, power, and banking sectors. Two of President Arroyo's proposed tax reform bills have been enacted including increasing alcohol and tobacco excises. In the power sector, a 40 percent hike in generation tariffs has been provisionally awarded, while the sale of a large generation plant has also been announced. In the banking sector, the disposal of nonperforming assets has begun. However, these are a small component of the total reform required. In fact, while financial markets have been relatively stable since the election, rating agencies have recently downgraded the sovereign rating on the grounds that the tax reforms to date have been inadequate.

GDP growth has exceeded expectations, but unemployment remains high. With exports staging a recovery and consumption boosted by overseas remittances and the election, GDP grew by 6.1 percent in 2004, up from 4.7 percent in 2003. On the production side, the growth drivers were strong performances by agriculture and services such as telecommunications, business process outsourcing, and tourism. Employment increased by 3.6 percent in 2004,

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

mainly reflecting the rapid creation of services sector jobs. Even so, unemployment averaged 11.8 percent in 2004, up from 11.5 percent in 2003.
Inflation has risen above the target range. The rate of inflation (1994 base) climbed to 7.9 percent y/y in December, from 3.1 percent y/y in December 2003, causing average inflation to increase to 5.5 percent, above the Bangko Sentral ng Pilipinas (BSP)'s target range of 4-5 percent. The primary cause was a succession of supply shocks, led by a jump in meat and fish prices and followed by the surge in world oil prices and, more recently, the hike in power tariffs. Nonetheless, some signs have emerged of more broad-based inflationary pressures, including a rise in core inflation. The BSP has so far kept policy rates on hold, preferring to wait for more definitive evidence that inflation is becoming generalized before taking monetary policy action.

The national government deficit (authorities' definition) is estimated to have declined to 3.8 percent of GDP in 2004, below the budget target of 4.2 percent of GDP, and down from 4.6 percent of GDP in 2003. Revenue is estimated to have remained broadly unchanged as a share of GDP, while primary spending has been compressed. The major sources of expenditure savings were personnel services, due to the absence of a general wage increase for the second consecutive year, and transfers to local government units staying fixed in nominal terms as a result of the re-enactment of the 2003 budget. However, power sector losses expanded to 1.5 percent of GDP in 2004, from 1.1 percent of GDP in 2003, and the nonfinancial public sector deficit is estimated to have only declined to 5.3 percent of GDP in 2004, compared to 5.6 percent of GDP in 2003.

The balance of payments proved fairly resilient in 2004. Strong growth of exports, tourism receipts, and remittances more than offset higher oil imports, causing the current account surplus to increase slightly to an estimated 4½ percent of GDP in 2004. For much of the year, this surplus looked insufficient to finance net capital outflows and negative errors and omissions, and a loss of foreign exchange reserves was expected. However, in the fourth quarter, the weak U.S. dollar took pressure off the peso and allowed the BSP to make modest purchases of foreign exchange. As a result, reserves, adjusted for pledged assets, ended the year up slightly at US$15 billion (119 percent of short-term debt by residual maturity).

The near-term outlook for the Philippine economy is clouded by the uncertain external environment. The rapid growth in 2004 is unlikely to be sustained, particularly given slowing global demand in the information technology sector and rising interest rates. Thus, staff expects GDP to grow at a more moderate 4¾ percent in 2005. However, there are uncertainties on both the upside and downside, depending on oil price movements, the strength of world demand, and weather conditions (which affect agriculture production). Staff expects inflation (using the new 2000 base) to remain above the target range of 5–6 percent in 2005.

Executive Board Assessment

Executive Directors noted that the economy has recorded strong economic growth in 2004, mainly driven by a recovery in exports and consumption, but that inflation has risen and unemployment has remained high. Directors welcomed the efforts being made by the administration to lay out a comprehensive package of reforms aimed at addressing the country's long-standing problems in the fiscal, power, and banking sectors, and in reducing its high debt levels. They praised the authorities' commitment to win the necessary political support for key reform measures, and were encouraged by a number of recent developments, including the passage of the bill raising alcohol and tobacco excises, and the recent increase in duties on oil and petroleum imports. Directors also welcomed the provisional tariff increase awarded to the National Power Corporation (NPC), and the recently announced sale of a large power plant.

Notwithstanding these welcome steps, Directors cautioned that, with the major part of the reform agenda still unfinished, vulnerabilities arising from the country's large external debt and financing requirements remain high. Thus, the economy remains susceptible to external shocks, especially changes in market sentiment and increases in global interest rates and oil prices. Moreover, Directors noted that, even with benign global conditions, the Philippines could find it difficult to meet its large external borrowing needs should the reform momentum falter.

Against this background, Directors regarded the full and quick implementation of the authorities' reform package as essential to reduce the vulnerabilities of the Philippine economy, achieve public debt sustainability over the medium term, and improve the investment and business climate. In particular, they attached importance to the passage of further tax measures with a clear and certain revenue yield, and also called for sustained reforms in other areas, such as the power sector, financial sector, and pension funds. Directors noted that such reforms will set the stage for higher economic growth, sustained reductions in unemployment and poverty, and achievement of the Millennium Development Goals. They therefore urged the authorities to take advantage of the unique opportunity afforded by the favorable post-election political environment to make a decisive break from the past and implement the urgently-needed reforms. It was also suggested that account should be taken of the economy's capacity to absorb reform measures, and the need to provide adequate safety nets.

Directors commended the authorities for maintaining control over the budget in 2004 despite election-related pressures, and for resisting pressures to limit the domestic pass-through of higher global oil prices in 2004, since the fiscal costs would have been unaffordable. However, with regard to 2005, most Directors emphasized the importance of a strong and front-loaded fiscal adjustment, so as to send a strong signal to markets about the commitment to tackling the fiscal problem.

Directors looked forward to the passage of additional revenue-raising measures as early as possible in 2005. In this context, Directors particularly welcomed the consideration being given to raising the VAT rate and repealing VAT exemptions. Directors noted that a substantial revenue yield from these measures will allow an aggressive upfront reduction in the deficit, as well as some additional spending in priority areas including infrastructure and social programs. In order to facilitate further fiscal consolidation over the medium term, Directors urged that additional steps be taken to improve tax administration, such as improved audit strategies and increased prosecution of evaders. In this context, several Directors warned against the introduction of a tax amnesty, which they believed will discourage future tax compliance.

Directors welcomed the efforts being made by the authorities to reform the civil service and improve the delivery of services, but emphasized the need for the reform to be underpinned by an affordable severance package. Directors also looked forward to the development of pension reforms that will place public pensions on a sustainable footing.

Directors viewed the significant increase in generation tariffs provisionally awarded to the NPC as an important contribution to the fiscal consolidation efforts. While welcoming the recent progress, Directors urged the authorities to accelerate the pace of power sector privatization, which is essential to restore the financial viability of the sector and to facilitate the investments needed to ensure adequate power supply. Directors looked forward to the authorities achieving their objectives of selling the transmission assets as soon as possible, and privatizing the majority of generation assets by the end of 2005. With regard to energy regulation, Directors stressed the importance of building a track record of adherence to a predictable rules-based framework so as to improve the investment climate.

Directors agreed that supply shocks have been the root cause of the inflation target having been missed in 2004, but pointed to a number of signs that price pressures have spread. Directors were also concerned that the persistence of above-target inflation for a prolonged period might lead to an upward revision to inflationary expectations. A number of Directors supported the approach of the BSP to continue to closely monitor inflationary pressures—in particular, weigh the evidence for inflation having become more generalized—and to take prompt action as needed. Many other Directors, however, took the view that the balance has already tipped, and that an increase in policy rates is required to guide inflationary expectations down. More generally, Directors welcomed the BSP's clear communication to the public that monetary policy will be guided by the inflation objective, as well as its commitment to continuing to manage the exchange rate flexibly.

Directors were encouraged that banks have begun to use the special purpose vehicle framework to dispose of nonperforming assets. They also welcomed the submission to Congress of amendments to the BSP Charter that are critical to strengthening bank supervision, and the efforts that have been taken to tighten regulation of the banks' trust operations. Directors viewed these steps as crucial to facilitating consolidation and recapitalization of the banking system, thereby fortifying the banking system and enabling it to fully contribute to economic growth. However, Directors noted that attempts to empower bank supervisors have repeatedly failed in the past, and that significant efforts will be needed to ensure that the current amendments are accepted. Directors commended the authorities for strengthening the anti-money laundering regime and welcomed the removal of the Philippines from the Financial Action Task Force's list of Non-Cooperative Countries and Territories. The authorities were also encouraged to take steps to further deepen financial markets, including the domestic capital market.

Directors welcomed the recognition in the Medium-Term Philippine Development Plan of weaknesses in the investment climate, and urged the authorities to push ahead with the needed reforms. In this regard, they attached importance to measures with respect to bankruptcy resolution, contract enforcement, and business entry regulation.

Directors welcomed the authorities' attempts to further strengthen statistics and looked forward to continued implementation of the recommendations of recent Fund technical assistance on balance of payments and public debt statistics.

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, 2000–05

	2000	2001	2002	2003	2004	2005	
					IMF Staff		
					Est.	Proj.	
Growth and prices (in percent change)							
GDP growth	4.4	1.8	4.3	4.7	6.1	4.7	
CPI inflation (1994 base; annual average)	4.3	6.1	3.0	3.0	5.5	6.8	
Public finances (in percent of GDP)							
National government balance (authorities definition)	-4.0	-4.0	-5.3	-4.6	-3.8	-3.5	
National government balance 1/	-4.5	-4.6	-5.6	-5.0	-4.2	-3.9	
Nonfinancial public sector balance 2/	-4.7	-4.9	-5.7	-5.6	-5.3	-4.4	
Revenue and grants 3/	...	23.0	20.9	20.9	20.7	21.7	
Expenditure 4/	...	28.0	26.6	26.5	25.9	26.1	
Money and credit (in percent change)							
Broad money (M3) 5/	4.6	6.8	9.5	3.3	9.2	...	
Credit to the private sector (net)	8.1	-3.0	1.2	1.8	4.7	...	
Interest rate (91-day Treasury bill, end period, in percent)	12.9	8.9	5.2	6.5	7.8	7.4	6/
Balance of payments (in percent of GDP)							
Trade balance	5.0	-1.0	0.5	-1.6	-1.2	-1.5	
Current account balance	8.2	1.9	5.7	4.2	4.5	3.5	
Gross international reserves							
In billions of U.S. dollars	15.0	15.6	16.2	16.9	16.0	...	
Adjusted, in billions of U.S. dollars 7/	13.4	13.2	14.3	14.7	15.1	...	
Adjusted, in percent of short-term liabilities 8/	128.1	114.3	119.5	122.4	118.7	...	

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

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 balance.
5/ For 2000, adjusted for the estimated effects of Y2K.
6/ Auction result on January 17.
7/ 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.

8/ 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.