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

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

- the staff report for the Post-Program Monitoring discussions, prepared by a staff team of the IMF, following discussions that ended on June 22, 2005 with the officials of the Philippines on economic developments and policies. Based on information available at the time of these discussions, the staff report was completed on August 29, 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 supplement of September 15, 2005 updating information on recent developments.

- a Public Information Notice (PIN) summarizing the views of the Executive Board as expressed during its September 19, 2005 discussion of the staff report that concluded the Post-Program Monitoring consultation.

- a statement by the Executive Director for the Philippines.

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

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INTERNATIONAL MONETARY FUND

PHILIPPINES

Report for the June 2005
Post-Program Monitoring Discussions

Prepared by the Asia and Pacific Department
(In consultation with other departments)

Approved by Masahiko Takeda and Michael Hadjimichael

August 29, 2005

- Post-Program Monitoring discussions were held in Manila during June 9–22. The staff team comprised Messrs. Takeda (Head), Gordon, Singh, Haksar (Resident Representative), Baqir, Ishi (all APD), Seshadri (PDR), and Ms. Zakharova (FAD). Ms. Amador (OED) also joined the discussions.

- The mission met with senior government officials including Finance Secretary Purisima, Bangko Sentral ng Pilipinas (BSP) Governor Tetangco, Budget and Management Secretary Boncodin, Socio-Economic Planning Secretary Neri, and Energy Secretary Lotilla, as well as with academics, financial market participants, and business representatives.

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

- The Philippines' outstanding borrowing from the Fund is currently 37 percent of quota, well below the 100 percent level at which Post-Program Monitoring (PPM) would normally end. The authorities see benefits from continuing with PPM until the fiscal position improves.

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

- The 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.

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GLOSSARY OF ABBREVIATIONS AND TERMS

AML....................Anti-Money Laundering
BOL.....................Board of Liquidators
BPO.....................Business Process Outsourcing
BSP ....Bangko Sentral ng Pilipinas
CIT ....Corporate Income Tax
CTF ....Common Trust Fund
ERC.....................Energy Regulatory Commission
EVAT..................Expanded Value-Added Tax
FATF...................Financial Action Task Force
FSSA...................Financial System Stability Assessment
Gencos.................NPC's generation assets
GSIS....................Government Service Insurance System
GOCCs................Government-Owned and Controlled Corporations
IFRS....................International Financial Reporting Standards
IPP.......................Independent Power Producer
IRRs ....Implementing rules and regulations
NDF.....................Nondeliverable Forwards
NFA.....................National Food Authority
NFPS...................Nonfinancial Public Sector
NG.......................National Government
NPA.....................Nonperforming Assets
NPC.....................National Power Corporation
NPL.....................Nonperforming Loans
NSO.....................National Statistics Office
PDIC ....Philippine Deposit Insurance Corporation
PNB ....Philippine National Bank
PPM.....................Post-Program Monitoring
SEC ....Securities and Exchange Commission
SNIT ....Simplified Net Income Taxation
SPV ....Special Purpose Vehicle
SSS......................Social Security System
Transco................National Transmission Corporation
TSCs ....Transition supply contracts
UITFs..................Unit Investment Trust Funds
y/y ....Year-on-year

EXECUTIVE SUMMARY

President Arroyo's election to a six-year term in May 2004 opened the way for long-standing fiscal and structural problems to be addressed. Important progress was made during the first year of the new administration, culminating in Congress passing a landmark expanded VAT (EVAT) reform in May 2005 that has the potential to sharply reduce the fiscal deficit. However, economic reforms have subsequently been interrupted by political events, including allegations of wrongdoing against the President that have led to impeachment complaints being filed before Congress, and the resignation of key Cabinet members including the Finance Secretary and the Budget and Management Secretary. Meanwhile, the Supreme Court issued a temporary restraining order in July that stopped the implementation of the new EVAT law.

Financial markets were initially roiled by political developments and the authorities took steps to restore calm, including the quick appointment of a new economic team that began to consider alternative fiscal measures. With the political scene less volatile in recent weeks, financial markets have stabilized. Nonetheless, markets are waiting to see whether the political uncertainties will drag on and constrain the ability of the administration to press ahead with reforms. A negative assessment by markets could have potentially severe consequences given the high levels of public debt and large external borrowing requirements.

In this light, the staff report recommends the following:

- The authorities should make every effort to implement the VAT reform as soon as events permit. This would allow the public sector deficit to be reduced below 3 percent of GDP. If the Supreme Court rules that part of the EVAT law is unconstitutional, legislative steps to remedy this should be explored, and if they prove infeasible, alternative fiscal reform measures should be swiftly introduced.

- Recent power tariff increases have much improved the financial health of the state-owned power utility, but power sector privatization has lagged and needs to be accelerated.

- Monetary policy should be tightened; inflation is set to remain above target, and although this is primarily supply-shock driven, there is a risk that inflation expectations may rise.

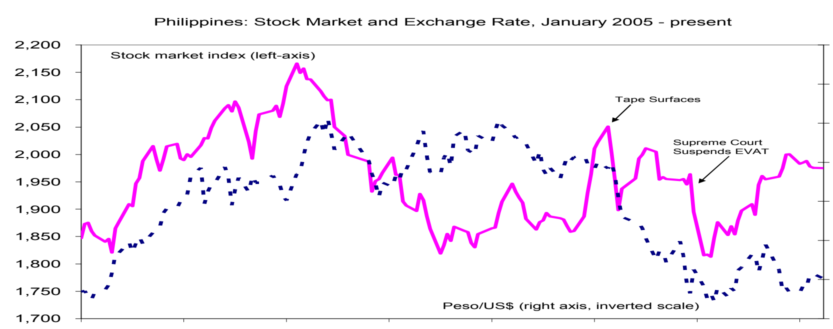
- Recent progress with banking sector reform notwithstanding, priority needs to be given to the passage of amendments to the central bank charter necessary to strengthen legal protection for bank supervisors.

I. Introduction and Background

1. **During the first year of the new administration's term, economic reforms advanced at a significant pace.** Following President Arroyo's election victory in May 2004, important progress was made with long-awaited fiscal and structural reforms. In the power sector, average generation tariffs were raised by more than one half, substantially cutting the losses of the state-owned National Power Corporation (NPC). In the financial sector, the Special Purpose Vehicle (SPV) framework set up to facilitate the sale of nonperforming assets began to gain traction. In the fiscal area, several tax measures were taken, culminating in May 2005 with Congress passing the expanded VAT (EVAT) legislation. This bill provided for a substantial broadening of the VAT base from July, and for an increase in the VAT rate from 10 to 12 percent from next January. In conjunction with the NPC tariff increases, the EVAT set the stage for a substantial reduction in the fiscal deficit from 2006.

2. **Subsequent events, however, have served to interrupt the reforms.** Allegations of wrongdoing against the President and her family surfaced in June, leading to Congressional inquiries into illegal gambling and possible misconduct in the 2004 election. On July 1, in a setback for the reform program, the Supreme Court issued a temporary restraining order halting the implementation of the EVAT law in response to petitions filed by opposition politicians and certain business interests.[1] On July 8, eight cabinet members, including the Finance Secretary and the Budget and Management Secretary, as well as the heads of the tax collection agencies, resigned, and called for the President to step down. At end-July, impeachment cases against the President were filed by the opposition in the House of Representatives.

3. **The authorities have taken steps to calm markets.** In the wake of the political turbulence, suspension of the EVAT law, and the mass resignation of Cabinet members, the stock market dropped, sovereign bond spreads rose, and the peso rapidly surrendered the gains achieved against the U.S. dollar earlier in the year. The government quickly reaffirmed its commitment to reform, and a new economic team was appointed. The team has made a case to



[1] The Supreme Court is expected to shortly issue a ruling on the EVAT law. A Supplement to this Staff Report explaining the implications of such a ruling for the fiscal program, as well as providing an update on other recent developments, will be issued in the week before the Board meeting.

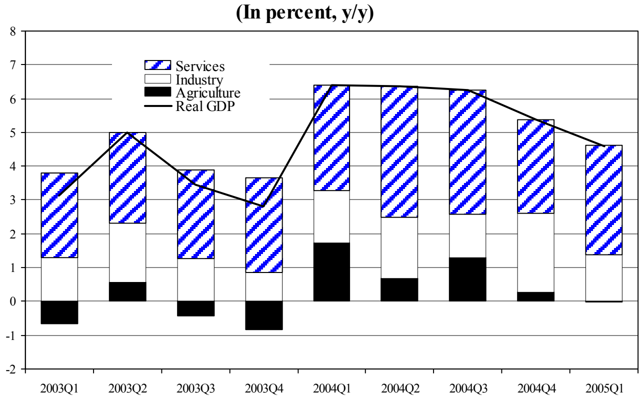
the Supreme Court for a full implementation of the EVAT, and also proposed alternative fiscal measures that could substitute for the EVAT if it were declared unconstitutional and legislative steps to remedy this proved infeasible. The Bangko Sentral ng Pilipinas (BSP) temporarily intervened in the foreign exchange market to support the peso, and subsequently raised reserve requirements on banks to absorb liquidity. With the political scene somewhat calmer in recent weeks, the peso has stabilized, and spreads and interest rates have returned to their May levels.

4. **Nonetheless, rapid resumption and deepening of reforms is key to maintaining market confidence.** Although financial markets have regained some lost ground, recent events have created considerable uncertainty about the prospects for reforms. In July, the ratings agencies revised down the Philippines' sovereign ratings outlook to reflect the heightened political uncertainty, and expressed doubts about the ability of the administration to preserve recent fiscal improvements. This concern is likely to have deepened as a result of a large tax shortfall reported for July. The Philippines will continue to remain vulnerable to shifts in market sentiment until the uncertainties about the fiscal policy direction are resolved. Reforms also need to be accelerated in other priority areas such as strengthening bank supervision and power sector privatization.

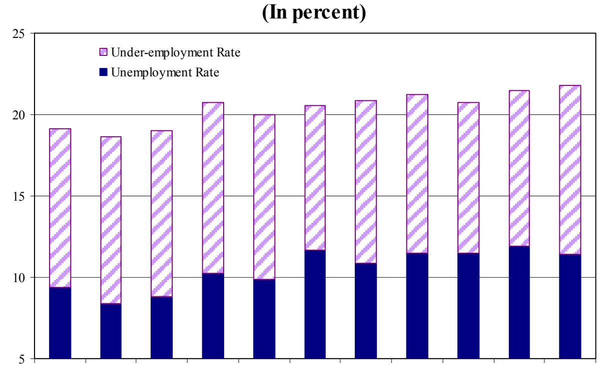
II. Recent Economic Developments

5. **Growth has slowed this year.** GDP grew by 4½ percent y/y in the first quarter of 2005, down from 5½ percent in the fourth quarter of 2004, reflecting the negative effects of El Niño on agriculture and a lackluster showing by manufacturing. Services growth, however, remained high, boosted by buoyancy in tourism and Business Process Outsourcing (BPO). On the demand side, exports softened, and while surging remittances continued to support incomes, higher oil prices exacted a toll on consumption. The unemployment rate, which has been on a rising trend, edged down in the first half of 2005 (on a seasonally adjusted basis), but this reflects declining participation rather than a pickup in job creation.

Contributions to GDP Growth
(In percent, y/y)



Unemployment and Underemployment Rates 1/
(In percent)



1/ Old definition. Data for 2005 1H are seasonally adjusted. Underemployment rate is defined as the number of persons working for less than 40 hours and wanting additional hours of work divided by total labor force.

6. **Inflation remains high, though it has moderated slightly in recent months primarily due to base effects.** Headline inflation fell to 7.1 percent in July (y/y) down from 7.6 percent in June, and 8.5 percent in each of the three previous months. With inflation running at well above the target range of 5–6 percent for 2005, the BSP raised policy rates by 25 basis points in April to avert a rise in inflation expectations. In addition, reserve requirements were lifted by 2 percentage points in July to prevent excess liquidity feeding into peso depreciation and creating inflationary pressure.

7. **Foreign reserves have risen in 2005.** The balance of payments recorded a surplus of $2 billion in the first half of the year; this primarily reflected a rise of more than one-fifth in overseas worker remittances (y/y), and a jump in net portfolio inflows to $1.9 billion, compared with $0.1 billion in the same period in 2004. Events since June have led to a marked slowing in portfolio inflows. Exports grew by only 3 percent through June (y/y) as a result of soft market conditions for Asian electronics, compounded by the lagged effects of relatively low investment in production capacity in recent years. Despite higher oil prices, imports remained virtually flat. Reserves (net of pledged assets) were $17.2 billion at end-July, well above the end-2004 level of $15.2 billion.

8. **Fiscal performance has been broadly favorable.** Aided by improved tax collections and the continued compression of capital spending, the National Government budget through June was on course to achieving the 2005 deficit target of 3½ percent of GDP (authorities' definition, see Table 2). In conjunction with reduced losses by NPC, this would allow the nonfinancial public sector (NFPS) deficit to be reduced to 4 percent of GDP in 2005, compared to 5¼ percent of GDP in 2004. The increase in tax revenues this year has coincided with a high profile campaign to pursue tax evaders that began in April and quickly showed up in monthly collections. However, although the new finance officials have stated their commitment to continuing the fight against tax evasion, preliminary data indicates that the improvement in collections may have been interrupted in July. Nonetheless, the overall better fiscal performance in 2005, aided by strong portfolio inflows, have kept financial markets liquid; the 91-day treasury bill rate has declined by about 210 basis points in 2005 to date.

III. Outlook and Risks

9. **Current uncertainties risk causing the economy to underperform.** In addition to the current surge in oil prices, the primary risk to the outlook is that the prevailing state of uncertainty proves to be protracted and makes it difficult to regain the economic reform momentum enjoyed earlier this year. If reforms were to stall, staff project that investment would likely remain subdued, and GDP growth is unlikely to exceed 4¾-5 percent in 2005 and 2006 (see scenario considered in Table 5). In such a world, the exchange rate is likely to remain weak, and inflation is expected to exceed the BSP's target range of 5–6 percent in 2005 and 4–5 percent in 2006. Meanwhile, the NFPS deficit would remain about 4 percent of GDP. With the public sector's high level of debt (98 percent of GDP at end-2004) and large external commercial financing requirements ($3-4 billion each year), the country will remain highly vulnerable to shifts in investor sentiment as well as global interest rate developments. This year, the National Government is yet to raise $850 million out of $3.1 billion planned.

10. **Such a "reforms stall" scenario has negative economic implications over the medium term as well.** Growth is expected to be moderate at best, with unemployment remaining high. Debt sustainability analysis (see Annex 1) indicates that the public sector debt-to-GDP ratio will decline only very gradually under this scenario, with the projected ratio in 2010 at 88 percent. The declining trend can easily be reversed if a small (but permanent) shock hits underlying macro variables (Figure A1).

11. **The outlook would be much brighter were strong reforms to resume.** Implementing all the components of the EVAT package, or alternative measures with similar yield, would permit the NFPS deficit to be reduced to about 2¾ percent of GDP in 2006. This would be about half way towards the authorities' goal of balancing the budget by 2010 (see "reforms proceed" scenario considered in Table 6). Such a significant step toward fiscal consolidation, combined with progress with reforms on other fronts, would create a climate conducive to higher investment and growth.[2] This process would likely be reinforced by declining interest rates, which could potentially take significant additional pressure off the budget (Box 1). If the reform momentum continues in years ahead, the debt dynamics would be more favorable, with the public sector debt-to-GDP ratio projected to fall below 70 percent by 2010.

IV. Report on the Discussions

A. Fiscal Policy

12. **With the EVAT law just passed, the fiscal discussions mainly covered medium-term issues, although recent events have brought the short-term policy priorities back into play.** The discussions, which were held prior to the suspension of the EVAT, focused on (i) the economic implications of the VAT reform; (ii) the medium-term fiscal strategy; (iii) the fiscal risks associated with public enterprises; and (iv) civil service and pension reforms. In the period since the mission, the new economic team has identified a list of revenue measures that could possibly substitute for the EVAT.

The Philippines: Annualized Revenue Yield from the VAT Bill 1/

Measure	Yield (Billions of pesos)	Yield (% of GDP, full year basis)
Widening the base	30.4	0.5
Raising the rate from 10 to 12 percent	30.0	0.5
Raising the CIT rate	15.4	0.3
Reducing excises on petroleum products	-13.6	-0.2
Changing refund procedures	15.8	0.3
Net impact	78.0	1.4

1/ Fund staff estimates.

13. **The EVAT package has the potential to substantially reduce the fiscal deficit in 2006**. Over the past few years, the fiscal deficit has been largely contained through expenditure control, and the EVAT bill, in conjunction with the NPC tariff rate hikes,

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2 The exchange rate and foreign reserves position would also be stronger under this scenario, although, on account of the VAT rate increase, inflation in 2006 would be slightly higher.

represents the first significant attempt to raise public sector revenue.[3] The EVAT law broadened the VAT base to include electricity, petroleum products, and selected professional services with effect from July 1, 2005, and grants the President authority to increase the rate from 10 to 12 percent after January 1, 2006. It also increases the corporate tax rate from 32 to 35 percent until 2009; introduces certain limits on investment and input VAT credits; and reduces excises on petroleum products. Even after allowing for some new spending, the EVAT package—estimated by staff to yield annual revenue of 1½ percent of GDP—should permit the NFPS deficit to be reduced to 2¾ percent of GDP in 2006. This would be close to the upfront fiscal consolidation that staff has been recommending.

14. **While welcoming the VAT reform, the mission cautioned that some of the provisions might complicate tax administration and discourage investment.** In particular, the staggering of the VAT investment credits over five years would likely increase the cost of capital. Furthermore, the limit on the VAT input credit risked increasing the effective taxation of businesses with a low value added margin and would lead to tax cascading. The authorities agreed with this assessment of the input cap and were considering how best to ameliorate its negative effects. In the event, limiting the VAT input credit was one of the provisions of the EVAT law that was challenged before the Supreme Court.[4]

15. **With the EVAT law suspended, the authorities have been working on a contingency plan to replace the lost revenue.** The authorities have indicated that should the Supreme Court declare aspects of the EVAT law to be unconstitutional, their first priority would be to amend the legislation to remedy the defects. Failing that, a number of alternative tax policy measures are being considered including (with the authorities' estimated annual revenue gains in parentheses): (i) increasing import tariffs across the board by 1 percent (0.2 percent of GDP);[5] (ii) rationalizing fiscal incentives (0.1 percent of GDP); and (iii) introducing Simplified Net Income Taxation (SNIT) of the self-employed (0.3 percent of GDP). However, staff consider the revenue impact of the latter two measures to be uncertain, which underscores the importance of persevering with the EVAT.

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[3] The other two tax bills passed by Congress have a smaller revenue impact. The increase in alcohol, cigarette and tobacco excises passed after a long delay in December 2004 is expected to yield 0.2 percent of GDP annually, and has generated little in 2005 to date due to advance stockpiling of inventories. The lateral attrition bill passed in January 2005 to incentivise revenue collectors is only likely to affect revenue gradually over time.

[4] Other provisions of the law that came under challenge include granting the President authority to increase the VAT rate and allowing the pass through of the VAT on petroleum products and electricity to consumers.

[5] The authorities are currently in the process of verifying that the proposed increase in import tariffs would be compatible with the Philippine commitments under the WTO and ASEAN agreements. The Philippine bound tariff average under the WTO agreement is 25.6 percent, while the actual average tariff is 7.4 percent.

16. **Even assuming that the fiscal program can be brought back on track by 2006, additional measures will be needed over the medium term.** The authorities noted that the fiscal position would benefit over time from further improvements in tax compliance and expected lower interest expenditure. However, staff suggested that additional measures were also likely to be necessary, especially if the corporate income tax rate was to be reduced from 2009 (as under the EVAT law), and the share of EVAT revenue allocated to new spending was to be increased over time.[6] However, the authorities responded that achieving the budget targets would take precedence over any new spending. Staff argued that there was significant additional revenue potential from the rationalization of fiscal incentives, if this applied to cooperatives. The authorities agreed, but noted that the taxation of cooperatives might be politically difficult. Other potential sources of additional revenue identified by staff included increasing alcohol, tobacco, and fuel excises and indexing them to inflation.[7]

17. **Fiscal consolidation efforts are being extended to the public enterprises**. While significant progress has been made in reducing NPC's losses (see paragraph 20 below), an annual deficit of ½ percent of GDP has recently emerged at the National Food Authority (NFA). This is mainly due to the NFA's provision of rice subsidies. Staff encouraged the authorities to improve targeting of this subsidy and recommended bringing the expenditure on to the budget to improve transparency and control. The authorities responded that they were closely monitoring the finances of the NFA and would limit its deficit in line with the overall fiscal targets. The authorities also noted, and staff welcomed, that they were planning to develop medium-term deficit targets for Government-Owned and Controlled Corporations (GOCCs).

18. **Civil service reform has gained momentum.** Implementing rules and regulations (IRRs) were issued in May and the authorities' initial estimate is that 27,000 positions may be eliminated with total severance payments of about P 8 billion (0.15 percent of GDP), although those affected will also have the option of redeployment within the civil service. In response to earlier concerns that the severance payments were too generous, especially for civil servants close to retirement, the IRRs exclude years of service beyond age 59 from the calculation of the payments. The authorities are currently working on detailed estimates of the likely costs of civil service reform, with the help from the World Bank.

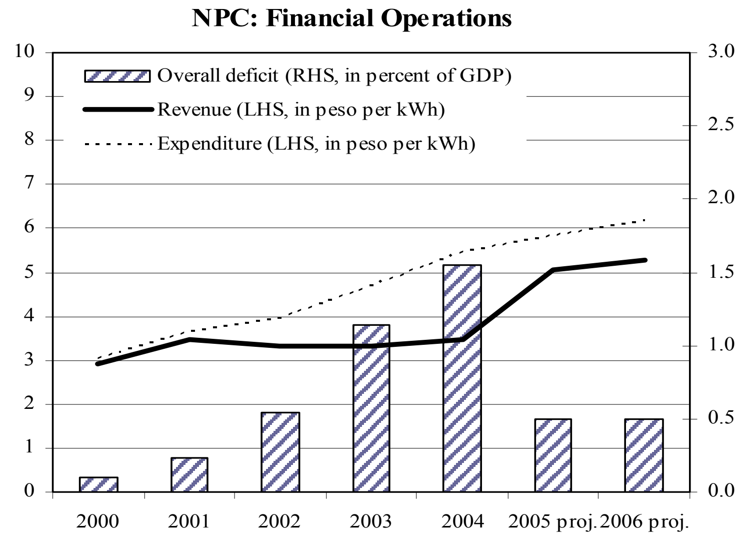
19. **Pension reform is also key to strengthening the long-term fiscal position.** The authorities are conducting an actuarial review of the Social Security System (SSS). The review is expected to show the continuing depletion of reserves and a need for pension benefits and contributions to be adjusted to ensure long-term solvency of the system. In the

[6] At the time of the mission, the authorities were planning to use 30 percent of the revenue gain from the EVAT law in 2006 to finance priority spending, such as infrastructure investment. The share of the VAT revenue allocated to such spending would be increased gradually in subsequent years.

[7] The revenue projections under the "reforms proceed" scenario (Table 6) assume additional revenues from such measures during 2006-2010.

meantime, the SSS and the Government Service Insurance System (GSIS) are focusing on improving their collections and strengthening and diversifying their investment portfolios.

B. Power Sector Policy



20. **The financial situation of NPC is much improved.** In April 2005, the Energy Regulatory Commission (ERC) finalized approval of the P 0.98 per kWh increase in average generation tariffs that had been provisionally granted in September 2004. The ERC also allowed NPC to increase generation tariffs by another P 0.46 per kWh, primarily to recover past losses from larger-than-expected fuel and IPP power purchase costs. Taken together, these awards imply more than a 50 percent increase in NPC's average generation tariffs, and about a 20 percent increase in retail tariffs in the Manila area. Meanwhile, NPC's interest costs have been reduced through the government's absorption of P 200 billion of NPC debt at the beginning of 2005. In total, these measures are expected to reduce NPC's deficit from 1½ percent of GDP in 2004 to ½ percent of GDP in 2005 and 2006. To keep NPC losses to the new lower levels going forward, staff and the authorities agreed that generation tariffs should be adjusted in a timely manner to reflect changes in fuel and other costs.

21. **However, privatization has proceeded slowly.** In early 2005, the bidding strategy for the concession of the transmission company (Transco) was changed again to open competitive bidding.[8] Staff raised concern about whether frequent changes in the bidding strategy might discourage potential investors and damage the credibility of the privatization process. The authorities considered the latest strategy to be more transparent, although they noted that the concession bidding schedule had now been postponed until late this year. With regard to generation assets (Gencos), the authorities are likely to fall well short of their target of privatizing 70 percent of assets by end-2005; thus far, less than 15 percent has been sold. The authorities attributed the slow progress to delays in finalizing power sale contracts (Transitional Supply Contracts) between NPC and distribution utilities.

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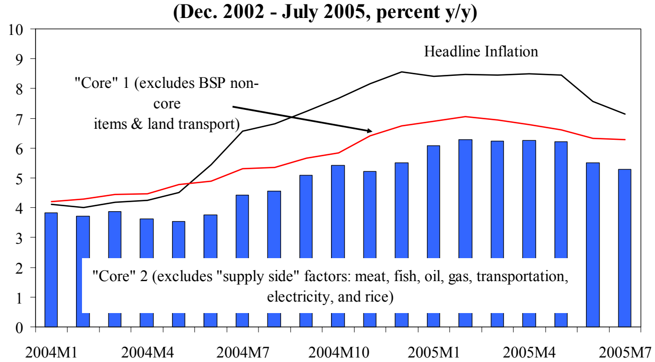
[8] The strategy had already been switched from bilateral negotiations to "limited source" competitive bidding in October 2004. The latter bidding strategy envisaged that only those investors having had bilateral negotiations with the authorities would be invited to bid.

22. **Other challenges lie ahead in the power sector.** The ERC has approved time-of-use pricing for NPC, which once fully implemented, was expected to improve the efficiency of production. In addition, cross subsidies for residential consumers in Manila areas were scheduled to be eliminated by October 2005. The authorities also expressed their firm commitment to launching a wholesale electricity spot market in early 2006 and retail competition in mid-2006, although they recognized that a number of issues remained to be resolved to achieve the smooth introduction of a competitive market mechanism.

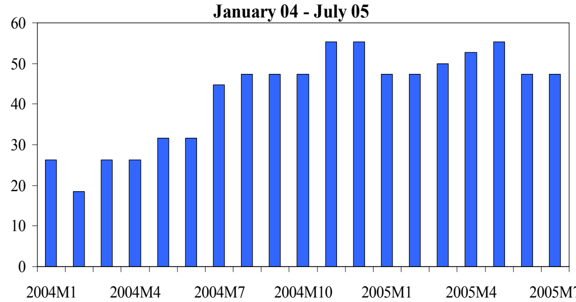
C. Monetary Policy

23. **Inflation remains above target.** Continued high inflation partly reflects additional supply shocks, including from rice prices that have been affected by El Niño and other factors. Nonetheless, staff pointed to signs, such as rising prices of clothes, rentals and services, that inflation had spread to other sectors. Indeed, excluding the effects of supply shocks on the CPI, staff judged inflation to be still considerably above target. However, in view of recent wage awards which were fairly moderate, the BSP was less convinced that inflation had become more generalized. In the BSP's view, the increase in inflation continued to be well-explained by the first-round effects of the supply-shocks, which the inflation target should accommodate.

Philippines: Headline and Underlying Inflation (Dec. 2002 - July 2005, percent y/y)



Philippines: Percent of CPI Components with Inflation Rates Greater than Target Ceiling 1/ January 04 - July 05



1/ Data for 2004 use 1994-based CPI and target ceiling of 5 percent. Data for 2005 use 2000-based CPI and revised target ceiling of 6 percent.

24. **Staff expressed concern about persistent inflationary pressures, and favored an early tightening of monetary policy.** Although further base effects were set to drop out in the second half of 2005, staff projected that the inflation rate would remain high because of current increases in transportation fares, as well as rising oil prices. Continued above-target inflation risked lifting long term inflation expectations. Moreover, while wage awards had not been excessive to date, rising fuel and transportation prices were likely to lead to higher wage demands in the period ahead, and all the more so if the VAT rate were to be increased. Narrowing interest rate differentials might also weaken the exchange rate and create additional inflationary pressure. The staff therefore argued that a tightening of monetary policy was appropriate, and that higher policy interest rates would help keep inflationary expectations in check.

25. **At the time of the mission, the authorities could see no clear reason to tighten monetary policy.** The BSP considered that it had been effective in communicating to the public that one-off supply shocks were the primary cause of higher inflation. This logic implied that inflation would eventually come down. The authorities also noted that aggregate demand remained weak and narrowing interest rate differentials had not led to portfolio shifts in favor of dollar assets. Nonetheless, the BSP recognized that continued high inflation might feed into an increase in inflation expectations and the rate increase in April was explicitly framed as an attempt to act on expectations. In the BSP's view, there was no compelling evidence that the strategy had not worked and that further monetary tightening had become necessary.

26. **Subsequent events led the BSP to raise reserve requirements in July.** In response to the exchange rate pressures set off by the political turmoil in late June, and the potential impact on inflation, the authorities increased the regular and liquidity reserve requirements on banks from 9 to 10 percent, and from 10 to 11 percent, respectively, on July 7. The authorities view changes in reserve requirements as particularly effective in mopping up liquidity that would otherwise spill over into the foreign exchange market.

D. Financial Sector Policy

27. **The staff welcomed recent developments in the banking sector.** NPL ratios have declined as a result of transactions agreed under the SPV Act, and were expected to decline further in the second quarter reflecting a rush of last minute sales agreed before the expiry of the SPV framework in April. The authorities noted that sales of about P 50 billion had been completed and another P 54 billion were waiting for certificates of eligibility. Together, this would cut almost a fifth of the stock of nonperforming assets in the banking system. The staff observed, however, that banks would only be amortizing the implied losses on these transactions over time; the banks' ability to do this without damaging their capital will depend critically on their future profits. The staff welcomed the progress made in rehabilitating intervened banks, including completion of the initial bidding for Philippine National Bank (PNB). Moreover, recent announcements of planned purchases of stakes in small banks by bigger banks will contribute to needed consolidation in the banking system.

28. **The large outstanding volume of distressed assets implies a need to extend the SPV framework.** Even if all the transactions in the pipeline were to materialize, about P 400 billion of nonperforming assets would remain in the banking system. To deal with the remaining stock of NPAs, the authorities were giving high priority to a draft bill that would extend the SPV framework for another two years. This bill had already been approved at the committee level in the House of Representatives. The authorities considered the prospective implementation of International Financial Reporting Standards (IFRS)—see below—in conjunction with the BSP's decision to phase in higher risk-weighting on NPLs, to have encouraged deals under the SPV framework. They were therefore confident that recent momentum in the sale of NPA sales could be maintained should the SPV framework be extended.

29. **The effective implementation of IFRS would lead to more realistic banking indicators.** The authorities reaffirmed their intention to adopt IFRS and banks have up to end-December 2005 to comply with the new standards. 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. The authorities explained that the more rigorous valuation requirements implied by IFRS rules governing loan loss reserves, deferred tax assets, and valuation of foreclosed real estate properties, would enhance transparency and promote greater discipline, consistent with the main thrust of Basle II. Nonetheless, the new standards could have a significant impact on banks' reported earnings and capital and some institutions would need time to comply. In such instances, an understanding would need to be reached with the BSP on a recapitalization plan.

30. **The proposed amendments to the BSP Charter remain 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. In this regard, staff welcomed the priority being given to the passage of long-delayed amendments to the BSP Charter. The version of the amendments agreed in the Senate Banking Committee holds supervisors to a standard of diligence no higher than that required of all public servants, which is a significant improvement on the "extraordinary diligence" standard set under the current legislation. The amendments would also enhance the ability of the BSP to deal with problem banks by clarifying the conditions of receivership and asset disposal.[9]

31. **The trust funds require close regulatory attention.** The new BSP guidelines require that the liquid assets of the Common Trust Funds (CTFs) be transferred to newly established Unit Investment Trust Funds (UITFs) and placed in highly liquid and tradable instruments. These rules, if effectively implemented, will give rise to losses in cases where the trusts are valued at unrealistically high levels. The authorities noted that a preliminary review of some of the major players had shown that holdings in CTFs were well-provisioned. Nevertheless, the extent of provisioning for the banking sector as a whole is unclear at this point. In any case, the authorities agreed with staff that any losses should be borne by investors rather than banks where possible.

32. **The pre-need industry also requires scrutiny.** The pre-need industry, which is supervised by the Securities and Exchange Commission (SEC), consists of nonbank financial institutions that fund household expenditures such as education. Several pre-need companies have recently encountered financial difficulties. Although small in size, the industry is a source of risk for a number of banks that have close linkages with pre-need companies. The authorities agreed that developments in the pre-need sector should be closely monitored. In her State of the Nation Address at end-July, the President gave high priority to the passage of a Pre-need Code that would provide a specific legal framework for the industry.

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[9] The authorities are also working on legislation to set up a credit information system and personal equity retirement accounts, amongst other bills to strengthen the financial sector.

E. Other Issues

33. **The staff welcomed the progress achieved in AML/CFT.** The Philippines was removed from the list of Non-Cooperative Countries and Territories in February 2005. The Financial Action Task Force (FATF) observes that the Philippines has since continued to implement anti-money laundering measures to remedy previously identified deficiencies.

34. **Improvements have been made to the statistical data.** Progress was made with consolidating the nonfinancial public sector debt data. The BSP made major revisions to BOP data in April 2005 to correct long-standing data recording deficiencies, and in line with the IMF Statistics TA mission. The revisions leave the overall BOP position essentially unchanged, but revise up measured imports to integrate an electronic system of recording and improved measurement methodology. These changes were followed by a set of broadly similar revisions to the NSO's trade data in August, although a lack of coordination between these two sets of revisions does not permit reconciliation at this stage. The authorities have indicated that further changes to the BOP data may be forthcoming.

V. Staff Appraisal

35. **President Arroyo's election to a six-year term in May 2004 opened the way for a revival of the economy.** Significant progress with much-needed economic reforms was made in the first year of the new administration. Prominent milestones achieved included the approval of power tariff hikes that will substantially stem NPC's losses and the passage of the EVAT law. The fiscal consolidation effort was also aided by resolute control over expenditures, while a crack-down on tax evaders showed initial success in raising collections. GDP grew strongly, boosted by buoyant remittances and service sector activity, while foreign investors began to show a new-found interest in the Philippines.

36. **Recent political developments, however, threaten the progress that has been made.** Political uncertainties have emerged over the past few months that place the economic achievements at risk. The authorities have been quick to reassure markets about their commitment to reform, and some stability has returned to markets. However, the longer the current political issues remain unresolved, the more the markets will fear that economic reforms will be sidelined. The costs of downward revision by markets of the Philippines' economic prospects could be substantial. Front-loaded implementation of reforms in key policy areas (fiscal, power, and banking sectors) is therefore critical.

37. **The outlook is also subject to considerable uncertainties in the global economy.** GDP growth of about 4¾ percent is expected in 2005-06, but soaring oil prices weigh on the outlook, particularly if they serve to soften demand for Philippine exports. Adverse developments in international capital markets are another potential risk; a correction in long-term global interest rates could have severe consequences.

38. **The EVAT reform represents the best option to reduce the fiscal deficit.** Some parts of the EVAT law, such as the limits on input and investment credits, may complicate tax administration and discourage investment. Nonetheless, providing the VAT rate is

increased to 12 percent, the package implies a substantial and durable revenue yield, which should allow the NFPS deficit to be reduced to about 2¾ percent of GDP in 2006. This would represent front-loaded fiscal adjustment and do much to convince markets that the Philippine's grave fiscal problems will be solved. By contrast, should EVAT implementation be further delayed, alternative revenue-raising measures would be necessary to prevent markets from reacting negatively.

39. **Over the medium-term, additional measures will be needed to balance the budget.** Even implementing the EVAT law as originally planned will leave the authorities short of their balanced-budget goal. Lower government borrowing will reduce interest payments over the medium term, and the yield from better tax compliance is potentially considerable, particularly if the courageous campaign launched against tax evaders earlier this year can be sustained. Nonetheless, these factors are unlikely to be sufficient to close the remaining gap. The authorities should therefore be planning measures additional to the EVAT for 2007 and beyond, such as a sweeping rationalization of tax incentives.

40. **The public enterprises should be closely monitored.** NPC's losses have been substantially reduced by the recent tariff increases. To maintain this improvement going forward, NPC will need to file petitions for future tariff adjustments in a timely manner. Steps should also be taken to limit the losses that have emerged at the NFA. One priority will be to improve the targeting of the rice subsidy that the NFA provides. More generally, the authorities' plans for developing medium-term deficit targets for GOCCs are essential to support fiscal consolidation.

41. **Civil service and pension reform are critical for sustainable fiscal consolidation.** The authorities are appropriately conducting an actuarial review of the SSS which is likely to show a need for parametric changes to pension benefits and contributions. Ensuring the solvency of the pension system will also be assisted by current efforts by SSS and GSIS to improve collections and strengthen their balance sheets. Civil service reform has gained momentum with the issuance of IRRs in May. The costs for the budget now look more manageable given that limits have been set on severance packages for civil servants close to retirement.

42. **Challenges lie ahead in advancing power sector reform.** The timetable announced for privatization has slipped. While the new open bidding strategy adopted for the Transco concession is more transparent, further delays in the bidding process risk discouraging buyers. To accelerate Gencos privatization, early finalization of Transition Supply Contracts (TSCs) between NPC and major distribution utilities is key. The TSCs should be carefully designed so as to ensure sufficient revenue predictability for potential investors. Considerable preparation needs to be made before the launch of a spot market and retail competition next year for the market-based mechanism to achieve intended efficiency gains.

43. **Continued above-target inflation risks increasing inflation expectations.** While base effects from last year's supply shocks are beginning to drop out of the headline rate, inflation will remain high in the near term as a result of increases in transportation fares and the current surge in oil prices. If the VAT reform is implemented as planned, there will be an

additional impact on prices of as much as 1¾ percent. Staff forecasts inflation to be 8.2 percent in 2005 and 7.5 percent in 2006, well above the inflation targets of 5–6 and 4–5 percent, respectively. As is well-recognized by the BSP, continued above-target inflation, even when caused by temporary factors, risks causing inflation expectations to be revised permanently upward.

44. **Staff believe monetary policy should be tightened.** Although a series of supply shocks underlie the rise in inflation, there is some evidence to suggest that price pressures have become more generalized, while increases in fuel and transportation prices may cause future wage demands to pick up. Interest rate differentials are also narrowing at a time when the Philippine political risk premium may have risen. This risks weakening the exchange rate and creating additional inflationary pressure. Staff therefore believes that the case for tightening monetary policy has gained strength, and higher policy rates are needed to forestall an increase in inflationary expectations and help preserve the credibility of the BSP's inflation targets.

45. **There have been encouraging developments in the banking sector.** The planned implementation of IFRS by end-2005 and the phasing-in of higher risk weights on NPLs, appear to have encouraged banks to sell NPAs under the SPV framework. However, the resulting decline in NPA ratios exaggerates the improvement in bank balance sheets since the losses on the assets sales will be amortized over time. Other positive developments are the progress made with privatizing PNB and prospective acquisitions of banks that pave the way for necessary banking consolidation.

46. **Further banking sector reform will require legislative changes.** The major priority continues to be the passage of amendments to the BSP Charter necessary to strengthen legal protection for bank supervisors. Staff welcomes the proposal to hold supervisors to a standard of diligence no higher than that required of all public servants. While Congress has repeatedly blocked attempts to strengthen the BSP’s powers in the past, the amendments are a precondition for a durable strengthening of the banking system. Staff also support the bill proposing a two-year extension to the SPV framework.

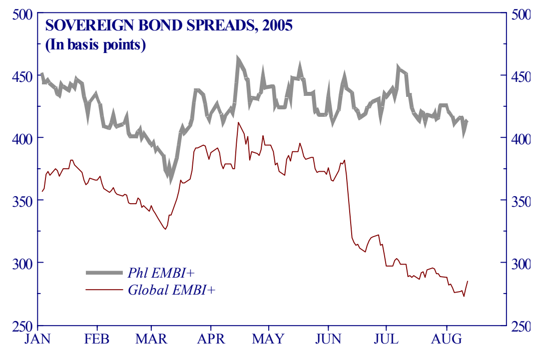
47. **Continued vigilance is required in other areas of the financial system.** The new BSP guidelines that require trust funds to place their resources in highly liquid and tradable instruments will cause losses in cases where current assets are valued at above-market levels. The BSP rightly intends to ensure that any such losses are borne by investors rather than banks when possible. The authorities also need to address current weakness in the pre-need sector, which, although relatively small in terms of the size of balance sheets, has important inter-linkages with certain banks. Staff welcome the recent FATF judgment that the Philippines is continuing to implement anti-money laundering measures to remedy previously-identified deficiencies.

48. **Improvements have been made to the statistical data.** The authorities have made commendable progress in consolidating the non-financial public sector debt data. Current attempts to revise Balance of Payments data are also welcome, although there is a need to better coordinate the changes being made by different agencies.

Box 1: The Philippines' Risk Premium and its Budgetary Implications

The Philippines has been one of the strongest performers in the EMBI Global index this year. Philippines bonds have returned 8.2 percent in 2005 to date (compared with 5.2 percent for the overall index). This outperformance, notwithstanding the volatility of recent events, may reflect underlying optimism regarding the prospects for fiscal reform, and raises the question of how much the country might gain if reforms could be sustained, and the Philippines risk premium were permanently lowered. Some crude estimates of the implications for interest rates and the government budget are derived below. These do not address the broader impact on the economy of lower interest rates, which would also be positive.

The performance of Philippines bonds in 2005 has been quite uneven. Market reports suggest that in the first few months of the year, investors were optimistic about the passage of the EVAT legislation, and the Philippines significantly outperformed the EMBI Global index. From mid-March, however, Philippine spreads widened in line with the deterioration in external credit market conditions. In this environment, the actual passage of the EVAT law in May had little impact on spreads. More recently, a broad emerging market rally has taken hold, which the Philippines has missed out on due to the political turmoil that surfaced in June, followed by the suspension of the EVAT law in July. From end-May to date, the Philippines has therefore significantly underperformed the market.



The table below compares the performance of the Philippines relative to three benchmarks; (1) the EMBI Global index; (2) an index of equally weighted countries with BB and split BB-single B ratings, which compares countries of similar risk profiles; and (3) another index of peer countries weighted so as to roughly capture their relative liquidity and market capitalization within the EMBI Global. The last index attempts to simulate comparisons made by investors in a more realistic setting, where they choose relative value based on both fundamentals and liquidity.

	Changes in spreads (bps)			
	Philippines	**EMBIG**	**Peers ("Equal weight")**	**Peers ("Mkt weighted")**
Jan to Mid-March	**-50**	**-2**	**24**	**27**
Mid-March to End-May	**28**	**17**	**5**	**8**
June to Date	**-25**	**-100**	**-48**	**-44**

These measures show that Philippines spreads could be 90-130 bps lower than at the beginning of the year, if the country had kept pace with the market or its peers since mid-March (the 50 bps tightening to mid-March, plus the net tightening since mid-March in the benchmark index of choice).[1]

These potential gains can be translated into budgetary terms. The annual gain from a 100 bps permanent reduction in average interest rates for the National Government budget would be 0.5 percent of GDP per annum over the medium term. The savings in the first year are small, but would grow over time as a result of dynamic factors, such as the gradual transmission of lower interest rates on new borrowing to average interest rates on government debt, and the reduction in required borrowing in the outer years as a result of interest savings in the earlier years

The Philippines: Impact of Interest Rates on the NG Budget 1/

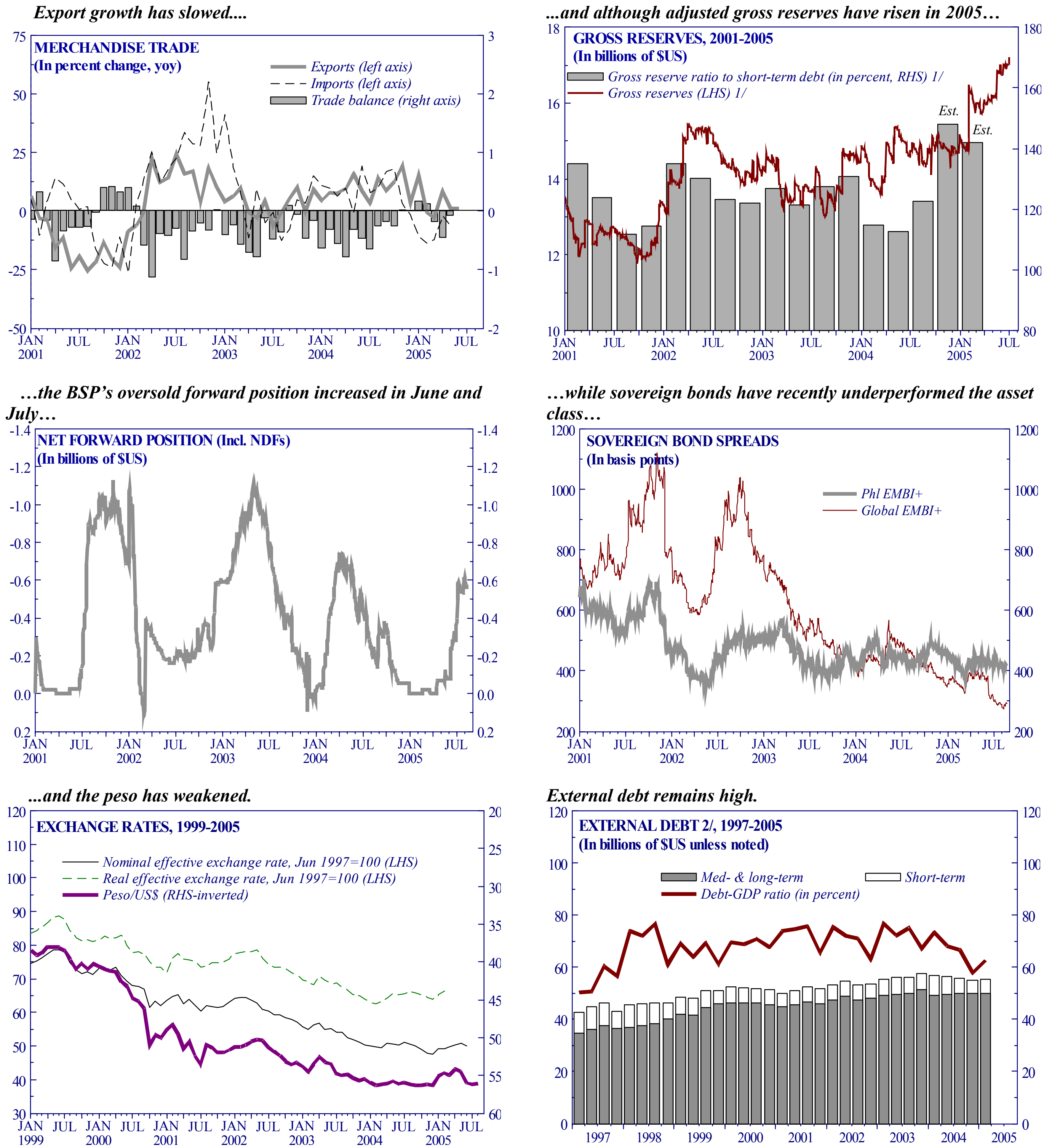
	First year, PHLP bln.	First year, percent of GDP	After five years, PHLP bln.	After five years, percent of GDP
New external borrowing	-0.7	-0.01	-7.7	-0.09
90-day T-bill	-4.2	-0.07	-9.4	-0.11
New bond borrowing	-3.3	-0.05	-23.5	-0.27
Total	-8.3	-0.14	-40.6	-0.46

Source: Fund staff estimates.

1/ Assumes a 100 b.p. permanent decline in average interest rates.

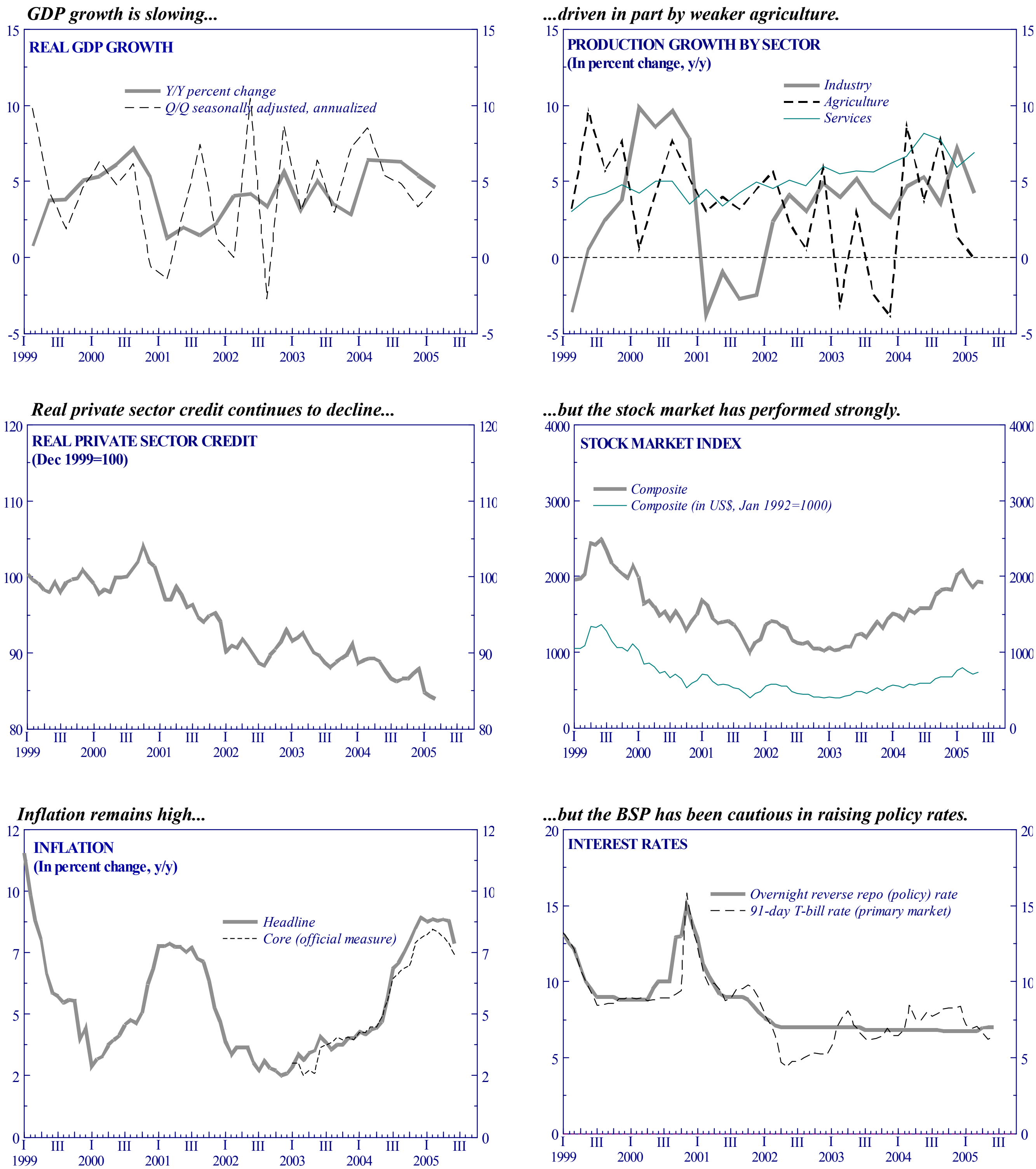
[1] The spread tightening in the EMBIG since June may be overstated due to the re-weighting of Argentina, but this does not hold for the two "peer" indices, neither of which includes Argentina.

Figure 1. Philippines: External Developments, 2001–2005



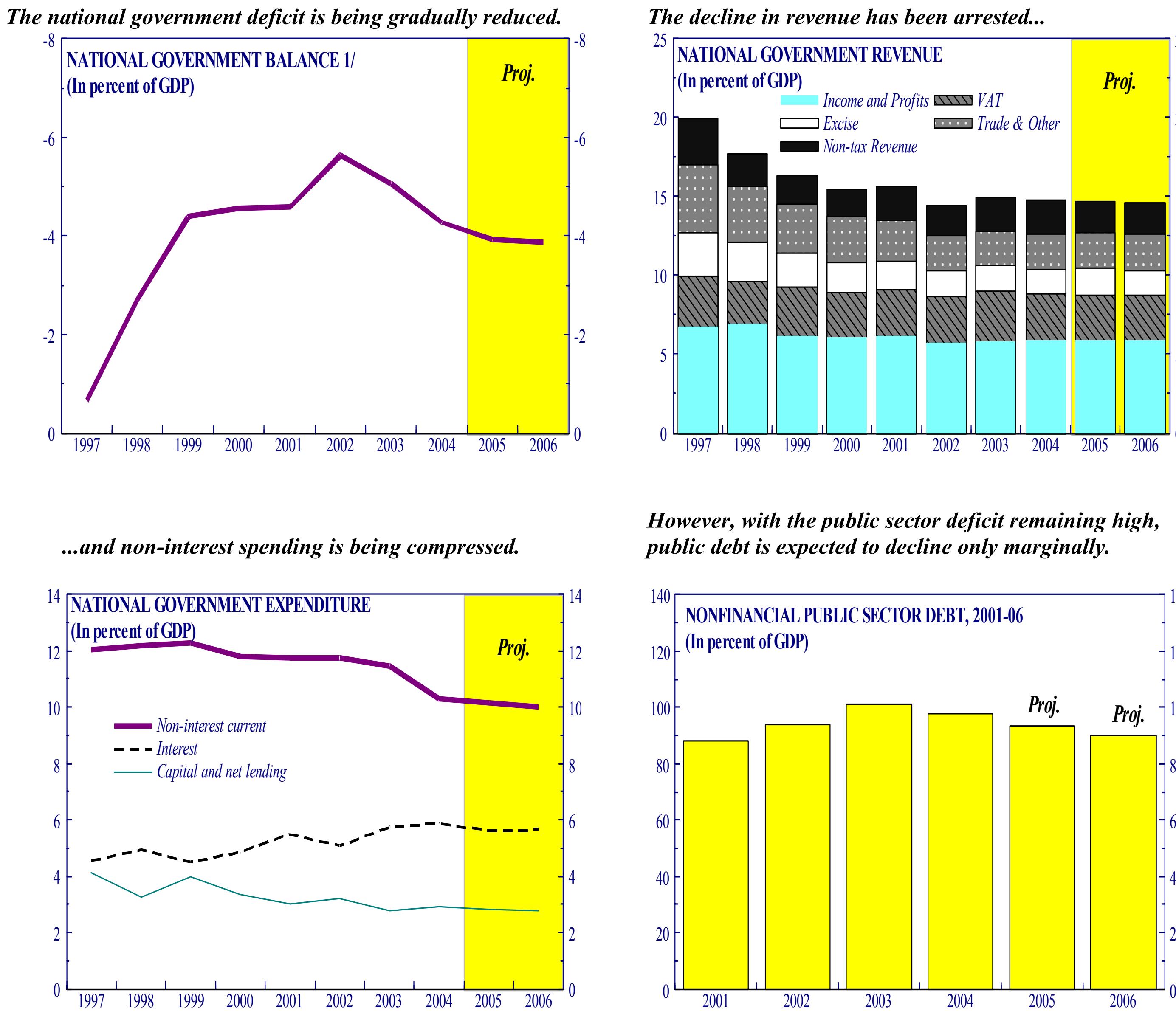
Sources: Data provided by the Philippine authorities; CEIC; and Fund staff estimates.
1/ Adjusted for pledged assets.
2/ Includes private sector inter-company accounts, loans without BSP approval, and obligations under capital lease.

Figure 2. Philippines: Domestic Developments, 1999–2005



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

Figure 3. Philippines: Fiscal Sector, 1997–2006

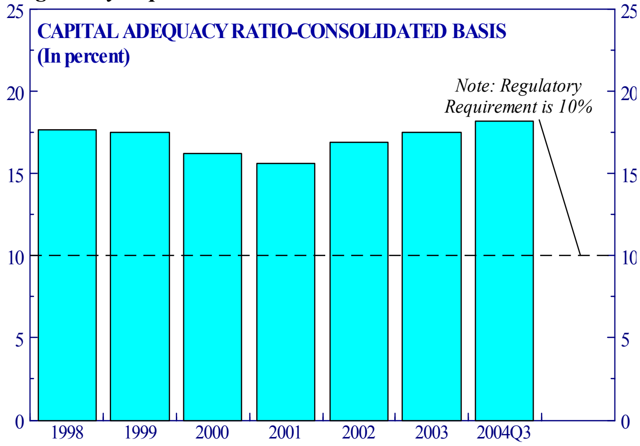


Source: Data provided by the Philippine authorities; and Fund staff estimates and projections.

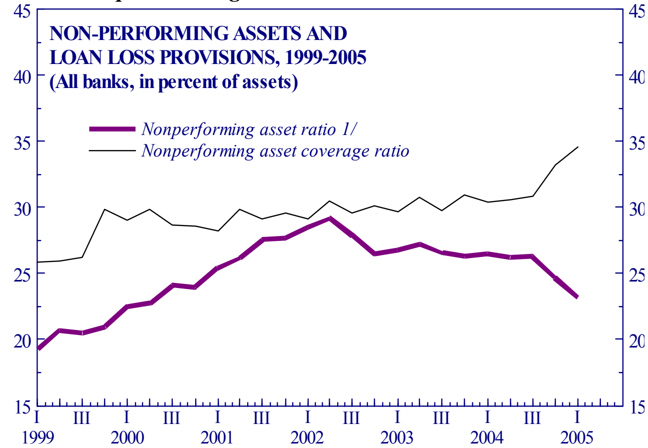
1/ Fund staff definition. Excludes privatization receipts of the national government and includes operations of the Central Bank-Board of Liquidators.

Figure 4. Philippines: Banking Sector, 1998–2005

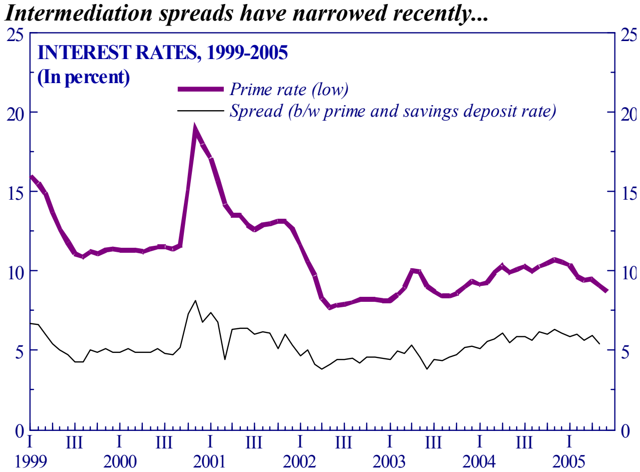
While reported capital adequacy continues to exceed the regulatory requirement...



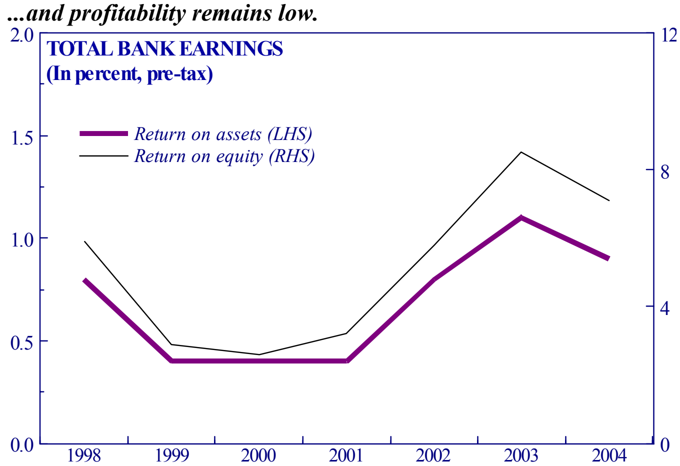
...low nonperforming asset coverage ratios suggest additional provisioning needs.



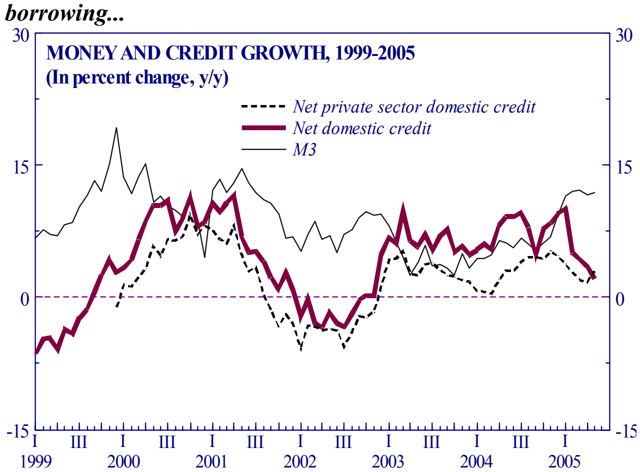
Intermediation spreads have narrowed recently...



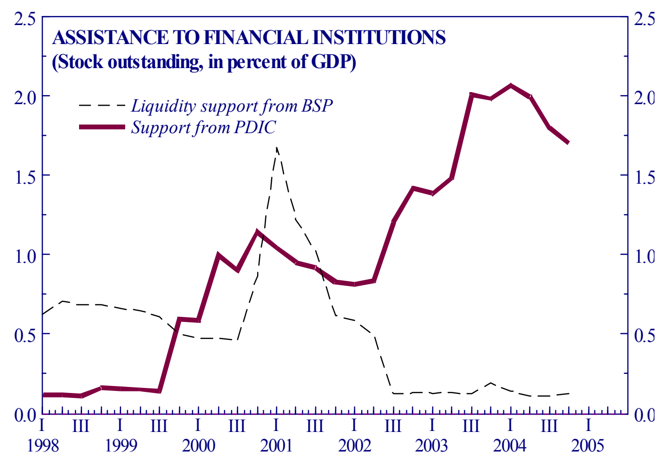
...and profitability remains low.



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



...although financial assistance from PDIC has declined.



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

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

Nominal GDP (2004): P4,739 million ($84.6 billion)
Population (2003, est.): 81.1million
GNP per capita (2003, est.): $1,051
IMF quota: SDR 879.9 million

	2002	2003	2004	2005	2006
				Staff Proj.	
GDP and prices (percentage change)					
Real GDP	4.3	3.6	6.1	4.7	4.8
CPI (2000 base; annual average)	3.0	3.5	6.0	8.2	7.5
CPI (2000 base; end year)	2.5	3.9	8.6	8.1	6.0
Investment and saving (percent of GDP)					
Gross investment	17.6	17.0	17.4	17.5	17.5
National saving	23.3	18.8	20.1	19.5	19.4
Public finances (percent of GDP)					
National government balance (authorities definition)	-5.3	-4.7	-3.9	-3.6	-3.6
National government balance 1/	-5.6	-5.1	-4.3	-3.9	-3.9
Nonfinancial public sector balance 2/	-5.7	-5.7	-5.2	-4.0	-4.0
Revenue and grants 3/	20.9	21.4	20.9	21.8	21.8
Expenditure 4/	26.6	27.1	26.1	25.8	25.8
Nonfinancial public sector debt 5/	93.8	103.3	97.8	93.2	90.0
Monetary sector (percentage change, end of period)					
Broad money (M3)	9.5	3.3	9.2	12.0 6/	...
Interest rate (91-day Treasury bill, end of period, in percent)	5.9	6.5	8.4	6.3 7/	...
Credit to the private sector	1.2	1.8	4.7	3.0 6/	...
External Sector					
Export value (percent change)	10.0	2.8	9.6	4.0	8.9
Import value (percent change)	6.2	20.1	10.6	5.2	9.2
Current account (percent of GDP)	5.7	1.8	2.7	2.0	1.9
Capital and Financial account (US$ billions, excluding errors and omissions)	1.2	-2.2	-2.1	-1.9	-1.2
Foreign direct investment (net)	1.7	0.2	0.1	0.2	0.4
Other	-0.5	-2.4	-2.2	-2.0	-1.6
Errors and omissions and trade credit (US$ billions)	-4.9	-0.8	0.4	-0.2	-0.2
Overall balance (US$ billions)	0.7	-1.7	0.6	-0.1	0.6
Monitored external debt (percent of GDP) 8/	77.8	80.8	72.9	66.7	63.3
Debt-service ratio (percent of exports)	19.9	20.6	19.7	18.4	19.2
Reserves, adjusted (US$ billions) 9/	14.3	14.7	15.2	15.0	15.6
Reserves / Short-term liabilities, adjusted 10/	123.9	122.9	121.2	109.8	110.5
Exchange rate (period averages)					
Pesos per U.S. dollar	51.6	54.2	56.3	56.1 11/	...
Nominal effective exchange rate (Jan 2, 2003 =100)	107.4	95.1	83.8	87.7 11/	...
Real effective exchange rate (Jan 2, 2003 =100)	92.5	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/ As of May, 2005.
7/ Secondary market at end-July.
8/ 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.
9/ Gross reserves less gold and securities pledged as collateral against short-term liabilities.
10/ Reserves as a percent of short-term debt (including medium- and long-term debt due in the following year). Both reserves and debt were adjusted for pledged assets.
11/ As of end-July.

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

	2001	2002	2003	2004	2005		2006
				Prel. Est.	Proposed Budget	Staff Proj. 1/	Staff Proj.
Revenue and grants	15.7	14.4	14.9	14.8	14.9	14.6	14.6
Tax revenue	13.5	12.5	12.8	12.6	13.2	12.7	12.6
Bureau of Internal Revenue	10.7	10.0	10.1	9.9	10.5	10.0	10.0
Bureau of Customs	2.6	2.4	2.5	2.6	2.6	2.5	2.5
Other offices	0.1	0.1	0.1	0.2	0.2	0.2	0.2
Nontax revenue	2.2	1.9	2.2	2.2	1.7	1.9	2.0
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	...	...	...	0.2	0.2	0.2	0.0
Expenditure and net lending	20.3	20.0	20.0	19.1	18.8	18.6	18.5
Current expenditures	17.3	16.8	17.2	16.2	16.3	15.8	15.7
Personnel services	6.6	6.7	6.6	6.0	5.6	5.9	5.9
Maintenance and operations	2.4	2.1	1.9	1.8	1.9	1.8	1.8
Allotments to local government units	2.5	2.8	2.7	2.4	2.4	2.3	2.2
Subsidies	0.2	0.1	0.3	0.1	0.1	0.1	0.1
Interest	5.5	5.1	5.7	5.9	6.3	5.6	5.7
National government	4.8	4.7	5.4	5.5	5.9	5.2	5.3
Central Bank-Board of Liquidators	0.7	0.4	0.4	0.4	0.4	0.4	0.3
Capital and equity expenditure	2.9	3.1	2.7	2.8	2.4	2.7	2.7
Net lending 2/	0.1	0.1	0.1	0.1	0.1	0.1	0.1
Balance	-4.6	-5.6	-5.1	-4.3	-3.9	-3.9	-3.9
On the authorities' presentation 3/	-4.0	-5.3	-4.7	-3.9	-3.6	-3.6	-3.6
Financing	4.6	5.6	5.1	4.3	3.9	3.9	3.9
Net external financing	0.6	2.8	3.4	1.7	-0.1	0.4	0.0
Net domestic financing	4.0	2.9	1.6	2.6	4.0	3.5	3.9
Memorandum Items:							
Nonfinancial public sector balance 4/	-4.9	-5.7	-5.7	-5.2	…	-4.0	-4.0
Consolidated public sector balance 4/	-4.8	-5.6	-5.4	-5.0	…	-3.9	-3.9
Primary national government balance	0.9	-0.6	0.7	1.6	2.4	1.7	1.8
National government debt 5/	62.8	66.6	73.2	71.7	…	69.3	68.2
(percent of NG revenues)	400.6	462.6	490.0	483.9	…	472.9	466.7
Nonfinancial public sector debt 6/	87.4	93.8	103.3	97.8	…	93.2	90.0
(percent of NFPS revenues)	379.8	448.1	483.0	469.2	…	427.7	413.4
National government gross financing requirements 7/	21.4	23.2	24.2	25.0	…	23.2	24.6
Of which: Domestic	19.5	18.2	18.5	20.8	…	20.0	21.5
Foreign	1.9	5.1	5.7	4.2	…	3.2	3.1
GDP (in billions of pesos)	3,631	3,960	4,211	4,739	5,122	5,344	6,017

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 3. Philippines: Balance of Payments, 2001–06
(In billions of U.S. dollars)

	2001	2002	2003 1/	2004 1/	2005	2006
					Staff proj.	
CURRENT ACCOUNT BALANCE	**1.3**	**4.4**	**1.4**	**2.3**	**2.0**	**2.0**
Trade Balance	-0.7	0.4	-5.5	-6.4	-7.2	-7.9
Exports, f.o.b.	31.2	34.4	35.3	38.7	40.3	43.9
Imports, f.o.b.	32.0	34.0	40.8	45.1	47.5	51.8
o/w: oil and related products	3.4	3.3	3.8	4.7	6.2	6.7
Services (net)	-2.1	-1.0	-1.7	-1.3	-1.0	-0.6
Receipts	3.1	3.1	3.3	4.1	4.6	5.4
Payments	5.2	4.1	5.0	5.4	5.6	6.0
Income	3.7	4.5	-0.2	0.4	-0.3	-0.5
Receipts, *of which:*	7.2	7.9	3.3	3.8	4.1	4.4
Remittances of resident workers abroad 2/	6.0	7.2	2.6	2.9	3.1	3.3
Payments	3.5	3.5	3.6	3.4	4.4	4.9
Interest payments	2.9	2.5	1.4	2.9	3.3	3.2
Transfers (net)	0.4	0.5	8.8	9.6	10.4	10.9
Receipts, *of which:*	0.5	0.6	9.0	9.9	10.8	11.3
Non-resident workers remittances 2/	…	…	8.2	9.0	10.0	10.7
Payments	0.1	0.1	0.2	0.3	0.3	0.3
CAPITAL AND FINANCIAL ACCOUNT	**1.7**	**1.2**	**-2.2**	**-2.1**	**-1.9**	**-1.2**
Capital Account	0.0	0.0	0.0	0.0	0.0	0.0
Financial Account	1.7	1.2	-2.3	-2.1	-1.9	-1.2
Direct Investment	1.1	1.7	0.2	0.1	0.2	0.4
Portfolio Investment	1.1	1.1	-1.3	-1.4	1.0	1.2
Equity	0.4	0.4	0.4	0.3	0.4	0.5
Debt	0.7	0.7	-1.7	-1.7	0.5	0.6
Other Investment (excluding trade credit)	-0.5	-1.6	-1.1	-0.7	-3.0	-2.7
ERRORS AND OMISSIONS (incl. trade credit)	**-3.2**	**-4.9**	**-0.8**	**0.4**	**-0.2**	**-0.2**
OVERALL BALANCE	**-0.2**	**0.7**	**-1.7**	**0.6**	**-0.1**	**0.6**
OVERALL FINANCING	**0.2**	**-0.7**	**1.7**	**-0.6**	**0.1**	**-0.6**
Monetization of gold and revaluation	-1.1	0.9	2.8	0.5	0.2	0.2
Change in Net international reserves (increase =-)	1.3	-1.6	-1.2	-1.1	-0.1	-0.8
BSP Gross Reserves (increase =-)	0.6	-0.5	-0.7	0.4	0.2	-0.6
Fund credit (net)	0.0	-0.4	-0.6	-0.5	-0.3	-0.2
Change in other BSP liabilities	0.7	-0.7	0.1	-1.1	0.0	0.0
Memorandum items:						
Current account/GDP	1.9	5.7	1.8	2.7	2.0	1.9
Short-term debt (original maturity)	9.1	8.0	8.2	8.1	8.6	8.8
Short-term debt (residual maturity)	14.0	13.4	14.1	13.6	14.7	15.1
Gross reserves	15.6	16.2	16.9	16.2	16.0	16.6
Adjusted gross reserves 3/	13.2	14.3	14.7	15.2	15.0	15.6
(in percent of st. debt by res. maturity) 4/	114.3	123.9	122.9	121.2	109.8	110.5
Net international reserves	11.4	12.8	13.9	15.1	15.2	15.7
Monitored external debt (in billions) 5/	58.1	59.7	62.8	61.6	64.1	65.3
(in percent of GDP)	81.6	77.8	80.8	72.9	66.7	63.3
Debt service ratio 4/	19.1	19.9	20.6	19.7	18.4	19.2
Export value (percent change)	-16.2	10.0	2.8	9.6	4.0	8.9
Import value (percent change)	-4.5	6.2	20.1	10.6	5.2	9.2
Gross external financing needs 6,7/	10.8	9.6	12.0	11.8	11.6	12.7
GDP (in billions)	71.2	76.7	77.7	84.6	96.0	103.2

Sources: Philippine authorities and Fund staff projections.

1/ Based on revisions to the data, made April 2005; Do not include further pending data changes commenced August 2005.
2/ The 2003-04 revisions to the data separate remittances made by Filipino residents working abroad (income), and non-resident workers' remittances (transfers).
3/ Gross reserves less gold and securities pledged as collateral against short term liabilities.
4/ As a percent of short-term debt excluding pledged assets of the central bank.
5/ Monitored external liabilities are defined as external debt plus liabilities of foreign banks in the Philippines to their headquarters, branches and agencies.
some external debt not registered with the central bank and private capital lease agreements.
6/ In percent of goods and non-factor services.
7/ Defined as the current account deficit, plus amortization on medium- and long-term debt, plus short-term debt at the end of the previous period.

Table 4. Philippines: Monetary Survey, 2000–05

	2000	2001	2002	2003	2004				2005	
	Dec.	Dec.	Dec.	Dec.	Mar.	Jun.	Sep.	Dec.	Mar.	Jun.
					(In billions of pesos)					
Net foreign assets	343	405	551	673	682	615	693	727	839	941
Central bank	430	449	547	637	631	635	661	690	724	816
Net international reserves	567	586	693	782	774	791	801	820	842	937
Medium and long-term foreign liabilities	138	136	146	145	143	156	140	130	119	121
Deposit money banks	-87	-44	4	37	51	-20	32	37	116	126
Net domestic assets	1,737	1,760	1,799	1,801	1,826	1,905	1,834	1,985	1,921	1,852
Net domestic credit	2,088	2,106	2,207	2,314	2,341	2,382	2,360	2,533	2,442	2,407
Public sector credit	581	645	727	807	845	874	836	956	916	855
National Government	426	532	590	620	649	673	636	764	725	643
Credits	575	690	749	807	849	866	878	923	951	899
Foreign exchange receivables	13	12	7	7	7	7	7	15	14	15
Treasury IMF Accounts	-41	-50	-50	-58	-58	-65	-65	-65	-65	-66
Deposits	-121	-120	-117	-137	-150	-136	-185	-109	-175	-205
Local government and others	104	97	132	184	195	199	199	191	190	212
Claims on CB-BOL 1/	51	15	6	4	2	2	1	1	0	0
Private sector credit	1,507	1,462	1,480	1,507	1,496	1,508	1,524	1,577	1,526	1,551
Other items net	-351	-347	-407	-513	-515	-476	-526	-548	-520	-554
Total liquidity	2,079	2,165	2,351	2,474	2,509	2,521	2,527	2,711	2,761	2,794
M4	2,013	2,111	2,298	2,401	2,435	2,447	2,463	2,649	2,691	2,729
M3 (peso liquidity)	1,427	1,525	1,670	1,725	1,713	1,740	1,728	1,884	1,922	1,970
Foreign currency deposits, residents	586	586	628	676	722	707	735	766	770	759
Other liabilities	66	54	53	73	74	74	64	62	69	65
					(12-month percent change)					
Net foreign assets	4.2	18.3	36.0	22.1	28.3	2.3	12.0	7.9	23.0	53.1
Net domestic assets	8.0	1.3	2.3	0.1	1.3	8.2	4.0	10.2	5.2	-2.8
Net domestic credit	8.6	0.9	4.8	4.8	5.4	9.1	4.8	9.5	4.3	1.0
Public sector	9.9	10.9	12.8	11.0	15.5	21.6	5.3	18.5	8.4	-2.2
Idem, adjusted 2/	4.4	10.7	11.5	9.9	14.1	19.7	4.9	17.0	9.6	-2.4
Private sector	8.1	-3.0	1.2	1.8	0.4	3.0	4.5	4.6	2.0	2.8
Idem, adjusted 2/	2.4	-3.5	0.6	1.7	-0.2	2.1	3.9	4.1	2.5	2.8
M4	6.7	4.9	8.9	4.5	6.8	6.4	6.6	10.3	10.5	11.5
M3	4.6	6.8	9.5	3.3	4.8	5.6	5.3	9.2	12.2	13.2
Memorandum items:										
					(In billions of pesos; unless otherwise stated)					
Gross domestic credit from deposit money banks	1,999	2,085	2,151	2,322	2,386	2,444	2,476	2,558	2,544	2,544
Private sector	1,492	1,451	1,470	1,498	1,487	1,499	1,514	1,566	1,516	1,542
(12-month percent change)	8.1	-2.7	1.3	1.9	0.4	3.1	4.5	4.6	2.0	2.9
Public sector	507	634	681	824	899	945	962	992	1,028	1,002
(In percent of total gross credit)	25.4	30.4	31.6	35.5	37.7	38.7	38.8	38.9	40.4	39.4
					(In billions of US dollars)					
Net foreign assets	6.9	7.9	10.2	11.9	11.9	10.7	12.1	12.7	15.3	16.7
Central bank	8.6	8.7	10.1	11.3	11.0	11.1	11.5	12.1	13.2	14.5
Deposit money banks	-1.7	-0.9	0.1	0.7	0.9	-0.4	0.6	0.6	2.1	2.2
Foreign currency deposits residents	11.7	11.4	11.8	12.2	12.8	12.6	13.0	13.6	14.0	13.5
Dollar-denominated credit to residents	10.8	10.2	9.9	9.9	11.1	11.7	11.5	11.2	11.0	10.8
Public sector	4.0	4.4	4.8	6.6	6.7	7.2	7.0	6.7	6.5	6.1
Private sector	6.8	5.8	5.2	3.3	4.3	4.5	4.5	4.5	4.5	4.7
					(In percent; unless otherwise stated)					
Dollar denominated credit / dollar deposits	92.0	89.4	84.0	81.0	86.3	93.0	88.5	82.5	78.4	80.0
Dollar denominated credit to public sector / dollar deposits	34.1	38.8	40.3	53.9	52.4	56.9	53.8	49.4	46.3	45.2
Exchange rate (peso per dollar; end-period)	50.0	51.4	53.1	55.6	56.4	56.2	56.3	56.3	54.8	55.9

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

Table 5. Philippines: Medium-Term Outlook, 2002–10
("Reforms Stall" Scenario)

	2002	2003	2004	2005	2006	2007	2008	2009	2010
		Staff Est.				Staff Proj.			
					(Percentage change)				
GDP and prices									
Real GDP	4.3	3.6	6.1	4.7	4.8	4.8	4.6	4.4	4.2
GDP per capita (US$)	957	947	1,007	1,118	1,177	1,225	1,269	1,312	1,353
CPI (2000 base; year average)	3.0	3.5	6.0	8.2	7.5	4.7	4.0	4.0	4.0
				(In percent of GDP; unless otherwise indicated)					
Labor									
Employment (million)	30.1	30.5	31.6	32.6	33.7	34.9	36.0	37.1	38.2
Employment (percentage change)	3.1	1.4	3.6	3.3	3.4	3.4	3.2	3.1	3.0
Unemployment rate (old definition, percent)	11.4	11.4	11.8	12.0	12.1	12.2	12.3	12.6	13.1
Investment and saving									
Gross investment	17.6	17.0	17.4	17.5	17.5	17.4	17.0	16.5	16.0
National saving	23.3	18.8	20.1	19.5	19.4	19.4	19.0	18.2	17.7
Foreign saving	-5.7	-1.8	-2.7	-2.0	-1.9	-2.0	-2.0	-1.7	-1.7
Public finances									
Nonfinancial public sector balance 1/	-5.7	-5.7	-5.2	-4.0	-4.0	-4.0	-4.1	-4.1	-4.2
Primary balance	0.1	0.8	1.5	2.4	2.3	2.4	2.3	2.3	2.2
Revenue and grants 2/	20.9	21.4	20.9	21.8	21.8	21.8	21.7	21.6	21.5
Expenditure (primary) 3/	20.8	20.6	19.4	19.4	19.5	19.4	19.4	19.3	19.3
Interest	5.8	6.5	6.7	6.4	6.3	6.3	6.4	6.4	6.4
Nonfinancial public sector gross financing	27.3	29.5	28.9	26.4	27.3	25.9	27.0	25.6	26.5
Domestic	21.9	22.6	25.8	23.6	23.8	21.2	21.2	19.3	20.7
Foreign currency	5.4	6.9	3.1	2.8	3.6	4.6	5.8	6.3	5.8
National government balance (authorities definition)	-5.3	-4.7	-3.9	-3.6	-3.6	-3.7	-3.7	-3.5	-3.6
National government balance 4/	-5.6	-5.1	-4.3	-3.9	-3.9	-4.0	-3.9	-3.7	-3.8
Nonfinancial public sector debt 5/	93.8	103.3	97.8	93.2	90.0	88.9	88.5	88.1	87.8
External sector									
Export value (percent change)	10.0	2.8	9.6	4.0	8.9	6.2	5.1	3.9	2.9
Import value (percent change)	6.2	20.1	10.6	5.2	9.2	5.4	4.6	3.7	2.7
Trade balance	0.5	-7.0	-7.5	-7.5	-7.7	-7.3	-7.0	-6.8	-6.6
Current account	5.7	1.8	2.7	2.0	1.9	2.0	2.0	1.7	1.7
FDI (net, US$ billions)	1.7	0.2	0.1	0.2	0.4	0.3	0.2	0.2	0.2
Reserves, adjusted (US$ billions) 6/	14.3	14.7	15.2	15.0	15.6	15.9	15.9	15.9	15.9
Reserves / Short-term liabilities, adjusted 7/	123.9	122.9	121.2	109.8	110.5	110.7	103.0	98.1	94.3
Gross external financing requirements (US$ billions) 8/	9.6	12.0	11.8	11.6	12.7	12.9	13.1	14.3	15.0
Monitored external debt 9/	77.8	80.8	72.9	66.7	63.3	61.1	60.1	59.6	58.9
Debt service ratio (in percent of exports of G&S)	19.9	20.6	19.7	18.4	19.2	19.6	19.1	19.8	19.7

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 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 6. Philippines: Medium-Term Outlook, 2002–10
("Reforms Proceed" Scenario)

	2002	2003	2004	2005	2006	2007	2008	2009	2010
			Staff Est.			Staff Proj.			
					(Percentage change)				
GDP and prices									
Real GDP	4.3	3.6	6.1	4.7	5.1	5.2	5.4	5.7	6.0
GDP per capita (US$)	957	947	1,007	1,133	1,250	1,342	1,428	1,524	1,631
CPI (2000 base; year average)	3.0	3.5	6.0	8.1	7.8	4.6	3.5	3.5	3.5
					(In percent of GDP; unless otherwise indicated)				
Labor									
Employment (million)	30.1	30.5	31.6	32.6	33.8	35.0	36.4	37.8	39.4
Employment (percentage change)	3.1	1.4	3.6	3.3	3.6	3.6	3.8	4.0	4.2
Unemployment rate (old definition, percent)	11.4	11.4	11.8	12.0	11.9	11.7	11.5	11.0	10.4
Investment and saving									
Gross investment	17.6	17.0	17.4	17.5	18.2	19.2	20.5	21.5	22.4
National saving	23.3	18.8	20.1	19.5	20.4	21.2	22.2	22.8	23.4
Foreign saving	-5.7	-1.8	-2.7	-2.0	-2.2	-2.0	-1.7	-1.3	-1.0
Public finances									
Nonfinancial public sector balance 1/	-5.7	-5.7	-5.2	-4.0	-2.8	-1.8	-1.2	-0.8	-0.4
Primary balance	0.1	0.8	1.5	2.3	3.2	3.9	4.2	4.3	4.3
Revenue and grants 2/	20.9	21.4	20.9	21.9	23.3	23.9	24.3	24.5	24.5
Expenditure (primary) 3/	20.8	20.6	19.4	19.5	20.1	20.0	20.1	20.2	20.2
Interest	5.8	6.5	6.7	6.4	6.0	5.7	5.4	5.1	4.7
Nonfinancial public sector gross financing	27.3	29.5	28.9	26.3	25.6	22.6	21.9	19.1	18.2
Domestic	21.9	22.6	25.8	23.5	22.3	18.4	16.8	13.7	13.4
Foreign currency	5.4	6.9	3.1	2.8	3.4	4.2	5.1	5.4	4.8
National government balance (authorities definition)	-5.3	-4.7	-3.9	-3.6	-2.4	-1.6	-1.0	-0.5	0.0
National government balance 4/	-5.6	-5.1	-4.3	-3.9	-2.7	-1.9	-1.2	-0.7	-0.2
Nonfinancial public sector debt 5/	93.8	103.3	97.8	91.3	85.0	80.7	76.8	72.4	67.7
External sector									
Export value (percent change)	10.0	2.8	9.6	4.0	10.6	6.4	6.6	6.6	6.5
Import value (percent change)	6.2	20.1	10.6	5.2	9.4	6.1	6.1	6.0	6.0
Trade balance	0.5	-7.0	-7.5	-7.4	-6.7	-6.4	-6.1	-5.7	-5.4
Current account	5.7	1.8	2.7	2.0	2.2	2.0	1.7	1.3	1.0
FDI (net, US$ billions)	1.7	0.2	0.1	0.6	0.6	0.7	0.7	0.6	0.5
Reserves, adjusted (US$ billions) 6/	14.3	14.7	15.2	18.3	20.7	22.7	24.4	25.7	26.6
Reserves / Short-term liabilities, adjusted 7/	123.9	122.9	121.2	133.8	146.1	157.8	158.4	158.7	157.8
Gross external financing requirements (US$ billions) 8/	9.6	12.0	11.8	11.6	12.2	12.8	13.2	14.5	15.7
Monitored external debt 9/	77.8	80.8	72.9	65.9	59.6	55.8	53.5	51.4	49.0
Debt service ratio (in percent of exports of G&S)	19.9	20.6	19.7	18.5	18.9	19.3	18.6	18.8	18.2

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 th 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: Banking Sector Indicators, 1999–2005
(End of year unless otherwise indicated)

	1999	2000	2001	2002	2003	2004	2005 Q1
Capital adequacy							
Total capital accounts to total assets	14.5	13.6	13.6	13.4	13.1	12.6	12.1
Net worth-to-risk assets ratio	17.5	16.2	15.8	16.7	16.7	16.5	16.5
Capital adequacy ratio (solo basis)	...	...	14.5	15.5	16.0	17.4	17.1
Capital adequacy ratio (consolidated basis)	...	...	15.6	16.9	17.4	18.4	18.1
Asset quality							
NPL ratio 1/	14.6	16.6	19.0	16.6 8/	16.1	14.4	13.1
NPA ratio 2/	21.0	24.0	27.7	26.5 8/	26.1	24.7	23.2
Distressed asset ratio 3/	24.4	27.7	31.7	31.0 8/	30.9	28.6	27.1
NPL coverage ratio 4/	45.2	43.7	45.3	50.2 8/	51.5	58.0	61.6
NPA coverage ratio 5/	29.8	28.6	29.6	30.1 8/	30.9	33.2	34.6
Net NPL to total capital 6/	28.3	34.5	37.7	28.9 8/	27.4	21.0	17.3
Net NPA to total capital 7/	56.3	69.6	78.9	73.3 8/	72.4	65.4	59.3
Profitability							
Net interest income to average earning assets	4.5	3.9	3.8	3.8	3.7	4.2	4.2
Return on assets	0.4	0.4	0.4	0.8	1.1	0.9	1.0
Return on equity	2.9	2.6	3.2	5.8	8.5	7.1	7.7
Cost-to-income ratio 9/	72.2	81.8	80.7	71.4	68.9	69.8	68.1
Liquidity							
Liquid assets to total assets	26.4	29.0	30.0	32.3	32.3	36.6	38.1

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 loss on NPAs over capital.
8/ Change in series largely due to new NPL definition in 2002.
9/ Operating expenses (net of bad debts and provisions) to total operating income.

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

	2002	2003	2004	2005	2006	2007	2008	2009
Fund repurchases and charges								
In millions of U.S. dollars	461.8	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	1.3	1.2	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	1.4	0.8	0.4	0.2	0.0	0.0	0.0
In percent of total external debt	2.8	1.8	1.2	0.6	0.3	0.0	0.0	0.0
Memorandum item:								
US$/SDR Period average	1.295	1.401	1.480	1.528	1.530	1.532	1.532	1.532

Source: Fund staff projections.

PHILIPPINES: DEBT SUSTAINABILITY ANALYSIS

The sustainability of the Philippines' public sector debt depends largely on the strength of future reforms (Table A1)**.** Under a baseline scenario (reforms stall), nonfinancial public sector (NFPS) debt would remain high at around 88 percent of GDP in 2010. This is predicated on an assumed average real GDP growth of 4.6 percent over 2005–10 and a primary balance adjustment of about 1 percent of GDP in 2005, reflecting the recent increases in electricity rates and alcohol and tobacco excises. However, if the political situation were to deteriorate and cause reforms to be reversed, the primary balance would return to its 2004 level (reforms reverse scenario), and debt would climb (assuming that GDP growth averages 3.8 percent over 2005–10). Conversely, strong reforms (reforms proceed scenario) would put debt on a firmly downward path. This scenario assumes that a stronger primary balance adjustment of 2.4 percentage points of GDP over 2005–07 (conditioned on full implementation of the EVAT bill) would improve debt dynamics both directly and indirectly, assuming that improved confidence and higher private sector investment would raise average real GDP growth to 5.4 percent.

Future shocks could adversely affect debt dynamics. Under the baseline scenario, the Bounds Tests (Figure A1) indicate considerable sensitivity of the projected debt ratio to shocks, especially to the exchange rate and growth. In contrast, the debt dynamics would be more resilient if strong and front-loaded reforms were adopted.

Success in reducing external vulnerabilities is also likely to depend on the reform effort. Under the baseline scenario, external debt would decline gradually to about 59 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. However, gross external financing requirements would continue to increase in US$ terms or remain high relative to GDP. The external debt position would also remain highly sensitive to an exchange rate depreciation and a deterioration in the current account (Figure A2).

Table A1. Philippines: Public Sector Debt Sustainability Framework, 2000–10
(Reforms Stall Scenario; in percent of GDP, unless otherwise indicated)

	2000	2001	2002	2003	2004	Projections 2005	2006	2007	2008	2009	2010	Debt-stabilizing primary balance 10/
Baseline: Public sector debt 1/	89.0	88.3	93.8	103.3	97.8	**93.2**	**90.0**	**88.9**	**88.5**	**88.1**	**87.8**	**1.1**
o/w foreign-currency denominated	43.0	57.5	61.8	70.0	64.5	57.6	52.4	51.3	50.8	50.1	48.6	
Change in public sector debt	4.6	-0.7	5.5	9.5	-5.4	-4.6	-3.2	-1.1	-0.4	-0.4	-0.3	
Identified debt-creating flows (4+7+12)	7.0	-1.3	0.1	3.5	-5.9	-6.8	-6.2	-3.8	-2.9	-2.7	-2.4	
Primary deficit	-0.7	-1.3	-0.1	-0.8	-1.5	-2.4	-2.3	-2.4	-2.3	-2.3	-2.2	-2.3
Revenue and grants 2/	23.0	23.0	20.9	21.4	20.9	21.8	21.8	21.8	21.7	21.6	21.5	
Primary (noninterest) expenditure	22.3	21.7	20.8	20.6	19.4	19.4	19.5	19.4	19.4	19.3	19.3	
Automatic debt dynamics 3/	6.5	0.6	0.3	3.7	-4.0	-4.7	-4.2	-1.7	-0.8	-0.6	-0.5	
Contribution from interest rate/growth differential 4/	-4.0	-0.6	-1.5	0.9	-4.8	-4.7	-4.2	-1.7	-0.8	-0.6	-0.5	
Of which contribution from real interest rate	0.5	0.9	2.0	5.0	0.8	-0.6	-0.2	2.3	3.0	3.0	3.0	
Of which contribution from real GDP growth	-4.5	-1.4	-3.5	-4.1	-5.6	-4.0	-4.0	-4.0	-3.8	-3.6	-3.4	
Contribution from exchange rate depreciation 5/	10.5	1.2	1.8	2.8	0.8	...	...	...	...	...	...	
Other identified debt-creating flows	1.2	-0.6	-0.1	0.6	-0.4	0.3	0.3	0.2	0.2	0.2	0.2	
Privatization receipts (negative)	-0.1	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Recognition of implicit or contingent liabilities	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Other (specify, e.g. bank recapitalization)	1.3	-0.6	0.0	0.6	-0.4	0.3	0.3	0.2	0.2	0.2	0.2	
Residual, including asset changes (2-3) 6/	-2.4	0.6	5.4	6.0	0.5	2.1	2.9	2.8	2.5	2.3	2.2	
Public sector debt-to-revenue ratio 1/	387.2	383.6	448.1	483.0	469.2	427.7	413.4	408.6	408.6	407.5	408.7	
Gross financing need 7/	28.7	27.2	27.3	29.5	28.9	26.4	27.3	25.9	27.0	25.6	26.5	
in billions of U.S. dollars	21.8	19.4	20.9	22.9	24.4	25.3	28.2	28.4	31.2	31.3	34.1	
Scenario with key variables at their historical averages 8/						**93.2**	**91.8**	**90.1**	**88.3**	**86.3**	**84.1**	**-0.9**
"Reforms Proceed" Scenario						**91.3**	**85.0**	**80.7**	**76.8**	**72.4**	**67.7**	
Reform reversal						**96.2**	**97.5**	**98.8**	**100.7**	**102.8**	**104.9**	
Key Macroeconomic and Fiscal Assumptions Underlying Baseline												
Real GDP growth (in percent)	4.4	1.8	4.3	3.6	6.1	4.7	4.8	4.8	4.6	4.4	4.2	
Average nominal interest rate on public debt (in percent) 9/	7.4	7.6	7.2	7.3	7.3	7.4	7.6	7.7	7.8	7.8	7.8	
Average real interest rate (nominal rate minus change in GDP deflator, in percent)	1.0	1.2	2.7	5.8	1.3	-0.4	0.2	3.0	3.8	3.8	3.8	
Nominal appreciation (increase in US dollar value of local currency, in percent)	-19.4	-2.7	-3.2	-4.5	-1.2	...	...	...	...	...	...	
Inflation rate (GDP deflator, in percent)	6.3	6.4	4.5	1.6	6.0	7.7	7.4	4.7	4.0	4.0	4.0	
Growth of real primary spending (deflated by GDP deflator, in percent)	2.4	-0.9	0.0	3.7	-0.3	4.9	5.4	4.2	4.6	4.0	4.2	
Primary deficit	-0.7	-1.3	-0.1	-0.8	-1.5	-2.4	-2.3	-2.4	-2.3	-2.3	-2.2	

1/ Nonfinancial public sector includes the national government, CB-BOL, 14 monitored government-owned enterprises, social security institutions, and local governments. Debt is gross and consolidated (net of intra-nonfinancial public sector holdings of debt). Data on local government debt are not available for 2001; it is assumed that these debts were the same as a share of GDP as in 2002.

2/ Revenue is the sum of all nonfinancial public sector revenue net of intra-public sector payments. It is assumed that 80 percent of Bureau of Treasury revenue represents interest and dividends from other parts of the nonfinancial public sector.

3/ Derived as [(r - p(1+g) - g + ae(1+r)]/(1+g+p+gp)) times previous period debt ratio, with r = interest rate; p = growth rate of GDP deflator; g = real GDP growth rate; a = share of foreign-currency denominated debt; and e = nominal exchange rate depreciation (measured by increase in local currency value of U.S. dollar).

4/ The real interest rate contribution is derived from the denominator in footnote 2/ as r - π (1+g) and the real growth contribution as -g.

5/ The exchange rate contribution is derived from the numerator in footnote 2/ as ae(1+r).

6/ For projections, this line includes exchange rate changes.

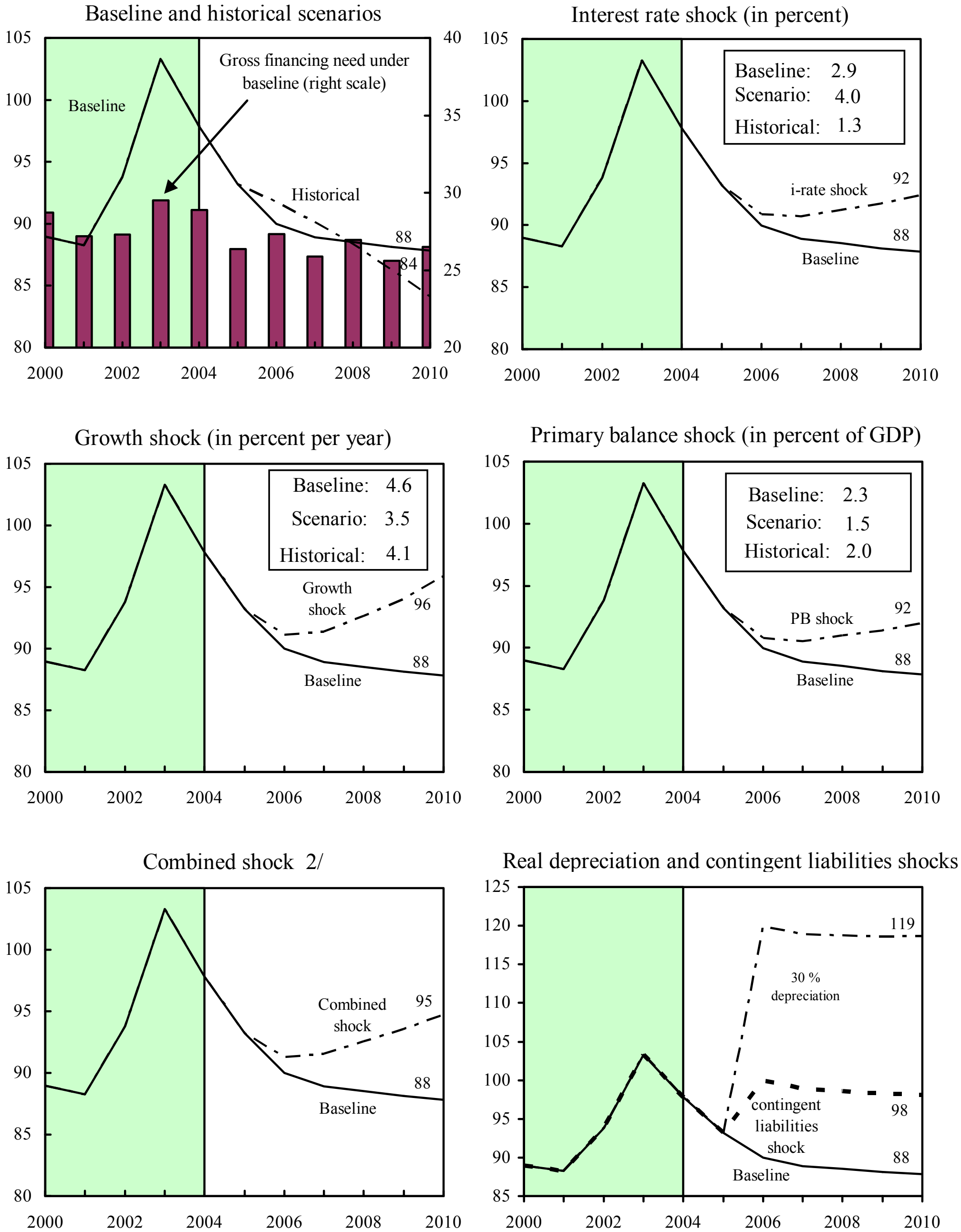
7/ Defined as public sector deficit, plus amortization of medium and long-term public sector debt, plus short-term debt at end of previous period.

8/ The key variables include real GDP growth; real interest rate; and primary balance in percent of GDP.

9/ Derived as nominal interest expenditure divided by previous period debt stock.

10/ Assumes that key variables (real GDP growth, real interest rate, and other identified debt-creating flows) remain at the level of the last projection year.

Figure A1. Philippines: Public Debt Sustainability: Bound Tests 1/
(In percent of GDP)



Source: Fund staff estimates.
1/ Shaded areas represent actual data.Individual shocks are permanent one-half standard deviation shocks. Figures in the boxes represent average projections for the respective variables in the baseline and scenario being presented. Ten-year historical average for the variable is also shown.
2/ Permanent 1/4 standard deviation shocks applied to real interest rate, growth rate, and primary balance.
3/ One-time real depreciation of 30 percent and 10 percent of GDP shock to contingent liabilities occur in 2006, with real depreciation defined as nominal depreciation (measured by percentage fall in dollar value of local currency) minus domestic inflation (based on GDP deflator).

Table A2. Philippines: External Debt Sustainability Framework, 2000–10
(Reforms Stall Scenario; in percent of GDP, unless otherwise indicated)

	Actual					Projections						
	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	**Debt-stabilizing non-interest current account 6/**
Baseline: External debt	76.8	82.9	79.0	82.1	72.9	**66.7**	**63.3**	**61.1**	**60.1**	**59.6**	**58.9**	**0.4**
Change in external debt	0.7	6.1	-3.9	3.1	-9.2	-6.1	-3.4	-2.2	-1.0	-0.6	-0.7	
Identified external debt-creating flows (4+8+9)	-8.5	1.2	-14.7	-3.8	-11.0	-5.7	-5.8	-5.4	-5.0	-4.5	-4.3	
Current account deficit, excluding interest payments	-12.4	-6.0	-9.1	-5.2	-5.8	-5.4	-5.2	-5.6	-5.7	-5.5	-5.4	
Deficit in balance of goods and services	-1.9	4.0	0.8	9.4	9.1	8.5	8.2	7.7	7.5	7.3	6.9	
Exports	55.2	49.0	49.5	50.5	50.6	46.7	47.8	47.8	47.6	47.1	46.2	
Imports	53.3	53.0	50.3	59.9	59.7	55.3	56.0	55.6	55.2	54.4	53.2	
Net non-debt creating capital inflows (negative)	-1.6	-1.9	-2.9	-1.1	-0.4	-0.6	-0.9	-0.5	-0.4	-0.3	-0.3	
Automatic debt dynamics 1/	5.4	9.2	-2.6	2.4	-4.8	0.4	0.3	0.7	1.0	1.2	1.3	
Contribution from nominal interest rate	4.0	4.1	3.3	3.3	3.0	3.4	3.3	3.6	3.7	3.7	3.7	
Contribution from real GDP growth	-3.4	-1.4	-3.3	-2.8	-5.7	-3.0	-3.0	-2.9	-2.7	-2.5	-2.4	
Contribution from price and exchange rate changes 2/	4.8	6.5	-2.6	1.8	-2.1	...	...	...	...	...	...	
Residual, incl. change in gross foreign assets (2-3) 3/	9.2	4.9	10.7	6.9	1.8	-0.4	2.3	3.2	4.1	4.0	3.6	
External debt-to-exports ratio (in percent)	139.1	169.1	159.4	162.5	143.9	142.8	132.6	127.7	126.2	126.6	127.4	
Gross external financing need (in billions of US dollars) 4/	5.8	10.8	9.6	12.0	11.8	11.6	12.7	12.9	13.1	14.3	15.0	
in percent of GDP	7.7	15.3	12.7	15.7	14.0	12.1	12.3	11.8	11.3	11.7	11.7	
Scenario with key variables at their historical averages 5/						**66.7**	**64.0**	**61.3**	**59.4**	**57.4**	**55.1**	**-1.8**
Key Macroeconomic Assumptions Underlying Baseline												
Real GDP growth (in percent)	4.4	1.8	4.3	3.6	6.1	4.7	4.8	4.8	4.6	4.4	4.2	
GDP deflator in US dollars (change in percent)	-5.9	-7.8	3.3	-2.3	2.6	8.5	2.6	1.3	1.0	1.0	1.0	
Nominal external interest rate (in percent)	5.2	5.0	4.3	4.3	4.1	5.2	5.3	6.0	6.4	6.6	6.5	
Growth of exports (US dollar terms, in percent)	5.8	-16.7	8.8	3.2	10.8	4.8	9.9	6.3	5.3	4.1	3.3	
Growth of imports (US dollar terms, in percent)	8.5	-6.8	2.3	20.4	10.2	5.1	8.9	5.4	4.9	3.9	2.8	
Current account balance, excluding interest payments	12.4	6.0	9.1	5.2	5.8	5.4	5.2	5.6	5.7	5.5	5.4	
Net non-debt creating capital inflows	1.6	1.9	2.9	1.1	0.4	0.6	0.9	0.5	0.4	0.3	0.3	

1/ Derived as [r - g - ρ(1+g) + εα(1+r)]/(1+g+ρ+gρ) 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 gro
ε = nominal appreciation (increase in dollar value of domestic currency), and α = share of domestic-currency denominated debt in total external debt.

2/ The contribution from price and exchange rate changes is defined as [-ρ(1+g) + εα(1+r)]/(1+g+ρ+gρ) times previous period debt stock. ρ increases with an appreciating domestic currency (ε > 0) and rising inflation (

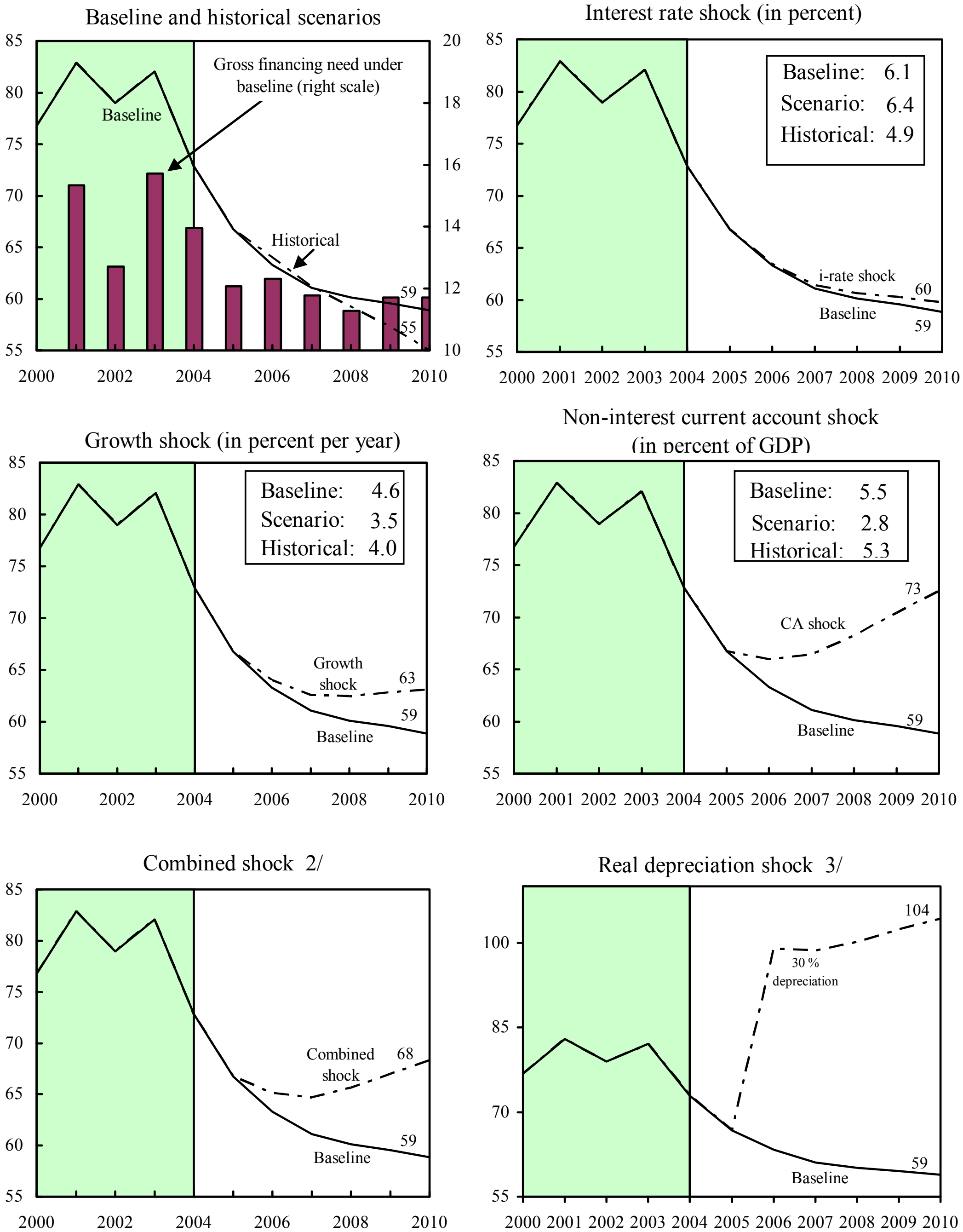
3/ For projection, line includes the impact of price and exchange rate changes.

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

5/ The key variables include real GDP growth; nominal interest rate; dollar deflator growth; and both non-interest current account and non-debt inflows in percent of GDP.

6/ Long-run, constant balance that stabilizes the debt ratio assuming that key variables (real GDP growth, nominal interest rate, dollar deflator growth, and non-debt inflows in percent of GDP) remain at their levels of the last projection year.

Figure A2. Philippines: External Debt Sustainability: Bound Tests 1/
(In percent of GDP)



Source: Fund staff estimates.
1/ Shaded areas represent actual data. Individual shocks are permanent one-half standard deviation shocks. Figures in the boxes represent average projections for the respective variables in the baseline and scenario being presented. Ten-year historical average for the variable is also shown.
2/ Permanent 1/4 standard deviation shocks applied to real interest rate, growth rate, and current account balance.
3/ One-time real depreciation of 30 percent occurs in 2006.

PHILIPPINES: FUND RELATIONS

(As of July 31, 2005)

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	1,114.68	126.68
Reserve position in Fund	87.49	9.94

III. **SDR Department**:	SDR Million	% Allocation
Net cumulative allocation	116.60	100.00
Holdings	4.72	4.05

IV. **Outstanding Purchases and Loans**:	SDR Million	% Quota
Stand-by arrangements	292.56	33.25
Extended arrangements	29.70	3.37

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	50.19	125.78	125.78	20.50	...
Charges/Interest	7.62	11.13	6.30	3.28	2.95
Total	57.82	136.92	132.09	23.78	2.95

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

IX. **FSAP and ROSC Participation**:

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

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

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

X. **Technical Assistance**:

An MFD resident banking supervision advisor has been stationed in Manila since May 2003, to assist the BSP in the implementation of a new supervisory model. An MFD mission visited Manila in February 2005 to review the payment systems, central bank accounting, and government bond market development.

An STA peripatetic mission visited Manila in July-August 2003 , January-February 2004, and February-March 2005 to provide technical assistance in balance of payments and international investment position statistics and in implementing the recommendations made by the ROSC Data Module mission.

An FAD mission to provide a briefing to the new tax commissioner took place in April–May 2001. An FAD mission reviewed VAT and excise administration in December 2001. An FAD staff member participated in the July 2004 PPM mission to evaluate and advise on tax measures.

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. Reza Baqir assumed the post of Resident Representative in July 2005.

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

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

INTERNATIONAL MONETARY FUND

PHILIPPINES

Report for the June 2005
Post-Program Monitoring Discussions
Supplementary Information

Prepared by the Asia and Pacific Department
(In consultation with other departments)

Approved by Masahiko Takeda and Michael Hadjimichael

September 15, 2005

1. **This supplement updates the information in the Staff Report issued on August 29, 2005.** As described in the staff report, key members of the previous economic team who met with the June 2005 Post-Program Monitoring (PPM) mission subsequently resigned in July. Staff therefore made a brief visit to Manila (September 7-12) to discuss policy priorities with the new economic team.[1] In addition to reporting on these discussions, this supplement describes political and economic developments since the staff report was finalized.

I. Recent Developments

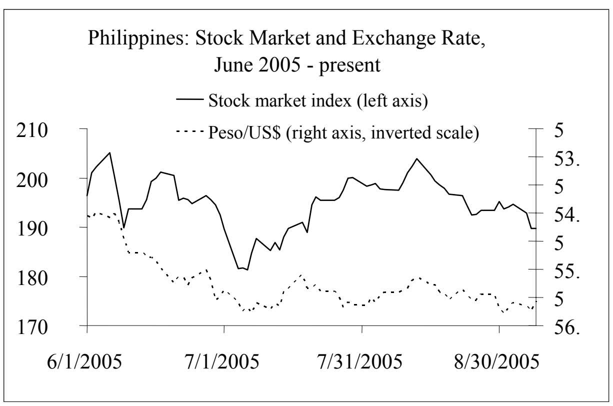
2. **Political uncertainties have receded somewhat in recent weeks.** The impeachment charges against President Arroyo were dismissed by the House of Representatives on September 6. The opposition is attempting to pursue the charges against the President outside Congress, but public protests have attracted limited support to date. On September 1, the Supreme Court declared the expanded value-added tax (EVAT) law to be constitutional, but retained the temporary restraining order in place for 15 days to allow for any appeals. Meanwhile, recent sharp increases in petroleum and power prices have led to moves in Congress to cancel, or at least postpone, the provision in the EVAT law for the elimination of the VAT exemptions on these products.

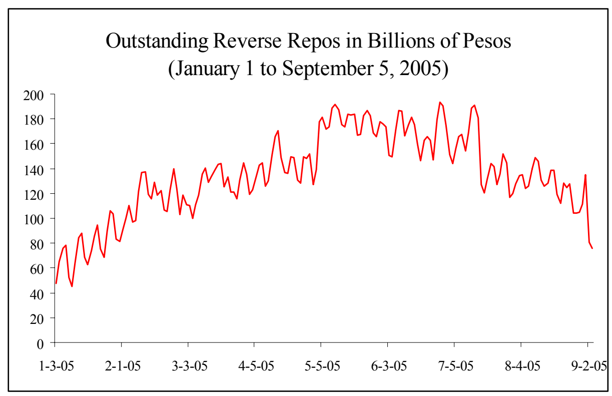
3. **Economic data have been generally positive.** GDP grew by 4.8 percent (y/y) in the second quarter, above staff and market expectations. Buoyant services continued to underpin

[1] The staff team, consisting of Messrs. Gordon (Head), Baqir (Resident Representative), and Brooks (all APD) and Ms. Zakharova (FAD), met with Finance Secretary Teves, Bangko Sentral ng Pilipinas (BSP) Governor Tetangco, Budget and Management Secretary Neri, Energy Secretary Lotilla, Trade and Industry Secretary Favila, Socio-Economic Planning Secretary Santos, and other senior officials. Ms. Amador (OED) joined the discussions.

growth. Private consumption showed resiliency to high oil prices, partly reflecting strong inflows of remittances. Headline inflation was above expectations in August at 7.2 percent (y/y), up from 7.1 percent in July. Export growth jumped to 11½ percent in July (y/y), implying growth of 4½ percent in the first seven months of 2005 (y/y). The government completed its external commercial borrowing program for the year by successfully raising $1 billion in early September. Foreign reserves, adjusted for pledged assets, rose to $17.5 billion at end-August, $2.3 billion above the end-2004 level.

4. **The authorities are on track to meet their deficit target for 2005.** Preliminary data for August indicate a recovery in tax revenue collections, which had weakened in July as a result of weakly performing corporate income and excise tax receipts. The national government deficit through August is provisionally estimated at P 80 billion, less than half of the annual target of P 180 billion (3½ percent of GDP) and well below the P 111 billion recorded in the first eight months of 2004. While revenue has grown in line with nominal activity, expenditure has contracted in nominal terms, primarily due to continued compression of capital spending.





5. **Markets have continued to show some stability.** As reported in the staff report, the BSP raised reserve requirements by 2 percentage points in mid-July to mop up liquidity accumulating in the reverse repo facility,[2] which, at a time of mounting political instability, risked weakening the exchange rate and triggering inflationary pressure. Combined with the more settled political situation, and generally positive news on the budget, domestic financial markets have remained fairly stable. Sovereign bond spreads have also shown little variation, including in response to the recent Supreme Court decision which had been widely anticipated. There was little apparent contagion from the financial turbulence experienced in Indonesia at the end of August.

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[2] The reverse repo is a standing facility offered by the BSP for commercial banks to invest their short-term funds. The reverse repo rate, which is the BSP's key policy rate, is currently 7 percent for overnight placements.

II. Report on the Discussions

6. **The authorities indicated that the government remained committed to fiscal consolidation.** The authorities intended to implement the EVAT as soon as the Supreme Court order was lifted. They were hopeful that implementation would be possible within the next few weeks. Nonetheless, the authorities were confident that the 2005 budget target was attainable even without any EVAT revenue this year. The sharp reduction in the deficit targeted for 2006, by contrast, rests squarely on full implementation of the EVAT since the alternative revenue-raising options are limited in the short run. For the medium-term, the authorities reaffirmed their commitment to balance the budget and were aiming to achieve this goal ahead of schedule by 2008. After the EVAT was implemented, they envisaged improved tax administration playing a crucial role in aiding fiscal consolidation, and noted that the poor tax collection in July was due to special factors rather than to any let up in the anti-tax evasion campaign. Staff argued that while improving tax administration would be important to achieve the authorities' medium-term budget targets, additional measures would also be needed, such as a sweeping rationalization of tax incentives.

7. **The 2006 National Government budget submitted to Congress in late August sets a deficit target of 2.1 percent of GDP**. The macroeconomic assumptions underpinning the budget (such as nominal GDP growth, the level of interest rates, and the exchange rate) are broadly in line with staff projections in the Staff Report under the "reforms proceed" scenario. The budget assumes full implementation of the EVAT law, including the rate increase from January 2006. After years of expenditure compression, the budget allows for some increases in infrastructure spending, maintenance and operations, and wages for government employees. The implied adjustment in the national government deficit, combined with tight control over the deficits of the Government-Owned and Controlled Corporations (GOCCs), would be sufficient to reduce the nonfinancial public sector (NFPS) deficit to about 2¾ percent of GDP in 2006. This is close to the upfront fiscal adjustment that staff have been recommending.

Philippines: National Government Cash Accounts, 2004-06

	2004 Act.	2005 Auth. Proj.	2006 Proposed Budget
	(In percent of GDP)		
Revenue and grants	14.8	14.8	16.1
Tax revenue	12.6	13.3	14.6
Nontax revenue	2.2	1.5	1.6
Expenditure and net lending	19.1	18.5	18.6
Current expenditures	16.2	15.9	15.8
Of which: interest	5.9	6.3	6.0
Capital spending and net lending	2.9	2.6	2.8
Balance	-4.3	-3.7	-2.4
On the authorities' presentation	-3.9	-3.4	-2.1
Memorandum Items:			
Primary national government balance	1.6	2.6	3.6
Primary expenditure	13.2	12.2	12.6

Sources: Philippine authorities; and Fund staff calculations

8. **Nonetheless, the fiscal outlook remains subject to considerable risks**. The extension of the VAT to power and petroleum products is facing mounting opposition in Congress, with amendments under consideration to re-introduce exemptions on electricity and fuel. While the authorities indicated that they are firmly committed to increasing the VAT rate next January, this step is also likely to face resistance. The authorities assured the

mission that achieving the fiscal targets was the major priority. In the event of revenue shortfalls, they would adjust expenditure. They would also seek alternative sources of revenue, although as noted above, the options are limited in the short run. Possible deterioration in GOCC finances was another source of risk, although the authorities indicated that they were closely monitoring individual enterprises to ensure that they contributed to the targeted reduction in the public sector deficit.

9. **To increase public support for the EVAT, the authorities were formulating mitigating measures.** Although the authorities planned to implement the EVAT law in its original form, a number of steps were being considered to mitigate the impact of higher energy prices on the poor. The EVAT law already provided for the elimination of excises on kerosene and a reduction in the excises on gasoline. The authorities were also considering reducing oil import duties from 5 percent to 3 percent, and possibly even to zero, and increasing the subsidy provided through electricity life-line tariffs. A public relations campaign had also been launched to explain the benefits of the EVAT to the public. Staff recognized the difficulty of raising taxes on energy in the current environment, but argued that tackling the fiscal problem could not be delayed until some future date when oil prices might be lower. Staff therefore endorsed the authorities' approach of only taking mitigating measures that preserved the integrity of the EVAT law. However, such measures would need to be well-targeted with limited cost in terms of foregone revenue.[3]

10. **The mission discussed other effects of higher oil prices.** Oil prices have risen sharply over the past few months and the authorities are planning to revise down their growth projections. By contrast, staff projections in the Staff Report of GDP growth of 4¾ percent in 2005 and 2006, which are considerably below the official projections, already incorporate the effects of recent oil price rises. The authorities also described their current energy savings campaign, which requires the rationing of fuel for government cars and for all agencies to cut their energy consumption by at least 10 percent. Consideration was being given to extending conservation schemes to the private sector, but the authorities stressed that participation would be voluntary.

11. **The monetary policy discussions focused on whether there was a need for tightening**. The BSP's measure of core inflation edged down in August to 6.6 percent (y/y) from 6.8 percent in July and 7.1 percent in June, and staff agreed that the evidence for inflation being more generalized had not become any stronger. Nonetheless, staff remained concerned that continued above-target inflation was feeding into higher inflationary expectations, while interest differentials had narrowed further given the latest Fed tightening. Moreover, recent regional developments starkly illustrated the risks from keeping interest

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[3] By staff estimates, widening the VAT base to include fuel and power yields annual revenue of P 27 billion (0.5 percent of GDP), while the planned reduction in petroleum excises reduces revenue by P 14 billion. Cutting the oil duty rate from 5 to 3 percent would cost a further P 7 billion; thus reducing the oil duty rate to zero would imply a net negative for the budget. Lifeline tariffs are funded by cross-subsidies.

rates too low. However, the authorities considered that the increase in reserve requirements in July represented a tightening of monetary policy that had not been adequately taken into account in the staff's assessment. They also downplayed the risks due to possible contagion effects from Indonesia, noting that there were no comparable fuel subsidies in the Philippines. Nonetheless, the authorities recognized that interest differentials had narrowed and that liquidity remained high, and assured the mission that they stood ready to raise policy rates should this be judged necessary to prevent inflation from escalating.

III. Staff Appraisal

12. **Staff welcome the authorities' reaffirmation of their commitment to reform, particularly given the challenges posed by high oil prices.** The EVAT law, which is key to achieving the sharp reduction in the public sector deficit targeted for 2006, should be fully implemented as soon as the Supreme Court lifts the restraining order. Adding taxes to already high energy prices will imply hardship for the poor and the authorities are appropriately considering mitigating measures. Staff support the authorities' preference for mitigating measures that preserve the integrity of the EVAT law rather than amending the EVAT legislation to defer the removal of VAT exemptions on energy. Nonetheless, mitigating measures should be well-targeted and affordable in terms of foregone revenue. Staff also welcome the authorities' intention to continue to allow full pass through of high oil prices into domestic fuel prices, thereby avoiding the provision of any subsidies and helping prevent a reversal of fiscal consolidation.

Table 1. Philippines: Selected Economic Indicators, 2002–2006

Nominal GDP (2004): P4,826 billion ($92.2 billion)
Population (2003, est.): 81.8 million
GNP per capita (2003, est.): $1,035
IMF quota: SDR 879.9 million

	2002	2003	2004	2005	2006
				Staff Proj. 1/	
GDP and prices (percentage change)					
Real GDP 2/	4.4	4.5	6.0	4.7	4.8
CPI (2000 base; annual average)	3.0	3.5	6.0	8.2	7.5
CPI (2000 base; end year)	2.5	3.9	8.6	8.1	6.0
Investment and saving (percent of GDP)					
Gross investment	17.5	16.7	17.1	17.2	17.2
National saving	23.2	18.4	19.8	19.2	19.1
Public finances (percent of GDP)					
National government balance (authorities definition)	-5.3	-4.7	-3.9	-3.6	-3.6
National government balance 3/	-5.6	-5.0	-4.2	-3.9	-3.9
Nonfinancial public sector balance 4/	-5.7	-5.6	-5.1	-4.0	-4.0
Revenue and grants 5/	20.9	21.0	20.5	21.8	21.8
Expenditure 6/	26.6	26.6	25.6	25.8	25.8
Nonfinancial public sector debt 7/	93.7	101.3	96.1	92.4	90.0
Monetary sector (percentage change, end of period)					
Broad money (M3)	9.5	3.3	9.2	13.2 8/	...
Interest rate (91-day Treasury bill, end of period, in percent)	5.9	6.5	8.4	6.4 9/	...
Credit to the private sector	1.2	1.8	4.7	2.8 8/	...
External Sector					
Export value (percent change)	10.0	2.8	9.6	4.0	8.9
Import value (percent change)	6.2	20.1	10.6	5.2	9.2
Current account (percent of GDP)	5.7	1.8	2.7	2.0	1.9
Capital and Financial account (US$ billions, excluding errors and omissions)	1.2	-2.2	-2.1	-1.9	-1.2
Foreign direct investment (net)	1.7	0.2	0.1	0.2	0.4
Other	-0.5	-2.4	-2.2	-2.0	-1.6
Errors and omissions and trade credit (US$ billions)	-4.9	-0.8	0.4	-0.2	-0.2
Overall balance (US$ billions)	0.7	-1.7	0.6	-0.1	0.6
Monitored external debt (percent of GDP) 10/	77.7	79.3	71.5	66.2	63.3
Debt-service ratio (percent of exports)	19.9	20.6	19.7	18.4	19.2
Reserves, adjusted (US$ billions) 11/	14.3	14.7	15.2	15.0	15.6
Reserves / Short-term liabilities, adjusted 12/	123.9	122.9	121.2	109.8	110.5
Exchange rate (period averages)					
Pesos per U.S. dollar	51.6	54.2	56.3	56.3 13/	...
Nominal effective exchange rate (Jan 2, 2003 =100)	107.4	95.1	83.8	87.3 13/	...
Real effective exchange rate (Jan 2, 2003 =100)	92.5	95.6	91.5	...	...

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

1/ "Reforms stall" scenario; see Staff Report (issued on August 29, 2005), Table 5.
2/ National accounts data for 2002-2004 have been revised since Staff Report was issued.
3/ Fund definition. Excludes privatization receipts of the national government, and includes net deficit from restructuring the central bank.
4/ Includes the national government, Central Bank-Board of Liquidators, 14 monitored government-owned enterprises, social security institutions, and local governments.
5/ The sum of all nonfinancial public sector revenue net of intra-public sector payments. It is assumed that 80 percent of Bureau of Treasury revenue represents interest and dividends from other parts of the nonfinancial public sector. Privatization receipts are excluded.
6/ Defined as difference between nonfinancial public sector revenue and balance.
7/ Debt is consolidated (net of intra-nonfinancial public sector holdings of debt). Data on local government debt are not available for 2001; it is assumed that these debts were the same as a share of GDP as in 2002.
8/ As of June 2005.
9/ Secondary market at end-August.
10/ Defined as external debt plus liabilities of foreign banks in the Philippines to their headquarters, branches and agencies, some external debt not registered with the central bank and private capital lease agreements.
11/ Gross reserves less gold and securities pledged as collateral against short-term liabilities.
12/ Reserves as a percent of short-term debt (including medium- and long-term debt due in the following year). Both reserves and debt were adjusted for pledged assets.
13/ As of end-August.

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

IMF Executive Board Concludes June 2005 Post-Program Monitoring Discussions with the Philippines

On September 19, 2005, the Executive Board of the International Monetary Fund (IMF) concluded Post-Program Monitoring discussions with the Philippines based on the information available through that date.[1]

Background

Following President Arroyo's election victory in May 2004, economic reforms advanced at a significant pace. In the power sector, average generation tariffs were raised by half, substantially cutting losses of the state-owned National Power Corporation. In the financial sector, the Special Purpose Vehicle framework set up to facilitate the sale of nonperforming assets began to gain traction. In the fiscal area, several tax measures were taken, culminating in Congress passing a landmark expanded VAT (EVAT) law in May 2005 that has the potential to sharply reduce the fiscal deficit. Subsequent events, however, interrupted the economic reform momentum. Allegations against the President led to impeachment complaints being filed before Congress, key Cabinet members resigned, and the Supreme Court issued a temporary restraining order on July 1 that stopped implementation of the new VAT law. The authorities quickly took steps to calm financial markets, including the appointment of a new economic team. On September 1, the Supreme Court declared the EVAT law to be constitutional, but retained the temporary restraining order in place for 15 days to allow for any appeals. Meanwhile, the impeachment charges against President Arroyo were dismissed by the House of Representatives on September 6, and with the political uncertainty having receded somewhat, financial markets have stabilized.

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

GDP grew by 4.8 percent y/y in the second quarter, above staff and market expectations, and up from 4.6 percent y/y in the first quarter. Buoyant services continued to underpin growth. Private consumption showed resilience to high oil prices, partly reflecting strong inflows of remittances. Headline inflation rose to 7.2 percent in August (y/y), up from 7.1 percent in July, and inflation through August averaged 8.1 percent. With inflation running at well above the target range of 5–6 percent for 2005, the Bangko Sentral ng Pilipinas (BSP) raised policy rates by 25 basis points in April to avert a rise in inflation expectations. In addition, reserve requirements were lifted by 2 percentage points in July to prevent excess liquidity feeding into peso depreciation and creating inflationary pressure.

Aided by continued compression of capital spending, the National Government budget through August appears to be on course to achieving the 2005 deficit target of 3½ percent of GDP (authorities' definition). In conjunction with reduced losses by the National Power Corporation, this would allow the nonfinancial public sector (NFPS) deficit to be reduced to 4 percent of GDP in 2005, compared to a little over 5 percent of GDP in 2004. An increase in tax revenues earlier this year coincided with a high profile campaign to pursue tax evaders that began in April and quickly showed up in monthly collections. After a deceleration in the growth of tax revenues in July, preliminary data indicate that tax collections recovered in August. The better fiscal performance in 2005, aided by strong portfolio inflows, has kept financial markets liquid; the 91-day treasury bill rate has declined about 200 basis points in 2005 to date.

The balance of payments recorded a surplus of $2 billion in the first half of the year; this primarily reflected a rise of more than one-fifth in overseas worker remittances (y/y), and a jump in net portfolio inflows to $1.9 billion, compared with $0.1 billion in the same period in 2004. Events since June have led to a marked slowing in portfolio inflows. Exports grew by only 4½ percent through July as a result of soft market conditions for Asian electronics, compounded by the lagged effects of relatively low investment in production capacity in recent years. Despite higher oil prices, imports remained virtually flat. Nonetheless, reserves (net of pledged assets) were US$17.5 billion at end-August, well above the end-2004 level of $15.2 billion.

The primary risk to the near-term outlook for the Philippine economy is that the prevailing state of uncertainty proves to be protracted and sidelines economic reforms. If reforms were to stall, investment is likely to remain subdued, and GDP growth of 4¾ percent is projected for 2005 and 2006. The outlook would be much brighter were strong reforms to resume. Soaring oil prices are a threat to the outlook, particularly if they serve to soften demand for Philippine exports. Adverse developments in international capital markets are another potential risk.

Executive Board Assessment

Executive Directors commended the authorities for the significant progress with much needed economic reforms that was achieved in the first year of the new administration. Furthermore, recent political uncertainties have receded, paving the way for improved market stability and resumed reform momentum. Directors cautioned, however, that the country's external debt and financing requirements are large and, despite its resilience, the economy remains vulnerable to external shocks, especially changes in market sentiment and increases in global interest rates and oil prices. In light of these concerns, Directors stressed the importance of the authorities pressing ahead with the implementation of their comprehensive reform package in the fiscal, power, and banking sectors, in order to reduce the vulnerabilities of the Philippine economy, achieve public debt sustainability over the medium term, and improve the investment and business climate for higher and sustainable growth. They emphasized that an accelerated pace of reforms would send a strong signal to markets and boost investor confidence.

Directors underscored the crucial importance of meaningful fiscal consolidation and debt reduction for enhancing stability and growth prospects. They considered the expanded Value Added Tax (EVAT) reform, including the envisaged VAT rate increase, as the best option to reduce the fiscal deficit. Directors therefore expressed concern that the EVAT implementation has been further delayed due to an appeal made to the Supreme Court, and urged the authorities to consider alternative revenue-raising measures in case the EVAT law cannot be implemented in full in the end. Directors also urged the authorities to continue their efforts to resist pressures to exempt energy products from the VAT increase. They recognized however, that adding taxes to already high energy prices will imply hardship for the poor, and accordingly supported the authorities' plans to consider well-targeted and affordable mitigating measures that would preserve the integrity of the EVAT law.

Directors noted that, even with the full and successful implementation of the EVAT law, the authorities will still have a gap to fill if they are to achieve their goal of balancing the budget by 2010. Directors therefore encouraged the authorities to plan additional measures, such as a sweeping rationalization of tax incentives. Expenditure reforms, including rationalizing and improving the targeting of rice subsidies, were also seen as essential. Directors commended the authorities' intention to continue to allow full pass through of high oil prices in domestic fuel prices, thereby avoiding provision of any subsidies, which would help prevent a reversal of fiscal consolidation.

Directors viewed the significant increases in generation tariffs awarded to the National Power Corporation as an important contribution to the fiscal consolidation effort. They encouraged the authorities to protect these gains by adjusting tariffs in the future in a timely manner. They supported the authorities' plans for developing medium-term deficit targets for Government-Owned and Controlled Corporations, as this would be essential to support fiscal consolidation.

Directors noted that civil service and pension reforms are critical for achieving sustainable fiscal consolidation. They welcomed the efforts being made by the authorities to reform the civil service and offer an affordable severance package. Directors also looked forward to the results of the actuarial review of the social security system that should pave the way for placing public pensions on a sustainable footing.

Directors stressed that power sector privatization is essential to restore the financial viability of the sector and to facilitate the investments needed to ensure adequate power supply. In this regard, they expressed concern about the delays in the bidding process for the transmission assets, and urged the authorities to finalize the agreements holding up the privatization of the generation assets. Directors underscored that the privatization process should be embedded in a sound regulatory framework.

While noting that a series of supply shocks have been the root cause of the rise in inflation, Directors were concerned that interest rate differentials were narrowing at a time when the Philippines' risk premium may have risen due to political uncertainties, which could lead to a weakening of the exchange rate and further additional inflationary pressure. Directors were also concerned that the persistence of above-target inflation for a prolonged period—even when caused by temporary factors—might lead to an upward and permanent revision of inflationary expectations, especially if the effects of higher oil prices, a weaker exchange rate, and the planned VAT increases are taken into account. Notwithstanding the recent increase in reserve requirements, they considered that a case still does exist for tightening monetary policy to guide inflation expectations down. Directors therefore welcomed the authorities' readiness to monitor developments closely.

Directors welcomed progress in banking sector reform, including the continued decline in nonperforming loan ratios. They were encouraged that banks have begun to use the special purpose vehicle (SPV) framework set up to facilitate the sale of nonperforming assets. Directors supported the authorities' plans to extend the SPV framework, and encouraged them to closely monitor developments in the trust and pre-need sectors. They also welcomed the privatization of the Philippine National Bank and recent acquisition announcements that would pave the way for necessary banking consolidation. However, Directors expressed concern that the amendments to the central bank's charter, which are critical to strengthening bank supervision, are still pending in Congress, and stressed the need for early approval. They also looked forward to the adoption of the International Financial Reporting Standards by the end of the year, which should lead to much needed improvements in transparency of banking sector indicators. Directors welcomed the continued progress made by the authorities in strengthening the anti-money laundering/combating the financing of terrorism regime.

Directors welcomed the authorities' efforts to further strengthen financial and balance of payments 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. The staff report for the Article IV consultation with the Philippines may be made available at a later stage if the authorities consent.

Philippines: Selected Economic Indicators, 2002–05

	2002	2003	2004	2005 IMF Staff Proj.	
Growth and prices (in percent change)					
GDP growth	4.4	4.5	6.0	4.7	
CPI inflation (average)	3.0	3.5	6.0	8.2	
Public finances (in percent of GDP)					
National government balance (authorities definition)	-5.3	-4.7	-3.9	-3.6	
National government balance 1/	-5.6	-5.0	-4.2	-3.9	
Nonfinancial public sector balance 2/	-5.7	-5.6	-5.1	-4.0	
Revenue and grants 3/	20.9	21.0	20.5	21.8	
Expenditure 4/	26.6	26.6	25.6	25.8	
Money and credit (in percent change)					
Broad money (M3)	9.5	3.3	9.2	13.2	5/
Interest rate (91-day Treasury bill, end period, in percent)	5.9	6.5	8.4	6.4	6/
Credit to the private sector (net)	1.2	1.8	4.7	2.8	5/
Balance of payments (in billions of U.S. dollars)					
Trade balance	0.4	-5.5	-6.4	-7.2	
Current account balance	4.4	1.4	2.3	2.0	
Gross international reserves					
In billions of U.S. dollars	16.2	16.9	16.2	17.9	6/
Adjusted, in billions of U.S. dollars 7/	14.3	14.7	15.2	17.5	6/
Adjusted, in percent of short-term liabilities 8/	123.9	122.9	121.2	...	

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 the difference between nonfinancial public sector revenue and balance.
5/ As of June 2005.
6/ At end-August.
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.

Statement by Jong Nam Oh, Executive Director for the Philippines and Cyd Amador, Senior Advisor to the Executive Director
September 19, 2005

Key Points

- Achieving fiscal consolidation is a central policy challenge. The government is committed to pursuing responsible reforms that will turn around the fiscal position and provide policy space to meet the country's development requirements and aspirations.
- Monetary policy remains on close guard against the escalation of inflation pressures.
- Headway has been made in structural reforms, particularly in the energy and financial sectors, but major impediments to robust and sustained growth remain.
- In sustaining macroeconomic prudence and continuing to pursue reforms, the authorities have stressed that short-term but difficult adjustments will need to be made to realize lasting dividends in the form of sustainable and balanced growth.

Early enthusiasm due to a string of positive economic indicators was evident during the first half of the year. The promise of purposeful reform, particularly in the energy and financial sectors, together with ambitious fiscal efforts that were in train to turn around the fiscal position and the competent handling of monetary policy whetted investor interest and enhanced market confidence.

However, difficult political conditions have surfaced over the past few months. Of late, concerns over the political dynamics have eased somewhat. The authorities are hopeful that the headwinds coming from external developments and the political arena will not interrupt the growth process or imperil the reform momentum. The new team of economic managers is determined to ensure that there is continuity as well as coherence in the economic program. Early in their tenure, they stressed that there will be no policy paralysis, policy drift or policy reversal that could cause growth and the reform efforts to peter out. They have continued to focus their attention and energies on sustaining sound economic fundamentals and advancing the reform agenda that had been mapped out earlier.

In justifying their call for continued reform, the message of the authorities has become more pointed: short-term but difficult adjustments and sacrifices will need to be made to realize lasting dividends in the form of sustainable and balanced growth. This is a tough message to deliver, requiring considerable persuasion and testing the authorities' astuteness in communicating with the public about the broader issues involved. To this end, the authorities have intensified their campaign to inform the public about the costs of inaction or delayed action on the economic front. The authorities are quite conscious of the difficulties in gaining popular support for reforms, and they are therefore mindful of the need to achieve policy goals with maximum efficiency and minimum welfare cost. While there are social safety nets that can ameliorate the costs of adjustments, these need to be well targeted given tight fiscal constraints. The authorities know that the key to ensuring that the political dynamics are supportive of the reform efforts is through sustained growth. They are determined to ensure that sound fundamentals remain in place for growth to proceed.

Engagement with the Fund

Our authorities thank the staff for the productive and collegial exchange of views during the PPM mission. The discussions were marked by constructive candor, and were tightly focused on substantive issues. The well-written staff report provides a concise summary and balanced account of the accomplishments to date and the challenges facing the Philippines.

The Philippines has benefited considerably from Fund policy advice and technical assistance. A high-level seminar on Capital Market Reform and Government Bond Market Development held in Manila last March also allowed the authorities to hold constructive talks with Fund management and staff. Engagement with the Fund has helped the authorities sharpen economic analysis, encouraged healthy discussions on policies and the reform agenda, and ground policy formulation and implementation more rigorously. Our authorities value the continuation of this close collaboration.

The economy continues to be resilient.

The economy performed respectably in the first semester, and the expectation is that the expansion will continue to proceed at a solid pace in the near term. Recent growth has been largely consumption-driven, however. While this home-grown stimulus to demand is welcome, the government is keenly aware of the need to broaden the sources of growth, including investments and exports, to erect sturdier underpinnings for lasting economic progress. The challenge becomes more stark when viewed against the downside risks of a less supportive external environment marked by surging oil prices, rising interest rates, slowing world economic growth and possibly less favorable global financial conditions.

Monetary policy is focused on quelling inflationary pressures.

The monetary authorities are unswerving in their commitment to promote price stability. A rate hike in April and increases in reserve requirements in July were aimed at cementing inflation expectations and signaling the Bangko Sentral's readiness to respond to forces that can stoke inflation.

The Bangko Sentral subscribes to the belief that a clear message on the considerations behind its policy decisions is critical to effective monetary management, and central bank officials have taken great care to communicate policy intentions together with the assessment of the inflation outlook. In past assessments, they have stressed that the primary drivers of inflation were coming from supply-side forces, which are not responsive to monetary policy action. Undue monetary tightening would only dampen demand, and choke economic expansion.

The central bank continues to keep a watchful eye on inflation expectations and price developments, including the spiraling price of oil and its knock-on effects alongside indicators of economic slack, demand pressures and domestic liquidity as well as other information variables. It stands ready to respond to threats to price stability, if and when necessary, and as warranted. Recent liquidity growth alongside narrowing interest rate differentials are being viewed with increasing concern. The authorities are not ruling out further policy action in the short run.

A comfortable level of international reserves is being built up while maintaining a flexible exchange rate policy. The peso has been broadly stable. Strong remittances have propped up the external accounts. The authorities are aware that the Philippines is exposed to the risk that the external environment could become less benign, given its high foreign debt and large external financing requirements. They know full well the need for prudent debt management and the urgency of lifting the pace of reform to help reduce the reliance on external debt and lessen the economy's vulnerability to global financial conditions.

Strengthening the country's fiscal health is a matter of highest priority.

The authorities are mindful of the need to sustain the efforts to turn around the fiscal position. There has been demonstrable progress in this direction. For the first seven months of this year, the budget deficit was less than half the ₱180 billion (around US$3.2 billion) forecast for the year, on the back of better revenue collection and prudent spending. This builds on the headroom in fiscal consolidation that was achieved last year. The authorities are open to a more rapid achievement of fiscal consolidation, possibly moving forward the date for a balanced budget.

Revenue generation is being intensified on all fronts. Tax reform is a critical component in making the budget more resilient and flexible. Since 2004, three new tax measures had been enacted: higher excise taxes on tobacco and liquor, a system of rewards and penalties to enhance performance in the revenue collection agencies, and the restructuring of the VAT system. These new revenue sources are being complemented with measures to improve tax administration, including the expanded computerization programs of the Bureaus of Customs and Internal Revenue (BOC and BIR), the No Audit Program aimed at enhancing voluntary tax compliance, and high-profile campaigns such as the Run After Tax Evaders (RATE), Run After The Smugglers (RATS), and Revenue Integrity Protection Service (RIPS) programs. Gains from strengthened tax enforcement and better tax compliance have been considerable, and the authorities are institutionalizing these improvements.

The next phase of fiscal reforms include the acceleration of privatization and the rationalization of fiscal incentives. Following the successful sale of its stake at the Philippine National Bank (PNB), the government intends to aggressively pursue the sale of other state-owned assets, with the proceeds to be used for deficit reduction. The rationalization of incentives is an integral part of the legislative agenda, which also includes simplified net income taxation and the fiscal responsibility bill.

Beyond exercising parsimony in spending, the government has taken steps to improve the quality of public service delivery. Salient examples are the streamlining of the bureaucracy and the procurement law, which has improved the transparency and efficiency of the government's business dealings with the private sector. Measures are also being taken to improve the management and financial health of government-owned and controlled corporations, including the National Power Corporation (NPC) and the National Food Authority, enhance the capacity of local governments to deliver basic services, and ensure the long-term solvency of public pension funds.

The government is determined to ramp up the quality of public governance. The administration's efforts against graft and corruption focus on preventive and punitive measures. Apart from e-procurement, other measures being pursued to improve governance include more transparent and accountable government procedures, lifestyle checks and suspension or removal of erring public officials.

Tangible progress in high-quality fiscal adjustments is expected to lead to lower fiscal deficits and reduced government borrowing. Lower interest costs would free resources that the government can use to step up its provision of sorely needed public goods. There are considerable and competing demands on the fiscal purse, however. The challenge for the authorities therefore is twofold: design well-targeted social programs and well-prioritized infrastructure projects, and finance these in a fiscally responsible manner.

In May, a long-awaited reform that broadens the VAT base and provide for a rate adjustment in 2006 was signed into law. The markets hailed this as bold move to shore up revenues and raise fiscal flexibility, helping move public finances to a sustainable path over the medium term. The implementation of the expanded VAT (EVAT), however, was stayed by the Supreme Court in July following challenges raised on its legality. Subsequently, in early September, the Court ruled favorably on its constitutionality, and the law is expected to take effect late this month or early October.

The authorities have stressed that the EVAT is needed to achieve fiscal consolidation and avoid a potential fiscal crisis that would bring even more hardships to the people. In their pronouncements, the authorities have invariably acknowledged that fiscal consolidation involves bitter medicine in the form of short-term adjustment costs. They have carefully balanced the message by emphasizing that the fiscal consolidation strategy incorporates mitigating measures and targeted social programs to ameliorate the adverse impact of the reform on the vulnerable segments of the population. With the EVAT implementation coinciding with the spiral in oil prices, the authorities are particularly sensitive to the concerns of the public. Social protection measures incorporated in the EVAT law include the reduction to zero of excise taxes on diesel, kerosene and bunker fuel oil, the zero-rating of VAT on electricity from non-oil power plants to encourage the use of renewable energy sources, and the removal of the franchise tax on power distribution utilities. Moreover, to lessen the economic pain caused by escalating oil prices, the authorities will be reducing the import tariffs on petroleum products when the EVAT is implemented. The authorities also plan to use part of the revenue gains in 2006 and beyond to fund spending on critical social needs and infrastructure, while continuing to keep overall expenditures under close watch.

The Philippines carries a heavy debt load. The recent modest headway toward fiscal consolidation should lower the debt trajectory and increase fiscal flexibility. The authorities are aware that the need to sustain and augment the recent fiscal consolidation efforts becomes more compelling because the large external debt of the public sector amplifies the effects of any weakening in the global appetite for emerging market assets and, more broadly, of adverse conditions in international capital markets.

The reform of the energy and financial sectors is starting to yield dividends.

Power sector reform is needed to ensure that energy is affordable and that its supply is stable and sufficient to meet the needs of a growing and competitive economy. The recent hikes in power rates have reduced NPC's shortfall, helping to limit the public sector deficit. To mitigate the social impact of higher electricity rates, poor households continue to enjoy lifeline or discounted rates.

Privatization is an important component of energy reform. Selling the country's power assets has been a labored process. The government plans to sell 70 percent of NPC's power generating assets by the first quarter of 2006. To date, it has sold six power plants, amounting to 11 percent, but more are scheduled to be auctioned before the year ends. The authorities continue to work at lifting the pace of privatization, including by fast tracking negotiations on power supply contracts between NPC and distribution utilities, which should support the sale of generation assets. The bidding for the concession of the transmission company is expected to be held by the first quarter of 2006, if not earlier. The authorities are also intent on vigorously reducing systems losses, pursuing efficiency improvements, aggressively promoting energy conservation and independence, and expanding the electrification of rural areas.

In the banking sector, the clean-up of non-performing assets is proceeding well. As a result of sales to SPVs and on the back of improved collections and loan settlements, the non-performing loan (NPL) ratio is down to single digit at 9.2 percent (as of end-June 2005), the lowest in seven years. Nearly a fifth of the stock of non-performing assets has been shaved off. Further improvements in banks' asset quality are expected if the bill pending in Congress to extend the SPV framework is passed. There has also been appreciable progress in the rehabilitation of intervened banks, including the sale of PNB, and in bank consolidation.

Prudential norms are being strengthened and aligned with international standards. The authorities plan to adopt tighter accounting standards by moving to the International Financial Reporting Standards by end-2005 and to phase in higher risk-weighting on NPLs prior to the implementation of Basel II in 2007. Corporate governance practices are being enhanced. They also continue to accord high priority to the BSP charter amendments that will strengthen bank regulation and supervision, including those that will enhance legal protection for bank supervisors and ensure the prompt resolution of problem banks.

Spurring the development of a well-functioning domestic capital market is a major challenge. The availability of domestic, longer-term financing will reduce reliance on foreign currency debt, provide an alternative to bank borrowing, and facilitate public debt management. Several steps are being taken to develop the financial market infrastructure. In March, the Fixed Income Exchange System was launched, promoting transparency and price discovery for the secondary trading of fixed-income government securities. This is supported by the Bangko Sentral's initiatives in implementing the third party custodian system to bolster market integrity and in encouraging the establishment of more domestic credit rating agencies to enhance the flow of financial information. The Bangko Sentral also supports other reforms to strengthen the financial sector, including the establishment of an enhanced credit information system through the passage of the Credit Information System Act, and advocates the passage of key legislation such as the Corporate Recovery Act, the Revised Investment Company Act, the Personal Equity Retirement Account Act, and the Pre-Need Industry Code.

Progress in other fronts of the structural reform agenda would unlock the country's productive potential, reduce vulnerabilities and rigidities, and enhance confidence.

The authorities are determined to build on reform initiatives to promote the linked objectives of growth, employment creation and poverty reduction. In this task, they intend to make the most of the complementarities between macroeconomic adjustments and structural reforms. Strengthening export competitiveness, enhancing the investment climate and fostering greater private sector dynamism require addressing infrastructure bottlenecks. Ensuring a decent quality of life for Filipinos and reducing poverty require investment in vital social and economic services. The authorities therefore put a premium on building fiscal space through determined efforts toward fiscal consolidation and macroeconomic stability.

The authorities are mindful that the pursuit of reform would require a lot of political suasion and will need to garner popular support. They have therefore taken care to pace reforms in a socially responsible manner while seeing to it that the most vulnerable are protected through well-targeted social transfers. Knowing full well that reform dividends will be evident only after some time, the authorities are mindful of the need for prompt, decisive action, and can ill afford to let distractions impede the reform process. While the challenges and risks loom large, the rewards of adhering to a coherent, well-thought out development template are greater in the form of improved social outcomes of better living standards, more jobs, greater equity, and lower poverty.