March 2011
IMF Country Report No. 11/59

Philippines: 2010 Article IV Consultation—Staff Report; Staff Statement; Public Information Notice on the Executive Board Discussion; and Statement by the Executive Director for Philippines

Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. In the context of the 2010 Article IV consultation with Philippines, the following documents have been released and are included in this package:

- The staff report for the 2010 Article IV consultation, prepared by a staff team of the IMF, following discussions that ended on December 10, 2010, with the officials of Philippines on economic developments and policies. Based on information available at the time of these discussions, the staff report was completed on January 18, 2011. The views expressed in the staff report are those of the staff team and do not necessarily reflect the views of the Executive Board of the IMF.

- A staff statement of February 18, 2011 updating information on recent developments.

- A Public Information Notice (PIN) summarizing the views of the Executive Board as expressed during its February 18, 2011 discussion of the staff report that concluded the Article IV consultation.

- A statement by the Executive Director for Philippines.

The document listed below has been or will be separately released.

Selected Issues Paper

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
Washington, D.C.

INTERNATIONAL MONETARY FUND

PHILIPPINES

January 18, 2011

Philippines: Staff Report for the 2010 Article IV Consultation

Prepared by Staff Representatives for the 2010 Consultation with the Philippines
Approved by Masahiko Takeda and Dominique Desruelle

Discussions: Manila, December 1–10, 2010. The team met with Finance Secretary Purisima, Bangko Sentral ng Pilipinas (BSP) Governor Tetangco, Budget Management Secretary Abad, National Economic Development Authority Secretary Paderanga, and other senior officials. The team also met with representatives from the private sector, academia, and unions. The BSP and staff held a joint workshop on policy research by Filipino economists and Fund staff.

Team: The staff team comprised V. Arora (Head), J. Ide, S. Peiris (all APD), A. Tuladhar (FAD), and P. Khandelwal (SPR), and was assisted by D. Botman (resident representative). Ms. Vongpradhip and Ms. Sicat (both OED) attended some of the meetings.

Consultation focus: With a recovery underway, the discussions focused on the policy challenges of preserving macroeconomic stability and enhancing the prospects for stronger medium-term growth. Doing so will require carefully managing the exit from stimulus policies while moving ahead with reforms to enhance the pace and quality of growth.

Past advice: In concluding the 2009 Article IV consultation, Executive Directors recommended that the exit from accommodative monetary policy await clear signs that the recovery is underway, and that the exit should start with a rollback of crisis-related liquidity measures. The BSP has indeed moved since January 2010 to roll back the latter measures. With respect to fiscal policy, Directors urged a measured withdrawal of stimulus, given limited fiscal space, and adoption of a medium-term consolidation plan to demonstrate commitment to fiscal prudence. These recommendations remain valid. The authorities have announced a medium-term consolidation starting from this year.

Outreach: The team held a press conference and issued a press release at the end of the mission.

Exchange rate: The Philippine peso is classified as a floating exchange rate. The Philippines has accepted the obligations of Article VIII, Sections 2, 3, and 4, and maintains an exchange system free of restrictions on payments and transfers for current international transactions.

Data: Data provision is adequate, but some shortcomings remain. The 2004 Data Report on Standards and Codes (ROSC) identified gaps in the national accounts and balance of payments statistics. The authorities have been making progress in these areas with Fund technical assistance.

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EXECUTIVE SUMMARY

Developments and outlook: After slowing during the global financial crisis, economic growth recovered strongly during the first three quarters of 2010. The recovery has been helped by supportive macroeconomic policies as well as strong private demand. The smooth transition to a new Administration in July 2010 and the government's focus on improving governance have strengthened investor confidence. Inflation has remained low and the balance of payments in sizable surplus. The staff projects growth to average 7 percent in 2010 and to settle at 5 percent from 2011.

Risks and challenges: Risks to the outlook are broadly balanced. High confidence could further boost investment and growth. Meanwhile, the external environment is complicated, as negative shocks to global growth would affect Philippine exports and remittances while large capital inflows would need to be handled carefully in order to avoid undue macroeconomic volatility. A key challenge will be to manage the exit from stimulus policies in this complicated environment, while moving ahead with reforms to enhance the pace and quality of growth. Accordingly, the discussions focused on the following key policy areas:

- ***Monetary policy:*** The accommodative monetary stance has been appropriate so far, helping to support the recovery as inflation has remained low. However, the stance needs to start being tightened in the near term in order to head off inflation risks.
- ***Managing external inflows:*** Rising external inflows during 2010 have been reflected in a large increase in international reserves and some exchange rate appreciation. The authorities have further liberalized capital outflows and eschewed capital controls. With reserves now at comfortable levels, the peso broadly in equilibrium, and inflows likely to persist there is scope to rely more on greater exchange rate flexibility going forward.
- ***Fiscal policy:*** The authorities' plan to reduce the fiscal deficit from nearly 4 percent of GDP in 2010 to 2 percent by 2013 is a welcome move toward fiscal consolidation. A greater consolidation could be considered to reduce public debt further as well as create more fiscal space for the government to respond effectively to future shocks. In order to achieve consolidation as well as allow the government to provide key public goods and services it will be essential to raise the tax effort, which is low by regional standards.
- ***Financial sector:*** The Philippine financial sector remains sound and asset bubbles have not been a concern so far. However, asset price movements continue to warrant careful attention, particularly in an environment of rising capital inflows. Further financial market development could be helpful for channeling external inflows toward much-needed infrastructure investment.
- ***Reforms to enhance growth:*** Raising growth toward the government's 7–8 percent objective will require a continuation of efforts to rebalance the economy toward investment, particularly private investment, as well as to address impediments to job creation and productivity.

I. INTRODUCTION

1. **The Philippine economy is poised at a key moment as the recovery from the global downturn and positive sentiment in the country provide a window of opportunity for moving ahead decisively with reforms to raise inclusive growth.** After slowing sharply in 2009, economic growth recovered to 7½ percent (year/year) during the first three quarters of 2010. The smooth passage of the presidential and legislative elections in May 2010 and transition to a new administration in July 2010, as well as the government's resolve to address long-standing impediments to investment and growth, have buoyed confidence. Meanwhile, inflation has remained low and burgeoning external inflows have contributed to a sizable balance of payments surplus. In November 2010, Standard and Poor's upgraded to BB its rating of Philippine long-term foreign currency debt in recognition of the country's stronger financial position.

2. **Against this background, the discussions focused on the challenge of preserving macroeconomic stability and enhancing the prospects for medium-term growth.** Meeting this challenge will require carefully managing the exit from stimulus policies in a complicated external environment, while addressing long-standing obstacles to higher investment, job creation, and productivity. The authorities and staff generally agreed on the nature of the policy challenges, although the authorities viewed as less pressing than staff the need to unwind stimulus measures based in part on a higher assessment of the economy's supply potential and rising investor confidence.

II. RECENT ECONOMIC DEVELOPMENTS AND OUTLOOK

A. A Strong Recovery

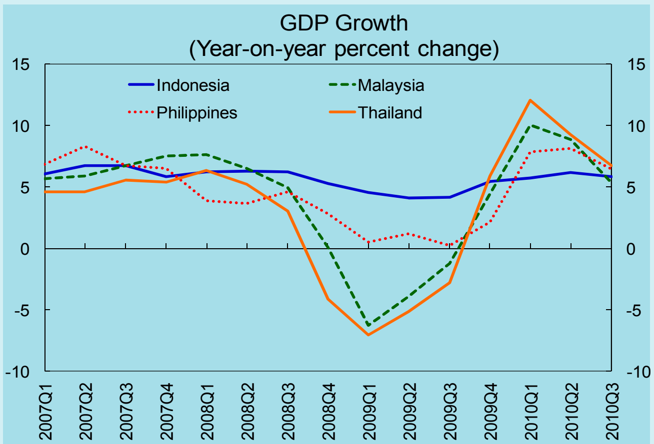
3. **Economic activity recovered strongly in the first three quarters of 2010** (Figure 1). Growth was broad-based across private consumption, investment, and exports, and was helped by continued policy stimulus, a temporary spending boost ahead of the May elections, and the re-stocking of global and regional inventories. These forces offset the adverse impact on growth of the El Niño drought in the first half of 2010. Business confidence and consumer sentiment continued to improve and employment increased. The unemployment and underemployment rates remained high, however, at nearly 7 percent and 18 percent, respectively, as of the third quarter. Private consumption has been supported by robust remittances, and investment by reconstruction following the late 2009 typhoons as well as growing interest in the business process outsourcing (BPO) sector. Exports have grown strongly on the back of recovering demand from advanced economies as well as other Asian countries, including China. In the third quarter of 2010, growth in the Philippines moderated, as it did in the rest of Asia, toward a more sustainable but still robust pace (6½ percent) as industrial production softened with the completion of the inventory cycle and government spending slowed.

4. **The external surplus continued to grow in 2010, underpinned by both the current**

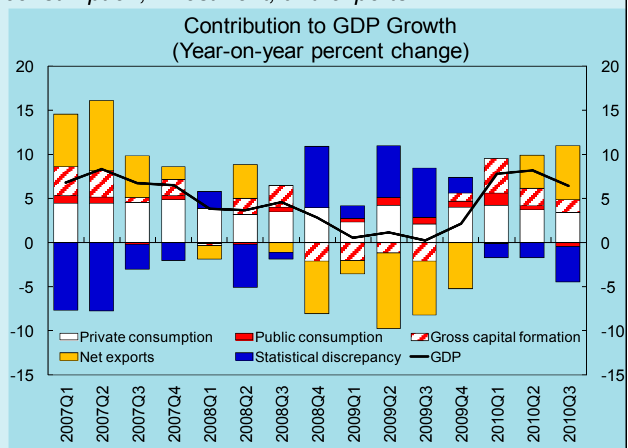
Figure 1. Philippines—Economic Recovery

Main Message: Growth recovered strongly in the first three quarters of 2010. In recent months, high frequency indicators suggest a moderating but still robust momentum.

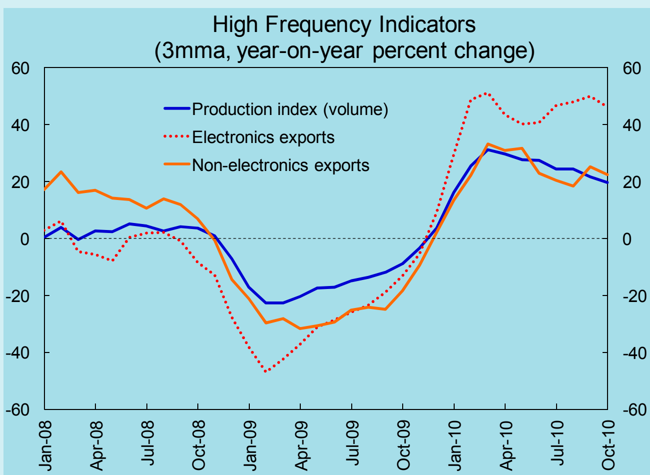
The economic recovery has continued, in line with other ASEAN economies.



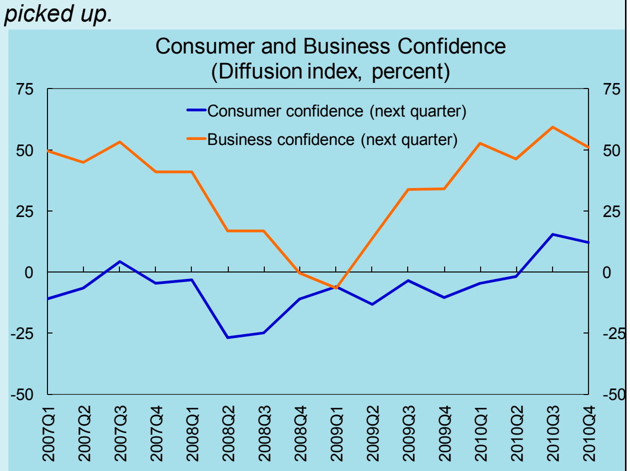
Growth has been broad based across private consumption, investment, and exports.



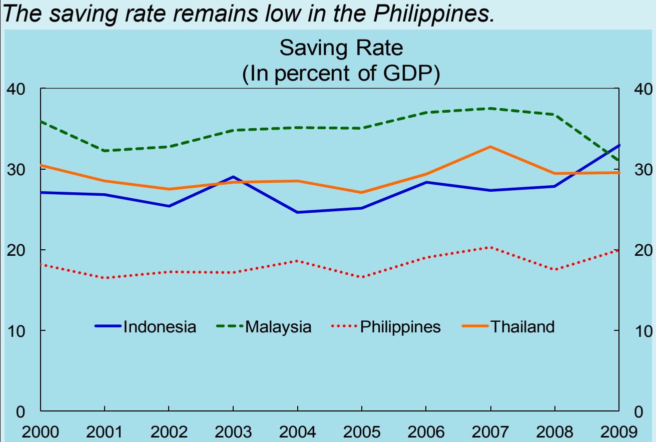
High frequency indicators suggest that growth has moderated but remained robust in recent months.



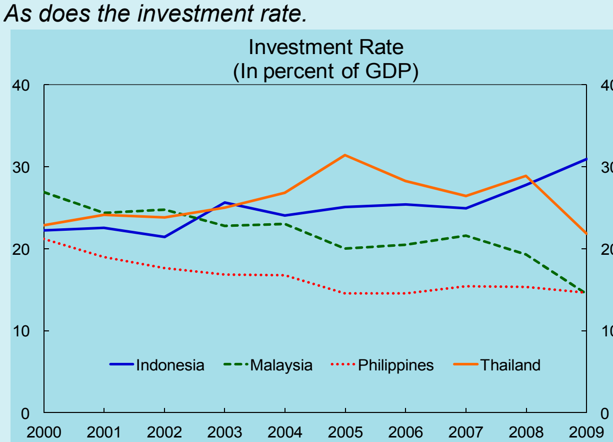
Consumer confidence and business sentiment have picked up.



The saving rate remains low in the Philippines.



As does the investment rate.



Sources: CEIC Data Company Ltd.; and IMF, WEO database.

and financial account (Figure 2). The surplus has reflected strong exports, remittances, sovereign bond issuance, and other capital inflows. Capital inflows have risen substantially since September as abundant global liquidity continues to find its way to emerging economies, including the Philippines, that have relatively strong growth prospects and offer favorable returns. Portfolio inflows, in particular, rose markedly in September and have continued to increase in recent months. Key sources of such inflows include the United States, United Kingdom, Hong Kong SAR, and Singapore. International reserves rose by about \$17 billion during January–November, to \$61 billion (10 months of imports), and the BSP forward book by about \$10 billion during January-October. The peso appreciated by around 4 percent in both nominal and real effective terms during January-November. The EMBI spread narrowed to 150 basis points as of late December, from around 250 points in June.

5. **Financial conditions remain accommodative, partly reflecting external inflows.** Credit growth has picked up since mid-2010, and benchmark government bond yields have fallen to historical lows amid ample liquidity and rising foreign demand.

6. **Inflation has nonetheless been moderate.** Headline inflation has remained well within the BSP's 3½–5½ percent target in recent months, and averaged 3.8 percent (year/year) during January-November 2010 (Figure 3). Food inflation remained subdued owing to favorable domestic supply conditions, and core inflation (excluding volatile food and energy items) was contained in the 3–4 percent range in part reflecting exchange rate appreciation. Inflation expectations over the coming year remain within the target range according to the BSP's December inflation report.

7. **Notwithstanding the strong recovery, fiscal revenue fell short of budget targets in January–September** (Figure 4)**.** The budget targets were ambitious, but the underperformance also owed to various revenue-eroding measures that remain in place. The national government deficit, however, came in slightly below the targeted level (3.3 percent of GDP) owing to a sharp slowdown in spending in the third quarter. Financing conditions have been comfortable, and in September 2010 the Philippines became the first emerging Asian country to issue a local currency-denominated global bond.

B. A Favorable Near-Term Outlook and Medium-Term Prospects

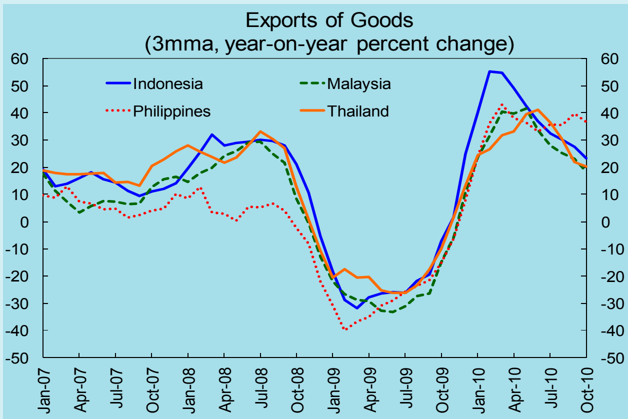
Staff's Views

8. **The near-term outlook is generally positive. Growth is projected to be 7 percent in 2010 and to moderate to a still robust 5 percent in 2011**. The projected moderation reflects a waning of the policy stimulus and a dissipation of temporary factors, such as the pre-election spending and post-typhoon reconstruction that supported the cyclical recovery in early 2010. While inflation has been low, pressures may start to build during the coming quarters and, in the staff's view, some tightening in financial conditions is

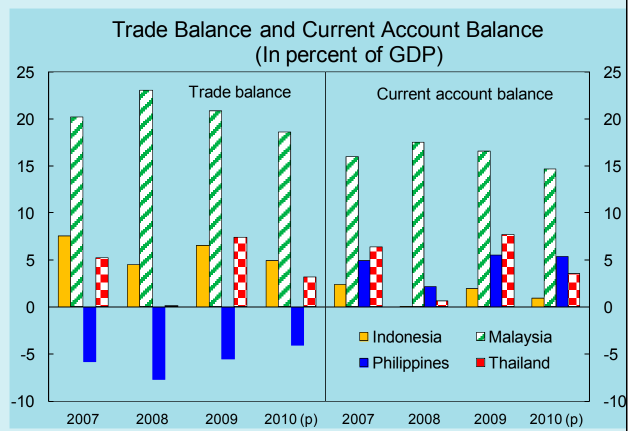
Figure 2. Philippines—Balance of Payments and External Adjustment

Main Message: The balance of payments has remained strong. Capital inflows have surged in recent months, contributing to upward pressure on exchange rate.

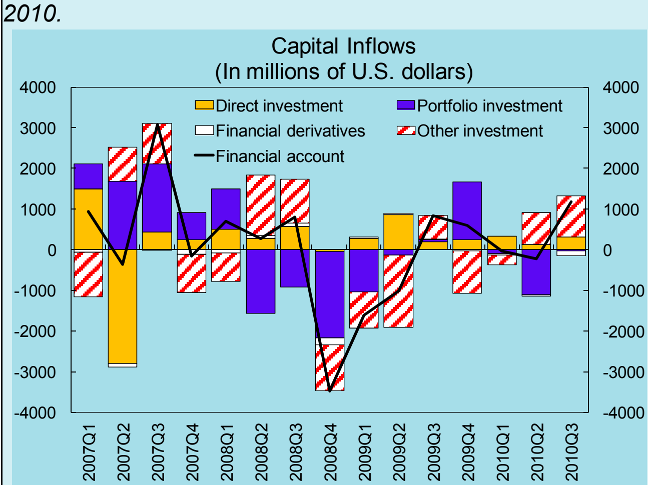
Exports have rebounded strongly, in line with other ASEAN economies.



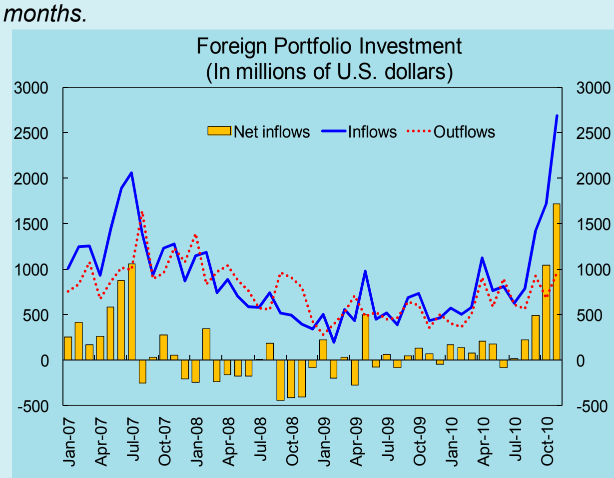
The current account balance remains in surplus.



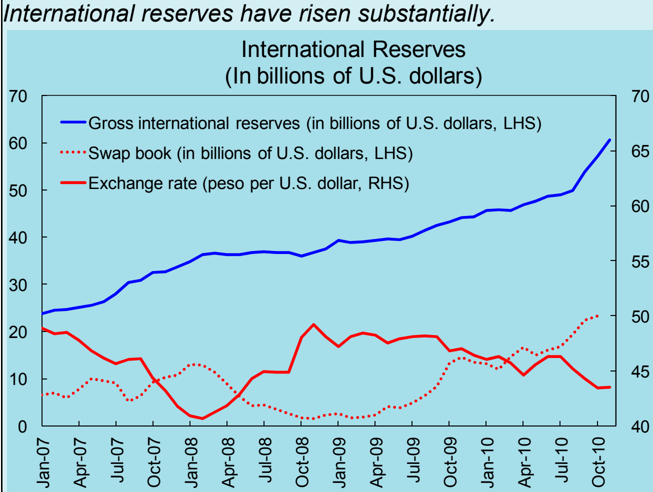
Capital inflows started to increase in the third quarter of 2010.



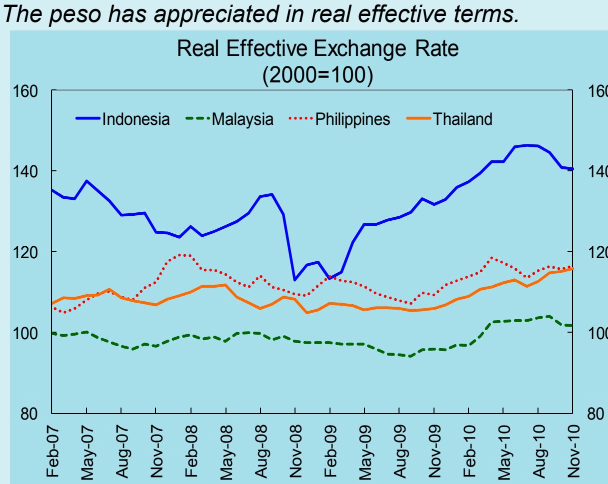
Foreign portfolio investment has increased in recent months.



International reserves have risen substantially.



The peso has appreciated in real effective terms.

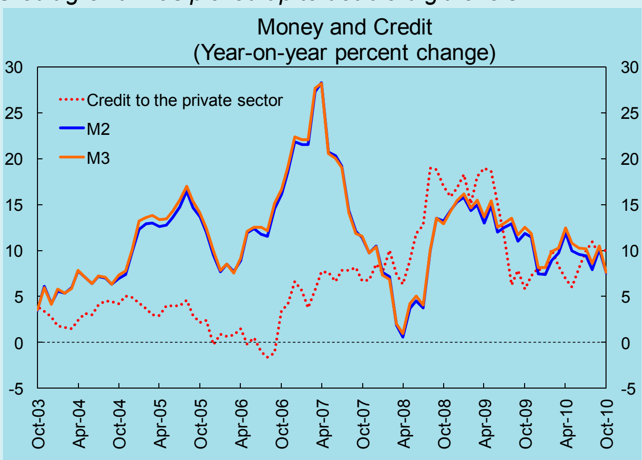


Sources: CEIC Data Company Ltd.; IMF, WEO database; and IMF staff calculations.

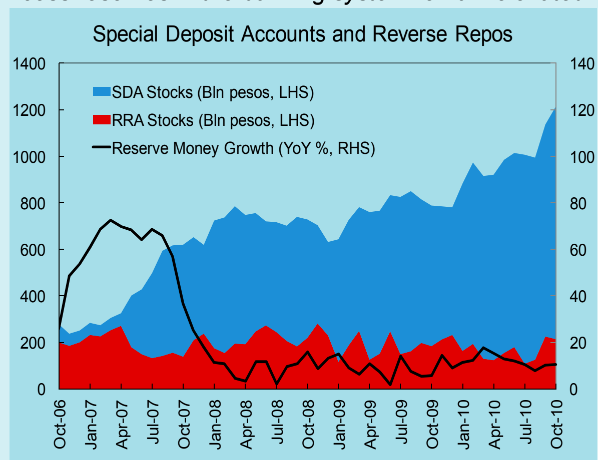
Figure 3. Philippines—Monetary Policy and Inflation

Main Message: Monetary and financial conditions remain accommodative. The time may soon be coming to tighten the monetary stance, although inflation remains contained.

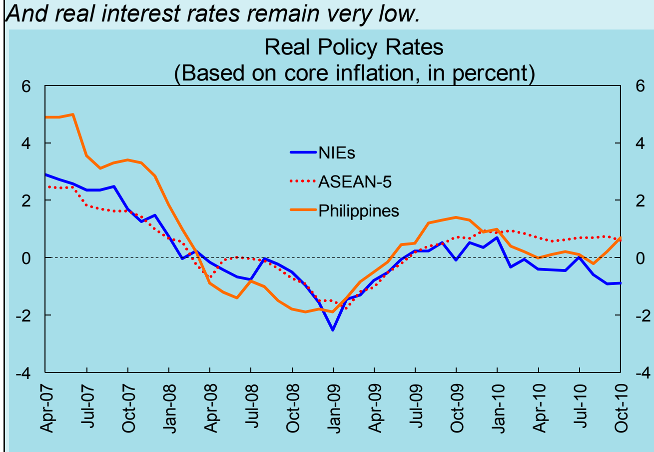
Credit growth has picked up to double-digit levels.



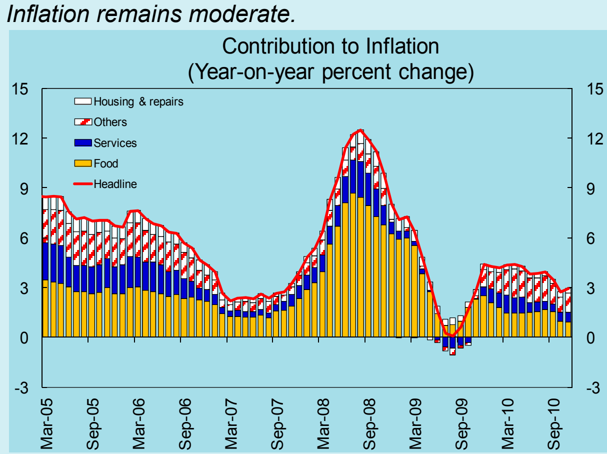
Excess reserves in the banking system remain elevated.



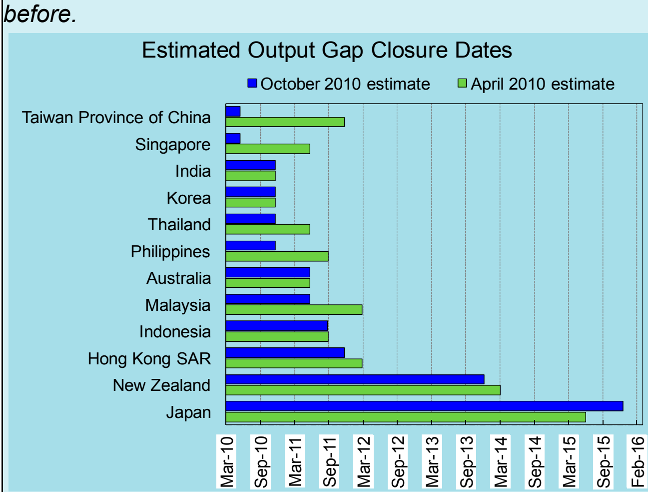
And real interest rates remain very low.



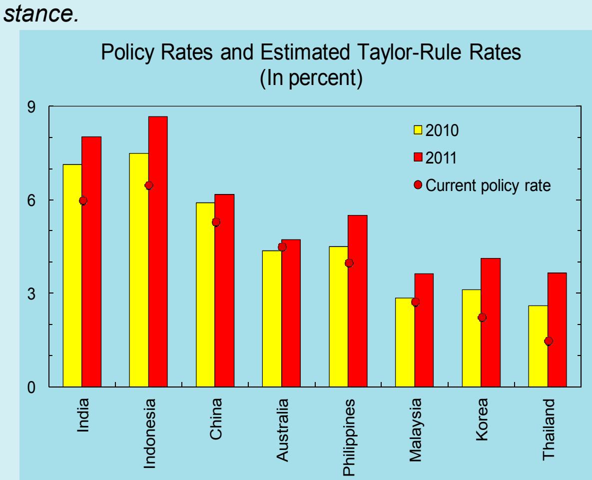
Inflation remains moderate.



But the output gap is closing more rapidly than expected before.



And the time may soon be coming to tighten the monetary stance.

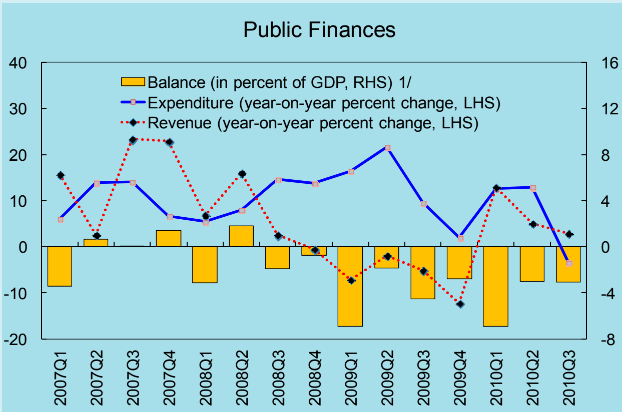


Sources: Bloomberg; CEIC Data Company Ltd.; IMF, *Asia and Pacific Regional Economic Outlook* (October 2010).

Figure 4. Philippines—Public Finances

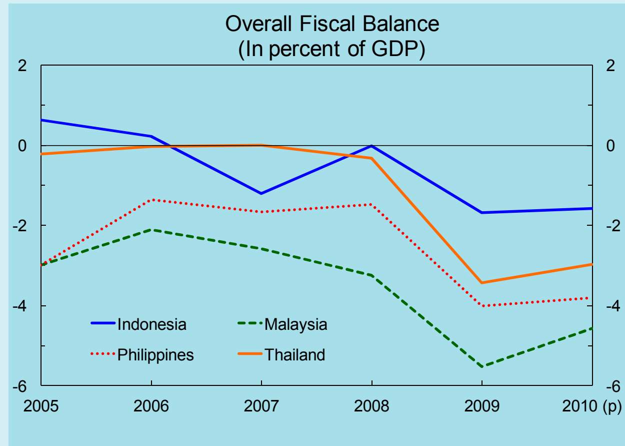
Main Message: Fiscal space is relatively limited, characterized by low revenue and high debt.

Despite the rapid recovery, fiscal revenue remains weak.

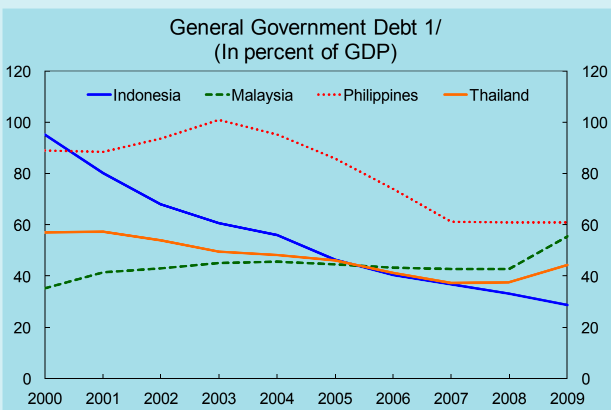


1/ Period flows divided by actual GDP during the same period.

The fiscal deficit is high relative to regional peers.

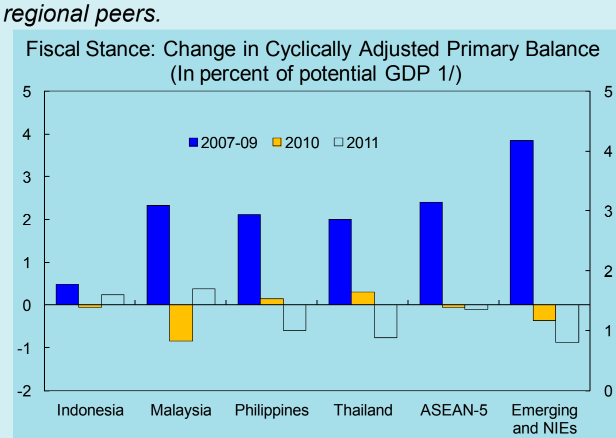


The debt to GDP ratio is relatively high.



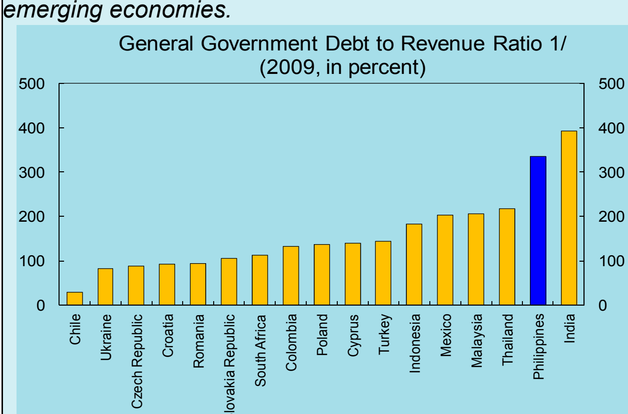
1/ Non-financial public sector debt is used for the Philippines.

The planned fiscal withdrawal looks comparable to regional peers.



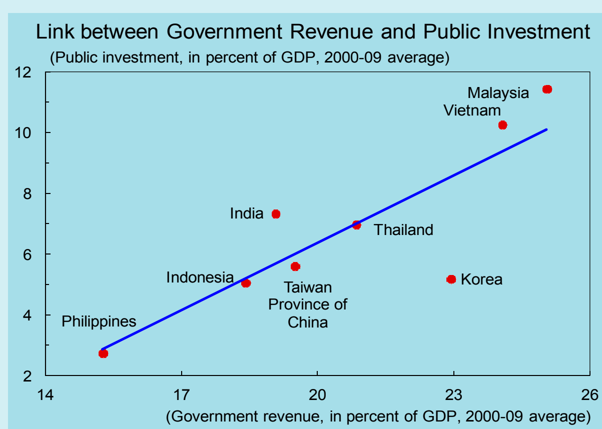
1/ Negative numbers indicate a withdrawal of fiscal stimulus.

The debt-to-revenue ratio is high compared with other emerging economies.



1/ For Indonesia and the Philippines, figures are for central government.

Low fiscal revenue constrains public investment.



Sources: CEIC Data Company Ltd.; IMF, WEO database; and IMF staff calculations.

likely needed to keep inflation within the target range over the next two years. The balance of payments is projected to remain in surplus as remittances and export diversification support the current account balance and the Philippines continues to attract capital inflows.

9. **Risks to the outlook are broadly balanced.** The positive economic sentiment in the country may boost private investment more than expected. However, renewed shocks to global growth and financial markets would affect Philippine exports and remittances. Meanwhile, surges in capital inflows could lead to asset price booms and busts, as well as raise the potential for future destabilizing outflows. Although historically the Philippines has not been a large recipient of capital inflows, the historical experience does not include a comparable period of abundant global liquidity.

10. **Over the medium term, the staff expects growth to continue at 5 percent annually** (Box 1). The projection is in line with the Philippines' regional peers and is somewhat higher than the staff's projections for the October 2010 *World Economic Outlook*. The projection is, however, lower than the authorities' 7–8 percent target, which would require additional measures to attain in the staff's view. Measures will be needed to rebalance the economy toward investment, particularly to improve the climate for private investment and strengthen public infrastructure, and to address impediments to greater job creation and productivity.

Authorities' Views

11. **The authorities shared the staff's broadly positive outlook, although they expect growth to be even higher.** Growing confidence, new initiatives such as PPPs, a continued diversification of exports, and robust remittances could contribute to raise growth to the 7–8 percent range in 2011 and the medium term. The authorities' more positive assessment of the economy's growth potential also contributed to their more benign near-term inflation outlook than staff, with inflation projected to stay well within the target range. The authorities broadly shared the staff's views on the risks to the outlook, although they emphasized concerns about capital inflows, as the easing of monetary policy in advanced countries could exacerbate future inflows to emerging Asia, including the Philippines.

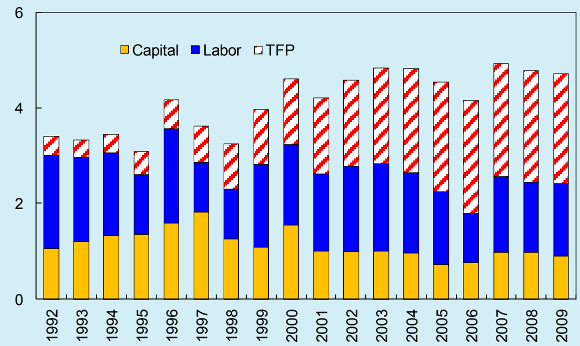
III. POLICIES—PRESERVING MACROECONOMIC STABILITY AND ENHANCING GROWTH

Preserving macroeconomic stability and enhancing medium-term growth prospects will require carefully managing the exit from stimulus policies in a challenging external environment, while moving ahead with long-awaited structural reforms to enhance investment, jobs, and productivity.

Box 1. Philippines—Potential Growth and Prospects[1]

Potential growth in the Philippines has increased since the late 1990s. Estimations based on a simple filtering approach, a production function approach, and a multivariate time-series model approach suggest that potential growth has risen from 3-4 percent in the 1990s to 4½–5 percent in recent years. The sources of growth in the Philippines have changed somewhat over time, in line with other ASEAN economies, with a rise in the contribution of total factor productivity (TFP) and a fall in the contribution of capital.

Potential Growth Contribution: Capital, Labor, and TFP
(In percent)



Source: IMF staff estimates.

TFP growth is aided by improvements in human capital and institutional quality and transition from agriculture to industry. Results from a cross-country panel regression suggest that, for the Philippines, an increase in average secondary schooling years and a transition of economic activity from agriculture to industry and services during 1996–2005 could be associated with an improvement in TFP growth by 1 percentage point.[2] In addition, an improvement in institutional quality during the same period could be associated with an improvement in TFP growth by 0.1 percentage point.

An illustrative reform scenario that would see potential growth rise to the authorities' target of 7-8 percent could include the following elements:

- ***Productivity.*** Based on the regression estimates, continued investment in human capital, further transition of economic activity from agriculture to industry and services, and improvements in institutional quality could raise the growth contribution of TFP from historical averages.

Growth Contribution Under a Reform Scenario

	2000-09 (average)	2015 (reform)
Potential growth (percent)	4.6	7.0
Contribution of TFP (percent)	2.0	3.0
Contribution of capital (percent)	1.0	2.0
Contribution of labor (percent)	1.6	2.0

Source: IMF staff estimates.

- ***Investment.*** Fiscal reforms and improvements in the business climate that raise the investment rate from its historical average of 15 percent of GDP to 19½ percent by 2015 could raise the growth contribution of capital from 1 percent historically to 2 percent by 2015.

- ***Employment.*** In addition to job creation, improvements in labor market flexibility and active labor markets measures such as job training and search assistance would be needed to increase the growth contribution of labor.

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[1] See Selected Issues Paper for details.

[2] The share of agriculture value added to GDP is used as a proxy to measure this transition.

A. Normalizing the Monetary Stance

Background

12. **Monetary policy responded well to the crisis and has helped foster the recovery.** A 200-basis-point cut in policy rates during December 2008–July 2009, and additional crisis-related liquidity support measures, helped to cushion the economy against the downturn. With the recovery underway, the BSP appropriately started to unwind its liquidity support measures since early 2010. In July, it extended through 2014 the 3-5 percent inflation target for 2011.

Staff's Views

13. **The BSP's holding stance has been appropriate, but it remains important going forward to respond proactively to price pressures.** The stance has been justified by the soft inflation data during most of 2010, uncertainties in the outlook, and relatively short lags in the Philippines between policy moves and inflation outturns.

14. **While inflation has been moderate so far, pressures could build during 2011.** Financial conditions remain accommodative, with real policy rates close to zero and below a Taylor-rule implied "neutral" rate and treasury bill yields falling below policy rates in mid-November (see Selected Issues Paper, Chapter 2). Moreover, rising external inflows could further fuel asset prices, depress local long-term yields, and stimulate domestic demand. A potential widening of the positive output gap amid accommodative monetary conditions suggests that monetary policy tightening likely needs to start in the near term in order to head off inflation risks. Should a tail risk materialize, such as renewed global turmoil, the timing of the monetary normalization could be recalibrated.

Authorities' Views

15. **The authorities appreciated the staff's assessment of monetary policy so far, but, looking forward, they saw the current monetary stance as being consistent with both low inflation and economic expansion.** The BSP saw inflation as remaining well within the target range in 2011–12 in the absence of adverse shocks. They felt that the economy's productive capacity had increased and would keep inflation well contained. The sharp fall in treasury yields since November was seen as temporary and liquidity as being broadly in line with economic activity. The authorities noted, however, that inflation risks were finely balanced and that generally higher global food and oil prices, as well as stronger demand momentum, could add to inflationary pressure. They emphasized that they stood ready to respond proactively should such pressure emerge.

B. Managing External Inflows

Background

16. **The authorities have sought to strike a balance between various measures in their toolkit for managing external inflows in recent years.** They further liberalized controls on capital outflows in October and have not modified regulations on capital inflows. They have had in place for some years macro-prudential measures that have worked well and have sought to prepay some external debt. The exchange rate has appreciated in nominal and real effective terms, although by somewhat less than in neighboring economies. Reserves have risen to high levels. Reserve coverage in the Philippines is now comparable to that in regional peers, but it is high in comparison to the past and would seem to be comfortable according to standard prudential metrics.

Net International Reserves (End-2009)

	In months of imports	In percent of short-term debt	In percent of broad money	In percent of short-term debt and foreign currency deposits
Indonesia	7.1	204.1	34.0	96.9
Malaysia	8.0	363.2	29.4	227.3
Philippines	9.7	389.1	46.3	126.2
Thailand	10.6	374.3	45.3	339.3

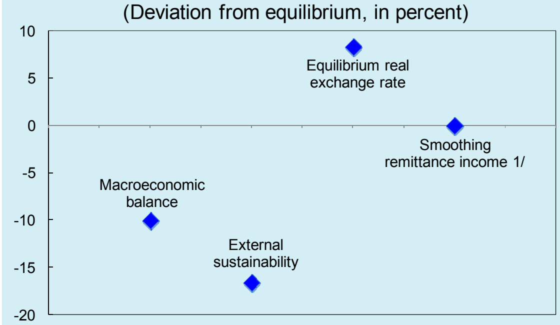
Source: CEIC Data Company Ltd.

The BSP has sterilized much of the reserve buildup in order to avoid an undue expansion in monetary aggregates, and sterilization costs have increased as domestic-foreign yield differentials have widened.

Staff's views

17. **The real exchange rate remains broadly in line with its medium-term fundamentals**. A panel estimation of the standard macro-balance, external sustainability, and equilibrium exchange rate approaches indicates a wide range of results with, on average, the peso not far from its medium-term fundamental level (around 6 percent below). An alternative estimation that takes into account long-term trends in remittances and the current account that may differ substantially from medium-term outcomes supports the conclusion that the exchange rate is close to its equilibrium level (Box 2).

Real Exchange Rate Assessments
(Deviation from equilibrium, in percent)

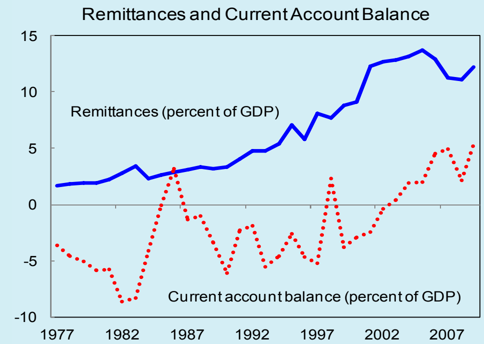


Source: IMF staff estimates.
1/ This approach derives a current account norm by smoothing remittance income to yield a constant real income stream per capita.

18. **With reserves at comfortable levels according to standard metrics and the exchange rate not overvalued, there is scope to shift the policy emphasis away from reserve accumulation and toward other measures in response to external inflows going forward**. The staff continues to support the authorities' stated policy of limiting foreign exchange market intervention to smoothing operations. In this context, greater exchange rate flexibility should be considered. Exchange rate appreciation also offers an important buffer that would help to tighten monetary conditions in a way that lessens speculative inflow pressures. Moreover, appreciation would be a necessary part of the adjustment to inflows that are likely to be sustained (Box 3).

Box 2. Philippines—Implications of Long-Term Trends in Remittances for the Equilibrium Exchange Rate

International migration is a prominent feature of the Philippine economy and remittances have played an important role in external balances. In recent years, strong growth in remittance inflows has contributed to a rising current account surplus, making the Philippines one of the largest recipients worldwide. A question that this raises is what the implications are for the equilibrium current account balances and, therefore, for the equilibrium exchange rate.



From a long-run perspective, remittances are likely to prove an exhaustible resource, with implications for external sustainability. According to U.N. estimates, outward migration rates from the Philippines climbed steadily from the late 1960s through the early 1990s, contributing to a rise in the number of migrants and in remittances. Going forward, the U.N. projections envisage a slowing population growth rate that contributes to a gradual decline in migration rates. Retirement by existing migrants, along with declining migration rates, would contribute over time to a decline in the number of overseas foreign workers (OFWs) and, accordingly, in remittance inflows. For example, a 3 percent annual retirement rate would contribute to a decline in remittances to 5 percent of GDP by 2050 from 13 percent of GDP in 2010.

In the face of a long-term decline in remittance receipts, intertemporal consumption smoothing would call for an accumulation of assets in the short and medium term. A balance sheet-based methodology, similar to that for oil producing countries, can help indicate an optimal intertemporal allocation of temporary income. The allocation would seek to save some of the remittances in order to generate a steady stream of income over time. The stream of income (an annuity) could be defined at different levels—a constant real annuity per capita; a constant annuity in percent of GDP; or a constant real annuity.

Intertemporal Consumption Smoothing of Remittances

	Equilibrium Current Account Balance
	(percent of GDP)
Constant real per capita annuity	1.8
Constant annuity/output ratio	8.5
Constant real annuity	-1.3

Source: IMF staff estimates.

Achieving a constant real annuity in per capita terms is the base case. For each desired level of future income, the equilibrium current account is determined as the difference between consumption and income and remittance flows. The table summarizes the main results. Achieving a constant real per capita annuity requires a medium-term current account surplus of 1.8 percent of GDP. Achieving a constant ratio of annuity income to GDP requires much higher saving through a large current account surplus, while achieving merely a constant annuity in real terms allows a current account deficit as remittances are projected to continue to grow in the near future.

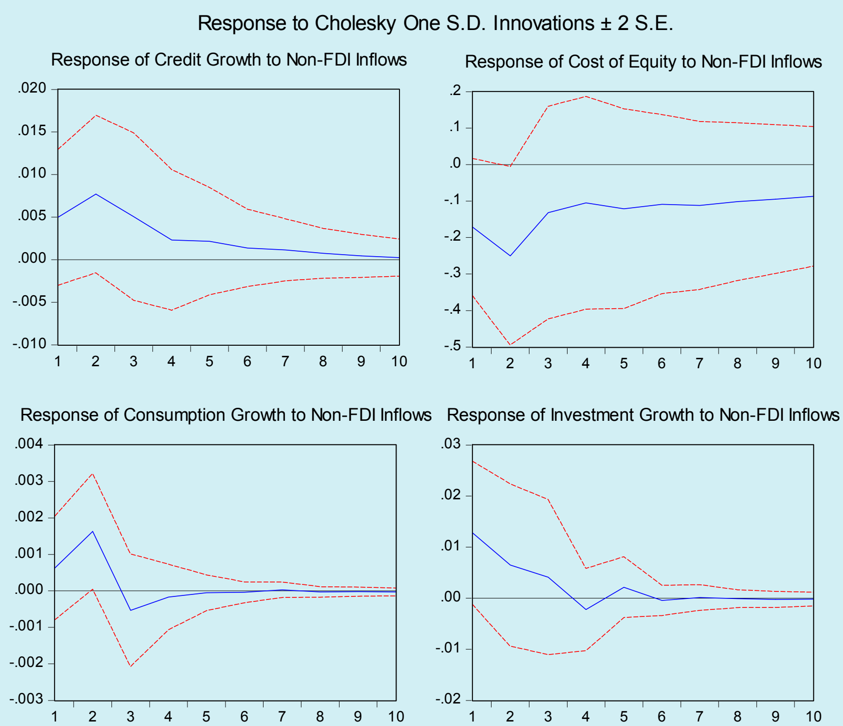
Intertemporal consumption smoothing of remittances income, as specified above, implies that the real exchange rate is broadly aligned with medium-term fundamentals. Stripping the Philippines' current account balances of temporary factors yields a medium-term current account balance of 1.9 percent of GDP, in line with the desired level of the current account balance, at 1.8 percent of GDP. Hence, the real exchange rate is assessed to be broadly in line with long-term fundamentals based on this methodology.

Box 3. Capital Flows to the Philippines: Determinants and Risks

Capital flows to the Philippines can be attributed to both external "push" factors and domestic "pull" factors. Results from a quarterly time series Exponential Generalized Autoregressive Conditional Heteroskedasticity (EGARCH) model of non-FDI inflows to the Philippines during 1990-2010 suggest that the key determinants of net capital inflows are the growth differential relative to advanced countries, interest rate differentials, the degree of global risk aversion (proxied by the VIX index), and exchange rate changes.

The outlook for capital flows to the Philippines is strong given expected patterns for the key determinants. Sizable growth- and interest rate differentials between the Philippines and advanced countries are likely to persist for some time, suggesting that the impetus for capital inflows should remain strong in 2011 and the medium term. At the same time, shocks to global risk aversion could lead to sudden stops or capital flow reversals.

Capital inflows present opportunities, but they can also pose macroeconomic and financial risks. The inflows, if channeled effectively, represent an opportunity to address long-standing investment needs, such as in infrastructure. However, capital inflows need to be managed carefully in order to avoid macroeconomic and financial risks. Inflows can increase liquidity and boost domestic demand and asset prices. In the Philippines, the empirical relationship between non-FDI capital inflows and domestic demand is strong (text chart). The main channel through which the relationship seems to work is by expanding credit and reducing the cost of finance. Although portfolio inflows have not so far led to overheating pressures, liquidity is unusually high and the government bond yield curve has fallen to historical lows, complicating the task of monetary policy. Asset price increases in recent quarters have been confined to equities, where, however, valuations are broadly in line with historical averages.



Authorities' views

19. **The authorities emphasized that their response to capital inflows was based on achieving a balance among various measures in the traditional toolkit.** The balance had been right in their view between exchange rate appreciation and reserve accumulation. Reserves had provided an important buffer during the crisis. They were studying the issue of reserve adequacy and recognized the costs of reserve accumulation. However, particularly in a volatile external environment, they would be reluctant to conclude too quickly that reserves were at adequate levels. Moreover, if a significant component of the inflows were transitory and driven by cyclical factors, then it was appropriate to smooth the impact on the exchange rate. At the same time, the authorities were looking for ways to increase the absorptive capacity of the economy and harness capital flows to support investment and potential growth.

C. Fiscal Consolidation through Higher Revenue

Background

20. **The authorities aim to reduce the national government deficit from 3.9 percent of GDP in 2010 to 2 percent from 2013.** Fiscal consolidation over the medium term would help to create more fiscal space for the budget to be able to respond effectively to future shocks. Consolidation would improve medium-term growth prospects by lowering sovereign risk and enhancing investment and it would reduce the share of debt service in government expenditure (see Selected Issues Paper, Chapter 3). It would also help in managing the macroeconomic impact of external inflows.

21. **The main elements of the authorities' fiscal plans are stronger tax administration, a reorientation of expenditure towards social sectors and infrastructure, and a public debt management strategy that reduces the share of external debt and lengthens the maturity structure.** A revenue based consolidation is envisaged that relies primarily on tax administration efforts, which will include technical assistance from the U.S. Millennium Challenge Corporation compact and the Fund. The authorities have pledged not to raise taxes at least until 2012. Expenditure plans include a greater emphasis on basic education, an expansion of the conditional cash transfer program and health insurance coverage, and a reduction in subsidies for rice imports and rail transportation. Efforts are underway to expand PPP projects for infrastructure with partial government investment being mobilized from government financial institutions and social security institutions. The civil service wage bill, however, continues to increase rapidly and accounts for over 40 percent of primary expenditure. While debt sustainability is not an immediate concern, the authorities are focused on reducing the debt burden as public debt stands at nearly 60 percent of GDP and 3 times fiscal revenue. Debt service absorbs a quarter of primary expenditure.

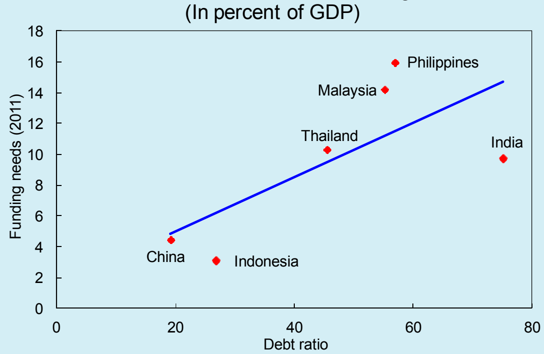
22. **Consistent with their medium-term consolidation goal, the authorities are planning a fiscal withdrawal in 2011**. The 2011 budget targets a reduction in the

national government deficit to 3.2 percent of GDP (authorities' definition, includes privatization receipts). The deficit reduction would imply a withdrawal of fiscal stimulus of about ½ percent of GDP, which is roughly in line with the pattern in regional peers (Figure 4). However, given expenditure plans, the 2011 deficit target would require a substantial increase in fiscal revenue, which fell short of targets in 2010. Under the staff's baseline forecast, which assumes no additional revenue measures to those that are already planned, the deficit could remain slightly above 3½ percent of GDP.

Staff's Views

23. **The authorities' medium-term consolidation plan is a welcome marker of the policy direction that would help improve investor confidence further and increase the government's ability to respond to shocks.** Public debt would, however, still be relatively high (nearly 50 percent of GDP and 200 percent of revenue by 2015, see Appendix I), government gross financing requirements substantial, and interest expenditure still a large share of the budget, suggesting that further debt reduction could be considered going forward. In 2011, with growth envisaged to remain robust and in light of the need to make credible progress toward medium-term consolidation, a greater withdrawal of fiscal stimulus could be considered.

Link between Debt Ratio and Funding Needs
(In percent of GDP)



Source: IMF, Fiscal Monitor.

24. **In order to achieve fiscal consolidation and scale up social expenditure and public investment, it will be essential to raise the tax effort.** The authorities' intention to focus initially on improving tax administration is appropriate and should help over time to enhance revenue collection. To make substantive gains in revenue, early actions to broaden the tax base and simplify the tax system should complement the planned tax administration measures, whose full effect will take time to materialize. In particular, in keeping with the advice of Fund technical assistance to the Philippines, reforms are needed to strengthen excise taxes, rationalize fiscal incentives, and address inefficiencies in the VAT.

25. **On the expenditure side, the reorientation of spending should help to support inclusive long-term growth.** Given the low levels of social spending, the staff supports the authorities' plans to limit rice and transport subsidies by public enterprises and move instead to more targeted conditional cash transfer programs. The roll-out of Public Private Partnerships should help to improve infrastructure, although these projects should be evaluated using sound cost-benefit analyses and the fiscal risks associated with them reflected in the fiscal accounts. The staff cautioned against the rapid growth in the civil service wage bill, and suggested a faster implementation of the government's plan to rationalize public services.

26. **The staff supports the government's recent initiatives to strengthen the fiscal framework.** A fiscal responsibility law is being proposed that should help impose greater

fiscal discipline by requiring that new budget proposals are deficit neutral. The authorities' ongoing efforts to strengthen public financial management, publish a fiscal risk statement, and focus debt management on reducing currency and maturity risk should help to further strengthen the public finances. Meanwhile, a medium-term budget framework would be very helpful for anchoring fiscal consolidation as well as improving fiscal planning and raising confidence among investors.

Authorities' Views

27. **The authorities reiterated their firm commitment to medium-term fiscal consolidation.** Recent debt management operations had gone some way to reduce currency and rollover risks, and in this light they viewed the medium-term target of 2 percent of GDP as achieving a good balance between fiscal consolidation and an appropriate level of development spending. While acknowledging that the 2011 deficit target would require a substantial revenue effort, the authorities noted that they would consider taking spending measures to meet the target should revenues underperform. On the other hand, they felt that any positive revenue surprises should be allocated not to deficit reduction but to meet spending needs.

28. **The authorities agreed that fiscal consolidation should be based primarily on revenue measures**. While they do not envisage any increase in tax rates in the near term, they have agreed on principles to limit tax exemptions and incentives. Proposals to reform excise taxes are under consideration in Congress.

29. **The authorities reiterated their commitment to a continued reorientation of expenditure toward social objectives.** A spending review that is ongoing under the "zero-based budgeting" approach should help to identify areas where there may be scope for savings. The authorities agreed that the size of the civil service would need to be carefully managed in order to restrain the public wage bill over the medium term.

D. Maintaining and Strengthening Financial Sector Resilience

Background

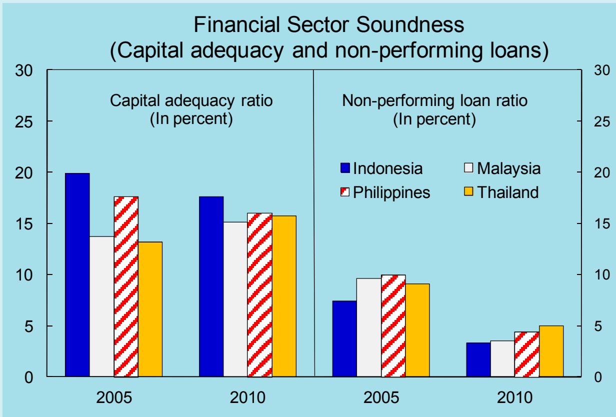
30. **The Philippine financial sector withstood the crisis well, and developments in recent quarters continue to support the January 2010 Financial System Stability Assessment (FSSA) that it remains sound** (Figure 5). The sector was relatively unaffected by global market turbulence last summer, as its direct exposure to Europe and reliance on foreign wholesale funding are limited. Universal and commercial banks' non-performing loan ratios have remained low (3.2 percent on average as of October 2010) and banks' capital adequacy ratios high at about 16 percent as of June (latest data available). Banks' profitability has improved, with net income growing by 22 percent (year/year) in the first half of 2010.

31. **Asset price bubbles have not been a concern so far, but surges in external inflows could pose a challenge.** Stock prices have risen rapidly since early 2010, with the Philippine stock market among the strongest performing in Asia, and price-earnings ratios have regained their pre-crisis levels. However, valuations are in line with long-run historical

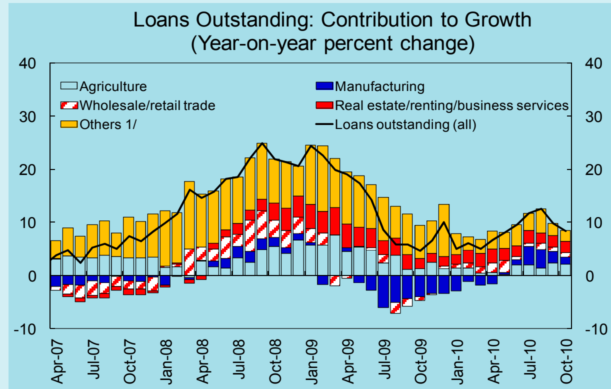
Figure 5. Philippines—Financial Stability and Asset Prices

Main Message: The financial sector remains sound. Price to earnings (P/E) ratios have increased in recent months, while property prices and credit to the real estate sector have remained moderate.

Philippine banks are well-capitalized, and non-performing loans are relatively low.

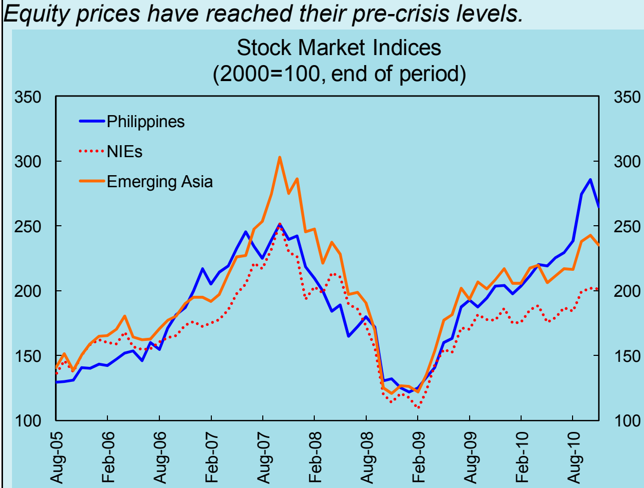


Bank lending has started to pick up in recent months across all sectors.

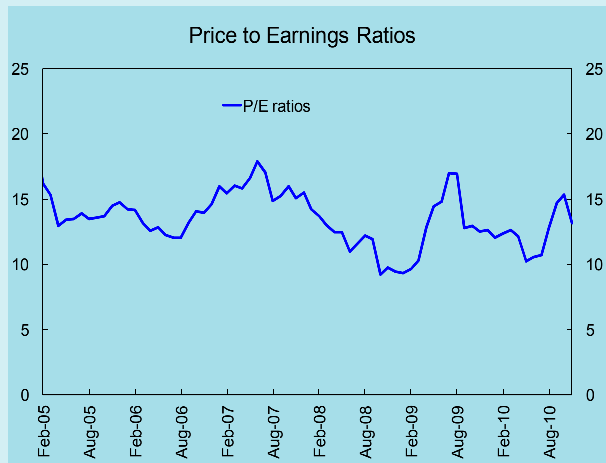


1/ Others include electricity, transportation, financial intermediation, and household consumption.

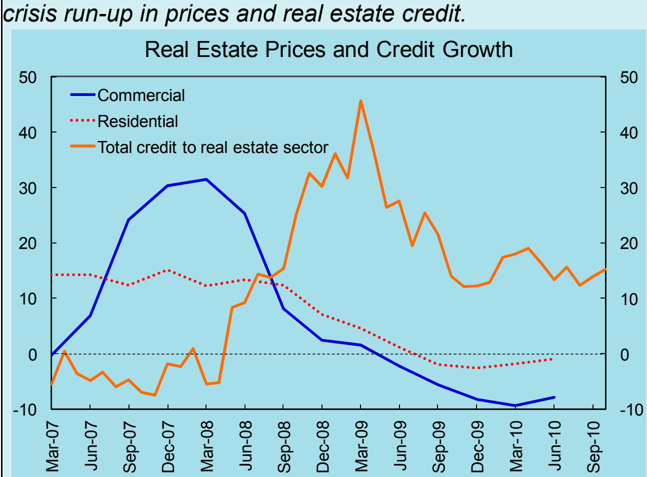
Equity prices have reached their pre-crisis levels.



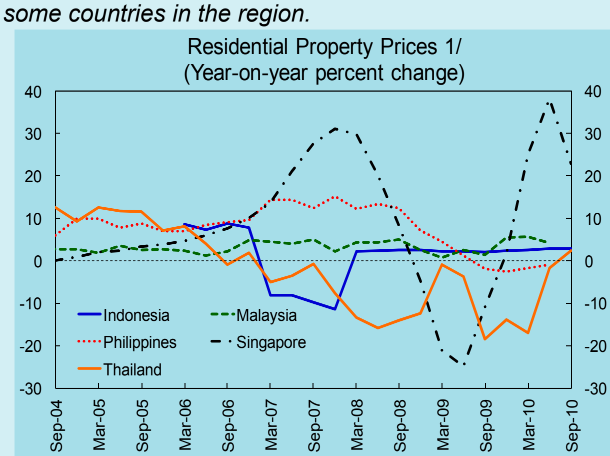
And P/E ratios have increased in recent months.



Property prices remain moderate notwithstanding the pre-crisis run-up in prices and real estate credit.



The residential property market remains soft unlike in some countries in the region.



1/ Prices in 14 cities are used for Indonesia. Prices in Makati are used for the Philippines.

Sources: Bloomberg; CEIC Data Company Ltd.; and Philippine authorities.

averages. Property prices remain moderate, particularly for commercial real estate. In recent months, prices have firmed in some segments, such as low-to-middle income housing, but existing prudential measures like the loan-to-value ratio and cap on real estate loans have kept prices in check. External inflows could, however, further fuel liquidity and swamp local financial markets, particularly the bond and swap markets, which are relatively small.

Staff's Views

32. **Two key risks to the financial system, as flagged in the 2010 FSSA update, are concentration risk and interest rate risk.** These risks are particularly relevant in the Philippines because of, respectively, the dominant role of conglomerates in corporate and bank ownership (which magnifies "connected" lending in banks' portfolios) and the large share of securities in banks' assets. The staff welcomes the authorities' continued vigilance over these sources of vulnerability. In November, the BSP approved a separate single borrower limit for infrastructure and development PPP projects, under which banks can extend loans and guarantees for such projects up to 25 percent of their net worth. The move will facilitate these projects, but such lending should be monitored for concentration risk and maturity mismatches.

33. **Further financial market development could be helpful for channeling the external inflows toward productive investment, such as infrastructure.** Infrastructure financing has specific requirements such as long-term funds and lumpy investment that are best met by private capital markets. However, the Philippine financial system remains bank dominated. Capital market development would benefit from a harmonizing of the various taxes and a lowering of the regulatory burden on some products and services. In particular, corporate bond and derivative markets would benefit from measures to further develop a benchmark yield curve, enhance third-party credit (such as bond insurance), develop hedging tools for investors and traders, and reduce the time and expense of new debt offerings.

34. **The Philippines has made significant gains in improving the supervisory and regulatory framework in recent years.** These gains helped the financial sector to remain resilient during the global crisis and to support the recovery. Looking ahead, it remains critical to further strengthen the banking supervisory and regulatory framework. In particular:

***Supervision**:* Proposed amendments to the BSP Charter should be promptly approved. The amendments would provide the supervisory authorities with stronger legal powers and protection as well as lift the remaining constraints imposed by bank secrecy laws on examiners. The amendments would also allow the BSP to issue its own debt securities, which would further strengthen monetary management.

Prudential regulation: A more risk-based approach to capital requirements is essential to better reflect banks' risk profiles. In this context, the staff welcomed ongoing efforts to introduce the internal capital adequacy assessment process (ICAAP) under Basel II in 2011. Banks' high levels of capital, particularly Tier 1 capital, and relatively low loan-to-deposit ratios should position them well to handle new global financial regulations, including Basel III.

AML/CFT regime: The authorities have submitted bills to Congress in recent months to address the gaps noted by the Financial Action Task Force (FATF) in adequately criminalizing money laundering and terrorist financing and identifying and freezing related assets.

Authorities' views

35. **The authorities broadly agreed with the staff's assessment of financial sector soundness.** Although they agreed that concentration risk and interest rate risk merited attention, they emphasized that supervisors pay close attention to the way systemically important conglomerates interface with banks. They noted that the sources of conglomerates' revenue were diversified across different business lines, which served to mitigate concentration risk.

36. **The authorities saw no indication of asset price bubbles.** The recent increase in stock prices was broadly in line with the economic recovery. They also highlighted that the existing prudential measures were adequate and they did not plan to resort to capital controls. The authorities were eager to find ways to harness the capital inflows for productive investment. In this context, they appreciated the staff's suggestions on financial market development.

37. **The authorities agreed that further strengthening the supervisory and regulatory framework would be important.** The BSP also emphasized that the introduction of ICAAP under Basel II in 2011 was on track and recognized that banks' internal risk management had improved. With respect to Basel III, the authorities did not see any immediate challenges since universal and commercial banks have adequate capital buffers.

E. Setting the Stage for Faster and More Inclusive Long-Term Growth

Background

38. **Low investment is a long-standing constraint to higher growth in the Philippines.** The level of investment is lower than its regional peers as both public and private investment have been anemic over the years, held down by revenue slippages and relatively poor perceptions of the business climate, respectively. In addition, unemployment and underemployment remain high, particularly among younger people.

Staff's Views

39. **In order to boost growth potential, rebalancing growth by relying more on investment will be critical.** Raising investment will also help to create more job opportunities and will go hand in hand with structural reforms to raise total factor productivity. Accordingly, all three pillars of long-term growth need to be strengthened:

Investment. Higher public investment is needed in order to strengthen infrastructure and the provision of other key public goods. Ultimately, however, the main source of higher investment will have to be the private sector. In this context, the authorities' emphasis on tackling corruption and reducing red tape is well placed. Developing capital markets would also be helpful as a way of expanding firms' access to finance for funding investment.

Employment. Higher investment would contribute to job creation, which is both a social priority and necessary for raising potential growth. In addition, measures may be needed to lower redundancy costs and step up job training and search assistance.

Productivity. The most sustainable source of faster growth is improvements in total factor productivity. In this context, improving human capital and institutional quality, and moving up the value chain from agriculture to industry and services would help raise total factor productivity.

Authorities' Views

40. **The authorities agreed that higher investment would be critical to raise potential growth.** In this context, they stressed that the planned PPP projects would play an essential role for improving infrastructure such as airports and roads. The 2010–16 Medium-Term Philippine Development Plan (MTPDP) , which is due in early 2011, would outline general strategies for raising medium-term growth and lowering unemployment and poverty.

IV. STAFF APPRAISAL

41. **The strong recovery and positive sentiment in the country provide a window of opportunity for moving ahead decisively with reforms to raise inclusive growth.** The smooth transition to the new administration and the government's focus on addressing long-standing impediments to investment and growth have strengthened confidence.

42. **The economic outlook remains generally favorable.** The staff projects growth to moderate to a still robust 5 percent in 2011. Over the medium term, a similar rate of growth should prevail, which is in line with the Philippines' regional peers and higher than previous Fund projections. Inflation has been low in recent months, but pressures could start to build during 2011 if financial conditions are not tightened. Meanwhile, potential surges in capital inflows could lead to asset price and macroeconomic volatility.

43. **In this setting, a key policy challenge for the Philippines remains to preserve macroeconomic stability while enhancing medium-term growth.** Meeting this challenge will require carefully managing the exit from stimulus policies in a challenging external environment, while moving ahead with reforms to rebalance the economy toward higher investment and improve job creation and productivity.

44. **Monetary policy responded well to the downturn, and has kept inflation low while fostering the recovery. Going forward, it will be important for the BSP to remain ready to respond proactively to price pressures.** The monetary stance likely needs to tighten in the near term in order to head off liquidity and inflation risks. If a tail risk were to materialize, such as renewed global turmoil, the timing of policy normalization could be recalibrated.

45. **The task of normalizing the policy stance is complicated by external inflow pressures.** The staff supports the BSP's stated policy of allowing the exchange rate to adjust to market pressures and limiting exchange market intervention to smoothing operations. The staff estimates that the real effective exchange rate of the peso is broadly in line with medium-term fundamentals. With reserves at comfortable levels on the basis of standard prudential metrics, greater

exchange rate flexibility should be considered in response to additional inflows. Exchange rate appreciation would also help to tighten monetary conditions in a way that lessens speculative inflow pressures. The staff welcomes the authorities' moves to further liberalize the regulations for foreign exchange outflows and avoid capital controls.

46. **The government's focus on medium-term fiscal consolidation is appropriate given the need to expand fiscal space and strengthen the ability of the budget to respond effectively to future shocks.** The authorities' intention to reduce the national government deficit to 2 percent of GDP by 2013 is a welcome marker of the policy direction and should help to anchor expectations and reduce public debt. The public debt would, nonetheless, remain relatively high and further debt reduction would be useful going forward.

47. **With the recovery well under way, the time is right for a measured withdrawal of fiscal stimulus**. The staff welcomes the authorities' plan to reduce the national government deficit to 3.2 percent of GDP in 2011 that would imply a small withdrawal of stimulus. The 2011 budget targets entail a significant increase in tax revenue that may require more measures to achieve than are currently envisaged. At the same time, with growth expected to remain robust, some additional withdrawal of stimulus could be considered in order to facilitate policy normalization.

48. **In order to achieve fiscal consolidation and scale up social spending and public investment, it will be essential to raise the tax effort further.** The staff considers as appropriate the government's intention to strengthen tax administration, which is being supported by scaled-up Fund technical assistance. In addition, the agenda will need to be complemented by early actions to reform excise taxes, rationalize fiscal incentives, and address distortions in the value added tax. Such actions will be important for supporting the authorities' plans to increase much-needed spending on health, basic education, conditional cash transfers, and infrastructure.

49. **The staff welcomes the government's initiatives to strengthen the fiscal framework.** A Fiscal Responsibility Law and Fiscal Risk Statement would be important steps in this context. A medium-term budget framework would also be very helpful for anchoring the fiscal consolidation plan.

50. **The financial sector withstood the crisis well, and developments in recent quarters continue to support the January 2010 Financial System Stability Assessment that it remains sound.** Banks' non-performing loan ratios have stayed low and capital adequacy ratios high. The staff welcomes the authorities' careful monitoring of two key sources of vulnerability highlighted in the 2010 FSSA, namely interest rate- and concentration risk. Asset bubbles have not been a concern so far, but asset price movements warrant careful attention in an environment of rising external inflows. Further financial market development would help for effectively channeling inflows toward long-term investments such as infrastructure.

51. **To further strengthen the banking supervision framework, it remains critical that the proposed amendments to the BSP Charter be approved.** Banks seem well placed to handle new global financial regulations, including Basel III, given their high levels of capital, particularly Tier 1 capital.

52. **In order for growth to rise to a higher level and to be more inclusive, it will be critical for the government to continue with efforts to rebalance the economy toward investment as well as address impediments to job creation and productivity.** Raising government revenue will be important for providing the needed fiscal space. Ultimately, however, the more sustainable expansion in investment will have to come from the private investment, which would be facilitated by improvements in the business climate, infrastructure, and power supply as well as by deeper capital markets.

53. It is recommended that the next Article IV consultation take place on the standard 12-month cycle

Table 1. Philippines: Selected Economic Indicators, 2007–11

Nominal GDP (2009): P7,679 billion ($161.2 billion)
Population (2009): 92.2 million
GDP per capita (2009): $1,748
Poverty headcount ratio at $2 a day at PPP (2003): 43 percent
IMF quota: SDR 879.9 million
Main products and exports: Electronics and agricultural products
Unemployment rate (2009): 7.5 percent

	2007	2008	2009	2010	2011 1/
				Staff Proj.	
GDP and prices (percent change)					
Real GDP	7.1	3.7	1.1	7.0	5.0
CPI (annual average)	2.8	9.3	3.2	3.8	3.9
CPI (end year)	3.9	8.0	4.3	3.0	4.5
Investment and saving (percent of GDP)					
Gross investment	15.4	15.3	14.6	15.2	15.4
National saving 2/	20.3	17.5	20.1	20.7	19.7
Public finances (percent of GDP)					
National government balance (authorities' definition)	-0.2	-0.9	-3.9	-3.8	-3.2
National government balance (IMF definition) 3/	-1.7	-1.5	-4.0	-3.8	-3.3
Total revenue and grants	15.8	15.8	14.6	14.5	15.5
Total expenditure	17.4	17.3	18.6	18.4	18.9
Non-financial public sector balance 4/	0.2	-0.3	-3.4	-2.6	…
Non-financial public sector debt	61.0	60.7	60.7	58.0	…
Monetary sector (percent change, end of period)					
Broad money (M3)	10.6	15.6	8.3	7.7 5/	...
Interest rate (91-day treasury bill, end of period, in percent) 6/	4.2	5.8	4.3	1.8 7/	...
Credit to the private sector	8.5	16.8	8.1	10.1 5/	...
External Sector					
Export value (percent change)	6.4	-2.5	-22.1	33.8	10.2
Import value (percent change)	8.7	5.6	-24.0	24.9	13.0
Current account (percent of GDP)	4.9	2.2	5.5	5.4	4.3
Capital and financial account (US$ billions, excluding errors and omissions)	3.5	-1.6	-1.1	7.4	6.3
Direct investment (net)	-0.6	1.3	1.6	1.9	2.0
Other	4.1	-2.9	-2.7	5.6	4.3
Errors and omissions (US$ billions)	-2.1	-1.9	-1.3	-1.5	0.0
Overall balance (US$ billions)	8.6	0.1	6.4	16.1	14.8
Total external debt (percent of GDP) 8/	46.3	39.2	40.2	38.6	39.2
Debt-service ratio 9/	13.0	12.7	14.3	13.5	12.3
Reserves, adjusted (US$ billions) 10/	33.8	35.9	44.2	62.9	78.4
Reserves/short-term liabilities, adjusted 11/	240.5	284.4	389.1	498.6	595.4
Exchange rate (period averages)					
Pesos per U.S. dollar	46.1	44.5	47.6	45.2 12/	...
Nominal effective exchange rate (2005 =100)	114.4	113.5	106.8	...	...
Real effective exchange rate (2005 =100)	119.6	124.4	121.2	...	...

Sources: Philippine authorities; and IMF staff projections.

1/ Public finance projections reflect the 2011 budget.
2/ The saving rate is calculated as the sum of the investment rate and the current account balance (all as a percent of GDP).
3/ Excludes privatization receipts and includes deficit from restructuring of the central bank (Central Bank-Board of Liquidators).
4/ Includes the national government, Central Bank-Board of Liquidators, 14 monitored government-owned enterprises, social security institutions, and local governments.
5/ October 2010 (year-on-year).
6/ Secondary market rate.
7/ November 2010.
8/ Includes liabilities of foreign banks in the Philippines to their headquarters, branches and agencies, external debt not registered with the central bank, and private capital lease agreements.
9/ In percent of exports of goods and non-factor services.
10/ Adjusted for gold and securities pledged as collateral against short-term liabilities.
11/ Short-term liabilities include medium- and long-term debt due in the following year.
12/ Average for January to November 2010.

Table 2. Philippines: National Government Cash Accounts, 2007–11

(In percent of GDP; unless otherwise noted)

	2007	2008	2009	2010 Auth. Budget	2010 Staff Proj.	2011 Auth. Budget	2011 Staff Proj.
Revenue and grants	15.8	15.8	14.6	15.6	14.5	15.5	14.9
Tax revenue	14.0	14.2	12.8	13.9	13.0	14.1	13.3
Net income and profits	6.4	6.5	5.7	...	5.9	6.0	6.0
Excises	1.0	1.0	1.0	...	1.1	...	1.2
VAT	4.1	4.0	3.9	...	3.9	...	4.1
Tariffs	1.0	1.2	0.9	...	0.9	...	0.8
Other 1/ 2/	1.4	1.4	1.3	...	1.2	...	1.2
Non-tax revenue	1.7	1.7	1.8	1.7	1.6	1.5	1.6
Of which revenue measures	...	...	...	...	0.0	...	0.0
Expenditure and net lending	17.4	17.3	18.6	19.6	18.4	18.9	18.4
Current expenditures	14.4	14.1	15.0	15.6	14.9	15.1	14.7
Personnel services	5.3	5.1	5.4	5.9	5.5	6.0	5.9
Maintenance and operations	1.9	1.9	2.3	2.3	2.3	2.3	2.3
Allotments to local government units	2.3	2.3	2.6	2.6	2.5	2.5	2.5
Subsidies	0.3	0.2	0.2	0.2	0.2	0.1	0.1
Tax expenditure	0.5	0.8	0.7	0.5	0.5	0.2	0.2
Interest	4.2	3.8	3.7	4.0	3.9	4.0	3.9
Capital and equity expenditure 3/	2.9	3.0	3.6	3.8	3.4	3.6	3.5
Net lending	0.1	0.2	0.1	0.2	0.1	0.2	0.2
Balance	-1.7	-1.5	-4.0	-4.0	-3.8	-3.3	-3.5
On the authorities' presentation 4/	-0.2	-0.9	-3.9	-3.9	-3.8	-3.2	-3.4
Memorandum Items:							
Non-financial public sector balance 5/	0.2	-0.3	-3.4	…	-2.6	…	-2.4
Consolidated public sector balance 5/	0.3	0.0	-3.2	…	-2.4	…	-2.2
Primary national government balance	2.5	2.3	-0.3	0.0	0.1	0.7	0.3
National government debt 6/	47.8	48.7	49.2	…	47.4	…	47.1
(percent of NG revenues)	303.4	307.4	336.7	…	326.4	…	317.0
Non-financial public sector debt 7/	61.0	60.7	60.7	…	58.0	…	57.3
(percent of NFPS revenues)	253.5	264.7	293.1	…	279.6	…	273.4
National government gross financing requirement 8/	17.8	15.0	18.9	…	16.5	…	16.2
GDP (in billions of pesos) 9/	6,649	7,409	7,679	8,316	8,485	9,045	9,262

Sources: Philippine authorities; and IMF staff projections.

1/ Projections do not include possible gains from tax administrative measures.
2/ Includes other percentage taxes, documentary stamp tax, and non-cash collections.
Non-cash collections are also reflected as tax expenditures under current expenditures.
3/ Excludes purchase of National Power Corporation securities and other onlending; includes capital transfers to LGUs. May exceed public investment in years when capital transfers to LGUs exceed their reported capital spending.
4/ Includes privatization receipts as revenue and excludes the operations of the Central Bank-Board of Liquidators (CB-BOL).
5/ Excludes privatization receipts from revenue.
6/ Consolidated (net of national government debt held by the sinking fund) and excluding contingent/guaranteed debt.
7/ Non-financial 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-non-financial public sector holdings of debt).
8/ Defined as the deficit, plus amortization of medium- and long-term debt, plus the stock of short-term debt at the end of the last period, plus market financing on behalf of NPC.
9/ For the budget, the lower bound of the range of GDP estimates.

Table 3. Philippines: Balance of Payments, 2007–11

(In billions of U.S. dollars)

	2007	2008	2009	2010	2011
				Staff proj.	
CURRENT ACCOUNT BALANCE	**7.1**	**3.6**	**8.8**	**10.2**	**8.5**
Trade Balance	-8.4	-12.9	-8.9	-7.7	-10.1
Exports, f.o.b.	49.5	48.3	37.6	50.3	55.4
Imports, f.o.b.	57.9	61.1	46.5	58.0	65.6
Services (net)	2.2	1.2	1.6	1.4	1.5
Receipts	9.8	9.7	10.2	11.9	13.4
Payments	7.5	8.6	8.7	10.5	11.9
Income	-0.9	0.1	0.0	-0.9	-1.6
Receipts, *of which:*	5.4	6.0	5.7	5.9	6.2
Remittances of resident workers abroad 1/	3.0	4.1	4.6	4.8	5.0
Payments	6.3	5.9	5.7	6.8	7.7
Interest payments	3.6	3.3	2.6	3.2	3.9
Transfers (net)	14.2	15.2	16.1	17.4	18.7
Receipts, *of which:*	14.6	15.8	16.7	18.1	19.5
Non-resident workers remittances 1/	13.3	14.5	15.1	16.7	18.0
Payments	0.4	0.5	0.6	0.7	0.8
CAPITAL AND FINANCIAL ACCOUNT	**3.5**	**-1.6**	**-1.1**	**7.4**	**6.3**
Capital Account	0.0	0.1	0.1	0.1	0.1
Financial Account	3.5	-1.7	-1.2	7.3	6.2
Direct Investment	-0.6	1.3	1.6	1.9	2.0
Portfolio Investment	4.6	-3.6	0.3	4.0	3.7
Equity	3.1	-1.2	-1.1	0.5	0.5
Debt	1.5	-2.4	1.4	3.5	3.2
Financial Derivatives	-0.3	-0.1	0.0	0.0	0.0
Other Investment, *of which:*	-0.2	0.8	-3.1	1.5	0.5
Currency and deposits	-3.2	-3.7	3.9	-0.5	-0.4
ERRORS AND OMISSIONS	**-2.1**	**-1.9**	**-1.3**	**-1.5**	**0.0**
OVERALL BALANCE	**8.6**	**0.1**	**6.4**	**16.1**	**14.8**
OVERALL FINANCING	**-8.6**	**-0.1**	**-6.4**	**-16.1**	**-14.8**
Monetization of gold and revaluation	2.2	2.2	1,8	2.5	0.7
Change in Net international reserves (increase =-)	-10.8	-2.3	-8.2	-18.6	-15.5
Memorandum items:					
Current account/GDP	4.9	2.2	5.5	5.4	4.3
Short-term debt (original maturity)	9.9	10.0	6.5	7.5	8.4
Short-term debt (residual maturity)	14.0	14.3	11.4	12.6	13.2
Gross reserves	33.8	37.6	44.2	62.9	78.4
Adjusted gross reserves 2/	33.8	35.9	44.2	62.9	78.4
(in percent of st. debt by res. maturity) 3/	240.5	284.4	389.1	498.6	595.4
Net international reserves	33.7	36.0	44.2	62.9	78.4
Monitored external debt (in billions) 4/	66.7	65.3	64.9	72.1	78.4
(in percent of GDP)	46.3	39.2	40.2	38.6	39.2
Debt service ratio 5/	13.0	12.7	14.3	13.5	12.3
Export value (percent change)	6.4	-2.5	-22.1	33.8	10.2
Import value (percent change)	8.7	5.6	-24.0	24.9	13.0
Gross external financing needs 6/	4.7	10.4	5.5	2.0	4.1
Remittances value (percent change)	13.2	13.7	5.6	8.1	7.6

Sources: Philippine authorities; and IMF staff projections.

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

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

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

4/ 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.

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

6/ 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: Depository Survey, 2007–10

(In billions of pesos; unless otherwise noted)

	2007	2008	2009	2010		
	Dec.	Dec.	Dec.	Mar.	Jun.	Sep.
Net foreign assets	1,659	1,931	2,420	2,494	2,648	2,610
Central bank	1,365	1,686	2,028	2,037	2,234	2,335
Net international reserves	1,397	1,717	2,054	2,064	2,261	2,360
Medium- and long-term foreign liabilities	32	31	26	27	27	25
Deposit money banks	294	245	392	457	414	275
Net domestic assets	2,422	2,738	2,638	2,531	2,486	2,547
Net domestic credit	3,162	3,691	3,963	4,001	4,109	4,134
Public sector credit	1,027	1,199	1,269	1,357	1,370	1,371
National government	767	891	970	1,055	1,031	1,029
Credits	1,082	1,223	1,359	1,386	1,390	1,436
Foreign exchange receivables	0	0	0	0	0	0
Treasury IMF accounts	-51	-58	-57	-54	-54	-54
Deposits	-265	-274	-331	-277	-305	-354
Local government and others	261	308	299	302	339	342
Private sector credit	2,134	2,492	2,694	2,643	2,739	2,763
Other items net	-740	-953	-1,325	-1,469	-1,623	-1,587
Total liquidity	4,081	4,669	5,058	5,025	5,134	5,157
M4	3,925	4,610	4,997	4,953	5,078	5,098
M3 (peso liquidity)	3,174	3,668	3,972	3,894	3,972	4,056
Foreign currency deposits, residents	751	942	1,026	1,058	1,106	1,042
Other liabilities	155	58	60	72	56	60
			Annual percent change			
Net foreign assets	21.4	16.4	25.3	18.0	22.7	12.8
Net domestic assets	-1.0	13.1	-3.7	2.4	-0.9	5.1
Net domestic credit	5.2	16.8	7.4	8.6	8.5	9.4
Public sector	-1.2	16.7	5.8	9.1	9.4	9.0
Private sector	8.5	16.8	8.1	8.3	8.1	9.5
M4	5.5	17.5	8.4	9.9	10.3	8.9
M3	10.6	15.6	8.3	10.3	10.3	10.5

Sources: Philippine authorities (New Depository Corporation Survey); and CEIC Data Company Ltd.

Table 5. Philippines: Baseline Medium-Term Outlook, 2008–15

(In percent of GDP, unless otherwise indicated)

	2008	2009	2010	2011	2012	2013	2014	2015
			Staff Proj.					
GDP and prices								
Real GDP (percent change)	3.7	1.1	7.0	5.0	5.0	5.0	5.0	5.0
GDP per capita (US$)	1,842	1,748	1,988	2,085	2,200	2,309	2,427	2,550
CPI (percent change, average)	9.3	3.2	3.8	3.9	4.7	4.0	4.0	4.0
Investment and saving								
Gross investment	15.3	14.6	15.2	15.4	15.7	15.9	16.1	16.3
Private	12.3	11.6	12.4	12.5	12.6	12.7	12.9	13.1
Public	3.0	3.1	2.9	2.9	3.1	3.2	3.2	3.2
National saving 1/	17.5	20.1	20.7	19.7	19.4	19.0	18.4	18.0
Private	14.5	20.2	20.2	18.9	18.0	16.9	16.3	16.1
Public	3.0	-0.1	0.5	0.7	1.4	2.1	2.1	1.9
Foreign saving	-2.2	-5.5	-5.4	-4.3	-3.7	-3.1	-2.3	-1.7
Public finances								
Non-financial public sector balance 2/	-0.3	-3.4	-2.6	-2.4	-1.9	-1.4	-1.3	-1.5
Primary balance	3.9	0.7	1.6	1.7	2.1	2.4	2.3	2.0
Revenue and grants 3/	22.9	20.7	20.7	21.0	22.0	22.9	22.9	22.8
Expenditure (primary) 4/	19.1	20.0	19.2	19.3	19.9	20.5	20.6	20.8
Interest	4.1	4.1	4.2	4.1	4.0	3.7	3.6	3.5
Non-financial public sector gross financing	14.9	19.3	15.9	15.6	13.3	11.1	11.1	11.0
Domestic	13.9	15.0	11.6	12.8	10.5	8.3	8.5	8.6
Foreign currency	1.0	4.3	4.3	2.8	2.7	2.7	2.6	2.4
National government balance (authorities' definition)	-0.9	-3.9	-3.8	-3.4	-2.7	-2.0	-2.0	-2.0
National government balance (IMF definition) 5/	-1.5	-4.0	-3.8	-3.5	-2.7	-2.0	-2.0	-2.1
Non-financial public sector debt 6/	60.7	60.7	58.0	57.3	55.7	53.7	51.4	49.4
External sector								
Export value (percent change)	-2.5	-22.1	33.8	10.2	6.5	5.6	5.5	5.5
Import value (percent change)	5.6	-24.0	24.9	13.0	7.3	7.0	7.3	7.1
Trade balance	-7.7	-5.5	-4.1	-5.1	-5.3	-5.6	-6.1	-6.5
Current account	2.2	5.5	5.4	4.3	3.7	3.1	2.3	1.7
Direct investment (net, US$ billions)	1.3	1.6	1.9	2.0	2.0	2.1	2.2	2.2
Reserves, adjusted (US$ billions) 7/	35.9	44.2	62.9	78.4	93.4	107.6	120.6	132.4
Reserves / Short-term liabilities, adjusted 8/	284.4	389.1	498.6	595.4	640.8	693.8	726.3	751.4
Gross external financing requirements (US$ billions) 9/	10.4	5.5	2.0	4.1	5.1	7.4	9.7	12.0
Total external debt (in percent of GDP) 10/	39.2	40.2	38.6	39.2	39.4	39.5	39.4	39.1
Debt service ratio (in percent of exports of G&S)	12.7	14.3	13.5	12.3	11.2	11.3	10.8	10.2

Sources: Philippine authorities; and IMF staff projections.

1/ The saving rate is calculated as the sum of the investment rate and the current account balance (all as a percent of GDP).
2/ Non-financial public sector includes the national government, CB-BOL, 14 monitored government-owned enterprises, social security institutions, and local governments.
3/ The sum of all non-financial 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 non-financial public sector. Privatization receipts are excluded.
4/ Defined as the difference between non-financial public sector revenue and primary balance.
5/ Excludes privatization receipts of the national government, and includes net deficit from restructuring the central bank.
6/ Net of intra-non-financial public sector holdings of debt.
7/ Gross reserves less gold and securities pledged as collateral against short-term liabilities.
8/ Reserves as a percent of short-term debt (including medium- and long-term debt due in the following year). Both reserves and debt were adjusted for gold-backed loans.
9/ Current account deficit, plus amortization on medium- and long-term debt, plus short-term debt at the end of the previous period.
10/ Defined as external debt plus liabilities of foreign banks in the Philippines to their headquarters, branches and agencies, some external debt not registered with the central bank and private capital lease agreements.

Table 6. Philippines: Banking Sector Indicators, 2007–10

(Percent)

	2007	2008	2009	2010 Q1
Capital adequacy				
Total capital accounts to total assets	11.7	10.6	11.1	11.4
Capital adequacy ratio (consolidated basis)	15.7	15.5	15.8	16.0 1/
Asset quality				
NPL ratio 2/	5.8	4.1	4.1	4.5
NPA ratio 3/	5.8	5.1	4.5	4.5
Distressed asset ratio 4/	12.5	10.8	9.3	9.9
NPL coverage ratio 5/	81.5	86.0	93.1	94.0
NPA coverage ratio 6/	39.8	45.0	48.7	50.2
Profitability				
Return on assets	1.3	0.8	1.2	1.3
Return on equity	10.7	6.9	10.8	11.4
Cost-to-income ratio	65.2	74.0	65.8	65.2
Liquidity				
Liquid assets to deposits	51.9	52.5	52.7	57.3
Loans (gross) to deposits	70.9	69.7	68.1	65.0

Source: Philippine authorities (Status Report on the Philippine Financial System).
Note: ROPA = Real and Other Property Acquired. ROPA is a measure of the stock of foreclosed properties held by a bank.

1/ As of March 2010.
2/ Non-performing loans (NPL) over total loan portfolio excluding interbank loans (TL).
3/ (Non-performing loans + ROPA) over total gross assets.
4/ Ratio of (NPLs + Gross ROPA + current restructed loans) to (Gross total loan portfolio + Gross ROPA).
5/ Ratio of loan loss reserves to NPLs.
6/ Ratio of valuation reserves (for loans and ROPA) to NPAs.

Table 7. Philippines: Indicators of External Vulnerability, 2007–11

(In percent of GDP, unless otherwise indicated)

	2007	2008	2009	2010	2011
				Staff Proj.	
External indicators (including external liquidity):					
Gross international reserves, adjusted (US$ billions) 1/	33.8	35.9	44.2	62.9	78.4
Maturing short-term debt (US$ billions)	9.9	10.0	6.5	7.5	8.4
Amortization of medium and long-term debt (US$ billions)	4.1	4.1	4.3	5.6	5.1
Net direct investment inflows (US$ billions)	-0.6	1.3	1.6	1.9	2.0
FX deposits residents (US$ billions) 2/	19.5	20.6	22.8	24.7	…
Total gross external debt	46.3	39.2	40.2	38.6	39.2
Public sector indicators:					
Overall balance	0.2	-0.3	-3.4	-2.6	-2.4
Primary balance	4.8	3.9	0.7	1.6	1.7
Non-financial public sector debt (NFPSD)	61.0	60.7	60.7	58.0	57.3
NFPSD denominated in FX or linked to the exchange rate (in percent of NFPSD)	57.2	58.5	58.8	58.0	56.5
Short-term general government debt (original maturity, in percent of NFPSD)	17.2	19.0	14.9	15.0	15.2
Average effective interest rate of government debt (in percent)	7.5	6.8	6.8	7.2	7.1
Amortization of total debt	18.3	14.6	15.9	13.3	13.2

Sources: Philippine authorities; and IMF staff projections.

1/ Gross reserves less gold and securities pledged as collateral against short-term liabilities.
2/ As of June 2010.

APPENDIX I. DEBT SUSTAINABILITY ANALYSIS

The outlook for public debt dynamics is favorable. Non-financial sector public debt has been steadily declining from over 100 percent of GDP in 2003 to below 60 percent of GDP in 2010. Based on the government's medium-term objective of a national government deficit to 2 percent of GDP, public debt is projected to continue this declining trend to 47 percent of GDP by 2015. Gross financing need is also expected to decline from 16 percent of GDP in 2010 to 11 percent of GDP by 2015. If the deficit were to remain 1 percent of GDP higher than currently projected or if medium-term growth were lower by 1 percent, debt levels would remain stable but at an elevated level above 55 percent of GDP through 2014. Given the high share of foreign currency debt, the main vulnerability arises from exchange rate risk.

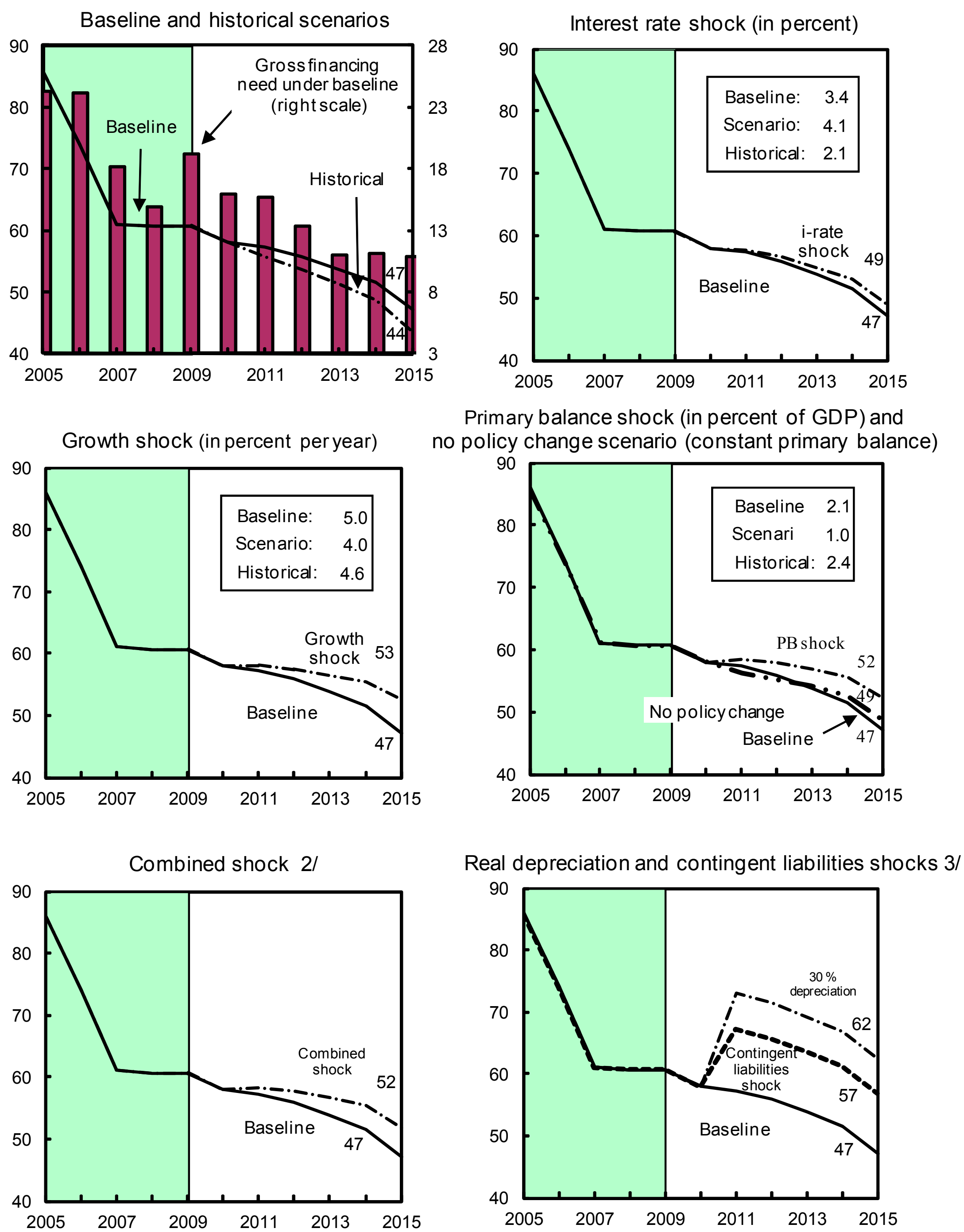
Projected external debt dynamics are stable. In recent years, external debt has steadily declined, from nearly 80 percent of GDP in 2002 to just over 40 percent of GDP at end-2009. Under the staff's baseline scenario, the external debt ratio is projected to remain stable, a result of debt creating capital inflows. Further, the debt dynamics appear to be relatively resilient to various shocks: one-half standard deviation shocks to interest rates, growth, and the current account lead to only a modest deterioration in the debt ratios over the medium term. However, exchange rate volatility remains a vulnerability as a one-time real depreciation of 30 percent would entail an 18 percent jump in the external debt ratio from its end 2009 level.

Table A1. Philippines: Public Sector Debt Sustainability Framework, 2005-2015
(In percent of GDP, unless otherwise indicated)

	Actual					Projections						
	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	**Debt-stabilizing primary balance 9/**
1 **Baseline: Public sector debt 1/**	85.9	73.9	61.0	60.7	60.7	**58.0**	**57.3**	**55.8**	**53.7**	**51.5**	**47.1**	**0.0**
Of which foreign-currency denominated	52.3	45.3	34.9	35.5	35.7	33.6	32.4	31.6	30.9	30.0	28.1	
2 Change in public sector debt	-9.3	-11.9	-12.9	-0.4	0.0	-2.7	-0.7	-1.5	-2.1	-2.3	-4.4	
3 Identified debt-creating flows (4+7+12)	-10.9	-12.1	-13.6	-0.9	-0.5	-3.2	-2.8	-2.9	-3.2	-2.9	-2.7	
4 Primary deficit	-4.3	-5.8	-4.8	-3.8	-0.8	-1.5	-1.5	-2.0	-2.5	-2.2	-2.1	
5 Revenue and grants	22.1	23.0	24.1	22.9	20.7	20.7	20.8	21.9	22.9	22.9	22.9	
6 Primary (noninterest) expenditure	17.8	17.2	19.3	19.0	19.9	19.2	19.3	19.9	20.5	20.6	20.8	
7 Automatic debt dynamics 2/	-6.9	-6.2	-9.1	2.7	1.1	-1.6	-0.8	-1.2	-1.0	-0.9	-0.8	
8 Contribution from interest rate/growth differential 3/	-3.6	-2.6	-2.3	-2.1	2.0	-1.6	-0.8	-1.2	-1.0	-0.9	-0.8	
9 *Of which* contribution from real interest rate	0.6	1.6	2.4	-0.1	2.6	2.2	1.9	1.4	1.6	1.5	1.5	
10 *Of which* contribution from real GDP growth	-4.2	-4.2	-4.8	-2.0	-0.6	-3.8	-2.7	-2.6	-2.6	-2.5	-2.4	
11 Contribution from exchange rate depreciation 4/	-3.3	-3.7	-6.8	4.8	-0.9	...	...	...	...	...	...	
12 Other identified debt-creating flows	0.4	0.0	0.2	0.2	-0.9	0.0	-0.5	0.3	0.2	0.2	0.2	
13 Privatization receipts (negative)	0.0	-0.1	-1.4	-0.4	0.0	0.0	-0.1	0.0	0.0	0.0	0.0	
14 Recognition of implicit or contingent liabilities	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
15 Other (specify, e.g., bank recapitalization)	0.4	0.1	1.6	0.6	-0.9	0.0	-0.4	0.3	0.3	0.3	0.3	
16 Residual, including asset changes (2-3) 5/	1.6	0.1	0.7	0.6	0.6	0.4	2.1	1.4	1.1	0.6	-1.7	
Public sector debt-to-revenue ratio 1/	389.5	321.5	253.5	265.2	293.3	280.0	275.3	255.0	234.3	225.0	205.6	
Gross financing need 6/	24.3	24.2	18.1	14.9	19.2	15.9	15.8	13.4	11.1	11.1	10.9	
In billions of U.S. dollars	24.0	28.4	26.1	24.9	31.0	29.8	31.5	28.8	25.4	27.3	28.9	
Scenario with key variables at their historical averages 7/						**58.0**	**55.8**	**53.7**	**51.4**	**48.7**	**43.6**	**-0.3**
Scenario with no policy change (constant primary balance) in 2010-2015						**58.0**	**56.4**	**55.3**	**54.2**	**52.6**	**48.8**	**0.0**
Key Macroeconomic and Fiscal Assumptions Underlying Baseline												
Real GDP growth (in percent)	5.0	5.4	7.1	3.7	1.1	7.0	5.0	5.0	5.0	5.0	5.0	
Average nominal interest rate on public debt (in percent) 8/	7.5	7.5	6.8	7.5	7.0	7.6	7.7	7.7	7.3	7.3	7.4	
Average real interest rate (nominal rate minus change in GDP deflator, in percent)	1.0	2.3	3.9	0.1	4.5	4.3	3.7	3.0	3.3	3.3	3.4	
Nominal appreciation (increase in U.S. dollar value of local currency, in percent)	6.0	8.0	18.7	-12.8	2.4	...	...	...	...	...	...	
Inflation rate (GDP deflator, in percent)	6.5	5.1	2.9	7.5	2.6	3.3	3.9	4.7	4.0	4.0	4.0	
Growth of real primary spending (deflated by GDP deflator, in percent)	-1.7	1.8	20.6	2.1	5.7	3.0	5.8	8.3	8.0	5.7	6.0	
Primary deficit	-4.3	-5.8	-4.8	-3.8	-0.8	-1.5	-1.5	-2.0	-2.5	-2.2	-2.1	

1/ Coverage of public sector is for non-financial public sector gross debt.
2/ Derived as $[(r - \pi(1+g) - g + \alpha\varepsilon(1+r)]/(1+g+\pi+g\pi))$ times previous period debt ratio, with r = interest rate; π = growth rate of GDP deflator; g = real GDP growth rate; α = share of foreign-currency denominated debt; and ε = nominal exchange rate depreciation (measured by increase in local currency value of U.S. dollar).
3/ The real interest rate contribution is derived from the denominator in footnote 2/ as $r - \pi(1+g)$ and the real growth contribution as -g.
4/ The exchange rate contribution is derived from the numerator in footnote 2/ as $\alpha\varepsilon(1+r)$.
5/ For projections, this line includes exchange rate changes.
6/ Defined as public sector deficit, plus amortization of medium- and long-term public sector debt, plus short-term debt at end of previous period.
7/ The key variables include real GDP growth; real interest rate; and primary balance in percent of GDP.
8/ Derived as nominal interest expenditure divided by previous period debt stock.
9/ 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/
(Public debt in percent of GDP)



Sources: International Monetary Fund, country desk data, and 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 2010, 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, 2005-2015
(In percent of GDP, unless otherwise indicated)

	Actual					Projections						
	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	**Debt-stabilizing non-interest current account 6/**
1 **Baseline: External debt**	62.9	52.1	46.0	39.0	40.1	**38.6**	**39.2**	**39.4**	**39.5**	**39.4**	**39.1**	**-2.4**
2 Change in external debt	-7.8	-10.7	-6.1	-7.0	1.1	-1.5	0.6	0.1	0.1	-0.1	-0.3	
3 Identified external debt-creating flows (4+8+9)	-13.7	-19.1	-16.3	-8.4	-4.4	-9.1	-7.6	-6.8	-6.1	-5.4	-4.7	
4 Current account deficit, excluding interest payments	-5.2	-7.3	-7.4	-4.1	-7.0	-6.9	-6.2	-5.4	-4.6	-3.9	-3.1	
5 Deficit in balance of goods and services	9.2	5.6	4.3	7.0	4.5	3.4	3.9	4.3	4.8	5.2	5.7	
6 Exports	45.3	45.1	41.1	34.8	29.7	32.9	33.0	32.9	32.8	32.6	32.4	
7 Imports	54.5	50.7	45.4	41.8	34.2	36.3	36.9	37.2	37.6	37.8	38.0	
8 Net non-debt creating capital inflows (negative)	-3.2	-4.5	-1.7	0.0	-0.3	-1.2	-1.2	-1.1	-1.1	-1.1	-1.0	
9 Automatic debt dynamics 1/	-5.3	-7.2	-7.1	-4.3	2.9	-0.9	-0.1	-0.2	-0.3	-0.4	-0.6	
10 Contribution from nominal interest rate	3.2	2.8	2.5	1.9	1.6	1.5	1.7	1.6	1.5	1.4	1.3	
11 Contribution from real GDP growth	-3.1	-2.8	-3.0	-1.5	-0.4	-2.4	-1.8	-1.8	-1.8	-1.8	-1.8	
12 Contribution from price and exchange rate changes 2/	-5.4	-7.2	-6.6	-4.8	1.7	...	...	...	...	...	...	
13 Residual, incl. change in gross foreign assets (2-3) 3/	5.9	8.4	10.2	1.4	5.5	7.6	8.2	6.9	6.2	5.3	4.5	
External debt-to-exports ratio (in percent)	138.8	115.7	111.9	112.1	134.9	117.4	118.8	119.8	120.6	121.0	120.9	
Gross external financing need (in billions of U.S. dollars) 4/	10.9	9.3	4.7	10.4	5.5	2.0	3.6	4.9	7.4	9.4	11.6	
in percent of GDP	11.0	7.9	3.3	6.2	3.4	1.1	1.8	2.3	3.2	3.8	4.4	
Scenario with key variables at their historical averages 5/						**38.6**	**40.1**	**40.5**	**39.8**	**38.4**	**36.1**	**-2.8**
Key Macroeconomic Assumptions Underlying Baseline												
Real GDP growth (in percent)	5.0	5.3	7.1	3.7	1.1	7.0	5.0	5.0	5.0	5.0	5.0	
GDP deflator in U.S. dollars (change in percent)	8.3	12.9	14.5	11.5	-4.3	8.4	1.8	2.5	2.0	2.1	2.1	
Nominal external interest rate (in percent)	5.1	5.3	5.8	4.9	4.0	4.3	4.6	4.3	4.1	3.9	3.4	
Growth of exports (U.S. dollar terms, in percent)	4.6	18.3	11.9	-2.2	-17.4	28.4	7.4	7.1	6.6	6.6	6.5	
Growth of imports (U.S. dollar terms, in percent)	7.2	10.5	9.8	6.5	-20.8	22.9	8.7	8.5	8.1	7.9	7.9	
Current account balance, excluding interest payments	5.2	7.3	7.4	4.1	7.0	6.9	6.2	5.4	4.6	3.9	3.1	
Net non-debt creating capital inflows	3.2	4.5	1.7	0.0	0.3	1.2	1.2	1.1	1.1	1.1	1.0	

1/ Derived as $[r - g - \rho(1+g) + \varepsilon\alpha(1+r)]/(1+g+\rho+g\rho)$ times previous period debt stock, with r = nominal effective interest rate on external debt; ρ = change in domestic GDP deflator in U.S. dollar terms, g = real GDP growth rate, 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 $[-\rho(1+g) + \varepsilon\alpha(1+r)]/(1+g+\rho+g\rho)$ times previous period debt stock. ρ increases with an appreciating domestic currency ($\varepsilon > 0$) and rising inflation (based on GDP deflator).

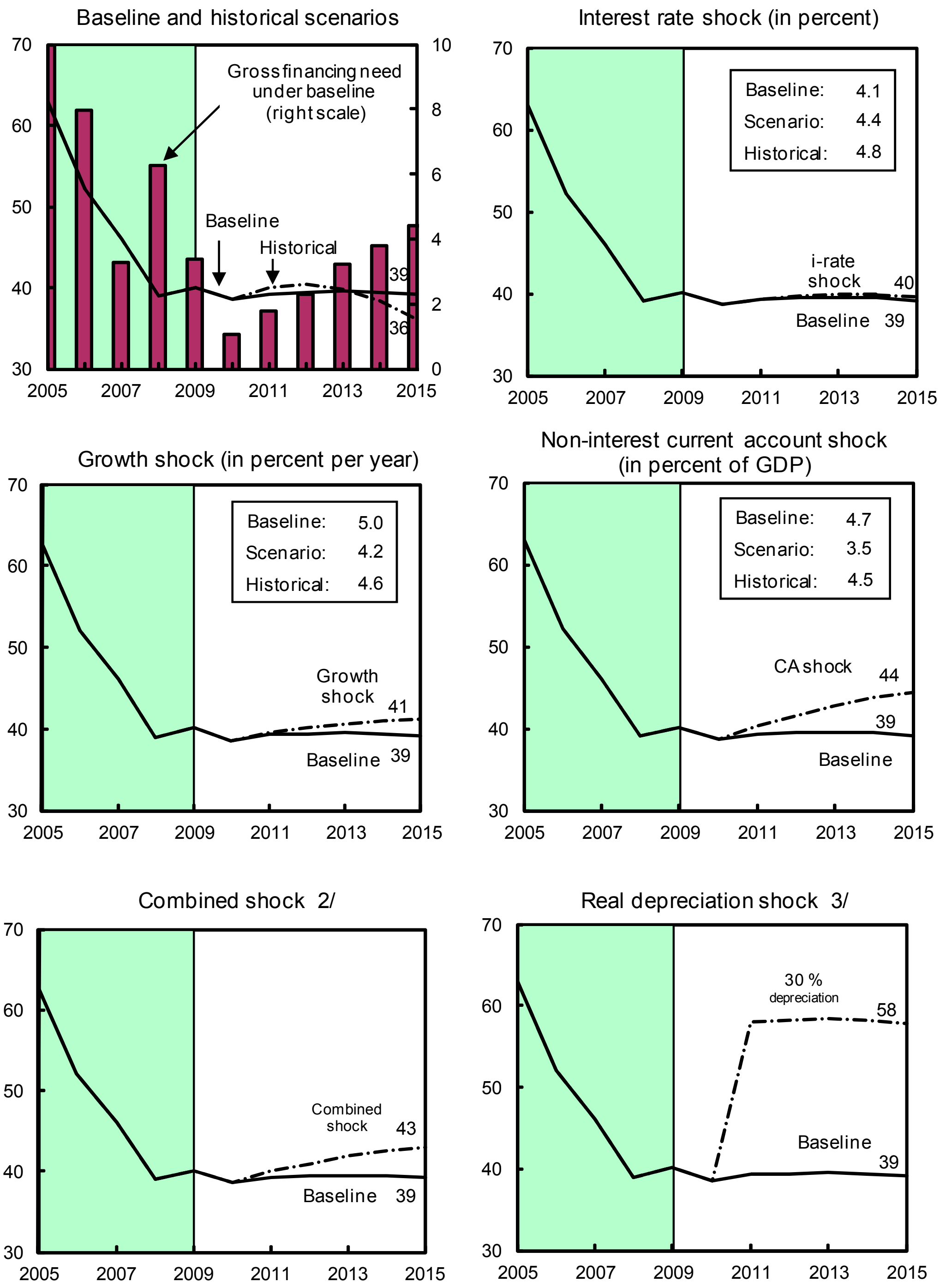
3/ For projection, line includes the impact of price and exchange rate changes.

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

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

6/ 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/
(External debt in percent of GDP)



Sources: International Monetary Fund, Country desk data, and 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 2010.

INTERNATIONAL MONETARY FUND

PHILIPPINES

Staff Report for the 2010 Article IV Consultation—Informational Annex

Prepared by the Asia and Pacific Department

January 18, 2011

Contents | Page

Annex I. Philippines: Fund Relations

(As of November 30, 2010)

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

II. **General Resources Account**:

	SDR Million	% Quota
Quota	879.90	100.00
Fund holdings of currency	717.13	81.50
Reserve position in Fund	162.79	18.50

III. **SDR Department**:

	SDR Million	% Allocation
Net cumulative allocation	837.96	100.00
Holdings	727.78	86.85

IV. **Outstanding Purchases and Loans**: None

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

Post-program monitoring ended following the advance repurchase made by the Philippines on December 29, 2006.

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

	Forthcoming			
	2011	2012	2013	2014
Principal	...	...	...	...
Charges/Interest	0.42	0.41	0.41	0.41
Total	0.42	0.41	0.41	0.41

VII. **Exchange Arrangement**:

The de jure exchange rate arrangement is *free floating*, while the de facto exchange arrangement is classified as *floating*. The value of the Philippine peso is determined in the interbank foreign exchange market; the Bangko Sentral intervenes in the spot and forward markets in order to smooth undue short-term fluctuations in the exchange rate and to strategically build reserves. The Philippines maintains an exchange system free of restrictions on payments and transfers for current international transactions.

VIII. **Article IV Consultation**:

The Philippines is on the standard 12-month cycle. The 2009 Article IV Consultation was discussed by the Executive Board on January 29, 2010.

IX. **Financial Sector Assessment Program (FSAP) and Report on Standards and Codes (ROSC) Participation**:

MCM: 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. The FSAP update mission took place in November 2009.

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. FAD advisers have visited Manila six times (June and September 2006, January, March, May, and July 2007).

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

X. **Technical Assistance (TA)**:

An MCM 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 MCM mission visited Manila in February 2005 to review the payment systems, central bank accounting, and government bond market development. An MCM mission took place in July 2006 to review the regulation and infrastructure of the domestic debt market. Another mission visited Manila in November 2006 to advise on liberalization of the foreign exchange market. MCM TA in the area of problem bank identification, management, and resolution took place in March 2009 and, together with TA on banking supervision, in April-May and October-December 2010 and a TA mission on stress testing visited Manila in June 2009. The Japan Administered Account for Selected IMF Activities inspection visit took place in May 2010.

An STA peripatetic mission visited Manila in July–August 2003, January–February 2004, and February–March 2005 to provide TA in balance of payments and international investment position statistics and in implementing the recommendations made by the ROSC Data Module mission. An STA mission took place in March–April 2006 to assist the authorities in compiling and disseminating government finance statistics in accordance with *Government Finance Statistics Manual 2001*. A STA mission took place in August 2009 to finalize a monetary statistics compilation system based on the Standardized Report Forms.

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 and FAD staff member participated in the July 2004 PPM mission to evaluate and advice on tax measures. An FAD mission visited Manila in November–December 2005 to provide assistance in the areas of tax and customs administration and another mission was fielded in March 2006 to reach agreement with the authorities on the priorities of the Bureau of Internal Revenue (BIR) reform agenda. An FAD tax administration advisor visited Manila seven times during the period June 2006 to September 2008 to assist the Tax Administration Reform Group. A mission reviewing progress in tax administration reforms and VAT performance took place in March 2009. A TA mission in October–November 2009 was part of a joint mission with the Millenium Challenge Corporation to (i) identify critical institutional, procedural, and functional reform priorities; and (ii) review of the ETIS tax administration computer system and tax reform program. This was followed in November 2010 by a mission to agree on the workplan and install the incoming resident advisor. A tax policy mission visited the Philippines in February 2010. FAD's peripatetic advisor on cash management reforms visited Manila in February and June 2009 and February 2011.

An LEG legal expert visited Manila to discuss anti-money laundering initiatives in March 2002 and for the regional United Nations Security Council Resolutions/Financing of Terrorism Convention Project workshop in July 2010.

XI. **Resident Representative**:

A Resident Representative has been stationed in Manila since January 1984. Mr. Dennis Botman assumed the post of Resident Representative in January 2009.

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.

ANNEX II. PHILIPPINES: BANK-FUND COLLABORATION

1. **The Bank and the Fund country teams led by Mr. Hofman (country director) and Mr. Arora (mission chief), respectively, met** on October 5, 2010, to exchange views on key macroeconomic prospects, identify macro-critical structural reforms and to coordinate the two teams' work for the period October 2010–September 2011.[1]

2. **The teams agreed on the Philippines' main macroeconomic challenges.** These are managing the exit from policy stimulus, reducing external and fiscal vulnerabilities, and outlining a reform agenda for raising potential growth in light of the new government's 7–8 percent objective and how to bring about more inclusive growth to reduce poverty. More specifically:

- Managing the exit from stimulus
    - Near-term growth and inflation outlook
    - Managing the exit from stimulus to avoid inflation risks, on the one hand, and foster the recovery on the other hand without hurting public investment.
    - Tools to manage the exit, particularly the monetary-fiscal policy mix.

- Monetary policy
    - Appropriate setting of monetary policy in view of inflation target and outlook
    - Tools for normalizing policy
    - The role of the exchange rate in monetary policy implementation
    - Policy responses to capital inflows and asset prices

- Fiscal policy
    - Fiscal stance in 2010 and 2011
    - Tax policy and administration
        - Tax policy reforms including excises and investment incentives
        - Strengthening large taxpayers service
        - Improving tax performance management
    - Expenditure management and efficiency
        - Better budget preparation (Medium-Term Expenditure Framework, FE, program evaluation) and execution
        - More budget transparency
    - Fiscal risks
        - Strengthening Department of Finance's capacity to handle contingent liabilities, Public Private Partnerships (PPPs), and Government-owned and Controlled Corporations (GOCCs) (e.g., National Food Authority)
    - Reforms for long-term fiscal sustainability

- Financial policy

[1] Other participating country team members included, on the Bank side, Ulrich Lachler, Lada Strelkova, Eric Le Borgne, and Yasuhiko Matsuda; on the Fund side, Dennis Botman, Joji Ide, Padamja Khandelwal, Jay Peiris, and Anita Tuladhar.

    - Bank soundness
    - Real-financial linkages
    - Regulatory and supervisory lessons from the crisis

- External sector
    - External vulnerabilities
    - Exchange rate assessment

- Raising potential growth and investment
    - Investment climate
        - PPPs, energy, transport, telecoms, water and sanitation policies and regulations
        - Constraints and costs of doing business
        - Competition policy
    - Governance
        - Strengthening public expenditure management
        - Decentralization
    - Factor markets
        - Financial market development
        - Enhancing labor market mobility
        - Understanding the role of the services sector

3. **Based on this shared assessment, the teams identified three structural reform areas as macro-critical,** in view of their central role in achieving macroeconomic stability and sustained inclusive growth: (i) recovery and potential growth; (ii) public finance; and (iii) the financial sector. Appendix 1 details the specific activities planned by the two country teams over the period October 2010–September 2011, along with their expected deliveries, and the division of labor among the teams.

4. **The teams have the following requests for information and collaboration from their counterparts:**

- The Fund team requests to be kept informed of progress in World Bank's discussions with the government on financing of infrastructure, PPPs, and a possible development policy loan. Review and sharing of analytical work, in particular the annually prepared Philippines Development Report (PDR), would be welcome, in addition to follow up from the 2010 FSAP, and on work related to the reform of social safety nets, public expenditure reviews, and public financial management.

- The Bank team requests to be kept informed of the Fund's assessments of macroeconomic policies and prospects and to coordinate closely the TA work, especially in areas such as tax policy and administration, where the Bank has an existing program in place, as well as in public expenditure analysis and management, where extensive Bank work is ongoing. The Bank would welcome an opportunity to participate in the 2010 Article IV mission meetings with the authorities. The Bank team also requested that the Fund designate one of its team members to serve as a peer reviewer of the forthcoming PDR.

5. **No disagreement between the two teams emerged either on the key issues, challenges or on the division of tasks to tackle these.** It was agreed that further details on collaboration, as necessary, would be agreed at the technical level as work progresses.

Appendix 1. Philippines: Bank and Fund Planned Activities in Macro-critical Structural Reform Areas, October 2010–September 2011

	Products	Expected Delivery Date
Bank Work Program	• Philippines Development Reports • Quarterly Economic Updates • Public Expenditure Review • Supervision of NPSTAR project • Development Policy Loan • Govt. Integrated Fin. Mgmt Info. System (GIFMIS) • TA for Statistical Development Plan • Analytical and Advisory Activities (AAA) on Power • AAA on Transport • AAA on Agriculture and Agribusiness • Innovations in Financing • Doing Business 2011 • Programmatic AAA on Education • Programmatic AAA on Health • Programmatic AAA for Social Protection and Poverty Reduction • Public Financial Management AAA • Programmatic AAA on Decentralization • Financial Crisis Preparedness Simulation Exercise	• January 2011 • Quarterly • 2010 and 2011 • Quarterly • April 2011 (tbd) • Tbd • 2011–2012 • June 2011 • June 2011 • June 2011 • June 2011 • August 2010 • 2010–12 • 2010–12 • 2010–12 • 2010–12 • 2010–12 • 2012 (tentative)
Fund Work Program	• Article IV Consultation Notes • Article IV Staff Report • July Staff Visit Concluding Statement	• January 2011 • January 2011 • July 2011

	• Possible Working Papers on issues addressed during the Article IV mission
	  • Potential Growth
	  • Growth-Friendly Fiscal Consolidation: Prospects for the Philippines
	  • Inflation Forecasting and Monetary Policy Analysis Framework for the Philippines
	  • [Implications of workers' remittances for external stability assessments]
		• Q1: 2011

	• Technical assistance
	  • Banking supervision
	  • Tax administration
	  • Public financial management (cash management and budget execution)
	  • Tax policy
		
		• Ongoing
		• Ongoing
		• Ongoing
		
		• Ongoing

Joint Work Program	Collaboration and Review of the Philippines Development Report	• End-2010

IMF-WB Collaboration Matrix: Macro-critical Structural Issues

	Short-term reforms	Medium- and Long-term reforms of direct relevance to IMF 1/	Other structural reforms 2/
Recovery and potential growth	Investment incentives Energy sector taxation Oil deregulation law	Corporate sector Corporate sector performance and vulnerabilities (IMF/WB) Investment environment Regulatory framework (WB) Corruption/rule of law (WB) Investment incentives (IMF) Energy sector Power supply and expected shortage (WB) Energy sector taxation (IMF) Rice market NFA operation and efficiency (WB) Pricing and subsidy of rice (WB/IMF) Labor market (WB in relation to education) Regulatory framework (WB) Wages/union structure (WB)	Corporate governance Concentration/ oligopoly/monopoly (WB-2005CEM)
Public finance	BIR reform Cash management Expenditure efficiency (capital spending)	Revenue administration BIR reform (IMF/WB) BOC (IMF in relation to customs/WB in relation to trade facilitation) Revenue forecasting (WB/IMF) Public financial management Cash management (IMF) IFMIS/fiscal reporting (IMF) Budget preparation (IMF/WB) Budget execution (IMF/WB) Tax policy (IMF/WB) Expenditure efficiency/policy Social safety net (WB) Level of spending (IMF/WB) Efficiency (WB) Medium-term Expenditure Framework (WB/IMF) GOCC reform (WB) Fiscal Responsibility Law (IMF/WB)	 PPPs (WB/IMF) Debt Management (World Bank/IMF)
Financial sector		Bank supervision (IMF) Banking sector soundness (IMF/WB) PDIC Contingency Framework (IMF) Capital market development (IMF/WB) Int'l coordination to limit regulatory arbitrage (IMF)	
Other	Official financing	External corporate bond issuance (IMF)	

1/ Issues directly relevant for IMF work; (IMF) means work done in-house, (IMF/WB) implies in-house work in parallel or collaboration with the WB; and no specific reference means input required from other institutions.
2/ Non-critical, but useful input to IMF analysis.

ANNEX III. PHILIPPINES: RELATIONS WITH THE ASIAN DEVELOPMENT BANK

From January 2005 to December 2010, the Asian Development Bank (AsDB) approved 17 public sector loans totaling $3.73 billion,[2] including $3.125 billion for 11 policy-based loans[3] and $48.73 million for 52 TA and grant-financed projects. As of 30 June 2010, cumulative direct value-added cofinancing for the Philippines since 1970 amounted to $3.2 billion for 38 investment projects and $22.1 million for 34 TA projects.

Since joining the AsDB in 1966, the Philippines has received 194 sovereign loans for a total of $11.9 billion, and 365 TA grants amounting to $169.17 million. Energy and public sector management account for the largest proportion of lending (Table 1). From 2006 to 2009, on average, more than 2/3 of the portfolio was in program loans.

Table 1. Philippines: Cumulative AsDB Lending to the Philippines
(As of December 2010)

	No. of Loans	Amount of Loans ($ million)	Percent (by amount)
Energy	26	2,688.2	22.6
Public Sector Management	9	2,328.0	19.6
Agriculture and Natural Resources	59	1,909.0	16.1
Transport and ICT	26	1,292.9	10.9
Finance	19	1,128.0	9.5
Water and Other Municipal Infrastructure and Services	27	1,042.9	8.8
Health and Social Protection	8	767.4	6.5
Multisector	7	301.2	2.5
Education	8	252.1	2.1
Industry and Trade	5	174.0	1.5
Total	**194**	**11,883.7**	**100.0**

AsDB's private sector operations in the Philippines began in 1986. As of 30 June 2010, cumulative approvals in 26 projects amounted to $768.1 million. AsDB's private sector operations in the Philippines included financing for power plants and investments in banks and private equity funds. In 2008, a $200 million loan was approved and disbursed for the acquisition, rehabilitation, and operation of the existing 600-megawatt Masinloc coal-fired thermal power plant in Zambales province by Masinloc Power Partners. In 2009, a loan for up to $120 million was approved for KEPCO SPC Power Corporation for the construction,

[2] Six project loans for $610 million were among these.

[3] In 2010, one policy-based loan totaling $250 million 38 percent of all lending and one project loan amounting to $400 million were approved.

operation, and maintenance of a new coal-fired power plant in the Visayas region using circulating fluidized bed technology. By supporting private sector investments in power, both projects are helping to further power sector reforms aimed at increasing efficiency and reducing costs.

Discussions with various sponsors are going on in regard with infrastructure projects that would (i) address power shortages; (ii) develop renewable energy; (iii) provide clean water and/or wastewater/sanitation services; and (iv) facilitate the movement of goods and services through toll road construction, mass transportation, and inter-island transport. In the financial sector, AsDB is working on projects that would channel funds to small and medium enterprises and microfinance, infrastructure, and trade finance.

AsDB is in the process of preparing its Country Partnership Strategy (CPS) for 2011–16. On request of Government, the cycle of the CPS was aligned with the government's planning cycle, namely the Medium-Term Philippine Development Plan 2011–16.

ANNEX IV. PHILIPPINES—STATISTICAL ISSUES

As of December 20, 2010

<table>
<tr><th colspan="2">I. Assessment of Data Adequacy for Surveillance</th></tr>
<tr><td colspan="2">General: Data provision to the Fund has some shortcomings, but is broadly adequate for surveillance.</td></tr>
<tr><td colspan="2">National Accounts: Despite the authorities’ efforts to improve quality, weaknesses remain in the national accounts. These include large statistical discrepancies in the GDP estimates between the expenditure and production sides with consequent differences in estimates of GDP growth. The data ROSC (2004) identified a number of causes for these problems. First, deaths and births of establishments are not adequately captured. This gap is of growing importance given the rapid structural change in the economy in recent years, with a large number of new establishments. Second, compilation relies on an outdated benchmark year and fixed input-output ratios. Estimates are derived by extrapolation of the 1988 benchmark year using fixed input-output ratios. Finally, statistical techniques in estimating GDP at constant prices are inadequate. For most activities, not all components of the production accounts are compiled, instead only value added is estimated. Value added at current prices is calculated by extrapolating the benchmark year value with an indicator for the value of output.
Price Statistics: The consumer price index has been compiled since February 2004 using weights based on the 2000 Family Income and Expenditures survey.</td></tr>
<tr><td colspan="2">External Sector Statistics: Steps have been taken to improve the quality of balance of payment statistics. In 2005, the Central Bank of the Philippines (BSP) created a Department of Economic Statistics, with one of its units to concentrate on compiling, analyzing, and publishing the balance of payments and the international investment position. Challenges remain for addressing certain compilation issues. Since deregulation in the early 1990s, international transactions have increasingly flowed through nontraditional channels that are not adequately covered by the statistical reporting system. The Foreign Currency Deposit Units (FCDUs), which account for about 70–75 percent of foreign exchange settlements, are exempt from reporting requirements because of strict banking secrecy rules.</td></tr>
<tr><td colspan="2">Monetary and Financial Statistics: Compilation of monetary and financial statistics (MFS) largely conforms to the Fund’s methodology.</td></tr>
<tr><td colspan="2">Government Finance Statistics: While the Philippines meet the requirements of fiscal transparency in many important respects, the fiscal and data ROSCs found areas that require strengthening. An important problem is that the budget is presented on an obligation basis, while the deficit is reported on a cash basis. In addition, the budget classification differs from the accounting classification, complicating comparisons of budget and outcomes. Moreover, for levels of the public sector beyond the budgetary central (national) government, consolidated fiscal outturns for items other than the fiscal balance are generally unavailable. However, the introduction of a standardized chart of accounts, and the electronic New Government Accounting System has facilitated the compilation of annual financial statements for all levels of the public sector.</td></tr>
<tr><th colspan="2">II. Data Standards and Quality</th></tr>
<tr><td>The Philippines subscribed to the Special Data Dissemination Standards (SDDS) in August 1996.</td><td>A data ROSC was published in August 2004.</td></tr>
</table>

Philippines: Table of Common Indicators Required for Surveillance

(As of December 20, 2010)

	Date of Latest Observation	Date Received	Frequency of Data[7]	Frequency of Reporting[7]	Frequency of Publication[7]	Memo Items:	
						Data Quality – Methodological Soundness[8]	Data Quality – Accuracy and Reliability[9]
Exchange Rates	12/20/2010	12/20/2010	D	D	D		
International Reserve Assets and Reserve Liabilities of the Monetary Authorities[1]	Nov 2010	Dec 2010	D	D	M		
Reserve/Base Money	Dec 2010	Dec 2010	D	W	W	O, LO, LO, LNO	LO, O, O, O, LO
Broad Money	Oct 2010	Dec 2010	M	M	M		
Central Bank Balance Sheet	Nov 2010	Dec 2010	M	M	M		
Consolidated Balance Sheet of the Banking System	Oct 2010	Dec 2010	M	M	M		
Interest Rates[2]	12/20/2010	12/20/2010	D	D	D		
Consumer Price Index	Nov 2010	Dec 2010	M	M	M	O, O, O, O	O, LO, O, LO, LO
Revenue, Expenditure, Balance and Composition of Financing[3] – General Government[4]	2009	Dec 2010	Q	Q	Q	LO, LO, O, O	LO, LO, LO, LO, LO
Revenue, Expenditure, Balance and Composition of Financing[3]– Central Government	Oct 2010	Nov 2010	M	M	M		
Stocks of Central Government and Central Government-Guaranteed Debt[5]	Q2 2010	Sep 2010	Q	Q	Q		
External Current Account Balance	Q2 2010	Sep 2010	Q	Q	Q	O, LO, LO, LO	LNO, LO, O, LO, LO
Exports and Imports of Goods and Services	Q2 2010	Sep 2010	Q	Q	Q		
GDP/GNP	Q3 2010	Nov 2010	Q	Q	Q	LO, LO, O, LO	LNO, LNO, O, LO, O
Gross External Debt	Q2 2010	Sep 2010	Q	Q	Q		
International Investment Position[6]	2009	Sept 2010	A	A	A		

[1] Includes reserve assets pledged or otherwise encumbered as well as net derivative positions.
[2] Both market-based and officially determined, including discount rates, money market rates, rates on treasury bills, notes, and bonds.
[3] Foreign, domestic bank, and domestic nonbank financing.
[4] The general government consists of the central government (budgetary funds, extra budgetary funds, and social security funds) and state and local governments.
[5] Including currency and maturity composition.
[6] Includes external gross financial asset and liability positions vis-à-vis nonresidents.
[7] Daily (D), Weekly (W), Monthly (M), Quarterly (Q), Annually (A), Irregular (I); Not Available (NA).
[8] Reflects the assessment provided in the data ROSC or the Substantive Update (published on August 25, 2004, and based on the findings of the mission that took place during September 1–16, 2003) for the dataset corresponding to the variable in each row. The assessment indicates whether international standards concerning concepts and definitions, scope, classification/sectorization, and basis for recording are fully observed (O), largely observed (LO), largely not observed (LNO), or not observed (NO).
[9] Same as footnote 8, except referring to international standards concerning source data, statistical techniques, assessment and validation of source data, assessment and validation of intermediate data and statistical outputs, and revision studies.

Statement by the IMF Staff Representative on the Philippines
February 18, 2011

The information below has become available following the issuance of the staff report. It does not alter the thrust of the staff appraisal.

Economic activity remains robust. GDP growth in 2010 was 7.3 percent (year/year), compared with a staff forecast of 7 percent. Growth rose to 7.1 percent in the 4th quarter, from 6.3 percent in the 3rd quarter, mainly driven by private domestic demand. Private consumption was fueled by strong remittances and fixed investment by high business confidence. Public consumption moderated, reflecting the government's efforts to keep the fiscal deficit within budget targets.

The balance of payments has remained strong. Export growth rose significantly to over 25 percent (year/year) in December, portfolio inflows moderated from their spike in November but remained high, and sovereign bond issuance proceeds and foreign investment income increased. International reserves rose to \$62.4 billion in December and \$63.6 billion in January (equivalent to 10½ months of imports and 11 times and 5½ times short-term external debt based on original and residual maturity, respectively). The exchange rate has remained roughly unchanged against the U.S. dollar since December. Broad money growth picked up to 10.6 percent in December from 7.5 percent in November.

Inflation rose in January. The authorities view the inflation picture as manageable but signaled a readiness to act in response to inflation risks. CPI inflation rose to 3.5 percent (year/year) and 0.8 percent (month/month) in January from 3 percent and 0.5 percent, respectively, in December. The increase was driven mainly by food and energy prices. Food prices were affected by domestic weather disruptions and energy prices by higher global prices and domestic distribution costs. Core inflation slowed slightly on a year/year basis, owing to base effects, but on a sequential basis it rose to 0.4 percent (month/month) in January from 0.3 percent in December. At its February 10 meeting, the Monetary Board left policy rates unchanged but observed that the balance of risks to the inflation outlook has tilted further to the upside. Risks were seen as arising from food and oil prices, electricity rates, and demand-side price pressures as output continues to expand faster than its historical trend. The board signaled its readiness to take action to arrest a potential buildup in inflation expectations and contain second-round effects of supply shocks.

INTERNATIONAL MONETARY FUND
Public Information Notice
EXTERNAL RELATIONS DEPARTMENT

Public Information Notice (PIN) No. 11/28
FOR IMMEDIATE RELEASE
March 1, 2011

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

IMF Executive Board Concludes 2010 Article IV Consultation with the Philippines

On February 18, 2011 the Executive Board of the International Monetary Fund (IMF) concluded the Article IV Consultation with the Philippines.[1]

Background

After slowing during the global financial crisis, economic growth recovered strongly during 2010. The recovery has been helped by supportive macroeconomic policies as well as strong private demand. The smooth transition to a new Administration in July 2010 and the government's focus on improving governance have strengthened investor confidence. The external surplus continued to grow in 2010, underpinned by both the current and financial account. Financial conditions remain accommodative, partly reflecting external inflows, although asset bubbles have not been a concern so far. Notwithstanding the strong recovery, fiscal revenue fell short of budget targets in January–September.

The near-term outlook is generally positive. Growth reached 7.3 percent in 2010 and is projected to moderate in 2011 to a still robust 5 percent. Inflation has been moderate and inflation expectations well anchored, although pressures may start to build during

[1] Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. A staff team visits the country, collects economic and financial information, and discusses with officials the country's economic developments and policies. On return to headquarters, the staff prepares a report, which forms the basis for discussion by the Executive Board. At the conclusion of the discussion, the Managing Director, as Chairman of the Board, summarizes the views of Executive Directors, and this summary is transmitted to the country's authorities. An explanation of any qualifiers used in summings up can be found here: http://www.imf.org/external/np/sec/misc/qualifiers.htm.

the coming quarters as demand closes in on the economy's supply potential. The balance of payments is projected to remain in surplus as remittances and export diversification support the current account balance and the Philippines continues to attract capital inflows, which may be largely structural in nature.

Risks to the outlook are broadly balanced. The positive economic sentiment in the country may boost private investment more than expected. However, renewed shocks to global growth and financial markets would affect Philippine exports and remittances.

Monetary policy responded well to the crisis and has helped foster the recovery. A 200-basis-point cut in policy rates during December 2008–July 2009, and additional crisis-related liquidity support measures, helped to cushion the economy against the downturn. With the recovery underway, the Bangko Sentral ng Pilipinas (BSP) appropriately started to unwind its liquidity support measures since early 2010. In July, it extended through 2014 the 3-5 percent inflation target for 2011.

The authorities have relied on the traditional toolkit for managing external inflows in recent years. They have sought to strike a balance between the various elements in the toolkit. The authorities further liberalized controls on capital outflows in October, have had in place for some years macro-prudential measures that have worked well, tried to repay external debt ahead of schedule, and have avoided capital controls. The exchange rate has appreciated, although by somewhat less than in neighboring economies, and reserves have risen to high levels.

Fiscal consolidation is needed in order to create more fiscal space for the budget to be able to respond effectively to future shocks. Consolidation would improve medium-term growth prospects by lowering sovereign risk and enhancing investment and it would reduce the share of debt service in government expenditure. It would also help in managing the macroeconomic impact of external inflows. Against this background, the authorities intend to reduce the national government deficit to 2 percent of GDP from 2013. The main elements of the authorities' fiscal strategy are a greater tax effort, a reorientation of expenditure towards social sectors and infrastructure, and a debt management strategy that reduces the reliance on external debt and lengthens the maturity structure.

The Philippine financial sector withstood the crisis well, and has been sound and stable in recent quarters. The sector was relatively unaffected by the global market turbulence last year.

Executive Board Assessment

Executive Directors commended the authorities for skillful macroeconomic management, leading to a robust economic recovery and improved consumer and investor confidence. The economic outlook is generally favorable, with sustained growth and a strong external position. A key policy challenge is to preserve macroeconomic stability while enhancing medium-term growth. Meeting this challenge will require a careful exit from stimulus policies in a complicated external environment, and further reforms to promote investment.

Directors noted that monetary policy had succeeded in keeping inflation low while fostering the recovery, and welcomed the gradual unwinding of liquidity support. Given a potential buildup of price pressures in the near term, they encouraged the authorities to stand ready to tighten the monetary stance to head off inflation risks.

Directors underscored the need for an appropriate mix of policy tools to manage capital inflows, while facilitating productive use of these inflows. They supported the central bank's policy of allowing the exchange rate to adjust to market pressures and limiting intervention to smoothing operations. With the exchange rate broadly in line with fundamentals and reserves comfortable, greater exchange rate flexibility could be considered in response to additional inflows. Directors took note of the authorities' intention to further liberalize foreign exchange regulations and avoid capital controls.

Directors welcomed the planned gradual withdrawal of fiscal stimulus and the focus on medium-term consolidation, which would create space for priority investment. Noting the relatively high public debt, they encouraged the authorities to consider accelerating the pace of debt reduction. Directors noted that achieving the deficit targets and increasing social and infrastructure spending will require substantial revenue efforts, including broadening the tax base and strengthening tax administration. They recommended early actions to reform excise taxes, rationalize fiscal incentives, and address gaps in the value added tax, complemented by reforms to strengthen the budgetary framework and control of the civil service wage bill.

Directors noted that the financial sector withstood the crisis well, with high banks' capital adequacy ratios and improving profitability. Going forward, they emphasized the need to monitor key sources of vulnerability closely, particularly concentration and interest rate risks. While asset prices have not been a concern so far, they warrant attention in an environment of rising capital inflows. Directors looked forward to an early approval of the amendments to the central bank law, increasing legal powers and protection for the supervisory authorities, and further progress in strengthening the AML/CFT (anti-money laundering and combating the financing of terrorism) framework.

Directors stressed that promoting private investment and addressing impediments to job creation and productivity are crucial for raising potential growth. They agreed that the public-private partnership program can play an important part in this regard, and encouraged careful evaluation of projects that takes appropriate account of fiscal risks. Directors also welcomed the preparation of the Medium-Term Philippine Development Plan, and ongoing efforts to improve the business climate and infrastructure, and to deepen capital markets.

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 (use the free Adobe Acrobat Reader to view this pdf file) for the 2010 Article IV Consultation with the Philippines is also available.

Philippines: Selected Economic Indicators, 2007–11

	2007	2008	2009	Proj. 2010	2011 1/
Growth and prices (percent change)					
Real GDP	7.1	3.7	1.1	7.0	5.0
CPI (annual average)	2.8	9.3	3.2	3.8	3.9
Public finances (percent of GDP)					
National government balance (authorities' definition)	-0.2	-0.9	-3.9	-3.8	-3.2
National government balance (IMF definition) 2/	-1.7	-1.5	-4.0	-3.8	-3.3
Total revenue and grants	15.8	15.8	14.6	14.5	15.5
Total expenditure	17.4	17.3	18.6	18.4	18.9
Non-financial public sector balance 3/	0.2	-0.3	-3.4	-2.6	…
Non-financial public sector debt	61.0	60.7	60.7	58.0	…
Monetary sector (percent change, end of period)					
Broad money (M3)	10.6	15.6	8.3	7.7 4/	…
Interest rate (91-day treasury bill, end of period, in percent) 5/	4.2	5.8	4.3	1.8 6/	…
Credit to the private sector	8.5	16.8	8.1	10.1 4/	…
External sector					
Current account (percent of GDP)	4.9	2.2	5.5	5.4	4.3
Reserves, adjusted (US$ billions) 7/	33.8	35.9	44.2	62.9	78.4
Reserves/short-term liabilities, adjusted 8/	240.5	284.4	389.1	498.6	595.4
Pesos per U.S. dollar	46.1	44.5	47.6	45.2 9/	...

Sources: Philippine authorities; IMF staff projections.

1/ Public finance projections reflect the 2011 budget.
2/ Excludes privatization receipts and includes deficit from restructuring of the central bank (Central Bank Board of Liquidators).
3/ Includes the national government, Central Bank-Board of Liquidators, 14 monitored government-owned enterprises, social security institutions, and local governments.
4/ October 2010 (year-on-year).
5/Secondary market rate.
6/ November 2010.
7/Adjusted for gold and securities pledged as collateral against short-term liabilities.
8/Short-term liabilities include medium- and long-term debt due in the following year.

9/ Average for January to November 2010.

Statement by Duangmanee Vongpradhip, Executive Director for the Philippines and and Iluminada Tapiru Sicat, Senior Adivsor
February 18, 2011

Introduction

The Philippine authorities would like to thank the IMF team, led by Mr. Vivek Arora, for the successful conduct of the 2010 Article IV consultation. The discussions were engaging, candid and constructive. They focused on policy reforms to preserve macroeconomic stability and enhance the prospects for higher medium-term growth. Overall, my authorities broadly agree with the staff's analyses and appreciate the policy recommendations.

Recent Economic Developments and Outlook

The Philippines is one of the few countries which managed to avoid the recession during the global crisis. From a modest growth of 1.1 percent in 2009, the economy registered its highest real GDP growth in 34 years at 7.3 percent in 2010. This growth which is well-above the official growth target of 5.0-6.0 percent has been broad-based and underpinned by significant economic developments both from the supply and demand sides. Providing support to the economic expansion were the appropriately accommodative monetary and fiscal policies, low inflation and interest environment, and stable exchange rate which spurred consumption and investment. The stability in the banking system also played an important role in fostering the recovery by allowing the critical flow of credit to continue to the productive sectors of the economy. The rebound in external demand and the availability of external financing also provided support to the growth momentum. In particular, the balance of payments posted a surplus of US$14.4 billion, which was more than twice compared to US$6.4 billion in 2009. The favorable external performance was boosted by the rebound of trading activity in goods and services, steady stream of remittance flows, and sustained investor appetite for local financial instruments. The strong foreign exchange inflows provided the opportunity to build up precautionary reserve buffers against possible external shocks, while maintaining the Philippine peso's stability and relative competitiveness. It is noteworthy that the healthy external performance has contributed to the decision by the Standard and Poor's, in November last year, to upgrade the country's credit ratings, and by Moody's Investors Service, in January 2011, to raise the outlook of the Philippines' sovereign bond ratings to positive from stable.

For 2011, the economy is expected to sustain its growth momentum at 7-8 percent driven by domestic consumption and investment, as well as external demand. While the pace of growth may taper off as base effects diminish, industry (particularly manufacturing) and services sectors will continue to show strength and remain to be the main driver of economic growth. On the demand side, growth will be increasingly driven by private sector activity supported by remittances and improving consumer and business confidence. Investments related to the public-private partnership program will also provide a strong support to growth. Meanwhile, government consumption is expected to be subdued due to some re-alignments in the budget.

To support this growth, inflation rate is expected to range within the target level of 3-5 percent. The external payments position is expected to remain in surplus in the near term with strong impetus from remittances, exports and continued capital inflows.

Policy Thrusts

While overall domestic economic recovery is firming up, authorities recognize that risks and challenges to economic outlook remain. Downside risks include the uneven pace of global growth, volatilities in global food prices, persistent increases in world oil prices, and remaining domestic structural weaknesses. The policy agenda, therefore, would be to consolidate the gains achieved thus far and create an environment that will continue to propel the economy forward. In this regard, the authorities are committed to pursue additional policy measures and reforms to address vulnerabilities that will hinder the attainment of sustainable medium-term growth.

Monetary and External Policy

The focus of monetary policy is to keep inflation low and prices stable with the view to promoting appropriate levels of interest rates that would also support domestic demand. Credit policy will therefore remain consistent with inflation targeting yet supportive of economic expansion. In its recent monetary policy meeting last 10 February 2011, the BSP's Monetary Board has decided to keep the policy rate steady noting that there is, thus far, limited evidence of spillovers or second-round effects of supply shocks. While the Monetary Board noted that prevailing price and output conditions suggest that the stance of monetary policy continues to be appropriate for the time being, the balance of risks to the inflation outlook has tilted further to the upside, with more risks expected in the near future. Given this, the BSP is closely watching the emerging risks to inflation outlook, and is prepared to undertake monetary action, if necessary, to arrest a potential build-up in inflation expectations and contain the second-round effects of supply shocks. Meanwhile, in line with the BSP's objective to have a more effective inflation management over the medium term, the BSP announced in 2010 the shift to a fixed medium-term inflation target from a variable annual inflation target. The adoption of a fixed medium-term inflation target aims to promote a long-term view on inflation, help better anchor inflation expectations, and support consumption and investment by fostering greater predictability in economic decisions. Two other key measures being pursued by the BSP relate to the amendment of the BSP Charter to allow it to issue its own debt instruments as well as to achieve the full BSP capitalization to enable it to carry out monetary policy more effectively.

On the exit strategy, the BSP had envisaged and announced a strategy that is comprised of two stages, namely: 1) the discontinuation of the liquidity measures; and 2) the withdrawal of interest rate stimulus. The BSP has already begun to implement the withdrawal of the liquidity-enhancing measures in the first quarter of 2010. As concerns about the liquidity and stability of the financial system abated and as inflation pressures rose moderately, the BSP pursued a rollback of liquidity-enhancing measures adopted during the crisis, namely, the alignment of the peso rediscount rate to the BSP's policy rate, reduction of the peso rediscounting budget from Php60 billion to Php20 billion, restoration of the loan value of all eligible rediscounting papers, and restoration of the non-performing loan ratio requirement for banks wishing to avail of the rediscounting facility. Meanwhile on the withdrawal of the interest rate stimulus, authorities view that this will, in large part, depend on the expectations and outlook for inflation as well as the strength and speed of the improvement of the domestic real sector and global economic conditions. The authorities, however, underscore that any potential policy rate hikes in the near term should be viewed mainly to curb inflation pressures and arrest the build-up in inflation expectations, and not an effort to normalize liquidity measures introduced at the height of the global financial crisis.

On capital flows, the BSP is mindful of the risks associated with the surge in foreign capital inflows and the challenge that these pose on monetary policy. In this regard, the BSP has employed a mix of policy instruments and strategies to manage the impact of surges in foreign exchange inflows and maintain overall stability in the foreign exchange market. Specifically, the BSP's policy toolkit includes: greater exchange rate flexibility; reserve accumulation and associated liquidity management operations; macroprudential tools; liberalization of outward foreign exchange transactions; and calibrations in monetary policy when necessary. The orderly management of large capital flows will contain their destabilizing effects on the economy and ensure the sustainability of growth.

Fiscal Policy

The current government has identified fiscal sustainability as a top priority and an integral part of the effective governance agenda. The main task is to address the narrow fiscal space and to get on a sustainable revenue-and-spending path. The fiscal authorities are aiming to address the fiscal sustainability concerns by increasing revenue, improving the allocative and operational efficiency of fiscal expenditures, and strengthening liability management. Specifically, the government aims to achieve a tax effort of 18% by 2016 through, among others, stringent tax enforcement, simplification of tax compliance rules, streamlining of clearance procedures and modernization of customs administration, reduction of discretionary administration, intensification of efforts against tax evaders, establishment of a tax registry, and strengthening of the Lateral Attrition Law by instituting a more effective system of rewards and penalties. The Fund's technical assistance to the Philippines on tax reforms could greatly help in increasing revenue collection. Meanwhile, fiscal expenditure reforms will be pursued by setting funding priorities while protecting social programs for the most vulnerable, enhancing inter-agency coordination, strengthening internal control systems to reduce wastage and corruption, and enhancing the transparency and accountability mechanism. On liability management, strategy will focus on lengthening the maturity profile of government debts through debt swaps and debt exchanges to avoid bunching, and diversifying the government's funding structure in terms of currency, maturity and markets. All these are expected to keep the deficit and government debt within manageable levels.

Financial Sector Policy

The thrust of financial sector policies is to establish a strong and vibrant financial system that would facilitate the liquidity requirements of the economy. In line with this, focus is placed to maintain a well-functioning banking system that will efficiently mobilize funds and channel these to productive uses. As such, the authorities will continue to undertake prudential measures to ensure the continued strength and stability of the banking system. In this regard, the BSP will sustain the implementation of critical reforms to improve governance, strengthen bank capitalization, clean up banks' balance sheets, and enhance risk management to create sound underpinnings for a healthier banking system. The authorities will continue to engage with other regulators to harmonize standards and procedures, and align domestic banking policies with global practices but with due regard to the economy's circumstance and peculiar financial service requirements.

On the issue of vulnerability arising from the concentration risks of banks to large conglomerates, three important points need to be clarified to alleviate this concern. First, the existence of conglomerates is part of the structure of the Philippine economy and they are a major driving force of the economy. Second, their funding needs are typically provided by the banks within the context of accepted underwriting standards. Third, the sources of conglomerates' revenues are diversified across different business lines, which, in turn, serve to mitigate concern on concentration risks.

On strengthening the banking regulation and supervision framework, the proposed amendments to the BSP Charter have already been submitted to Congress for deliberation. Specifically, these amendments aim to rationalize the secrecy of bank deposit rules, allow the BSP more flexibility to order consolidations in the banking industry, clarify the grounds for closing problem banks or declaring them insolvent, and strengthen legal protections for BSP officers acting in their official capacity.

Structural reforms

Given the limited fiscal space and the need to deliver the needed investments in infrastructure development to sustain medium-term economic growth, the government has adopted as a strategy to increase participation of the private sector through the Public-Private Partnerships (PPP) program. The authorities recognize the essential role of the private sector as an important partner for economic development and job creation. The program seeks to address the gap on development investments by tapping resources of the private sector and capitalizing on renewed foreign investor interest in the country. The PPP aims to: a) focus on infrastructure facilities for tourism, agriculture, social, services and growth centers; b) provide incentives to stimulate private resources; c) ensure competition, fairness and transparency; d) provide assistance to stakeholders to move the project onward; e) improve the approval process of the project; and f) protect public interest. To set clearly the growth strategies, policies, programs and activities for the medium-term, the government is currently crafting the Medium-Term Philippine Development Plan, 2010-2016.

Final Remarks

Taking advantage of the firm recovery from the global downturn, the Philippines is embarking on a reform agenda that would sustain and elevate it to the next stage of growth and development. The authorities are fully cognizant of the vulnerabilities and challenges facing the economy. As such, they are firmly committed to continue pursuing sound macroeconomic management and structural reforms to strengthen the resilience of the economy against shocks and allowing sustained rapid growth moving forward.