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SM/88/113
Correction 1

CONTAINS CONFIDENTIAL
INFORMATION

June 15, 1988

To: Members of the Executive Board
From: The Secretary
Subject: Philippines - Staff Report for the 1988 Article IV Consultation

The following corrections have been made in SM/88/113 (5/25/88):

Page 9, Table 4, unit statement: for "(In billions of U.S. dollars)"
read "(In millions of U.S. dollars)"

Page 11, Table 5, column 2, line 2: for "18.0" read "12.8"

Page 27, Table 11: add unit statement

Corrected pages are attached.

Att: (3)

Other Distribution:
Department Heads

Table 4. Philippines: Balance of Payments, 1985-88 1/

(In millions of U.S. dollars)

	1985	1986	1987		1988	
			Program 1/	Actual	Jan. 1988 Program	Revised
Trade balance	-482	-202	-741	-1,017	-1,016	-1,085
Exports, f.o.b.	4,629	4,842	5,372	5,720	6,385	6,590
Imports, f.o.b.	-5,111	-5,044	-6,113	-6,737	-7,401	-7,675
Oil	-1,277	-728	-938	-1,062	-1,090	-1,110
Non-oil	-3,834	-4,316	-5,175	-5,675	-6,311	-6,565
Services	85	757	245	-76	-24	-102
Receipts	3,288	3,791	3,529	3,497	3,702	3,712
Of which:						
Economic Support Fund (ESF)	(62)	(300)	(180)	(152)	(120)	(174)
Payments	-3,203	-3,034	-3,284	-3,573	-3,726	-3,814
Of which: interest	(-2,208)	(-2,046)	(-2,131)	(-2,226)	(-2,311)	(-2,299)
Transfers	379	441	528	554	511	648 2/
Current account	-18	996	32	-539	-529	-539
(As percent of GNP)	(-0.1)	(3.3)	(0.1)	(-1.6)	(-1.5)	(-1.4)
Capital account (net)	1,009	246	781	803	764	871
Direct investment (net)	17	140	131	205	207	167
Medium- and long-term loans (net)	890	815	351	242	-190	171
Inflows	2,344	2,545	2,366	2,437	1,857	2,319
Pipeline	317	664	506	415	377	350
New commitments	314	246 3/	404 3/	566 3/	416 3/	567 3/
Concerted lending	400	525	--	--	--	--
Rescheduling 4/	1,313	1,110	1,456	1,456	1,064	1,155
Outflows	-1,454	-1,730	-2,015	-2,195	-2,047	-2,148
Short-term capital (net)	-849	-916	2	141	347	133
Trade facility	-721	-136	361	390	517	335
Other short-term (including errors and omissions)	-128	-780	-359	-249	-170	-202
Other financing (net) 5/	818	--	--	--	--	--
Monetization of gold, and valuation adjustments	133	207	297	215	400	400
Change in net international reserves of the banking system						
(- increase) 6/	-991	-2,242	-813	-264	-505	-332
Central bank (net)	26	-922	-614	-188	-468	-301
Assets (- increase)	-175	-1,398	-48	500	159	109
Use of Fund credit (net)	178	4	-104	-156	-64	-67
Purchases	340	275	207	161	92	97
Repurchases	-162	-271	-311	-317	-156	-164
Other liabilities 7/	23	472	-462	-532	-563	-343
Commercial banks (net)	-1,017	-320	-199	-76	-37	-31
Financing gap	--	--	--	--	270 8/	296 8/
Memorandum items:						
Gross official reserves (months of current year's imports of goods and services)	1,061	2,459	2,507	1,959	1,800	1,850
Imports of goods and services	1.5	3.7	3.2	2.3	1.9	1.9
Exceptional finance	3,954	1,770	1,514	1,514	2,135	2,268
Rescheduling	3,554	1,245	1,514	1,514	2,135	2,268
Paris Club	660	379	599	599	269	300
Commercial banks 9/	2,853	866	915	915	1,866	1,968
Suppliers	41	--	--	--	--	--
Concerted bank lending	400	525	--	--	--	--

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

1/ Adopted at the time of the second review.

2/ Includes \$49 million interest rebate on rescheduled debt paid in 1987 at pre-rescheduling interest rates.

3/ Commitments made after December 31, 1985.

4/ Excludes rescheduling of monetary liabilities.

5/ Includes unremittable arrears and rollover of nonmonetary trade arrears in 1985.

6/ Excludes rescheduled maturing monetary liabilities.

7/ Includes utilization of the trade facility.

8/ Assumed to be financed by rescheduling of debt service obligations due to Paris Club creditors during the second half of 1988 on terms comparable to those granted for 1987 and the first half of 1988.

9/ Includes rescheduling of maturing monetary liabilities.

significant discount (up to 6 percent) of the peso in the parallel market, which persisted during January-February 1988 but virtually disappeared thereafter (Chart 4). At the same time, the peso came under strong pressure in the official market and the Central Bank provided support through large sales of foreign exchange. As a result, gross official reserves declined steeply in the last four months of the year. Almost all of the loss of official reserves (\$0.5 billion) was reflected in an increase of foreign exchange holdings of commercial banks. Gross reserves amounted to about \$2 billion at end-1987, equivalent to slightly over two months of imports of goods and services, compared with over three months at the end of 1986.

The peso's exchange rate vis-a-vis the U.S. dollar has remained virtually unchanged since early 1986. During 1987, the peso depreciated by about 9 percent, in real effective terms, vis-a-vis trading partners, but remained broadly unchanged against a weighted basket of the Philippines' main Pacific area competitors.

Developments in the areas of structural policies are described in Section III.6.

(5) Performance criteria

The quantitative performance criteria for base money and NIR of the monetary authority for end-March 1988 were met (Table 5). It is expected that the limits on external debt and borrowing were also observed. Information on the observance of the limit on the PSBR will not be available before early June.

III. Policy Discussions

1. Objectives and policies for 1988

The original program for 1988 was presented in detail in EBS/88/29 (2/12/88). The immediate aim of economic policy was to strengthen confidence and to prevent a further weakening of the external position; in addition to this immediate concern, policies were designed to achieve continuation of the economic recovery. (The principal macroeconomic objectives for 1988 are shown in Table 3.) Thus, the key elements of economic policies were (a) a mopping-up of excess liquidity; (b) a reversal of Central Bank intervention from large sales to sizable purchases of foreign exchange; (c) a substantial increase in public investment; and (d) continuation of the structural reforms. At the Executive Board meeting to discuss the extension of the stand-by arrangement, there was a consensus on the need for immediate policy action, though Directors differed on the relative emphasis to be placed on interest rate and exchange rate policies. A number of Directors expressed concern about the envisaged increase in the public sector deficits and the potential for inflationary pressures.

Table 5. Philippines: Quantitative Performance Criteria, 1987-88

	Dec. 31, 1987		March 31, 1988		June 30, 1988
	Ceiling	Actual	Ceiling	Actual	Ceiling
(In billions of pesos)					
Monetary base <u>1/</u>	59.3	61.7	61.4 <u>2/</u>	58.7	60.8 <u>2/</u>
Public sector borrowing requirement (cumulative from Jan. 1, 1988)	29.7	12.8	10.5	...	15.0
(In millions of U.S. dollars)					
Floor on net international reserves of the monetary authority <u>3/</u>	70 <u>4/</u> (-300)	-820	-933 <u>4/</u> (-770)	-792 <u>5/</u>	-565
Short-term external debt outstanding	7,600	6,744	7,600	...	7,600
Approvals of external borrowing with maturities of					
1-12 years	1,000 <u>6/</u>	140	1,000 <u>6/</u>	...	1,000 <u>6/</u>
1-5 years	200 <u>6/</u>	4	200 <u>6/</u>	...	200 <u>6/</u>

Source: Based on discussions with the Philippine authorities.

1/ The ceilings will be adjusted downward (upward) to reflect any reduction (increase) in the reserve requirement of deposit money banks.

2/ In addition, the ceilings will be adjusted upward by the amount that NIR exceeds the program floor up to a maximum of P 2.0 billion. The excess of NIR over the floor will be converted into pesos at P 18.002/US\$1.

3/ Floors for the respective test dates will be adjusted: (1) upward (downward) by the amount by which the cumulative total of new money disbursements after January 1, 1988 on external debt contracted after December 31, 1985 from foreign commercial banks and official sources exceeds (falls short of) \$73 million at end-March 1988, and \$231 million at end-June 1988; (2) upward (downward) by the amount that the level of deposit liabilities of the Central Bank to foreign commercial banks under the trade facility falls short of (exceeds) \$709 million at end-March 1988, and \$586 million at end-June 1988; and (3) upward (downward) by the amount that the level of Central Bank-assumed liabilities under Circular 1091 falls short of (exceeds) \$374 million at end-March 1988, and \$391 million at end-June 1988. In addition, the floor will be adjusted upward (downward) by the amount that actual rescheduling falls short of (exceeds) the following amounts: (i) the floors for end-March 1988, and end-June 1988 assume a rescheduling from commercial banks between January 1, 1988 and March 31, 1988 of \$198 million, and June 30, 1988 of \$397 million; (ii) the floors for end-March 1988, and end-June 1988 assume a rescheduling of principal and interest by Paris Club creditors between January 1, 1988 and March 31, 1988 of \$134 million, and June 30, 1988 of \$269 million.

4/ Adjusted floor; the unadjusted floor is shown in parentheses.

5/ Preliminary.

6/ Cumulative approvals from January 1, 1987 onward on all public and private sector foreign borrowing in the specified maturities, excluding reserve liabilities of the banking system and concessional loans (i.e., with a grant element of 25 percent or more).

Compared with the policy strategy discussed at the beginning of the year, the authorities have put more emphasis on monetary restraint and less on exchange rate policy to ease the pressure on reserves. In the area of fiscal policy, there has been an unfavorable shift in the composition of expenditure--larger personnel outlays and lower capital expenditure--compared with the earlier estimates while the projected fiscal deficits have remained virtually unchanged. With speculative activities having now largely died down, the main policy issues for 1988 are: (a) to contain the pressure on the balance of payments and prices resulting from rapidly rising private and public sector demand, mainly consumption; (b) to forestall a deterioration in competitiveness in the face of rising inflation and large wage increases in the public sector; and (c) to press ahead with structural reforms.

The macroeconomic objectives for 1988 have remained virtually unchanged from those established at the beginning of the year. Growth is still expected to amount to about 6 percent in 1988 and inflation is forecast at about 7-8 percent. The consolidated public sector deficit and the PSBR are projected to increase by about 2 1/2 percent of GNP in 1988, owing to strong expenditure growth. However, the excess of private sector saving over investment is projected to increase by about 2 1/2 percent of GNP in 1988, because of a recovery of private savings from its unusually low level in 1987. As a result, the external current account deficit would remain broadly unchanged in 1988 (1.4 percent of GNP).

Both exports and imports are projected to grow by about 8 percent in volume terms, with a small improvement in the terms of trade. Export volume growth will be concentrated in the nontraditional sector, although traditional exports are expected to rebound from the 1987 drought. Inflows of medium- and long-term capital are expected to be somewhat lower than in 1987 (mainly because of the large disbursements at the end of 1987). ^{1/} Similarly, short-term capital inflows are now forecast to be smaller than projected in January 1988, because of substantially lower utilization of the trade facility. Official reserves at the end of 1988 are projected at \$1.85 billion, broadly unchanged from the end-March 1988 level and the earlier program target.

2. Exchange rate policy

In early February 1988, the Central Bank ceased to provide support for the peso through large sales of foreign exchange. Subsequently, net

^{1/} The current rescheduling arrangement for Paris Club debts covers only debt service in the first half of 1988, and the authorities intend to approach the Paris Club shortly for a rescheduling of future debt service. Exceptional financing from banks is projected at over \$1.9 billion in 1988, reflecting the rescheduling of medium- and long-term debt (\$850 million) and of short-term monetary liabilities (close to \$1.1 billion).

Table 11. Philippines: Medium-Term Balance of Payments Projections, 1987-93 ^{1/}

(In millions of U. S. dollars)

	1987	1988	1989	1990	1991	1992	1993
Trade balance	-1,017	-1,085	-1,390	-1,460	-1,445	-1,410	-1,355
Exports, f.o.b.	5,720	6,590	7,235	8,180	9,315	10,530	11,900
Imports, f.o.b.	-6,737	-7,675	-8,625	-9,640	-10,760	-11,940	-13,255
Services and transfers (net)	478	546	367	231	39	-3	-3
Services (net)	-76	-102	-258	-392	-620	-722	-790
Of which: interest payments	(-2,226)	(-2,299)	(-2,324)	(-2,480)	(-2,694)	(-2,817)	(-2,899)
Transfers (net)	554	648	625	623	659	719	787
Current account	-539	-539	-1,023	-1,229	-1,406	-1,413	-1,358
(in percent of GNP)	(-1.6)	(-1.4)	(-2.5)	(-2.8)	(-3.0)	(-2.7)	(-2.4)
Capital account	-653	-531	-325	-476	-236	31	-333
Medium- and long-term loans	-1,214	-1,231	-808	-1,110	-867	-695	-1,190
Inflows ^{2/}	981	917	1,227	1,270	1,314	1,360	1,408
Of which: to be arranged	(—)	(—)	(—)	(77)	(348)	(566)	(1,027)
Outflows	-2,195	-2,148	-2,035	-2,380	-2,181	-2,055	-2,598
Direct investment (net)	205	167	147	150	154	203	262
Other (net)	356	533	336	484	477	523	595
Net international reserves (- increase)	-264	-332	-938	-1,170	-1,553	-643	-755
Gross reserves (-increase)	22	178	-648	-571	-1,050	-471	-504
Liabilities	-287	-510	-290	-599	-503	-172	-251
Use of Fund credit (net)	-138	-67	-191	-351	-305	-172	-70
Purchases	150	97	—	—	—	—	—
Repurchases	-288	-164	-191	-351	-305	-172	-70
Financing gap	-1,456	-1,402	-2,286	-2,875	-3,195	-2,025	-2,446
Rescheduling	1,456	1,106	897	996	934	742	569
Paris Club	599	300	—	—	—	—	—
Commercial banks	857	806	897	996	934	742	569
Possible further Paris Club rescheduling ^{3/}	—	296	547	511	479	494	—
Residual exceptional financing	—	—	842	1,368	1,782	789	1,877
External financing to be arranged ^{4/}	—	296	1,389	1,956	2,609	1,849	2,904
Memorandum items:							
Gross official reserves	1,959	1,850	2,425	2,919	3,892	4,282	4,703
(In months of imports)	2.3	1.9	2.3	2.5	3.0	3.0	3.0
External debt outstanding	28,070	28,213	29,566	31,041	33,134	33,905	37,199
(In percent of GNP)	81.8	75.7	73.3	70.9	69.8	65.9	66.8
Debt service ratio (in percent)							
Before rescheduling	51.1	44.8	41.4	42.9	38.4	33.6	33.4
After rescheduling ^{3/}	35.3	31.1	28.2	30.5	27.4	25.4	30.0
Interest payments in percent of GNP (before rescheduling)	6.5	6.2	5.8	5.7	5.7	5.5	5.2

Sources: Philippine authorities.

^{1/} Assumes annual average real GNP growth of 6 percent, export volume growth of 8.5 percent, import volume growth of 8 percent, annual improvement in the terms of trade by 0.5 percentage point and average 6-month LIBOR of 8 percent.^{2/} From official and multilateral sources.^{3/} Assumes Paris Club rescheduling with terms comparable with those for 1987 and the first half of 1988.^{4/} Medium- and long-term loans and rescheduling to be arranged and residual exceptional financing.

The inflow of medium- and long-term loans from bilateral and multi-lateral lenders is expected to increase substantially in 1989, owing to a pickup in project implementation and larger program loans, and to remain unchanged in real terms thereafter. An important aspect of the scenario is the projected buildup in gross official reserves from its current level of less than two months of imports to three months of imports by 1991. Indeed, the authorities believe that, given the uncertain external environment, a more rapid rebuilding of reserves than currently envisaged would be desirable.

This balance of payments scenario leaves annual financing gaps of between \$2-3 billion during 1989-93. 1/ To cover this gap, the authorities intend to pursue a strategy that would involve both the provision of new money and debt exchanges that would contribute to a reduction in debt. They are now in the process of discussing these issues with official creditors and commercial banks. The authorities plan to request further debt rescheduling from Paris Club creditors, and Table 11 shows, for illustrative purposes, the estimated effect of a rescheduling of Paris Club debts through 1992. 2/ The residual exceptional financing gap (after rescheduling) would be about \$1.2 billion per year during 1989-92, virtually identical to that implied by the medium-term scenario presented in the second program review (EBS/87/204, Supplement 1). If it is assumed that no new rescheduling arrangements will be sought for the period after 1992, 3/ the residual financing need would be \$1.9 billion in 1993. These residual gaps would have to be filled through concerted or spontaneous new lending from banks, debt exchanges resulting in a debt reduction, and larger-than-currently envisaged official support and direct investment (no assumptions have been made about possible future use of Fund resources). The authorities' projections imply a decline in the debt/GNP ratio from 82 percent in 1987 to some 67 percent in 1993. There would also be significant reductions in the debt service ratio and in the ratio of interest payments to GNP.

1/ Preliminary staff estimates indicate that (i) a 1 percentage point increase (decline) in LIBOR would raise (reduce) the financing gap by about \$150 million per year; (ii) a \$1 per barrel increase (decline) in oil prices would raise (reduce) the financing gap by about \$100 million per year; and (iii) a 1 percentage point increase (decline) in export volume growth would reduce (raise) the financing gap by about \$100 million per year.

2/ Based on the assumption that the terms would be similar to those obtained in the last arrangement, covering all principal and 70 percent of interest payments.

3/ Although the current rescheduling arrangement with bank creditors covers the period 1987-92, the rescheduling of previously rescheduled principal repayments provides for significant debt relief during 1993-94.