SM/82/55
Correction 1

CONTAINS CONFIDENTIAL
INFORMATION

July 14, 1982

To: Members of the Executive Board

From: The Acting Secretary

Subject: Philippines - Staff Report for the 1982 Article IV Consultation

The following corrections have been made in SM/82/55 (3/24/82):

Page 8, column 2, line 11: for "(-1.3)" read "(-0.2)"

line 12: for "(-1.6)" read "(-2.7)"

column 6, line 11: for "(5.3)" read "(5.5)"

line 12: for "(0.7)" read "(0.5)"

Page 10, column 2, line 13: for "8.3" read "0.8"

column 7, line 5: for "(9,793)" read "(9,613)"

Page 12, column 6, line 4: for "-948" read "-958"

line 5: for "556" read "566"

Page 15, 4th full para., lines 7 and 8: for "₱ 5.3 billion" read "₱ 5.5 billion"

Corrected pages are attached.

Att: (4)

Other Distribution:
Department Heads

was within the program projection. The policy intentions with regard to structural reform were implemented (as described below).

The policies followed by the authorities are reviewed in greater detail below, mainly in relation to program intentions.

a. Fiscal policy

The outturn of the National Government budget fell substantially short of the expectations underlying both the original and the revised program. At the time of the mid-term review, the projected overall deficit had been raised from ₱ 4.2 billion (1.3 per cent of GNP) to ₱ 9.1 billion (2.9 per cent) to take account of additional budgetary expenditures, yet the original revenue estimates had been retained, despite a considerable revenue shortfall in the first five months of the year (Table 3). The latest estimates, based on 11 months data, show an overall deficit of ₱ 11.9 billion (3.9 per cent of GNP). The increase in the overall deficit compared with the revised program was entirely due to revenue shortfalls, totalling ₱ 5.8 billion, that occurred in all the major tax categories and in nontax revenue. Total revenue was only slightly higher than in 1980, with tax revenue rising by only 4 per cent and nontax revenue declining marginally. Receipts from taxes on international trade declined, while the growth of domestically based tax receipts slowed down markedly. These revenue developments could not be attributed to discretionary measures. According to official estimates, a loss of revenue from discretionary measures, such as an increase in personal income tax exemptions, suspension of certain export duties, and tariff reductions, was offset by revenue gains from other discretionary measures, including the provisions of a tax amnesty in September 1981. The authorities stated that there was no accumulation of tax arrears, except for ₱ 500 million in import duties owed by the Philippine National Oil Company. Thus, the poor revenue performance must be attributed mainly to the depressed economic conditions and to a sharp decline in the income elasticity of tax revenue, reflecting problems of tax administration.

Budgetary expenditure policies in 1981 were influenced by the disruption of financial markets and the slower-than-expected pace of economic activity. To assist in the rehabilitation of distressed enterprises, the Government stepped up sharply its equity contributions and lending and, in an effort to compensate for depressed private investment, accelerated the implementation of the infrastructure program. However, in the second half-year, as the revenue shortfalls continued to increase, drastic economy measures were imposed on current expenditures in order to contain the widening budget deficit: these included postponement of maintenance expenditures, freezing of new staff positions, and cutbacks in fertilizer subsidy payments and aid to local governments. In addition, the salary adjustment announced earlier in the year was only partially implemented. Thus, while capital expenditures turned out to be ₱ 3.0 billion higher than in the revised program, current expenditures were ₱ 6.0 billion lower

Table 3. Philippines: National Government Cash Budget, 1978-82

(In billions of pesos)

	1978	1979	1980	1981 Original program estimates	1981 Revised program estimates	1981 Latest estimates	1982 Estimates
Revenue	24.0	29.5		41.5	41.5	35.7	40.7
Tax revenue	20.5	25.9		35.3	35.5	31.7	36.0
Nontax revenue	3.5	3.6	4.2	6.2	6.0	4.0	4.7
Expenditure	26.2	29.8	38.1	45.7	50.6	47.6	51.2
Current expenditure	19.2	20.6	24.5	31.2	32.5	26.5	30.4
Capital expenditure	7.0	9.2	13.6	14.5	18.1	21.1	20.8
Overall surplus/deficit (-)	-2.2	-0.3	-3.4	-4.2	-9.1	-11.9	-10.5
Financing	2.2	0.3	3.4	4.2	9.1	11.9	10.5
Foreign borrowing (net)	1.9	3.2	2.0	2.1	3.2	5.9	5.3
Domestic borrowing (net)	0.3	-2.9	1.4	2.1	5.9	6.0	5.2
Banking system	(--)	(-0.2)	(1.2)	(0.7)	(4.0)	(5.5)	(4.5)
Nonbank sector 1/	(0.3)	(-2.7)	(0.2)	(1.4)	(1.9)	(0.5)	(0.7)

Source: Data provided by the Philippine authorities.

1/ Includes trust funds.

The staff team expressed concern at the decline in the ratio of tax revenue to GNP, from 11.5 per cent in 1980 to 10.4 per cent in 1981, and the associated sharp expansion of the overall deficit. The authorities responded that in the context of the sluggish economy, the expanded budget deficit reflected an appropriate fiscal policy stance; in particular, since net credit use by the public sector was within the program projection, financing the enlarged deficit could not have resulted in a crowding-out of private sector investment. They also emphasized that a substantial part of the deficit reflected government lending to the private sector.

b. Credit polic

The evolution of c lit policy in 1981 was influenced by the authorities' decision to accommodate a significantly greater net credit use by the public sector, particularly the National Government, than in previous years, and to counter the financial difficulties of nonbank financial institutions and certain major firms resulting from the confidence crisis and sluggish economic activity Of the expansion of net domestic assets of the banking system, 37 per cent reflected net credit use by the public sector, and 22 per cent, Central Bank credit for the financial rescue operation. Moreover, the increase in net credit to the public sector was equivalent to 52 per cent of the expansion in total liquidity in 1981, compared with an average of 14 per cent for the years 1979-80. In response to the staff team's concern about this development, the authorities stated that the distribution of credit between the public and private sectors reflected the weakness of private demand and the compensatory expansion of public investment; the latter, rather than constraining private sector activity, had been supportive of it.

At the mid-term review, the end-1981 net domestic asset ceiling was raised by P 3.4 billion, or 3.8 per cent. In the event, however, this ceiling was exceeded by P 1.1 billion or 1.2 per cent (Table 4). The authorities explained that the continuing repercussions of the financial crisis had made it imperative to increase Central Bank financing of the rescue operation to P 3.3 billion from the P 1.5 billion envisaged at mid-year. Thus, the increase in such financing more than accounted for the excess of net domestic asset expansion over the December ceiling. In response to questions from the staff team as to why offsetting measures of credit restraint were not used, the authorities replied that the unexpectedly sluggish economy, as well as the possible dangers to financially troubled firms of credit tightening, precluded such use.

The average Central Bank rediscount rate on outstanding loans increased to 7.8 per cent in the fourth quarter of 1981, from 5.6 per cent in the same quarter of 1980. Further, the Central Bank removed the remaining ceiling on interest rates on savings and time deposits with a maturity of two years or less. The impact of this action on deposit rates was partially nullified, however, by efforts by the Bankers Association to hold these rates at the prevailing 9 per cent level, perhaps because of bankers' reluctance to actively compete for deposits in the

(In millions of Philippine pesos)

	1978 Dec.	1979 Dec.	1980 Dec.	1981 Mar. 1/	1981 June 1/	1981 Sept. 1/	1981 Dec. 1/	1982 Dec. 2/
Net foreign assets	-2,090	-7,164	-10,536	-12,176	-12,462	-14,301	-14,876	-18,980
Net domestic assets	53,927	64,524	78,339	80,480	83,964	86,183	93,415	111,656
Total domestic credit	63,075	79,551	95,269	96,021	101,266	103,064	111,148	...
Net credit to public sector 3/	8,206	8,637	10,573	10,765	14,082	13,440	16,152	21,652
Of which: National Government, net	(3,272)	(3,098)	(4,336)	(4,458)	(7,274)	(6,592)	(9,613)	(14,293)
Credit to private sector	54,869	70,914	84,696	85,256	87,184	89,624	94,996	90,004
Other items, net	-9,148	-15,027	-16,930	-15,541	-17,302	-16,881	-17,733	
Total liquidity	51,837	57,360	67,803	68,304	71,502	71,882	78,539	92,676
Narrow money	16,945	18,844	22,537	21,655	21,997	20,337	23,332	...
Time and savings deposits	23,398	26,565	32,894	33,132	34,284	35,637	39,284	...
Deposit substitutes	11,494	11,951	12,374	13,517	15,221	15,908	15,923	...
	(Annual percentage changes) 4/							
Net domestic assets	20.3	20.4	24.1	23.0	28.7	25.2	22.2	23.2
Credit to public sector	2.2	0.8	3.4	3.6	8.0	5.5	8.2	7.0
Credit to private sector	24.2	31.0	24.0	21.6	20.2	17.0	15.2	...
Total liquidity	18.0	10.7	18.2	15.5	23.4	17.4	15.8	18.0
Memorandum item:								
Net domestic assets ceiling (million pesos)	...	...	...	80,610	84,677	86,339	92,277	...

Source: Data provided by the Philippine authorities.

1/ Effects of mergers of nonbank financial institutions into banking system were excluded per stand-by definition.

2/ Official preliminary projections.

3/ Defined as net credit of National Government plus gross credit extended to selected public sector entities.

4/ In relation to liquidity stock at beginning of the period.

face of the continuing interest rate ceiling on loans of one year or less. However, for money market instruments, the weighted average interest rate rose to an annual average of 15.8 per cent in 1981 from 13.3 per cent in 1980, reflecting primarily higher interest rates in the interbank market and for Central Bank Certificates of Indebtedness (CBCIs). Nevertheless, during most of 1981 as in 1980, nominal interest rates for these instruments remained below foreign interest rates (Chart 3). With the lower inflation rate, real interest rates rose from negative 3-4 per cent in 1980 to positive 3-4 per cent in 1981 (Chart 4).

Structural reform of the financial sector continued in 1981 and was supplemented by measures to enhance the effectiveness of monetary policy. Regulations and procedures governing the issuance of commercial paper--a factor in the financial crisis--were tightened; progress was made in multi-purpose banking with the commencement of operations by six "universal" banks; and, with a view to enabling the Government to finance an increasing proportion of its deficit through Treasury debt instruments rather than Central Bank credit, the government securities market was strengthened by the institution of a new system of accredited dealers.

c. External policies

The external trade deficit, at $2.5 billion, was broadly in line with the program projection of $2.3 billion. Export value increased by only 2 per cent (13 per cent in SDR terms) and import value increased by 9 per cent (20 per cent in SDRs) (Table 5). Export volume increased by 3 per cent--a substantially lower rate of growth than in the previous year. Nontraditional exports, including manufactures, performed much better than traditional exports such as coconut, sugar, forestry, and mineral products.1/ The relatively poor export performance was mainly due to the weakness of foreign demand and to growing protectionism. Import volume declined by 3 per cent, mainly because of the sluggish economy. Although interest payments on foreign debt increased by nearly 40 per cent to $1.0 billion, increases in other current earnings, especially remittances of Filipinos working abroad, held the current account deficit to $2.4 billion (6.2 per cent of GNP), virtually the level targeted in the modified program ($2.5 billion, or 6.4 per cent of GNP).

The authorities noted that although the current account deficit to GNP ratio had widened, it still remained within the targets set in the 1980-81 stand-by arrangement. They viewed their external position as consistent with the emphasis on the supply side of adjustment that was incorporated in the 1981 program.

In allowing for the increase in the current account deficit, the 1981 stand-by program had provided for a shift toward greater use of medium- and long-term foreign borrowing. The program projected net inflows of

1/ Nontraditional exports increased by 14.2 per cent in 1981, compared with 29.0 per cent in 1980; traditional exports declined by 5.3 per cent in 1981, compared with a 23.9 per cent increase in 1980.

Table 5. Philippines: Summary Balance of Payments, 1978-82

(In millions of U.S. dollars)

	1978	1979	1980	1981			1982
				Original Estimate 1/	Revised Estimate 2/	Preliminary Actual	Official Preliminary Projections
Merchandise trade	-1,307	-1,541	-1,939	-2,280	-2,290	-2,490	-2,450
Exports, f.o.b.	(3,425)	(4,601)	(5,788)	(7,080)	(6,520)	(5,910)	(6,550)
Imports, f.o.b.	(-4,732)	(-6,142)	(-7,727)	(-9,360)	(-8,810)	(-8,400)	(-9,000)
Investment income (net)	-406	-527	-732	-990	-1,000	-958	-1,332
Other services (net)	228	137	186	180	300	566	596
Transfers (net)	313	355	434	450	500	470	526
Current account balance	-1,172	-1,576	-2,051	-2,640	-2,490	-2,412	-2,660
Medium- and long-term capital (net) 3/	908	1,061	1,044	1,785	1,460	1,392	1,911
Short-term capital (net)	263	80	765	225	390	202	118
Exceptional financing (net) 4/	59	88	81	130	227	227	125
Monetization of gold	32	41	128	125	130	400	132
Errors and omissions 5/	-180	-273	-319	--	-92	-295	...
Overall balance	-90	-579	-352	-375	-375	-486	-500

Source: Data supplied by the Philippine authorities.

1/ As per EBS/80/270.

2/ As modified in EBS/81/160.

3/ Includes all transactions relating to the nuclear power project.

4/ Includes the Trust Fund, SDR allocations, and the IBRD Structural Adjustments Loans.

5/ Includes valuation adjustments.

cent growth target may thus be overly optimistic. The staff team's tentative suggestion is for adoption of a growth target of 4.0 per cent.

Inflation: The target of reducing the average rate of inflation by a further 2 percentage points to 10 per cent in 1982 seems reasonable. However, if the international inflation rate is forecast to be substantially below 10 per cent, the authorities could aim to reduce the inflation rate by more than 2 percentage points to approximate the international rate more closely.

The balance of payments: The increases in the current account deficit in recent years, from 4 per cent of GNP in 1978 to over 6 per cent in 1981, reflect the increase in oil prices in 1979-80 and, more recently, cyclically depressed commodity prices and higher international interest rates. Although it would be reasonable to expect a developing country like the Philippines to have a current account deficit, particularly in a year of international recession, it is important that progress be made in reducing a deficit of the magnitude experienced in 1981, because of the need to contain external borrowing to amounts which are consistent with sustainable levels of debt service. A substantial reduction in the current account deficit should, therefore, be aimed for in 1982. Furthermore, the overall balance of payments target of a deficit of $500 million is too high, since deficits of this magnitude cannot continue to be financed out of reserves as was the case in 1981.

The establishment of appropriate growth, inflation, and balance of payments targets would, of course, have implications for overall demand management as well as other supporting policies. These implications were discussed with the authorities and are reported below, along with the views of the authorities on the appropriate policies to follow.

a. Fiscal policy

The 1982 budget provides for a deficit of ₱ 10.5 billion, equivalent to 3.0 per cent of GNP, on the basis of a projected growth in revenue of 14 per cent and in expenditure of 8 per cent. Current expenditure is projected to increase by nearly 15 per cent, while capital expenditure would be slightly below its high 1981 level. External financing and net borrowing from the banking system are projected at ₱ 5.3 billion and ₱ 4.5 billion, respectively, as compared with ₱ 5.9 billion and ₱ 5.5 billion, respectively, in 1981.

The authorities explained that certain tax proposals contained in the 1982 budget message have been either deferred or shelved, partly on the grounds that the system of indirect taxation and the fiscal incentive schemes are currently under review. However, the "modified gross income taxation scheme" had been implemented as planned on January 1, 1982.1/

1/ Under this scheme, employment income would be taxed on a "gross basis," after allowance for personal exemptions, while other types of income would remain taxable on a "net basis." Since the rates applicable to employment income were reduced relative to those for other types of income, the new system resulted in schedular taxation.

The authorities stated that the new system seeks to simplify tax administration and would release manpower resources from the detailed examination of tax returns for employment income for concentration on other income taxes, especially the corporate income tax. While they expected that the new system would result in a significant improvement in government revenue in the longer run, they found it difficult to assess its short-run impact. They added that certain additional measures to improve public sector revenues were under consideration, including increases in excise taxes, fees and charges, and public utility rates, but even if these measures were adopted, the likely impact on budgetary revenue would be relatively small. Also, they did not expect measures resulting from the review of indirect taxes and fiscal incentives to have an impact on government revenue until 1983. The staff team expressed skepticism that revenue growth of 14 per cent could be achieved without discretionary measures and considered that even the projected budget deficit could, therefore, be significantly exceeded.

The authorities expressed the view that the budgetary position should be looked at in a medium-term context and that the planned reduction in the deficit from 3.9 per cent of GNP in 1981 to 3.0 per cent in 1982 represented a significant adjustment. In particular, infrastructural investment expenditure and equity contributions to government corporations had been scaled down by 12 per cent and 11 per cent, respectively. They stated, further, that the 1980 budget deficit, amounting to 1.3 per cent of GNP, had reflected the slow implementation of public sector investment projects and that a carry-over of investment expenditures and improved project implementation contributed to the higher 1981 deficit. As regards 1982, it was their considered assessment that a deficit equivalent to 3.0 per cent of GNP was appropriate in light of the continued need for fiscal stimulus in a sluggish economy. Their intention to limit the deficit to this level was a firm one; although they had no major revenue measures in view, they had flexible disbursement procedures in place which would enable them to reduce expenditures, if necessary.

b. Credit policy and financial sector reform

On the basis of the targets, the authorities projected that liquidity would increase by 18 per cent in 1982 and that net domestic assets would increase by 23 per cent of the stock of liquidity at the beginning of the year. Not only was the projected liquidity growth higher than the targeted growth in nominal GNP, but also the projected increases in liquidity and net domestic assets were higher than the actual increases in 1981, even though nominal GNP growth in 1982 would be lower than that experienced in 1981. If the targets for real growth, inflation, and the balance of payments deficit were to be lowered in line with the staff team's suggestions, the case for lowering the liquidity and net domestic asset projections would probably be strengthened. The team noted that the authorities' projections involved some redirection of net credit use from the public sector to the private sector. However, the projected increase in net credit to the public sector, at 39 per cent of the expansion in domestic liquidity, was well above historical levels although lower than the corresponding figure of 52 per cent for 1981. If the hoped-for revival